THE TREATMENT OF TAX IN INVESTOR-STATE ARBITRATION OF EXPROPRIATION AND NATIONAL TREATMENT PROTECTION

A thesis submitted for the degree of

Doctor of Philosophy

by

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Abstract: *This thesis examines the treatment of tax in investor-state arbitration of expropriation and national treatment protection. The root of the study is the special characterisation of tax in the sovereignty of the state and the consequent sensitivity of states to have their tax policies being the subject of private adjudication. Tax has in the past been characterised as a non-arbitrable matter, but that is true only if states have purposefully deemed them so under the international investment treaties that they are party to. Tax is generally arbitrable under the expropriation provisions of international investment treaties, but states are seldom found liable for tax expropriation. National treatment, on the other hand, is generally not arbitrable under international investment treaties, but when an investment treaty permits the arbitration of alleged national treatment tax violations, violations are affirmed in more cases than not. The reason behind the comparable success rates is the difficulty in proving the existence of expropriation by taxation whereas national treatment tax violations are comparatively easier to substantiate. This thesis establishes what constitutes a tax expropriation, and how the success rate of claims for national treatment tax violations justifies the general exclusion of the application of national treatment protection to tax matters for sovereignty retention. In order to achieve the foregoing, this thesis examines sovereignty and the sovereign power to tax; the relinquishment of tax sovereignty under international investment treaties; the arbitrability of tax and the reasoning behind the reluctance of states to submit tax disputes to arbitration; the capability of tax to be expropriatory; the fundamentals of the expropriation standard under customary international law and international investment treaties and how they are applied by arbitral tribunals in tax expropriation claims; and the fundamentals of the national treatment protection and how they are applied by arbitral tribunals in claims for national treatment tax violations.*

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Table of Abbreviations

General

AEC	AEC Ecuador Limited
AFFIMET	Affinage des Métaux
ALMEX	Almidones Mexicanos S.A. de C.V.
ASEAN	Association of Southeast Asian Nations
BFG	BaikalFinansGroup
BIT	Bilateral Investment Treaty
BTT	Bilateral Tax Treaty
CAFTA	Central America FTA
CAFTA-DR	Dominican Republic-Central America FTA
CAPSA	Compañías Asociadas Petroleras
CBI	Confederation of British Industry
CEMSA	Corporación de Exportaciones Mexicanas, S.A. de C.V.
COL	City Oriente Limited
CPI	Corn Products Inc.
CPIng	Corn Products Ingredientes
DSB	WTO Dispute Settlement Body
DSU	WTO Dispute Settlement Understanding
DTT	Double Taxation Treaty
EC	European Community
ECC	European Communities Commission
ECHR	European Convention on Human Rights
ECLAC	United Nations Economic Commission for Latin America and the Caribbean
ECT	Energy Charter Treaty
ECtHR	European Court of Human Rights
EU	European Union
EUR	Euros
FEZ	Free Economic Zone of Chisinau (Moldova)

FDI	Foreign Direct Investment
FTA	Free Trade Agreement
GATS	General Agreement on Trade in Services
GATT	General Agreement on Tariffs and Trade
HFCS	High Fructose Corn Syrup
ICC	International Chamber of Commerce Court of Arbitration
ICC Code	International Chamber of Commerce's 1949 International Code of Fair Treatment for Foreign Investment
ICSID	International Centre for Settlement of Investment Disputes
ICSID Convention	1965 Washington Convention on the Settlement of Investment Disputes between States and Nationals of Other States
IEPS	*Impuesto Especial sobre Producción y Servicios* (Mexico's *Special Tax on Production and Services*)
IISD	International Institute for Sustainable Development
IIT	International Investment Treaty
ILA	International Law Association
ILC	International Law Commission
Iran-USCTR	Iran-United States Claims Tribunal
ISDS	Investor-State Dispute Settlement
ITRL	Internal Tax Regime Law of Ecuador
LCIA	London Courts of International Arbitration
LCR PREM	Latin America and the Caribbean Region: Poverty Reduction and Economic Management
McGill L.J.	McGill Law Journal
MFN	Most-Favoured-Nation
MIT	Multilateral Investment Treaty
MNC	Multinational Corporation
NAFTA	North American Free Trade Agreement
OECD	Organisation for Economic Co-operation and Development

OED	Oxford English Dictionary
OEPC	Occidental Exploration and Production Company
PCA	Permanent Court of Arbitration
PCIJ	Permanent Court of International Justice
SCC	Stockholm Chamber of Commerce Arbitration Institute
SHCP	Secretaría de Hacienda y Crédito Público (Mexico's Ministry of Finance and Public Credit)
SRI	Sericio de Rentas Internas (Ecuadorian Tax Authority)
TLIA	Tate & Lyle Ingredients America
UNCITRAL	United Nations Commission on International Trade Law
UNFCCC	United Nations Framework Convention on Climate Change
USTR	Office of the United States Trade Representative
VAT	Value Added Tax
WTO	World Trade Organisation
WWI	World War One
WWII	World War Two
YNG	OAO Yuganskneftegaz

Journals and Yearbooks

A.J.I.L	*American Journal of International Law*
Am. Econ. Rev.	*American Economic Review*
Australian YIL	*Australian Yearbook of International Law*
B.C.L. Rev.	*Boston College Law Review*
B.U.L. Rev	*Boston University Law Review*
Brit. Y.B. Int'l L.	*British Yearbook of International Law*
Chi. J. Int'l L.	*Chicago Journal of International Law*
Colum. J. Transnat'l L.	*Columbia Journal of Transnational Law*
Eur J Law Econ	*European Journal of Law and Economics*
Harv. J.L. & Pub. Pol'y	*Harvard Journal of Law & Public Policy*

ICSID Review F.I.L.J.	*ICSID Review Foreign Investment Law Journal*
Int'l Tax & Pub. Fin.	*International Tax & Public Finance*
ILM	*International Legal Materials*
J.W.T.L.	*Journal of World Trade Law*
J. Int'l Dis. Sett.	*Journal of International Dispute Settlement*
Law & Pol'y Int'l Bus.	*Law & Policy in International Business*
LQR	*Law Quarterly Review*
Minn L. Rev.	*Minnesota Law Review*
Minn. J. Int'l L.	*Minnesota Journal of International Law*
Osgoode Hall L. J.	*Osgoode Hall Law Journal*
Suffolk Transnat'l L. Rev	*Suffolk Transnational Law Review*
U. Pa. J. Int'l Econ. L.	*University of Pennsylvania Journal of International Economic Law*
Va. J. Int'l L.	*Virginia Journal of International Law*

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1958 Convention on the Recognition and Enforcement of Foreign Arbitral Awards (New York Convention)

1965 Washington Convention on the Settlement of Investment Disputes between States and Nationals of Other States (ICSID Convention).ASEAN-India Free Trade Agreement

1975 Inter-American Convention on International Commercial Arbitration (Panama Convention)

1979 Inter-American Convention on Extraterritorial Validity of Foreign Judgments and Arbitral Awards (Montevideo Convention)

1994 North American Free Trade Agreement (NAFTA)

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Electrabel S.A. v The Republic of Hungary, ICSID Case No. ARB/07/19, Decision on Jurisdiction, Applicable Law and Liability of 30 November 2012

Emilio Agustín Maffezini v. Kingdom of Spain, ICSID Case No. ARB/97/7, Award of 13 November 2000

EnCana Corporation v Republic of Ecuador (LCIA Case No. UN3481, Award and Partial Dissent of 3 February 2006

Enron Corporation and Ponderosa Assets L.P. v Argentine Republic, ICSID Case No. ARB/01/3, Award of 22 May 2007

Eudoro Armando Olguin v. Republic of Paraguay, ICSID Case No. ARB/98/5, Award of 26 July 2001

Fireman's Fund Insurance Company v United Mexican States, ICSID AF Case No. ARB(AF)/02/01, Award of 17 July 2006.

Fireman's Fund Insurance Company v United Mexican States, ICSID Case No. ARB(AF)/02/01 Award of 17 July 2006

GAMI Investments Inc. v United Mexican States (NAFTA Arbitration), Final Award of 15 November 2004

GAMI Investments Inc. v United Mexican States, NAFTA Arbitration, Final Award of 15 November 2004

Generation Ukraine, Inc. v Ukraine, ICSID Case No. ARB/00/9, Award of 16 September 2003

Hellenic Electric Railways Ltd v Government of Greece, Ad Hoc Arbitration, Geneva, Award of 18 March 1930

Hulley Enterprises Limited (Cyprus) v Russian Federation, ECT Arbitration, PCA Case No. AA 226, Interim Award on Jurisdiction and Admissibility of 30 November 2009

Inceysa Vallisoletana, SL v. *Republic of El Salvador*, ICSID Case No. ARB/03/26, Award of 2 August 2006

Ioan Micula, Viorel Micula, S.C. European Food S.A, S.C. Starmill S.R.L. and S.C. Multipack S.R.L. v Romania, ICSID Case No. ARB/05/20, award of 11 December 2013

Kügele v Polish State, Arbitration before the Upper Silesian Arbitral Tribunal, 5 February 1932

LG&E Energy Corp., LG&E Capital Corp., LG&E International Inc. v Argentine Republic, ICSID Case No. ARB/02/1, Decision on Liability of 3 October 2006

Link-Trading Joint Stock Company v Department for Customs Control of the Republic of Moldova, UNCITRAL Arbitration, Final Award, 18 April 2002

M.C.I. Power Group L.C. and New Turbine Inc. v. Republic of Ecuador, ICSID Case No. ARB/03/6, Award of 31 July 2007

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

Metalclad Corporation v United Mexican States, ICSID Case No. ARB(AF)/97/1, Award of 30 August 2000

Methanex Corporation v. United States of America, NAFTA Arbitration, Award of 3 August 2005

Middle East Cement Shipping and Handling Co. S.A. v Egypt, ICSID Case No. ARB/99/6, Award of 12 April 2002

MTD Equity Sdn. Bhd. and MTD Chile S.A. v Republic of Chile, ICSID Case No. ARB/01/7, Award of 25 May 2004

Nations Energy Inc., Electric Machinery Enterprises Inc., Y Jaime Jurado v The Republic of Panama, ICSID Case No. ARB/06/19, Award of 24 November 2010

Norway v United States of America, PCA, Award of 13 October 1922 (*Norwegian Shipowners' Claims*)

Occidental Exploration and Production Company v The Republic of Ecuador, LCIA Case No. UN 3467, Award of 1 July 2004

Occidental Petroleum Corporation and *Occidental Exploration and Production Company* v *Republic of Ecuador*, ICSID Case No. ARB/06/11, Award of 5 October 2012

Omer Dede and Serdar Elhüseyni v Romania, ICSID Case No. ARB/10/22, Award on Jurisdiction of 5 September 2013

Pac Rim Cayman LLC v Republic of El Salvador, ICSID Case No. ARB/09/12, Decision on the Respondent's Preliminary Objections under CAFTA Articles 10.20.4 and 10.20.5

Perenco Ecuador Limited v Republic of Ecuador, ICSID Case No. ARB/08/6

Phelps Dodge International Corp. v Government of the Islamic Republic of Iran, IRAN-USCTR Case No. 99, Award No. Award No. 217-99-2 of 19 March 1986

Philip Morris Asia Limited v The Commonwealth of Australia, Ad hoc arbitration under the UNCITRAL Rules

Philip Morris Brands Sàrl, Philip Morris Products S.A. and Abal Hermanos S.A. v Oriental Republic Of Uruguay, ICSID Case No. ARB/10/7, Decision on Jurisdiction of 2 July 2013

Plama Consortium Limited v Republic of Bulgaria, ICSID Case No. ARB/03/24, Award of 27 August 2008

Pope & Talbot, Inc. v Government of Canada, NAFTA Arbitration, Interim Award of 26 June 2000

Quasar de Valores SICA V S.A., 0RGOR DE V AWRES SICA V S.A., GBI 9000 SICA V S.A., ALOS 34 S.L. v The Russian Federation, SCC Case No. 24/2007, Award of 20 July 2012

Revere Copper Brass Inc. v Overseas Private Investment Corporation, AAA Case No. 16 10 0137 76, Award of 24 August 1978

RosInvest Co. UK Limited v The Russian Federation, SCC Case No. V 079/2005, Award on Jurisdiction of 1 October 2007 (*RosInvest* Jurisdiction Award) and Final Award of 12 September 2010 (*RosInvest* or *RosInvest* Award)

Ruby Roz Agricol LLP v Republic of Kazakhstan, Ad hoc arbitration under the UNCITRAL Rules, Award on Jurisdiction of 1 August 2013

Salini Construttori S.p.A. and Italstrade S.p.A. v Kindom of Morocco, ICSID Case No. ARB/00/4, Decision on Jurisdiction of 23 July 2001

Sea-Land Service, Inc. v The Islamic Republic of Iran, Ports and Shipping Organisation, Award No. 135-33-1 of 22 June 1984, 6 Iran-USCTR 149

Sempra Energy International v Argentine Republic, ICSID Case No. ARB/02/16, Award of 28 September 2007

SGS Société Géneralé de Surveillance S.A. v Republic of Philippines, ICSID Case No. ARB/02/6, Decision on Objections to Jurisdiction of 29 January 2004

Siemens A.G. v Argentine Republic, ICSID Case No. ARB/02/8, Award of 6 February 2007

Southern Pacific Properties (Middle East) Limited v Arab Republic of Egypt, ICSID Case No. ARB/84/3

Southern Pacific Properties (Middle East) Limited v Arab Republic of Egypt, ICSID Case No. ARB/84/3, Award on the Merits of 20 May 1992

Starrett Housing Corporation, Starrett Systems Inc, Starrett Housing International Inc. v The Government of the Islamic Republic of Iran et al, Iran - Iran-USCTR, Case No. 24, Interlocutory Award No. ITL 32-24-1 of 19 December 1983

Técnicas Medioambientales Tecmed, S.A. v. United Mexican States, ICSID Case No. ARB(AF)/00/2, Award of 29 May 2003

Telenor Mobile Communications A.S. v Republic of Hungary, ICSID Case No. ARB/04/15, Award of 13 September 2006

Telsim & Rumeli v Republic of Kazakhstan, ICSID Case No. ARB/05/16

Tradex Hellas S.A. v Republic of Albania, ICSID Case No. ARB/94/2, Decision on Jurisdiction of 24 December 1996

Trans-Global v The Hashemite Kingdom of Jordan, ICSID Case No. ARB/07/25, Decision on the Respondents Objection under Rule 41(5) of the ICSID Arbitration Rules

United Parcel Service of America Inc. v Government of Canada, NAFTA Chapter 11 Arbitration, Award on the Merits of 24 May 2007

Vattenfall AB and others v. Federal Republic of Germany, ICSID Case No. ARB/12/12

Vattenfall AB, Vattenfall Europe AG, Vattenfall Europe Generation AG v Federal Republic of Germany, ICSID Case No. ARB/09/6, Award of 11 March 2011

Veteran Petroleum Limited (Cyprus) v Russian Federation, ECT Arbitration, PCA Case No. AA 228, Interim Award on Jurisdiction and Admissibility of 30 November 2009

Waste Management Inc. v United Mexican States, ICSID Case No. ARB(AF)/00.3, Award of 30 April 2004

Yukos Universal Limited (Isle of Man) v Russian Federation, ECT Arbitration, PCA Case No. AA 227, Interim Award on Jurisdiction and Admissibility of 30 November 2009

Zhinvali Development Limited v. Republic of Georgia, ICSID Case No. ARB/00/1, Award (unpublished)

Chapter 1 Introduction

1.1 Research Questions and Methodology

Policy-makers, businesses, academics, lawyers and arbitrators face an on-going challenge in the interplay between a host state's obligations to protect foreign investments under international law and flexing their power to tax. Arguably the greatest challenge is "to define expropriation with respect to tax measures."[1] The challenge exists because tax measures are in a special category in the context of expropriation. This is so the universal state prerogative of the power to tax is protected from expropriation claims. The primary focus of this thesis therefore is to examine "what extent and under what conditions the imposition of certain taxes could constitute expropriation"[2] to determine whether tax has a *lex specialis* character in relation to the general international law rule of expropriation.

This thesis also examines whether tax has a *lex specialis* character in relation to the international law of national treatment. If it does not, host states would be vulnerable to numerous claims from foreign investors for discrepancies or for striking deals with specific foreign investors or foreign investors from specific counties, thus putting into doubt a major aspect of fiscal sovereignty. Examining the treatment of tax under national treatment protection also serves as a comparator for the treatment of tax under the rules of expropriation, assisting in examining whether *lex specialis* truly exists for tax under expropriation rules or not.

A number of major issues are also examined as a pretext to the expropriation and national treatment chapters. This includes introducing the reader to the notion of sovereignty and the sovereign power to tax, international investment treaties (IITs), the relationship between sovereignty and international investment arbitration, and vitally it discusses the arbitrability of tax disputes.

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[1] UNCTAD, 'Taxation' (2000), Series on Issues in International Investment Agreements, Doc. No. UNCTAD/ITE/IIT/16, 72 <http://unctad.org/en/docs/iteiit16_en.pdf> accessed 15 August 2011.
[2] *ibid*.

The methodology utilised to examine the treatment of tax in investor-state arbitration of expropriation and national treatment protection (the standard(s)) includes the following in each chapter respectively: (i) an introduction into each standard of treatment; (ii) the historical development of each standard; (iii) the relationship between the standard and tax; (iv) an examination of the provisions of the standard in IITs; and primarily (v) a first-hand examination of arbitral jurisprudence contained in arbitral awards to analyse how arbitrators treat tax in expropriation and national treatment claims.

1.2 Contribution to Knowledge

This thesis provides the first comprehensive text into the relationship between international investment law and taxation and international investment arbitration and taxation, most vitally in the context of expropriation and national treatment protection. It is the first write-up of its kind in which an extensive analysis of arbitral awards is conducted in order to draw conclusions on the treatment of tax in claims that expropriation rules and national treatment protection have been violated. Indeed, the school of academia has recognised the necessity for an in-depth analysis of arbitral jurisprudence to specific tax-related disputes that have been emerging under international law.[3] The in-depth analysis has allowed the writer to draw conclusions on the *lex specialis* character of tax under IITs and in investment treaty arbitration and therefore furthers the knowledge of academics and can assist law practitioners in making and framing their claims (for investors) and defences (for host states). The thesis also gives policy-makers food for thought when drafting IITs because they can consider in one broad text how tax will be treated in investor-state claims according to the drafting of a relevant treaty – this is important for new drafts in the making. It also enables policy-makers to consider the advantages (for capital exporting investors) and the disadvantages (for capital importing states) of permitting the arbitration of tax expropriation and national treatment claims under the auspices of IITs. The thesis also brings into one write-up a historical account of the treatment of

[3] Thomas Wälde and Abba Kolo, Investor-State Disputes, 'The Interface Between Treaty-Based International Investment Protection and Fiscal Sovereignty' (2007) 35(8/9) *Intertax* 424, 449.

tax as expropriation at domestic and international law level and the role of tax in developing the national treatment standard as it is applied today.

1.3 Brief Overview of the Thesis

The state's power to tax people and companies that work and operate in its jurisdiction is a central theme of state sovereignty and critical to the state's very existence, including the funding of its governance and vital services that constitute good governance such as defence, policing, national health, environmental protection and education.

Tax issues are therefore "powerful lightning rods for critics concerned about sovereignty",[4] predominantly for revenue raising and fiscal policy control reasons.[5] Debates on tax sovereignty usually arise in the international tax context, including international tax competition,[6] control over tax policies in the European Union (EU)[7]

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[4] Diane M. Ring, 'What's at Stake in the Sovereignty Debate?' (2008) 49:1 *Va. J. Int'l L.* 155, 167.

[5] *ibid*.

[6] International tax competition is the use of a country of its tax regime to "attract investment, business activity, or cash flow to the country itself" (*ibid* 184) – this is achieved by offering low tax rates and tax incentives; the Organisation for Economic Co-operation and Development (OECD) is heavily vested in global tax cooperation and eliminating what it sees as harmful tax practices by employing counteractive 'solutions' to countries that employ such practices even if those countries are not OECD members (Allison Christians, 'Sovereignty, Taxation, and Social Contract' (2009) 18(1) *Minn. J. Int'l L.* 99, 117) and the counteractive measures include sanctions for uncooperative OECD members and non-members and reports on compliance thereafter (Allison Christians 117). These 'solutions' clearly infringe on the fiscal sovereignty of states on the receiving end of them, especially non-OECD members.

[7] Indirect taxes such as turnover taxes and value-added-tax (VAT) are harmonised in the EU under Article 93 of the Treaty Establishing the European Community (EC Treaty) (Consolidated Version of the Treaty Establishing the European Community [2002] OJ C 325/33) to an "extent necessary to sustain the Single Market" (William Nicoll and Trevor Salmon, *Understanding the European Union* (Routledge 2000) 243), and the necessary extent can mean minimum and maximum thresholds for tax, such as a standard rate of VAT at a minimum of 15% with exceptions to apply VAT rates under 15% for certain goods and services (European Union, 'Summaries of EU Legislation: Common system of value added tax (VAT) ('the VAT Directive')' <http://europa.eu/legislation_summaries/taxation/l31057_en.htm> accessed 28 December 2013); Direct taxes in the EU including income, corporate and property taxes are not harmonised (there is no equivalent article in the EC Treaty for direct taxes as there is for indirect taxes at Article 93), allowing EU member states complete sovereignty from the EU in that aspect, and whilst no EU institution including the European Court of Justice (ECJ) can mandate income tax rules without the unanimous consent of EU member states, the ECJ has encroached on the direct tax sovereignty of EU member states in a number of cases by negating the tax provisions of member states (Michael J. Graetz and Alvin C. Warren Jr., 'Income Tax Discrimination and the Political and Economic Integration of Europe' (2006) 115 *Yale L. J.* 1186, 1193). Many of the domestic laws of EU member states that the ECJ has struck down have been anti-tax avoidance measures (Lilian V. Faulhaber, 'Sovereignty, Integration and Tax Avoidance in the European Union: Striking the Proper Balance' (2009-2010) 48

and control over tax policies at the World Trade Organisation (WTO).[8] Countries also relinquish part of their sovereignty to the International Monetary Fund (IMF) when they enter into IMF loan programmes. IMF loan conditions require these countries to devalue their currency, cut their government spending, and alter their tax regime,[9] which has nationalists criticising IMF programmes for “the loss of sovereignty”[10] that they entail.

States have liberalised access to their economies partly as a result of globalisation and subsequent economic integration through domestic deregulation and international cooperation on tax matters. The entering by states into agreements that affect their own internal tax regimes which reduce the level of sovereignty over their own tax affairs (tax sovereignty) are in themselves sovereign choices to make but are effectively ‘take it or leave it choices’,[11] whereby if states do not enter into agreements where they partially cede their tax sovereignty as well as other areas of domestic law and regulation, they risk undermining the economic development of their state.[12]

Disputes that occur between states on the alleged lack of conformity with agreements can be settled in private discussions among themselves but are often the subject of

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Colum. J. Transnat'l L. 177, 180) and taken together the actions of the ECJ have been summarised as having the following effects: “Member State sovereignty is threatened, tax avoidance is more likely and no solution to this impasse currently exists” (Lilian V. Faulhaber 180). The ECJ rulings have definitely had an effect on EU member states’ internal policies: “The influence of the [ECJ] continues to loom large over developments in UK company taxation” (Stephen Bond, ‘Taxation of Multinationals and the ECJ’, (2007) Institute of Fiscal Studies IFS Green Budget 2007, 178 <http://www.ifs.org.uk/budgets/gb2007/07chap10.pdf> accessed 6 July 2013).

[8] See generally section 2.1 of Chapter 2.

[9] Devesh Kapur, ‘The IMF: A Cure or a Curse’ (1998) No. 111 *Foreign Policy* 114, 116.

[10] *ibid* 117.

[11] This is expanded upon in Chapter 2.

[12] This is typical of the debate on whether the United Kingdom should leave the EU or not. Whilst the EU provides a platform for member states to encroach on each other’s sovereignty, the benefits reaped are tremendous for business (and therefore the economy) and there is a genuine argument that the advantages outweigh the disadvantages of non-membership – see ‘Our Global Future: The Business Vision for a Reformed EU’ (2013) Confederation of British Industry (CBI) <http://www.cbi.org.uk/media/2451423/our_global_future.pdf> accessed 28 December 2013, particularly: “Closing off from this world is not how the UK will create and keep the jobs it needs to pay for public investment and provide a decent standard of living for all its citizens, or maintain its status as a global leader” (at 24) and “Like any international arrangement, UK membership of the EU has had advantages and disadvantages. When countries sign bilateral treaties or join multilateral institutions, there will always be aspects of these arrangements that are trade-offs; the benefits of co-operation almost by definition come with some form of compromise. But, for the UK, the net benefits of EU membership have been extensive” (at 58).

formal dispute resolution mechanisms at the WTO under the auspices of the WTO's Dispute Settlement Body (DSB), and tax disputes have been among these.[13] WTO disputes are decided by the DSB, but as part of the WTO and therefore all 159 WTO members,[14] it can be said that the international community make the decisions. Although a country on the receiving end of DSB rulings and recommendations that require amendments/repeals to its tax laws takes from that country's sovereignty of the highest order, the encroachment of sovereignty takes place at an internationally cooperative and diplomatic level.

As part of these global developments and in order to attract foreign direct investment (FDI), countries also enter into international investment treaties (IITs) which are mostly made up of bilateral investment treaties (BITs) but also multilateral investment treaties (MITs) and free-trade agreements (FTAs) with investment provisions which I will also refer to as MITs.[15] IITs contain provisions for the protection of foreign investment and most also contain dispute resolution provisions that provide for arbitration (arbitration agreements in IITs) which give rise to investor-state arbitration (also known as 'international investment arbitration'). The protections accorded to investors and investments of other states which can be violated through tax measures and result in the arbitration of tax matters ('tax arbitration') include the obligation to: (i) refrain from unlawful nationalisation or expropriation of foreign investments;[16] (ii) provide national treatment;[17] (iii) provide

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[13] See section 2.1.2 of Chapter 2, in particular notes 56 to 59.

[14] There were 159 WTO member states on 2 March 2013 (WTO, 'Understanding the WTO – Members and Observers' <http://www.wto.org/english/thewto_e/whatis_e/tif_e/org6_e.htm> accessed 5 July 2013.

[15] For example, the North American Free Trade Agreement (NAFTA), and the Dominican Republic-Central America Free Trade Agreement (CAFTA-DR).

[16] Claims of expropriation by taxation (tax expropriation) are discussed in Chapter 3. The most severe tax measures that have eradicated investments occurred in [16] *Kügele v Polish State*, Arbitration before the Upper Silesian Arbitral Tribunal, 5 February 1932 (*Kügele*) (reprinted as Case No. 34 in Hersch Lauterpacht (ed), *International Law Reports: Volume 6 – Annual Digest of Public International Law Cases 1931-1932* (CUP 1945) 69) and the expropriation by Russia of the Yukos Oil Company: *Quasar de Valores SICA V S.A., 0RGOR DE V AWRES SICA V S.A., GBI 9000 SICA V S.A., ALOS 34 S.L. v The Russian Federation*, SCC Case No. 24/2007, Award of 20 July 2012 (*Quasar*) and *RosInvest Co. UK Limited v The Russian Federation*, SCC Case No. V 079/2005, Final Award of 12 September 2010 (*RosInvest*).

[17] *Occidental Exploration and Production Company v The Republic of Ecuador*, LCIA Case No. UN 3467, Award of 1 July 2004 (*Occidental*); *Marvin Roy Feldman Karpa v United Mexican States* (ICSID Case No. ARB(AF)/99/1), Award December 16 2002; *Archer Daniels Midland Company and Tate & Lyle Ingredients Americas Inc. v United Mexican States*, ICSID Case No ARB(AF)/05/05, Final Award (Redacted Version) of 21 November 2007 (*Archer Daniels*); *Cargill v United Mexican States*, ICSID Case No. ARB(AF)/05/2, Award (Redacted Version) of 18 September 2009 (*Cargill*);

most-favoured-nation (MFN) treatment; (iv) provide fair and equitable treatment;[18] (v) to guarantee full protection and security for investments;[19] and (vi) to fulfil performance requirements.[20] In addition, tax measures can also result in a claim being brought against a state for breach of a stabilisation clause[21] in a contract between the state and the foreign investor.[22]

The parties to an investment arbitration will be: (i) the investor(s) of one state (the investor is referred to in this thesis as an 'investor' or a 'foreign investor'; the country that the investor originates from is called the 'home state'); and (ii) the government of another state in which the investor(s) has invested in (in investment arbitration, the country receiving the FDI is called the 'host state' and will likewise be called the host state in this thesis). Investor-state arbitration can be triggered by the arbitration agreement in an IIT, by the domestic investment law of the host state or by an agreement between made between the foreign investor and the host state, for example through one of the host state's ministries or entities.

By entering into IITs, countries take the risk that they will be litigated against in international arbitration which are presided over by private adjudicators. Therefore, when an investor initiates investment arbitration against a host state and claims the host state has violated IIT protections through tax measures, the arbitral tribunal will be judging the legality of the host state's tax laws and/or tax treatment of the investor. This is yet another example of the relinquishment of sovereignty by the state in its tax affairs.

Unlike the surrender of sovereignty under the intergovernmental WTO agreements and subsequent settlement of state-state disputes under the WTO's DSB, entering

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and *Corn Products International Inc. v United Mexican States*, ICSID Case No. ARB(AF)/04/01, Decision on Responsibility (Redacted Version) of 15 January 2008 (*Corn Products*).

[18] *Occidental* and *Cargill*.

[19] *Occidental*.

[20] *Archer Daniels, Cargill* and C*orn Products*.

[21] A tax stabilisation clause or agreement is an agreement with the host state whereby the state agrees not to increase the rate of tax that the investor/concessionaire pays and the rate of increase can be capped to a certain threshold, or it can be capped at the applicable rate at the time when the stabilisation clause/agreement is negotiated or takes effect.

[22] *Revere Copper Brass Inc. v Overseas Private Investment Corporation*, AAA Case No. 16 10 0137 76, Award of 24 August 1978*;* and *Duke Energy International Peru Investments No.1 Ltd v Republic of Peru*, ICSID Case No. ARB/03/28, Award of 18 August 2008.

into IITs with other states, despite being intergovernmental agreements, provide for the settlement of investor-state disputes by foreign nationals (the arbitral tribunals).[23] International arbitration is not the only forum for the settlement of investor-state disputes and the natural forum for any disputes affecting private property rights are national courts, and when a dispute concerns a state party and the legitimacy of its laws and actions, the national courts of the host-state are the natural forum for such matters. Countries therefore prefer their national courts to have a monopoly[24] on the adjudication of investor-state tax disputes which are really about the legitimacy of the state's exercise of one of its most vital sovereign powers which governments rely on for their very existence, and the legitimacy of those powers should naturally be decided by the state's own nationals in its own judiciary. Tax arbitration is therefore an inquisition of the state's tax powers by private arbitrators acting outside of the taxing state's jurisdiction, and for that reason tax was long seen as a non-arbitrable matter.[25]

It is said that "[o]ther than the power to declare war, a democracy's power to assess taxes affects the largest percentage of its citizens in almost every aspect of their lives",[26] hence the reluctance of states to pass that power on to arbitral tribunals. It is a fact, however, that that power is sometimes passed on to arbitral tribunals because tax is arbitrable in international investment arbitration if the state has agreed to it. In essence, the arbitrability of tax in investment arbitration depends on the state's acquiescence to tax arbitration which must be contained in an IIT, in the state's domestic investment law or in an agreement made with the foreign investor.

In Chapter 2 of this thesis, the sovereignty issues surrounding tax arbitration is studied. This entails a discussion on: (i) the sovereign power to tax; (ii) globalisation's effect on sovereignty and the coinciding change in state sovereignty from the nation-state to the market-state; (iii) the emergence of IITs and an introduction to investor-state arbitration; (iv) the arbitrability of tax and the

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[23] It is usually possible for a party-appointed member of the arbitral tribunal to be a national of the home or host state provided that the other party consents to that appointment.
[24] William W. Park, 'Arbitrability and Tax' in Loukas A. Mistelis and Stavros L. Brekoulakis (eds), *Arbitrability: International & Comparative Perspectives* (Kluwer Law International 2009) 180.
[25] *ibid* 179.
[26] James R. Repetti, 'Introduction to the State of Federal Income Taxation: Rates, Progressivity, and Budget Processes' (2003-2004) 45 *B.C.L. Rev.* 989.

arbitrability and public policy objections to the enforcement of arbitral awards; (v) the efficacy of IITs in attracting FDI with a focus on Brazil's no-BIT-ratification policy and subsequent sovereignty retention; and (vi) the risks to host states' tax sovereignty (especially developing countries) upon agreeing to international investment arbitration in IITs.

In Chapter 3, the treatment of the expropriation protection in tax arbitration is studied. This entails a discussion on: (i) what expropriation is; (ii) the historical background and development of the expropriation principle; (iii) the capability of a host state to expropriate investments through taxation; (iv) an analysis of expropriation provisions in IITs and how they affect tax expropriation claims; (v) an analysis of inclusions, exclusions and vetoes in IITs to the application of the expropriation provision to tax measures; (vi) an introduction into the different types of expropriation (direct and indirect); (vii) an analysis on the requirements to be fulfilled to prove state liability for indirect expropriation; (viii) a study of how the principles for finding state liability for expropriation have been applied to tax arbitrations where tax expropriation is claimed; and (ix) following on from the last point, the circumstances in which a state will be found to have violated the expropriation standard through tax measures.

In Chapter 4, the treatment of the national treatment protection in tax arbitration is studied. This entails a discussion on: (i) what national treatment is; (ii) the historical background and development of the national treatment principle; (iii) an analysis of national treatment provisions in IITs and how they shape the requirements to be fulfilled in finding state liability for breach of the national treatment protection; (iv) an analysis of inclusions and exclusions in IITs to the application of the national treatment provision to tax measures; (v) a study on how the principles that are applied to finding state liability for a violation of the national treatment protection have been applied to tax arbitrations where such violations through tax measures are claimed.

There is a stark difference between the success of claimants in international investment arbitrations for tax expropriation claims and national treatment violations by taxation, with claimants succeeding in tax expropriation claims only twice[27] (and those arbitral awards were rendered throughout the time of my writing this thesis), whereas national treatment violations through tax measures had been successfully claimed before I began my research into the topic.

I have focused on expropriation and national treatment for many reasons, namely because:

(i) there is no comprehensive text on the treatment of taxation in investor-state arbitration, and questions such as "to what extent and under what conditions [does] the imposition of certain taxes constitute expropriation?"[28] and statements such as "there is a need to define expropriation with respect to tax measures",[29] need to be answered;[30]

(ii) taxation is in a special category from the perspective of expropriation, whereby the levying of bona fide taxes are "not a taking of property"[31] because if they were, the universal state prerogative of the sovereign power to tax would be undermined by a guarantee of success in an expropriation claim – expropriations must therefore be extraordinary, arbitrary or punitive in amount to be expropriatory;[32]

(iii) expropriation can occur through the physical taking of property, and so the taking or retaining of taxes that the state has no right to take or keep is capable of being a direct expropriation and this is something to examine;

[27] This does not include two situations in which tax expropriations occurred because those claims were brought against political risk insurers (Overseas Private Investment Corporation – OPIC) rather than the host states: (i) one of the tax expropriations ended in arbitration between the investor (Revere Copper Brass Inc.) and OPIC in which the claimant investor succeeded in its compensation claim (*Revere*); and (ii) the other tax expropriation claim resulted in a settlement between the would-be claimant (Reynolds Metals Company) and OPIC (Settlement Agreement between OPIC and Reynolds Metals Company of 25 February 1975; see Mark Kantor, Michael D. Nolan and Karl P. Sauvant, *Reports of Overseas Private Investment Corporation Determinations* (OUP 2011) 320-321).

[28] UNCTAD, 'Taxation' (2000), Series on Issues in International Investment Agreements, Doc. No. UNCTAD/ITE/IIT/16, 72 <http://unctad.org/en/docs/iteiit16_en.pdf> accessed 15 August 2011.

[29] *ibid.*

[30] Although these two questions focus on expropriation and not national treatment, national treatment is used in this thesis because investors can succeed rather easily (especially in comparison to tax expropriation claims) in tax arbitration for alleged national treatment violations – it therefore works well as a comparator to the treatment of expropriation in tax arbitration and gives an excellent insight as to why it is excluded from applying to tax measures in most IITs (see section 4.2.6 of Chapter 4).

[31] *EnCana Corporation v Republic of Ecuador*, LCIA Case No. UN3481, Award of 3 February 2006 at para 177; 'taking' in this context means expropriation.

[32] *ibid*.

(iv) tax can also be used to deprive an investor of the use and enjoyment of an investment, for example, by taxing 100% of profits, and that deprivation of profits makes tax capable of being an indirect expropriation (this includes covert taxation measures being applied by the state over a long period of time) – so it is important to try and gauge when these kinds of taxation measures are expropriatory;

(v) tax expropriation may seem like an 'easy' option for claimants to claim under because of the ability of tax to be a direct expropriation and indirect expropriation and because the power to tax entails the power to destroy, but the reality is very different. In order to succeed in an expropriation claim, the claimant will have to succeed in proving the taxation was arbitrary or punitive (and not bona fide general taxation) as well as proving that the state substantially deprived the investor of his investment through the adoption of the taxation measures. These will not be easy to prove and expropriation is therefore the most difficult treaty protection to claim under in tax arbitration and I seek to explain why that is;

(vi) taxation is also in a special category from the perspective of national treatment, whereby most IITs exclude the application of national treatment to tax measures[33] (whereas most allow the application of expropriation provisions to tax measures)[34];

(vii) national treatment claims are generally not easy for claimants to succeed under, but as far as tax arbitrations are concerned, national treatment is the easiest treaty protection to successfully claim a violation of, predominantly because it will not require the claimant to prove that the taxation measures were arbitrary or punitive or that substantial harm came as a result of the adoption of the taxation measures by the host state. National treatment is, in short, quite straightforward to prove in relation to quantitative discrimination such as differential tax treatment;[35] and

[33] UNCTAD 'Taxation' (n. 25) 2.

[34] UNCTAD, 'Expropriation' (2012) UNCTAD Series on Issues in International Investment Agreements II, Doc No. UNCTAD/DIAE/IA/2011/7, 133 <http://unctad.org/en/docs/unctaddiaeia2011d7_en.pdf> accessed 4 January 2013.

[35] Andrew Newcombe and Lluís Paradell, *Law and Practice of Investment Treaties – Standards of Treatment*, (Kluwer Law International 2009) 184.

(viii) national treatment is not a black and white rule, however, it can be broken down into a question of whether the foreign investor is treated as favourably as a comparable[36] national investor or not; i.e. all things being the same, is the foreign investor liable to pay a tax that a *like* host state investor is not; or does the foreign investor pay a higher rate of the same tax as compared with a *like* host state investor; or is the foreign investor denied tax rebates which are granted to a *like* host state investor? I therefore examine how straightforward it is to succeed on a national treatment tax violation claim.

The *Occidental*[37] case is a useful practical example of the varying level of success between a tax expropriation claim and a national treatment claim. In *Occidental*, the claimant (Occidental Exploration and Production Company – OEPC) claimed that Ecuador had violated the expropriation provision and the national treatment protection of the US-Ecuador BIT[38] by retrospectively and prospectively declining OEPC's tax refund applications for VAT paid on locally purchased or imported goods that were used in the production of exported oil. The arbitral tribunal found that OEPC was entitled to the tax refunds under Ecuador's tax laws[39] as well as under Andean Community Law.[40] Despite this finding, the tribunal dismissed the claim for expropriation because the denial of the tax refunds, although due to OEPC, did not meet the thresholds required to find liability for expropriation.[41] OEPC was successful, however, in the claim under the national treatment protection[42] because there was a difference in treatment between OEPC and *like* host state investors. Additionally, in *EnCana*, a case which was based on the same laws and measures adopted by Ecuador in *Occidental*, the claimant (EnCana) could only claim under the

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[36] Proving to the arbitral tribunal that host state investors/investments are in like circumstances (comparators) to the claimant or the claimant's investments (in order to prove that the host state's investors/investments were treated more favourably than the home state investor/investments) will be the most arduous task in proving a violation of national treatment.

[37] *Occidental Exploration and Production Company v Republic of Ecuador*, LCIA Case No. UN 3467, Award of 1 July 2004. (*Occidental* Award).

[38] Treaty between the United States of America and the Republic of Ecuador concerning the Reciprocal Encouragement and Protection of Investment, signed 27 August 1993, entered into force 11 May 1997 (US-Ecuador BIT).

[39] *Occidental* Award at para 141.

[40] *ibid* at paras 146 and152.

[41] *ibid* at para 89.

[42] *ibid* at paras 177 and 179.

Chapter 2 Sovereignty and Foreign Direct Investment as Drivers of Tax and Arbitration

The sovereignty of the state is what gives a state the power to legislate, regulate and take action. In theory, countries have absolute sovereignty over their affairs. In practice, the necessity of participating in and benefitting from the globalised and mutually interdependent world has transformed absolute choices into 'Hobson's choices'.[1] The effect of globalisation on sovereignty was summarised brilliantly by Lord John Boyd Orr who said that:

> "We are now physically, politically, and economically one world and nations so interdependent that the absolute national sovereignty of nations is no longer possible."[2]

Absolute sovereignty is almost impossible to achieve and is extremely rare[3] because the cost of being isolated from the world can have disastrous effects on an isolated state's economy and population.[4] The rule now is deregulation and liberalisation of the domestic economy to foreign investment,[5] some states such as Burma and North Korea being the exception.[6] Tax sovereignty is no exception to the near impossibility of absolutism as well as deregulation rule in the face of globalisation,[7] and this comes from voluntary market-induced tax sovereignty limitations,[8] negotiated limitations on tax

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[1] A Hobson's choice is a 'take it or leave it' option and is defined by the Oxford English Dictionary (online edition) as: "a choice of taking what is available or nothing at all". 'Hobson's choice' is named after Thomas Hobson (1554-1631) who hired out horses and gave his customers the 'choice' of the horse nearest the door or none at all (Oxford English Dictionary (online edition)).

[2] Lord John Boyd Orr, 23 September 1880 – 25 June 1971.

[3] "Of course, complete sovereignty is impossible, except perhaps for a country that is totally isolated from external influences, such as Burma" (Charles E. McLure Jr., 'Globalization, Tax Rules and National Sovereignty', (2001) Bulletin of International Bureau of Fiscal Documentation 328, 329.

[4] Take for example North Korea, which is "largely isolated and disengaged from the world's economy" and "remains an unreformed and essentially closed dictatorial state" and "[f]ormal trade is minimal" ('2013 Index of Economic Freedom' (*The Heritage Foundation*) <http://www.heritage.org/index/country/northkorea> accessed 31 December 2013.

[5] Thomas Wälde and Abba Kolo, 'Confiscatory Taxation under Customary International Law and Modern Investment Treaties' (1999) 4(17) CEPMLP Journal <http://www.dundee.ac.uk/cepmlp/journal/html/vol4/article4-17.html> accessed 25 May 2010.

[6] *ibid*.

[7] Natalia Quiñones Cruz, 'International Tax Arbitration and the Sovereignty Objection: The South American Perspective' (2008) *Tax Notes International* 533, 540.

[8] McLure (n. 3) 329; voluntary market-induced tax sovereignty limitations are unilateral tax decisions a country makes which it might not make if not for market forces and the necessity to compete with other countries in keeping investment within its jurisdiction as well as attracting more investment from outside its jurisdiction.

sovereignty,[9] externally imposed limitations on tax sovereignty[10] and conflicts in sovereignty,[11] all of which can play against each other.[12] All of these limitations are the result of Hobson's choices, even the voluntary limitations.[13]

The type of tax sovereignty we are concerned with in this thesis stems from the voluntary market-induced tax sovereignty limitations which, as explained in Chapter 1, arise from countries entering into international investment treaties (IITs) which are predominantly bilateral investment treaties (BITs), but include multilateral investment treaties (MITs) and free-trade agreements (FTAs) with investment provisions, for the promotion and protection of foreign direct investment (FDI) from one state into the other.

In this chapter, I will expand upon the sovereignty debate in the context of countries ceding tax sovereignty to arbitral tribunals who are able to rule on the legitimacy of states' tax decisions in investor-state arbitrations[14] and why that is almost patriotically taboo from the host state's context. This will entail a discussion of the following: (i) the balance between a state's sovereign power to tax on the one hand and justice for a foreign investor on the other; (ii) the effect of globalisation on sovereignty and how that

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[9] *ibid* 330; negotiated limitations on tax sovereignty are state-state agreements such as the General Agreement on Tariffs and Trade (GATT), as well as bilateral tax treaties (BTTs) which provide for, inter alia, "source-country taxation of business profits" and "the primacy of residence-country taxation of interest, dividends and royalties" (*ibid* 330).

[10] *ibid* 331; externally imposed limitations on tax sovereignty are limitations that are forced upon a state at the decision of one or more states, such as sanctions imposed by the Organisation for Economic Co-operation and Development (OECD) on its members and non-members for using what the OECD perceives as harmful tax practices (Allison Christians, 'Sovereignty, Taxation, and Social Contract' (2009) 18(1) Minnesota Journal of International Law 99, 117).

[11] McLure (n. 3) 331-332; conflicts in sovereignty occur when one state (State X) uses its sovereignty to unilaterally determine its tax laws and, for example, offer zero or near zero tax rates (a 'tax haven') to foreign investors as an incentive for them to bring their capital into State X. The conflict occurs when a neighbouring country (State Y) must also decrease its tax rates and/or offer other or more incentives for investors to bring their capital to it instead of State X – that is effectively a 'sovereign 'decision that it would be forced to make, hence not really being sovereign at all.

[12] Take for example a state that makes a sovereign decision to become a tax haven but is then forced by the OECD at the threat of or actual use of sanctions to alter its tax regime in conformity with the OECD's guidelines on tax co-operation.

[13] For example, if a state does not enter into negotiations with other states on tax policies and does not make demands and concede on its own sovereignty, then it will be isolated and isolation is a choice a state will seldom take. Likewise, a country threatened with sanctions can prevent the sanctions being employed by taking unilateral action that is demanded of it, and while it has the sovereign capacity to reject the demanded changes to its tax regime, sanctions are not an option it is likely to accept – it therefore does not really have much choice other than to comply with demands or to at least water down those demands through negotiations.

[14] See generally Chapter 1.

has affected tax sovereignty in the negotiated limitations context, using the World Trade Organisation[15] (WTO) as a practical example of the necessity and popular method by which tax sovereignty is ceded and how that has brought us to where we are today in the IIT universe; (iii) the emergence of IITs and an introduction to international investment arbitration including the reasons to arbitrate and where arbitrations take place; (iv) the arbitrability of tax and public policy objections to tax arbitration including a discussion on exclusions and vetoes to tax arbitration; and (v) the risks to host states (especially developing countries) from entering into IITs with arbitration agreements or offering arbitration in their domestic investment law and why there is controversy surrounding the tax arbitration issue (this also includes a discussion on Brazil's non-ratification of BITs policy and subsequent sovereignty retention).

2.1 Sovereignty and Globalisation

2.1.1 The Sovereign Power to Tax versus the Right to Justice

The power to tax, born out of the formation of states,[16] is at the core of national sovereignty.[17] A primary source of income for states is raising money for public expenditure by taxing people and companies that work and operate in their territories because "taxes are what we pay for civilised society."[18] Governments protect and serve the people by controlling state-run departments such as education, health, military defence and policing, and to do so requires inhabitants who enjoy the luxury of freedom and civilised life to pay money into public coffers. Raising and spending money collected from taxation is at the heart of modern government practice,[19] where in the United Kingdom, pre-19th Century taxes were raised primarily for expenditure on armed

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[15] The World Trade Organisation (WTO) was borne out of the Marrakesh Agreement Establishing the World Trade Organisation, Concluded at Marrakesh on 15 April 1994 (Registered by the Director-General of the WTO acting on behalf of the Parties on 1 June 1995).

[16] Luca CM Melchionna, 'Tax Disputes and International Commercial Arbitration', (2003) 74 Diritto e Pratica Tributaria Internazionale 769, 771.

[17] Thomas Wälde, 'National Tax Measures Affecting Investors Under The Discipline of International Investment Treaties', (2008) 102 American Society of International Law Proceedings 51, 55; ECC, 'Report on the Scope for Convergence of Tax Systems in the Community', Doc. No. COM(80)139 Final, 27 March 1980, 6.

[18] *Compañía General de Tabaco de Filipinas v Collector of Internal Revenue*, (1927) 275 U.S. 87, 100, per Justice Holmes; William W Park, 'Tax Arbitration and Investor Protection' in Chapter 12 of Catherine A. Rogers and Roger P. Alford (eds), *The Future of Investment Arbitration* (2009 OUP) 227.

[19] William Park, 'Arbitrability and Tax' in Loukas A. Mistelis and Stavros L. Brekoulakis (eds), *Arbitrability: International & Comparative Perspectives* (Kluwer Law International 2009), 179-180; and 'Public Spending' <available at http://www.politics.co.uk/reference/public-spending> accessed 13 June 2011.

forces[20] and post-19th Century tax expenditure from the Victorian era to date on military as well as social spending.[21] A state's ability to fund the necessities of civilisation, such as policing and the legal system comes from tax revenues "that an unregulated market cannot provide by itself."[22]

Ideally, a state would levy taxes legitimately, indiscriminately and to a reasonable level whether the levies are on investments of its nationals, investments of foreigners or on the incomes of its working population.[23] Governmental systems such as taxation are, however, far from perfect, and wrongful takings by the state can and do occur. Whether such takings transpire with or without intention, the effect is the same and that should be compensated. It is therefore imperative that sovereignty does not legitimise wrongful state actions and this is summed up well by the following statement:

> "In the absence of justice, what is sovereignty but organised robbery?"[24]

In the absence of a justice system for state accountability, the sovereign power to tax would be a form of organised robbery, where the wrongfully taxed, including foreign investors, cannot claim back what is rightfully theirs.[25] The absence of justice against a sovereign state for any offences, including illegitimate taxation, would be a form of totalitarianism that would counter the principle of due process of law if the "absolute monarch, like the 800-pound gorilla, can do what he wants."[26]

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[20] 'Public Spending' (n. 19); and Jari Eloranta, 'Warfare and Welfare? Understanding 19th and 20th Century Central Government Spending' (2004) University of Warwick, Warwick Economic Research Papers No.699, 2, < http://wrap.warwick.ac.uk/1489/1/WRAP_Eloranta_twerp699.pdf> accessed 13 June 2011.

[21] *ibid*; social spending includes cash benefits, health care, education, food, housing, other welfare services and public debt (Eloranta (n. 20) 2).

[22] Diane M. Ring, 'What's at State in the Sovereignty Debate? International Tax and the Nation-State', (2008) 49:1 *Va. J. Int'l L.* 155, 167.

[23] In previous centuries in the industrialised world when 10 to 16 hour work days for labourers were the norm, Robert Owen (14 May 1771 – 17 November 1858) campaigned for a more balanced day and coined the slogan: "Eight hours labour, eight hours recreation, eight hours rest", and that eventually resulted in the eight hour work day. When workers are remunerated for their 8 hours of labour, ideally they will not be taxed to a point where they cannot enjoy their 8 hours of recreation and have enough money in the bank to be able to get their 8 hours of sleep at night.

[24] Saint Augustine, 13 November 354 – 28 August 430.

[25] If the state has breached an obligation(s) to the foreign investor.

[26] Calvin R. Massey, 'Takings and Progressive Rate Taxation' (1996-1997) 20:1Harv. J.L. & Pub. Pol'y 85, 89.

Despite the legitimate and positive undertones of taxation, it has its limits no matter who or what it is levied on, be it the tax levying host state's population or companies within its jurisdiction or foreign nationals or their investments operating within its jurisdiction. These limitations have been likened to rearing sheep, where "it is well to stop when you get down to the skin."[27] We live in a globalised society where foreign investment between nations is rife and those investments are subject to taxation by host states.

Most investor-state disputes, whether for a claim based on alleged illegitimate taxation[28] or any other state measure, take place in international arbitration.[29] Arbitration is seen as a more neutral forum than the national courts of the host state where proper justice can be served and this is especially so in less developed countries where the national courts are not very independent from government pressure.[30] The reasons that states adhere to international arbitration (either through IITs, their domestic laws or agreements with investors) and allow their laws, regulations, policies and decisions to be deliberated by a tribunal based outside the state's jurisdiction and made up of private individuals rather than its own national judiciary is discussed in section 2.1.2 below.

2.1.2 Sovereignty and Globalisation

The sovereign's form has evolved through time, from being a monarch/single leader (this stems from 'absolutist theory') and evolving to become the self-determination of

[27] Attributed to Austin O'Malley (1858-1932), whose full quote reads, "In levying taxes and in sheering sheep it is well to stop when you get down to the skin." The quote is similar to the saying by French Economist and Minister of Finance under King Louis XIV of France, Jean-Baptiste Colbert (1619-1683): "The art of taxation consists in so plucking the goose as to obtain the largest amount of feathers with the least possible amount of hissing."

[28] Illegitimate taxation meaning that taxes were incorrectly levied resulting in nationalisation or expropriation, or a violation of national treatment, most-favoured-nation treatment, fair and equitable treatment, the guarantee of full protection and security, performance requirements, or a breach of stabilisation clauses or any other obligations given by the host state to the foreign investor.

[29] Investor-state disputes are also sometimes raised at the courts of the host state, and failing the desired justice, they are then brought in international arbitration, such as in *EnCana Corporation v Republic of Ecuador* (LCIA Case No. UN3481, Award and Partial Dissent of 3 February 2006) (*EnCana*, *EnCana* Award or *EnCana* Partial Dissent).

[30] Even in some more developed states the judiciaries are not free from political influences, as demonstrated with the treatment of Yukos Oil Company (Yukos) in the 'advanced development economy' Russian state, where judges who did not act or refused to act in the manner that the government authorities wanted were either removed from the case or the bench, whereas those who supported State measures against Yukos were awarded with medals – (*RosInvest Co. UK Limited v The Russian Federation,* SCC Case No. V 079/2005*,* Final Award of 12 September 2010, at para 71; Ulric R. Nichol, *Focus on Politics and Economics of Russia and Eastern Europe* (Nova Science, 2006) 33

the people ('popular sovereignty'/'democracy').[31] Sovereignty was often an attribute of a powerful individual who gained the power to rule over territory purportedly from "direct or delegated divine or historic authority."[32] Political legitimacy now comes from popular support, whereby "the sovereignty of the sovereign became the sovereignty of the people."[33]

There are four ways that the word 'sovereignty' has been used:[34] (i) national sovereignty, which is the authority of a sovereign (ruler) to govern its territory through domestic authority structures;[35] (ii) international legal sovereignty, which is the mutual recognition of states and allows states to enter into agreements with one another and join international organisations[36]; (iii) Westphalian sovereignty, which refers to the territoriality of a state and the non-intervention by external actors from a state's internal affairs[37] (this is the embodiment of what is called the 'nation-state'); and (iv) interdependence sovereignty, which is the ability of government authorities to *control* cross-border movements.[38]

Globalisation has affected all the above types of sovereignties. The sovereign power to tax is a concept of national sovereignty in an authoritative context and is affected by international legal sovereignty and Westphalian sovereignty. Interdependence sovereignty is concerned with *control* (e.g. the ability to collect taxes) rather than *authority* (e.g. the authority to levy taxes)[39] and is therefore outside the scope of this thesis as the research centres on the legitimacy of taxation, not the ability to collect it.

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[31] Saskia Sassen, *Losing Control? Sovereignty in an Age of Globalization* (Columbia University Press, 1996) 2.
[32] W. Michael Reisman, 'Sovereignty and Human 'Rights in Contemporary International Law' (1990) 84 *A.J.I.L.* 866, 867.
[33] *ibid*.
[34] Stephen D. Krasner, *Sovereignty: Organised Hypocrisy* (Princeton University Press, 1999) 9.
[35] *ibid*.
[36] *ibid* 9 and 14.
[37] *ibid* 9 and 20.
[38] *ibid* 9.
[39] *Authority* over cross-border movements is different from *control* over cross-border movements in the sense that the power to legislate is authoritative but strict enforcement of that legislation is subject to control. States cannot completely control the flow of goods, persons, pollutants, diseases or ideas across territorial boundaries nor can it completely shield itself from the effects of atmospheric pollution, the drugs trade and economic crises (*ibid* 12). For example, states can use their authority to legislate that counterfeit goods are illegal and must not enter its territory, however the state cannot completely control whether the counterfeit goods make it through its borders or not. This also works in the context of exports, for example, legislation dictates that it is illegal to export recreational or counterfeit pharmaceutical drugs but the practice cannot be controlled. In the context of taxation, a state can, for

Globalisation has influenced Westphalian sovereignty and transformed the role of the state from a 'nation-state' into a 'market-state'.[40] Globalisation has pushed (and been aided by) countries into using their international legal sovereignty to create and join international organisations such as the WTO and enter into IITs with one another for the sake of economic development and reciprocal protection of their interests. The joining of international organisations like the WTO and entering into IITs, although defined as Hobson's choices at the outset of this chapter, are nevertheless voluntary decisions for states to make. These voluntary decisions allow the market-state model to flourish because they invite greater external influence on the national policies of nations in order to establish competitive markets[41] which in turn has resulted in supranational control or discipline in many areas of state policy which transgress Westphalian sovereignty.[42] This is witnessed at WTO level through the WTO agreements and IITs which either prevent states from voluntarily taking actions which can result in IIT violations or force states to comply with IITs in fear of investor-state arbitration (see section 2.4.2 below). The transgression of Westphalian sovereignty therefore affects a state's tax sovereignty, i.e. its power to effectively and unilaterally legislate on matters of taxation.

Nations have accepted external influences on their state powers in the areas of "trade, investment… human rights"[43] and the environment by international agreements,[44] whereby recourse for alleged breaches may be brought in several fora, including the WTO, where the WTO General Council delegates the solution of disputes to the Dispute Settlement Body (DSB)[45] under the Rules and Procedures Governing the Settlement of Disputes,[46] commonly referred to as the Dispute Settlement Understanding (DSU); and in international investment arbitration at the World Bank's

example, legislate that excise duties are payable on goods purchased from outside the state by travellers, but it cannot control whether all travellers declare these goods nor can it check every passenger's suitcase.

[40] Abba Kolo, 'Tax "Veto" as a Special Jurisdictional and Substantive Issue in Investor-State Arbitration: Need for Reassessment?' (2008-2009) 32 *Suffolk Transnat'l L. Rev* 475.

[41] Ibid.

[42] Krasner (n. 34) 20.

[43] Kolo (n. 40) 475.

[44] Trade agreement examples include WTO agreements such as the 1947 and 1994 General Agreement on Tariffs and Trade (GATT) and the General Agreement on Trade in Services (GATS) 1995; investment agreements include the 1994 North American Free Trade Agreement (NAFTA), human rights agreements include the 1950 European Convention on Human Rights (ECHR), and environmental agreements include the United Nations Framework Convention on Climate Change's (UNFCCC) 1997 Kyoto Protocol.

[45] WTO Agreement, Article IV(3).

[46] WTO Agreement, Annex 2.

International Centre for Settlement of Investment Disputes (ICSID),[47] the intergovernmental Permanent Court of Arbitration (PCA), or private institutions such as the London Courts of International Arbitration (LCIA), International Chamber of Commerce Court of Arbitration (ICC) or ad hoc arbitrations.

The dilution of state autonomy by joining international organisations like the WTO and therefore accepting a high degree of policing by international panels in areas of law and regulation which were traditionally "the exclusive sovereign preserve of states"[48] is required in order to compete in the globalised world, whereas the refusal to engage with other states would result in the exclusion from benefits such as trade liberalisation which would have negative consequences on the prosperity of the state. Similarly, it is perceived that entering into IITs is imperative to countries, especially capital-importing countries, to compete in attracting FDI (this point is expanded upon throughout this chapter).

The WTO offers an excellent, practical and recently historical portrayal of the interplay between the state's power to tax and the effect of outside forces on that power. The WTO was formed in 1995, replacing the 1947 General Agreement on Tariffs and Trade (GATT). The GATT is still in force through its 1994 version (together 'the GATT'). The WTO, from its beginnings as the GATT, began with a focus on trade liberalisation through the reduction in tariffs[49] (taxes levied on the country's borders on incoming capital and goods). The reduction in tariffs at the behest of other states is in itself a practical example of the trade-off of sovereignty for the sake of having a place in the global market (of course the state that reduces its tariffs also benefits its own exporters who can take advantage of reduced tariffs in other states). The WTO expanded the number of agreements under its belt during the Uruguay Round of negotiations to include the General Agreement on Trade and Services (GATS), the Trade-Related Investment Measures Agreement (TRIMs), the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS), the Agreement on Subsidies and Countervailing

[47] 1965 Washington Convention on the Settlement of Investment Disputes between States and Nationals of Other States (ICSID Convention).
[48] Rajesh Pillai, 'National Treatment and WTO Dispute Settlement' (2002) 1(3) World Trade Review, 321.
[49] Michael Daly, 'WTO Rules on Direct Taxation' (2006) 29(5) The World Economy 572, 528.

Measures (SCM) and the Agreement on Agriculture, and the Bali Round of negotiations which concluded on 7 December 2013 has produced the 'Bali Package'.[50]

The success of multilateral trade negotiations in over half a century resulted in tariffs declining.[51] Meanwhile, internal taxes can also be used to have a detrimental impact on imported capital, goods and services and can vitiate the success of tariff reductions.[52] For that reason, the aforementioned agreements play an "increasingly important role in regulating the use of tax measures [i.e. internal taxation], especially where these measures affect the international movement of goods, services, capital, persons and technology"[53] and whilst the WTO's focus on tariffs resulted in trade-offs of sovereignty for the sake of trade, as a result of the expansion of WTO agreements, the WTO now has the ability to "encroach on Members' freedom to decide their own internal tax policies"[54] and tax disputes at the WTO on internal taxes are becoming more frequent.[55] Tax disputes at the WTO have included Mexican tax measures on sweeteners other than cane sugar which are used in soft drinks,[56] Japanese, Korean and Chilean tax measures on alcoholic beverages,[57] Indonesian tax measures on the automotive industry[58] and United States tax exemptions for the sale or lease of United States-produced goods for export outside the United States.[59]

The dispute resolution mechanism between contracting parties under the GATT prior to the introduction of the WTO's DSU was regulated by Article XXIII of GATT as it was in 1947 (GATT 1947), under which any contracting party, including the state whose conduct is complained of (the respondent state), could block the review process of its

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[50] WTO 2013 News Items, '5-7 December 2013 - Ninth WTO Ministerial Conference - Days 3, 4 and 5: Round the Clock Consultations Produce 'Bali Package' (7 December 2013) < http://www.wto.org/english/news_e/news13_e/mc9sum_07dec13_e.htm> accessed 28 December 2013.
[51] Michael Daly (49) 528.
[52] *ibid* 528.
[53] *ibid* 529.
[54] *ibid*.
[55] *ibid*.
[56] WTO, *Mexico – Tax Measures on Soft Drinks and Other Beverages*, adopted on 24 March 2006; the same tax measures were subject to international arbitration between *Cargill Incorporated v United Mexican States*, ICSID Case No. ARB(AF)/05/2, Award (Redacted Version) of 18 September 2009 and *Archer Daniels Midland Company and Tate & Lyle Ingredients Americas Inc. v United Mexican States* (ICSID Case No ARB(AF)/05/05), Final Award (Redacted Version) of 21 November 2007.
[57] WTO, *Japan – Taxes on Alcoholic Beverages*, adopted on 1 November 1996; WTO, *Korea – Taxes on Alcoholic Beverages*, adopted on 17 February 1999; and WTO Panel Report, *Chile – Taxes on Alcoholic Beverages*, adopted on 12 January 2000.
[58] WTO, *Indonesia – Certain Measures Affecting the Automotive Industry*, adopted on 23 July 1998.
[59] WTO, United States – *Tax Treatment for "Foreign Sales Corporations"*, adopted on 20 March 2000.

conduct at any stage (i.e. it required a positive consensus). The current mechanism under the WTO's DSU does not require a positive consensus, i.e. if a complaint is lodged by a GATT contracting party against the policies of another contracting party, the deliberation of those policies will proceed even if an objection to the review process is made by a WTO Member (including, of course, the respondent state). Under the old mechanism, the respondent state retained greater sovereignty because it could block the review of its employment of its sovereign powers. Even if a state allowed the WTO to review its laws which were found to violate the GATT, the violating state could even block the authorisation of countermeasures against it for such non-implementation of the recommended changes to bring it into conformity with its GATT obligations.[60] Evidently, the capability of states to block the review of their laws and actions as well as blocking retaliatory actions against them for non-implementation of any WTO recommendations allowed them to theoretically maintain absolute sovereignty. However, the GATT 1947 dispute settlement procedure was seldom blocked because although a WTO report may have been unfavourable to the respondent state, it would have been unfavourable only in the short-term, whereas the long-term systemic benefits of not hampering the process served to prevent against retaliation by other member states[61] who could have unilaterally neutralised a respondent state's benefits of GATT membership through measures such as trade embargoes.[62] For these same reasons, states exercise their sovereign powers to sign and ratify IITs, sovereignly trading-off their absolute independence not only to other states but to those states' nationals (investors) too. States do this in the hope of becoming or remaining competitive in the international market-place and because in this modern era, more than ever before, nations depend on each other for resources, support and security. Pure and absolute sovereignty is not achievable if a country wishes to support itself and its population and to participate in international trade with any degree of success, whereby not participating in politico-economics will ensure its failure to compete in exporting goods and services and

[60] WTO, 'Dispute Settlement System Training Module: Chapter 2: Historic Development of the WTO Dispute Settlement System', <http://www.wto.org/english/tratop_e/dispu_e/disp_settlement_cbt_e/c2s1p1_e.htm> accessed 11 May 2011.

[61] *ibid*.

[62] Trade embargoes would have been agreed by states outside the GATT system because under GATT 1947 the violating state also had the power to block measures such as trade embargoes against it.

attracting FDI into its country.[63] The purpose of a state's legislature is to effectively pursue and implement the policies of its people,[64] and owing to globalisation, broadly speaking, it cannot do that alone.[65] States therefore pursue paths that dilute their sovereignty because they desire the enrichment of their country, and this would hardly be achievable if they go at it alone because conditions outside their jurisdiction will affect the economy within their jurisdiction in any event.[66] Globalisation has transgressed economic lines of division that used to be marked by political boundaries.[67] This brings us now to the discussion on IITs and arbitration.

2.2 International Investment Treaties

2.2.1 The Role of International Investment Treaties

Countries whose regimes offer stability for investment, with their laws and regulations seldom used to impede investment, pose attractive attributes to attract foreign investors. Some states, such as Argentina, are known for their instability, and it is possible that the reservations foreign investors have when calculating investment risk in such a country is alleviated to some extent when said states are bound by IITs. A vital feature that benefits investors and is contained in most IITs is a dispute resolution provision that entitles an investor of one party to an IIT to initiate arbitration proceedings against the other party in its capacity as a state. It is also vital that states that are unsuccessful in their arbitrations implement the resulting arbitral awards;[68] otherwise the concept of the arbitration provision in IITs and arbitration itself would be pointless.

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[63] In the discussion about Brazil in at 2.4.1 below, we shall see that Brazil have not ratified any IITs. But this does not mean that Brazil does not participate in the international community, it is a member of the WTO and it has signed many bilateral tax treaties and is a member of various free-trade zones in South America. Brazil also has an attractive domestic investment law.

[64] Ring (n. 22) 171.

[65] *ibid.*

[66] *ibid*, citing the work of Michal Zürn, 'Democratic Governance Beyond the Nation-State', in Michael Th. Greven & Louis W. Pauly (eds.), *Democracy Beyond The State? The European Dilemma and the Emerging Global Order* (Rowman & Littlefield, 2000), 91, 93.

[67] John Ward Cutler, 'The Treatment of Foreigners' (1933) 27 *A.J.I.L* 225, 226.

[68] Recently there have been problems between US investors and Argentina who have refused to pay on two arbitral awards exceeding US $300 million – *Azurix Corp. v Argentine Republic*, ICSID Case No. ARB/01/12, Award of 14 July 2006 and *CMS Gas Transmission Company v Argentine Republic*, ICSID Case No. ARB/01/8, Award of 12 May 2005.

2.2.2 The Emergence of International Investment Treaties

IITs are primarily composed of BITs, but there are a number of MITs, free trade agreements (FTAs) with investment provisions, as well as economic partnership agreements and regional agreements.[69] The first modern day BIT was signed on 25th November 1959 and made between the Federal Republic of Germany and the Islamic Republic of Pakistan and this was the only BIT concluded in 1959. The number of BITs in force grew decade upon decade: end of 1969: 72 BITs; end of 1979: 165 BITs; end of 1989: 385 BITs. The number of BITs then grew exponentially in the 1990s to 1,857 BITs by the end of 1999. In the 12 years from the end of 1999 to the end of 2011, the number of BITs in force grew to 2,833,[70] as well as 331 other types of IITs (primarily MITs and FTAs), totalling 3,164 IITs by the end of 2011.[71] The quantitative domination of BITs makes them the most instrumental tool in the IIT universe, however the economic significance of regional FTAs is on the rise, whereby a trilateral investment agreement between China, Japan and the Republic of Korea (South Korea) was concluded in 2012;[72] Mexico signed a FTA with Costa Rica, El Salvador, Guatemala, Honduras and Nicaragua (Mexico-Central America FTA) in 2011;[73] the Association of Southeast Asian Nations (ASEAN)[74] has developed further, such as with the conclusion

[69] UNCTAD, 'Towards a New Generation of Investment Policies' (2012) World Investment Report, xx <http://www.unctad-docs.org/files/UNCTAD-WIR2012-Full-en.pdf> accessed 8 August 2012.
[70] *ibid*.
[71] *ibid*.
[72] Agreement among the Government of Japan, the Government of the Republic of Korea and the Government of the People's Republic of China for the Promotion, Facilitation and Protection of Investment, signed 13 May 2012.
[73] Tratado de Libre Comercio (TLC) Único entre México y Centroamérica (FTA between Mexico and Central America), signed 22 November 2011.
[74] The ASEAN is a 10-country strong economic area consisting of Indonesia, Malaysia, the Philippines, Singapore, Thailand (all previous countries are original members since 8th August 1967), Brunei, Burma (Myanmar), Cambodia, Laos and Vietnam.

of the ASEAN-India FTA;[75] and the European Commission now has the power to negotiate IITs on behalf of the entire European Union (EU).[76]

The brief discussion in the preceding section 2.1.2 focused on the GATT because it was an agreement that significantly altered on a worldwide scale the dynamic between states by giving each other the ability to openly and publicly question each other's sovereign economic decisions. The remainder of this thesis will focus on IITs, especially BITs, which have a substantially different application to the GATT and the WTO (referred to forthwith as the WTO). The WTO focuses primarily on trade liberalisation by inhibiting discrimination[77] and provides a platform for states to challenge other states' domestic discriminatory practices. These challenges are non-monetary and not brought by

[75] The ASEAN-India Free Trade Agreement (ASEAN-India FTA) consists of three agreements: (i) Framework Agreement on Comprehensive Economic Cooperation between the Republic of India and the Association of Southeast Asian Nations, signed 8 October 2003; (ii) Protocol to Amend the Framework Agreement on Comprehensive Economic Cooperation between the Association of Southeast Asian Nations and the Republic of India, signed 13 August 2009; and (iii) Agreement on Trade in Goods Under the Framework Agreement on Comprehensive Economic Cooperation between the Association of Southeast Asian Nations and the Republic of India, signed 13 August 2009; altogether entered into force 1 January 2010.

[76] The Treaty of Lisbon amending the Treaty on European Union and the Treaty establishing the European Community, (2007/C 306/01), signed at Lisbon, 13 December 2007, entered into force 1 December 2009 ("the Lisbon Treaty"). The Lisbon Treaty renamed the *Treaty establishing the European Community* (AKA "the Treaty of Rome") to the *Treaty on the Functioning of the European Union* ("the TFEU") (Lisbon Treaty, Article 2(1), C 306/42). Article 12 of the Lisbon Treaty gave the EU exclusive competence on the EU's "common commercial policy" by amending the Treaty of Rome with the addition of Article 2B(e) (now Article 3.1(e)). The Treaty of Rome was amended with the inclusion of Article 188B (Lisbon Treaty, Article 157; now Treaty of Rome, Article 206), requiring the EU to contribute to the abolition of restrictions on international trade and FDI, and Article 188C (Lisbon Treaty, Article 158; now TFEU, Article 207.1), which requires that the common commercial policy be based on uniform principles including the conclusion of tariff and trade agreements and FDI. In a Proposal for a Regulation of the European Parliament and of the Council establishing a framework for managing financial responsibility linked to investor-state dispute settlement tribunals established by international agreements to which the European Union is party (Brussels, 21 June 2012, Doc. No. 2012/0163 (COD), (the Proposal)), it was confirmed by the European Commission (the Commission) that the EU has exclusive competence to conclude agreements relating to foreign investment (page 3, para 1.2). The Proposal established a legal and financial framework for investor-state dispute settlement (by arbitration) whereby a claim can be brought by a foreign investor against the EU as a state (European Commission, News archive, 'EU takes key step to provide legal certainty for foreign investors', Brussels 21 June 2012 <http://trade.ec.europa.eu/doclib/press/index.cfm?id=808> accessed 25 June 2012). That said, none of this is final and in fact it is far from so. Under the Lisbon Treaty the EU gained competence in international trade and FDI but save for a few minor international trade agreements nothing substantive has taken place on the FDI front. The Commission/Parliament are of the view that intra-EU BITs are superseded by EU law whereas ICSID tribunals take the opposite view.

[77] Directorate-General for External Policies, 'Responsibility in Investor-State Arbitration in the EU' (2012) European Parliament, 17 <http://www.europarl.europa.eu/committees/fr/studiesdownload.html?languageDocument=EN&file=794 > accessed 28 January 2013.

affected investors. On the other hand, IITs focus on investment liberalisation.[78] IITs, especially BITs, promote foreign investment from state to state by affording certain safeguards (standards of treatment) by the host country to foreign investors, including national treatment, prompt and adequate compensation for expropriation or nationalisation, fair and equitable treatment, most-favoured-nation treatment, protection of contractual rights and performance requirements. It is in this respect that BITs can be categorised "as a developing country's way to compete for international capital by making a credible commitment to respect property rights."[79] An alleged breach by a state of a standard of treatment contained in an IIT will be rectified by providing a platform for the investors themselves to commence proceedings against that state and seek monetary compensation under the relevant IIT(s),[80] whereas a finding at the WTO of a breach will not compensate individual investors for any harm suffered.

2.2.3 International Investment Treaties and the Agreement to Arbitrate

Countries enter into IITs to attract FDI. Most IITs contain an invitation for investors of the home state to arbitrate with the host state and this is called a 'standing offer to arbitrate'. The standing offer to arbitrate is a trade-off of sovereignty because when invoked, the host state's behaviour (as well as the legality of its decisions) when exercising its sovereign powers will be judged by a tribunal made up of foreign citizens.[81]

2.2.3.1 Why Arbitrate?

Arbitration is the primary method of litigation for investor-state disputes and is perhaps the most neutral method of getting to the bottom of any issues. Recourse to the host

[78] Deborah L Swenson, 'Bilateral Investment Treaties and International Integration', (August 2008) University of California, Davis and National Bureau of Economic Research, 5 <http://www.econ.ucdavis.edu/faculty/dswenson/BITsIntegration08.pdf> accessed 2 February 2012

[79] Zachary Elkins, Andrew Guzman and Beth Simmons, 'Competing for Capital: The Diffusion of Bilateral Investment Treaties, 1960-2000' (2004) UC Berkeley, Boalt Working Papers in Public Law, 32 <http://www.escholarship.org/uc/item/1hg4f4dw> accessed 2 February 2012.

[80] Other types of relief can be sought at arbitration, however, monetary compensation is usually the main type of relief sought as it is the most easily enforceable due to the New York Convention and the ICSID Convention, compared to other types of relief, such as rectification, e.g. giving expropriated land back to the investor.

[81] It is standard practice for neutrality's sake that the tribunal is not made up of members whose citizenship is the same as any party to the arbitration (unless otherwise agreed by the parties themselves).

state's judiciary is an option, however it is an option that need not be inscribed in a legal instrument because it is a natural route for justice. Some investors may exploit the host state's judiciary before or in unison with the arbitration route. In some BITs, utilisation of the home state's courts is a prerequisite to commencing arbitration,[82] the non-exploitation of which could result in the arbitral tribunal declining jurisdiction to preside over the dispute.[83] The standing offer to arbitrate contained in most of today's IITs is the child of the drafters of 1980s IITs, which, in that period in time, was seen as an innovative step because it deviated from the traditional requirement for the consent to arbitrate to be contained in an arbitration agreement in a commercial contract.[84] It was especially innovative in light of the fact that customary international law does not give private parties a right of action against host states.

The arbitration agreement in IITs gives investors peace of mind by providing them with the ability to avoid putting to the test the real or imagined bias of local judges, with those worries possibly creating a commercial anxiety that prevents FDI.[85] Arbitration was chosen because a tribunal for whom patriotism, government pressure or corruption is not an issue can be expected to judge the host state's alleged illegitimate measures[86] more fairly than its own judiciary.[87] We shall see at section 2.4 below that most respondents to investment arbitration are developing countries, and this could be "because courts in many poor countries are corrupt, inept or unfair"[88] which necessitates the need for arbitration in international trade.

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[82] Article 6(4), Agreement between the Government of Romania and the Government of the Republic of Turkey on the Reciprocal Promotion and Protection of Investments, signed 24 January 1991, entered into force 7 April 1996 (Romania-Turkey BIT); Article X(3), Agreement for the Promotion and Reciprocal Protection of Investments between Argentina and the United Republic of Spain, signed 3 October 1991, entered into force 28 September 1992 (Spain-Argentina BIT).

[83] *Omer Dede and Serdar Elhüseyni v Romania*, ICSID Case No. ARB/10/22, Award on Jurisdiction of 5 September 2013.

[84] Gary Born, 'BITs, BATs, and Buts – Keynote Speech' (Kiev Arbitration Day, Kiev, 15 November 2012) <http://www.globalarbitrationreview.com/cdn/files/gar/articles/BITs_BATs_and_Buts2.pdf> accessed 15 June 2013.

[85] William W. Park, 'Arbitration and the Fisc: NAFTA's "Tax Veto"' (2001) 2 *Chi. J. Int'l L.*, 231, 232.

[86] Illegitimate measures being a breach of the relevant national law, IIT, or contract or investment agreement concluded directly with the foreign investor.

[87] This does not preclude an investor from attempting to bring the dispute before the national courts of the host state.

[88] Editorial, 'The Secret Trade Courts' *New York Times* (New York, 27 September 2004) <http://www.nytimes.com/2004/09/27/opinion/27mon3.html?_r=0> accessed 25 December 2013.

Arbitration is also the chosen method for investors over and above diplomatic protection because the investors have direct recourse for their grievances against the host state and effectively take matters into their own hands and seek legal remedies in an independent international forum.[89] Investors therefore avoid lobbying and save time by avoiding the diplomatic route. Arbitration is also more favourable than diplomatic protection because it depoliticises disputes which will therefore be decided on matters of law and not politics or diplomacy.[90]

2.2.3.2 Where Do Investor-State Arbitrations Take Place?

ICSID is the most prominent investor-state arbitration institution.[91] Of the 514 known investment treaty arbitrations by the end of 2012,[92] 314 were brought under the ICSID Convention and the ICSID Additional Facility Rules (AF Rules).[93] Arbitrations under the ICSID Convention are between the host state who is a contracting party to the ICSID Convention and a national of a country that is also party to the ICSID Convention. Arbitrations can be administered under the AF Rules if the host state is not a contracting party to the ICSID Convention, or if it is a contracting party but the investor is a national of a country that is not party to the ICSID Convention. Arbitrations under the AF Rules are administered outside of the ICSID Convention framework.

ICSID was established by the World Bank to be an autonomous international institution for the resolution of investor-state disputes.[94] As a World Bank institution it is

[89] Gabrielle Kaufmann-Kohler, 'Non-Disputing State Submissions in Investment Arbitration: Resurgence of Diplomatic Protection?' in Chapter 15 of Laurence Boisson de Chazournes, Marcelo G. Kohen and Jorge E. Viñuales (eds), *Diplomatic and Judicial Means of Dispute Settlement* (Brill Nijhoff 2012), 306.
[90] *ibid.*
[91] Todd L. Allee and Clint Peinhardt, 'Contingent Credibility: The Reputational Effects of Investment Treaty Disputes on Foreign Direct Investment' (2008) Unpublished Article by Univ. of Illinois and Univ. of Texas at Dallas, 8.
< http://politicalscience.osu.edu/intranet/gies/papers/Allee%20Peinhardt%20Sept2009.pdf> accessed 8 April 2013).
[92] UNCTAD, 'Latest Developments in Investor-State Dispute Settlement (ISDS)' (2013) IIA Issues Note No.1, 3. (UNCTAD ISDS 2013).
[93] *ibid* 3*;* there have been 131 investor-state arbitrations brought under the UNCITRAL Rules and these arbitrations can be either ad hoc or administered by an arbitration institution, but because the UNCITRAL Rules do not specify an institution, one cannot compare the ICSID institution to a set of arbitration rules. However, the ICSID Convention/AF Rules by comparison to the UNCITRAL Rules still have more than double the number of investor-State arbitrations brought under them.
[94] 'About ICSID',

headquartered in Washington DC.[95] The establishment of ICSID under an international convention as well as the fact that it is a World Bank institution has resulted in its prominence in investor-state arbitration.[96] Pursuant to Article 54(1) of the ICSID Convention, ICSID arbitral awards are recognised and enforced as national court judgments in the country of enforcement[97] and this gives the institution even more weight and credibility.[98] This recognition and enforcement does not benefit an award made under the AF Rules, because the ICSID Convention does not apply to the AF Rules.[99] The finality of awards under the AF Rules is subject to recognition and enforcement under the New York Convention[100] (NYC), which is why the AF Rules require the seat of an AF Rules arbitration to be in a NYC signatory state.[101] So rather than being automatically recognised and enforced in any national court of an ICSID Convention state, AF Rules awards may be subject to judicial control at the place of arbitration (which in some states is mandatory),[102] and the awards may also be declined recognition and enforcement if they fall foul of the public policy where recognition or enforcement are sought or the matter is considered non-arbitrable by the recognising and enforcing state.[103]

Another advantage of ICSID is that it publicises "the nature, timing and outcomes of its proceedings and awards"[104] (including those under the AF Rules) which makes it a very transparent arbitral institution and the only one to publish such information.[105]

2.2.3.3 Standing Offer to Arbitrate in Domestic Investment Laws

Some domestic investment laws contain a standing offer to arbitrate, whereby the state consents in advance to arbitration commenced by a hypothetical investor. Article 8(2)

<https://icsid.worldbank.org/ICSID/FrontServlet?requestType=CasesRH&actionVal=ShowHome&pageName=AboutICSID_Home> accessed 17 January 2013.

[95] *ibid*.

[96] Allee and Peinhardt (n. 91) 8.

[97] Article 54(1), ICSID Convention.

[98] Allee and Peinhardt (n. 91) 8.

[99] Article 3, ICSID AF Rules.

[100] 1958 Convention on the Recognition and Enforcement of Foreign Arbitral Awards (New York Convention).

[101] Article 19, ICSID AF Rules.

[102] Park (2001) (n. 85) 234.

[103] See section 2.3 below.

[104] Allee and Peinhardt (n. 91) 8.

[105] Many ICSID awards are available on its website and will be examined in this thesis.

Albanian Law No. 7764 of 1993 on foreign investment[106] is a perfect example of this submission, which provides:

> "If a foreign investment dispute arises … then the foreign investor may submit the dispute for resolution and the Republic of Albania *hereby consents* to the submission thereof, to [ICSID]" (emphasis added).[107]

Other domestic laws interpreted as containing a standing offer to arbitrate have included Article 16(2) of Law of Georgia No. 473-10 on the Investment Activity Promotion and Guarantees,[108] Article 15 of El Salvador's Foreign Investment Law of 1999,[109] Article 27 of Kazakhstan's Law on Foreign Investments,[110] and Article 8 of Egypt's 1974 Law No. 43.[111]

2.3 Arbitrability of Tax and Public Policy Considerations

Tax arbitration is engulfed by doctrinal objections because "tax sovereignty is one of the fundamental components of national sovereignty, and … one of the fundamental prerogatives of national parliaments is the right to vote taxes."[112]

[106] Albanian Law No. 7764 of 2 November 1993, entered into force on 1 January 1994.

[107] *ibid*, Article 8(2); there are various versions of Article 8(2) of Albanian Law No. 7764 of 1993 online which do not contain the consent provision replicated here. The parts of Article 8(2) replicated here are accurate and have been obtained from *Tradex Hellas S.A. v Republic of Albania*, ICSID Case No. ARB/94/2, Decision on Jurisdiction of 24 December 1996, 174; and Michele Potestá, 'The Interpretation of Consent to ICSID Arbitration Contained in Domestic Investment Laws' (2011) 27:2 *Arbitration International* 149, 156.

[108] Law of Georgia No. 473-10 on the Investment Activity Promotion and Guarantees of 12 November 1996 (Georgian Investment Law), which was considered by the arbitral tribunal in *Zhinvali Development Limited v. Republic of Georgia*, ICSID Case No. ARB/00/1, Award (unpublished). The Georgian Investment Law has now been amended to remove the standing offer to arbitrate – see section 2.4.2.3 below.

[109] Republic of El Salvador, Ley de Inversion de 1999 (Foreign Investment Law of 1999). This has also been amended – see section 2.4.2.3 below. This law was considered in *Inceysa Vallisoletana, SL* v. *Republic of El Salvador*, ICSID Case No. ARB/03/26, Award of 2 August 2006.

[110] Law of the Republic of Kazakhstan on Foreign Investments of 27 December 1994. This law containing the standing offer to arbitrate has been repealed – see section 2.4.2.3 below. It was, despite its repeal, used in conjunction with Article 6 of that same law (stabilisation clause) to successfully bring proceedings by the claimant in *Telsim & Rumeli v Republic of Kazakhstan*, ICSID Case No. ARB/05/16. More recently, the tribunal in *Ruby Roz Agricol LLP v Republic of Kazakhstan*, Ad hoc arbitration under the UNCITRAL Rules, Award on Jurisdiction of 1 August 2013, did not find they had jurisdiction to hear the dispute under that same law.

[111] Arab Republic of Egypt, Law No. 43 of 1974. Egypt's standing offer has since been revoked – see section 2.4.2.3 below. The standing offer was used to commence proceedings by the claimant in *Southern Pacific Properties (Middle East) Limited v Arab Republic of Egypt*, ICSID Case No. ARB/84/3.

[112] 'Report from the Commission to the Council on the Scope for Convergence of Tax Systems in the Community' (Bulletin of the European Communities, 25 March 1980) Doc. COM (80) 139, 6.

Arbitral tribunals are made up of privately appointed individuals[113] that preside over disputes which would ordinarily be entertained by the courts of the host state which naturally enjoys jurisdiction by reason of the parties' residence, *lis pendens*, or other.[114] These tribunals are given the power to rule on the legitimacy of a state's legislative measures (including tax measures). The decisions by adjudicators who are not judges of the host state dilutes the sovereignty of the state because its sovereignty is transgressed by the entire arbitral process; i.e. a state's sovereignty is never questioned if its policies are reviewed by its own national courts because such review is an internal procedure in which the legitimacy of the exercise of the state's powers is decided by its own judiciary and is therefore a completely internal sovereign process based on the separation of powers. On the other hand, investor-state arbitration results in foreigners outside the state's jurisdiction deciding on "challenges to governmental measures, sometimes measures of general application intended to promote or achieve important public policy goals,"[115] including environmental protection, public health and revenues from taxation, and this is clearly a ceding of sovereignty by the respondent host state.

Despite the reputation for tax as being non-arbitrable because of the jurisdictional and doctrinal objections, "not all disputes relating to tax are outside the ambit of arbitration."[116] It is a fact that tax matters have been arbitrated in international commercial arbitration[117] and investor-state arbitration so it is useful now to predispose of that misconception.

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[113] Despite international investment arbitrations brought by foreign investors against states often taking place at the intergovernmental PCA or at the World Bank's ICSID, in similar fashion to commercialised courts of arbitration (LCIA, ICC, etc.), the arbitrators are appointed on a case-by-case basis.

[114] See generally Chapter 1.

[115] J. Anthony VanDuzer, 'Enhancing the Procedural Legitimacy of Investor-State Arbitration Through Transparency and Amicus Curiae Participation', (2007) 52 *McGill L.J.* 681, 684.

[116] Ilias Bantekas, 'The Foundations of Arbitrability in International Commercial Arbitration' (2008) 27 *Australian YIL* 193, 201.

[117] See generally Melchionna (n. 16); international commercial arbitration centring on taxation are generally disputes on commercial aspects of paying a tax and not the legality of the tax itself (as is the situation in investor-state arbitrations). In this context, disputes might arise between joint venture partners as to who is liable to pay a tax or the percentages in which the tax must be shared between them, or disputes might arise between a taxpayer and his tax adviser "when advice about a tax shelter proves unfounded and leads to liability" (Park 2009 (n. 19) 181).

2.3.1 Arbitrability

The most important convention in international commercial arbitration is the NYC and it also plays a role in the recognition and enforcement stage of investment arbitration awards not made under the ICSID Convention.[118]

The principle of party autonomy permits parties to an arbitration agreement to submit to arbitration any and all disputes that have arisen or may arise between them and this is recognised by the NYC.[119] Arbitration agreements can therefore be tailored in a way that specifically includes or excludes certain matters, including taxation. Disputes centring on taxation will fall within the ambit of an arbitration agreement if the agreement encompasses *all* disputes, or specifies taxation as a matter to arbitrate, or discounts some types of matters but not taxation. The same concept applies to the dispute resolution provisions (i.e. arbitration agreements) in IITs. If state parties to an IIT want the IIT protections to apply to taxation measures but want a dispute on taxation to fall under the jurisdiction of only the host state courts, they can fulfil that desire by inserting an exclusion to the arbitration of tax matters in the IIT dispute resolution article.[120]

Another limb to arbitrability is that matters referred to arbitration must concern "a subject matter *capable of settlement by arbitration*"[121] (emphasis mine). Article II(1) of the NYC is a perfect example of the two stages in which arbitrability is a condition that the parties must satisfy, namely in the arbitration agreement and the law and/or public policy of relevant jurisdictions.

[118] For example, investor-state arbitral awards under the AF Rules will require enforcement through the New York Convention, and all of the rules in the New York Convention that allow states to not recognise and enforce awards will therefore apply, including non-recognition and enforcement for not non-compliance with the state's public policy or for being non-arbitrable. An award can be deemed non-arbitrable at the country of recognition and enforcement even if it was deemed arbitrable in the *lex arbitri* (Bantekas (n. 116) 195).

[119] Article II(1), New York Convention: "Each Contracting State shall recognize an agreement in writing under which the parties undertake to submit to arbitration all or any differences which have arisen or which may arise between them…"

[120] Tax matters are usually excluded from the ambit of arbitration by being excluded from the ambit of all or most IIT protections and such exclusions will prevent the arbitration of any foreseeable tax disputes as well as prevent the litigation under the IIT of tax disputes at the courts of the host state. This will not prevent an investor from bringing an action in the courts of the host state claiming a violation through taxation measures of any law other than the applicable IIT.

[121] Article II(1), New York Convention.

Once the matter of the dispute is caught by the arbitration agreement, the scrutiny of whether that matter is capable of settlement by arbitration will be wholly dependent on:

(i) the law and/or public policy of the place governing the arbitration agreement;

(ii) the law and/or public policy of the place governing the arbitration, which will be the *lex arbitri* or the *lex fori*; and

(iii) the law and/or public policy of the place of recognition and enforcement of the award.

For the purposes of investor-state arbitration, tax will be an arbitrable matter under the *lex arbitri* unless the applicable IIT excludes its application to matters of taxation,[122] and this is the case despite the jurisprudential objections to arbitrating matters of taxation because they concern the (fiscal) sovereignty of the state. Indeed, it is the very sovereignty of the state that permits states to sign and ratify IITs[123] under which matters of taxation will become arbitrable, and by entering into such IITs, states consciously declare tax disputes as arbitrable.[124] The arbitrability of tax is therefore more straightforward to determine in international investment arbitration than it is in international commercial arbitration because the investment arbitration will be taking place on the backdrop of a treaty entered into by sovereign states who have consciously permitted tax arbitration by either not excluding the applicability of the IIT to tax matters or excluding only some treaty provisions from tax matters (tax exclusions) or inserting qualifications to jurisdiction on tax arbitration (tax vetoes).[125] Furthermore, the exclusion of only some treaty protections to matters of taxation is even more obvious proof of the cognisant submission to the arbitrability of tax on the non-excluded

[122] When certain matters (e.g. taxation) are "deemed arbitrable in the *lex arbitri,* there is no guarantee that the country of enforcement will itself consider it as both arbitrable or compliant with its public policy." (Bantekas (n. 116) 195). There is therefore a real possibility that tax matters are deemed non-arbitrable at the recognition and enforcement stage if the recognition and enforcement is not governed by the ICSID Convention but is governed instead by the NYC or other regional conventions.

[123] *S.S. Wimbledon (U.K. v. Japan)* [1923] P.C.I.J. (ser. A) No. 1 (Aug. 17) at para 35: "The Court declines to see in the conclusion of any Treaty by which a State undertakes to perform or refrain from performing a particular act an abandonment of its sovereignty. No doubt any convention creating an obligation of this kind places a restriction upon the exercise of the sovereign rights of the State, in the sense that it requires them to be exercised in a certain way. *But the right of entering into international engagements is an attribute of State sovereignty*" (emphasis mine).

[124] Supra Bantekas (n. 116) 201.

[125] See: section 2.3.2 below, section 3.2.4 in Chapter 3; and sections 4.2.5 and 4.2.6 of Chapter 4.

matters. In an investor-state arbitration in which the claimant investor claims the host state has violated IIT protections through taxation, as long as nothing in the applicable arbitration agreement (which is likely to be the dispute resolution provision in the applicable treaty, or possibly a unilateral offer to arbitrate in the host state's domestic law) precludes arbitration on matters of taxation (whether general or protection-specific (e.g. national treatment)) and/or as long as the applicable IIT containing the treaty protections does have tax exclusions for all or some treaty protections, an arbitral tribunal will have the jurisdiction to preside over the dispute.

If an arbitral tribunal finds that it has jurisdiction, the burden of proof on a foreign investor to convince an arbitral tribunal to find a state liable for an alleged breach of a treaty obligation by taxation will not be straightforward whether it is for breach of national treatment, expropriation or any other treaty protection because there is a presumption of validity of the host state's legislation. A quote from the recent *El Paso*[126] award serves this point well:

> The tax policy of a country is a matter relating to the sovereign power of the State and its power to impose taxes on its territory. The Tribunal agrees that the State has a sovereign right to enact the tax measures it deems appropriate at any particular time. Every year, governments around the world propose the adoption of tax measures which constitute either new initiatives or amendments to the existing fiscal legislation. There is a *presumption of validity in favour of legislative measures* adopted by a State, and it is up to *those who challenge such measures to demonstrate their invalidity*. This idea has been embodied in Article XII of the BIT, the effect of which is to only limit slightly the State's power to levy taxes[127](emphasis mine).

2.3.2 Tax Exclusions and Tax Vetoes in International Investment Treaties

The avoidance of the applicability of treaty protections to matters of taxation comes in the form of exclusions or vetoes. Some IITs exclude the application of all IIT provisions

[126] *El Paso Energy International Company v Argentine Republic*, ICSID Case No. ARB/03/15, Award of 31 October 2011.
[127] *ibid* at para 290.

to matters relating to taxation[128] and this makes all alleged treaty violations by taxation subject only to the courts of the host state. IITs generally do not exclude the application of all treaty provisions from tax measures, but most do exclude national treatment and most-favoured-nation (MFN)[129] while permitting the application of expropriation provisions to tax matters.[130] Sticking with national treatment and MFN for now, in practice, such exclusions will enable a host state to give advantages to its national investors or investments or those of a third state without extending the advantages to investors and investments of the other party to the IIT, basically amounting to favouritism/discrimination. The primary reason for the tax exclusion to national treatment and MFN protections is for IIT signatories to retain as much fiscal sovereignty as possible.[131] Differential tax treatment between a foreign investor and a host state national or a national of a third state are, as stated in Chapter 1, straightforward to prove.[132] Tax advantages and incentives (together 'advantages') are commonly given to host state nationals or nationals of third states (through reciprocal agreements), therefore disadvantaging many foreign investors who are nationals of states not privy to such advantages. These hypothetical aggrieved investors would have legitimate claims against a hypothetical host state through IITs that make tax matters in relation to national treatment and MFN arbitrable, thus resulting in: (i) a loss of fiscal sovereignty through arbitral awards finding the host state liable to pay damages; (ii) the host state amending its tax laws to avoid future claims by the same and other investors; (iii) a loss of tax sovereignty by acquiescing to investor demands on tax matters due to threats of arbitration (known as 'regulatory chill' – see section 2.4.2.3 below).

[128] Article 5, Agreement between the Government of the Argentine Republic and the Government of New Zealand for the Promotion and Reciprocal Protection of Investments, signed 27 August 1999 (not entered into force as of 1 June 2013) (Argentina-New Zealand BIT); Article 8, Agreement between the Government of New Zealand and the Government of the Republic of Chile for the Promotion and Protection Of Investment, signed 22 July 1999 (not entered into force as of 1 June 2013) (Chile-New Zealand BIT); Article 5, New Zealand and China Agreement on the Promotion and Protection of Investments (with exchange of notes), signed 22 November 1988, entered into force 25 March 1989 (China-New Zealand BIT); Article 8, Agreement between the Government of Hong Kong and the Government of New Zealand for the Promotion and Protection of Investments, signed 6 July 1995, entered into force 5 August 1995 (Hong Kong-New Zealand BIT).

[129] UNCTAD, 'Taxation' (2000), Series on Issues in International Investment Agreements, Doc. No. UNCTAD/ITE/IIT/16, 2 <http://unctad.org/en/docs/iteiit16_en.pdf> accessed 15 August 2011; treaties that exclude taxation from national treatment and MFN standards are discussed in sections 4.2.5 and 4.2.6 of Chapter 4.

[130] UNCTAD, 'Expropriation' (2012) UNCTAD Series on Issues in International Investment Agreements II, Doc No. UNCTAD/DIAE/IA/2011/7 , 133 <http://unctad.org/en/docs/unctaddiaeia2011d7_en.pdf> accessed 4 January 2013 (UNCTAD Expropriation 2012).

[131] UNCTAD, 'Taxation' (2000) (n. 127) 36.

[132] Andrew Newcombe and Lluís Paradell, *Law and Practice of Investment Treaties – Standards of Treatment*, (Kluwer Law International 2009), 184.

If not for the national treatment and MFN tax exclusions in most IITs, host states would be constantly held to ransom over their tax policies and this is the position all states with a foreign corporate presence would be in, from ‘developed’ capital exporting countries to ‘developing’ capital importing countries. The situation can be contrasted with expropriation because most arbitral tribunals require substantial deprivation to find a host state liable for expropriation, so even if a tax measure results in tax takings of almost US$80 million, that may not be a substantial a deprivation[133] when that figure amounts to approximately 5.6% of the value of an investment.[134] National treatment, meanwhile, requires only differential treatment between a host state investor and a foreign investor and the significance of quantitative losses are not imperative in finding state liability.

Tax vetoes that are contained in some IITs[135] give home and host state tax authorities the option to review allegedly expropriatory tax measures and make a determination on whether the measures are expropriatory or not, and absent a determination between the authorities, the foreign investor can then bring a claim in arbitration. The reason why states allow the deliberation of tax measures to determine alleged violations expropriation but not violations of national treatment is because the application of national treatment to tax will not give countries enough leeway in pursuing their tax policies, whereby, for example, small quantitative differences in the treatment of host state nationals and foreign investors will result in a treaty violation; expropriation on the other hand will allow differences in the treatment of host state nationals and foreign investors, but to exclude tax matters from expropriation protection will be give states the scope to completely neutralise the enjoyment of foreign investments, for example by taxing all profits, and that would be wholly wrongful and not give investors the confidence to invest in certain countries.

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[133] US$78,347,323 was claimed in *EnCana* (*EnCana* Partial Dissent at para 74).

[134] The US$78.3 million claimed in *EnCana* is approximately 5.6% of the US$1.42 billion sale price that EnCana received for its investments in Ecuador from a Chinese joint venture (EnCana Corporation, ‘2005 News Releases: EnCana to sell its oil and pipeline business in Ecuador to Andes Petroleum Company for US$1.42 billion’, 13 September 2005 <http://www.encana.com/news/newsreleases/2005/P1161204545248.html> accessed 14 December 2010).

[135] For example NAFTA, Article 2103(6); and Article 170(4)(b), Agreement between Japan and the United Mexican States for the Strengthening of the Economic Partnership, entered into force 1 April 2005 (Japan-Mexico BIT).

2.3.3 Enforcement of Awards

An arbitration on tax matters under the ICSID Convention with an award in favour of the claimant investor for the host state's violations of IIT obligations should not experience any hardship at the enforcement stage at the courts of the losing respondent (host) state for two reasons: (i) the award will be enforced as though it is a judgment of the respondent (host) state court;[136] and (ii) if the *lex arbitri* has allowed the arbitration of tax matters, the respondent (host) state cannot decline enforcement of the award by claiming the award violates its domestic law by being on a non-arbitrable matter or for being contrary to its public policy – this is because the host state is estopped from claiming that its domestic law is a barrier to upholding its obligations under international law.[137] States are not justified in violating their obligation to enforce foreign awards under the New York Convention by claiming that by doing so they are relying on their domestic law. This rule, well-recognised under customary international law, is reflected in Article 32 of the ILC Articles on State Responsibility. Nonetheless, given that Article V of the New York Convention grants member states the right to apply public policy considerations to foreign awards, their invocation of domestic public policy rules would not violate Article 32. However, an abusive application of public policy rules under Article V may give rise to the forum's international liability. The principle of estoppel applies only to a state's obligations under international law such as those in IITs; it will not apply to obligations contained in an agreement between a state and an investor.[138]

Although it is generally a rule of public policy for the courts of a state to enforce arbitral awards (including awards made against the enforcing state itself), the enforcing courts will have to balance that rule with refusing enforcement of awards on non-arbitrable matters and awards that violate the public policy of the enforcing state. Arbitral awards

[136] Article 54(1), ICSID Convention.

[137] This principle of estoppel is part of customary international law and is enshrined at Article 32 of the International Law Commission's 2001 Articles on Responsibility of States for Internationally Wrongful Acts (ILC Articles); Article 32 of the ILC Articles is titled "*Irrelevance of Internal Law*" (emphasis original) and provides that: "The responsible State may not rely on the provisions of its internal law as justification for failure to comply with its obligations under this Part." The obligations "under this Part" includes making full reparation for the injury caused by the wrongful act (Article 31, ILC Articles).

[138] *BCB Holdings Ltd and The Belize Bank Ltd v Attorney General of Belize (on behalf of the Government of Belize)*, LCIA Case No. 81169, Award of 29 August 2009 (*BCB Holdings (LCIA))*; and the recognition and enforcement proceedings for the preceding arbitration: *BCB Holdings Ltd and The Belize Bank Ltd v Attorney General of Belize* [2013] CCJ 5 (AJ) (*BCB Holdings (CCJ)*).

on tax laws are an area that have been recognised as falling within the scope of public policy exceptions to enforcement.[139] The arbitral tribunal in *BCB Holdings (LCIA)*[140] awarded the claimants damages in the region of GB£13.4 million/US$22 million[141] for Belize's renege on tax waivers that were part of a unique tax regime contained in a deed that was agreed to by and between the claimants and Belize's Finance Minister in March 2005 and applicable from 1 April 2005.[142] The tax regime contained in the deed was void of Belize's public policy for two primary reasons: (i) it purported to be unalterable by Belize's Parliament, which means it intended on supplanting and superseding all current and future statutes enacted by Belize's legislature, for as long as the claimants operated in Belize[143]; and (ii) the power to enact tax legislation in Belize, including the granting of tax waivers, was constitutionally vested in the Belizean legislature which meant only Belize's Parliament or a body selected by Parliament could give waivers to the payment of taxes,[144] and the enactment of tax legislation is given an extraordinary value by the Belizean constitution which contains special provisions for the making of tax legislation,[145] so Belize's laws could not have been interpreted as granting the Finance Minister "the power to do what the Deed purported to do"[146]. Although the Finance Minister was not prevented from giving the waivers, the waivers could only be enforceable after being approved by Belize's Parliament and that approval was not sought nor was there any intention by the Finance Minister or the claimants to seek such approval.[147] The Finance Minister and the government administration at the time violated Belize's constitution by giving the tax waivers and enforcing them until they left office to be replaced by a new administration.[148] Enforcement of the award was therefore declined on public policy grounds,[149] and an otherwise decision would be "effectively… rewarding corporate citizens for

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[139] ILA, 'Final Report on Public Policy as a Bar to Enforcement of International Arbitral Awards' (2002) ILA New Delhi Conference: Committee on International Commercial Arbitration, 7 at para 30.
[140] *ibid*.
[141] Luke Eric Peterson, 'Caribbean Court of Justice Refuses to Enforce $22 Million (US) LCIA Award that had Upheld Secretive "Illegal" Tax Waivers for Foreign-Owned Companies' *Investment Arbitration Reporter* (New York, 31 July 2013) < http://www.iareporter.com/articles/20130731_1> accessed 1 August 2013.
[142] *BCB Holdings (CCJ)* at paras 1, 4 and 36.
[143] *ibid* at para 36.
[144] *ibid* at para 43.
[145] *ibid* at para 46.
[146] *ibid* at para 47.
[147] *ibid* para 39.
[148] *Investment Arbitration Reporter* 31 July 2013 (n. 139).
[149] *BCB Holdings (CCJ)* at paras 3 and 61.

participating in the violation of the fundamental law of Belize and punishing the State for refusing to acquiesce in the violation."[150] Unfortunately, the court did not consider the non-arbitrability of tax because the public policy point disposed of the case.[151]

Objections to enforcement of arbitral awards for tax matters should only occur for legitimate public policy objections such as that in *BCB Holdings*, or if tax was not arbitrable on the basis of tax exclusions,[152] or if the awards order more than only monetary damages, such as a total impeachment on the sovereignty of the host state by requiring it to change its laws or not levy certain taxes.[153]

In the pro-arbitration environment, courts apply the public policy objection in a restrictive manner because enforcement of awards is a public policy objective itself in light of globalisation and interdependence of the world, where "it is in the interest of the promotion of international trade and commerce that courts should eschew a uniquely nationalistic approach to the recognition of foreign awards."[154]

2.4 Foreign Direct Investment, International Investment Treaties and Tax Arbitration

In this section, I will put together the complex web of interactions between FDI, IITs and tax arbitration. At 2.4.1, Brazil's success in being a major capital importer of FDI without ratifying any BITs is discussed because the attraction of FDI is normally stated to be the primary reason that states enter into IITs and importantly IITs with arbitration agreements.

At 2.4.2, the risks to host states in acquiescing to international investment arbitration are discussed. This will look at arbitrators' expansive approach to jurisdiction which means that the investors' claims are likely to reach the merits phase; economic risks to a

[150] *ibid* at para 61.
[151] *ibid* at para 17.
[152] *Republic of Ecuador v Occidental Exploration & Production Co* [2006] EWHC (Comm) at para 3.
[153] An arbitral award in favour of the investor which awards monetary damages for illegitimate taxation measures will be an indirect way of ruling that the host state's laws or actions are wrongful, and this would be an indication to the host state that it should amend whatever measure(s) have resulted in the arbitration and its subsequent losing the arbitration or else face more disputes in the future for the same measure(s); this is not to be confused with arbitration for a 'lawful' expropriation in lieu of compensation (see opening section of Chapter 3 on the distinction between lawful and unlawful expropriation).
[154] *BCB Holdings (CCJ)* at para 24.

respondent state from arbitration; regulatory chill used by foreign investors (particularly multinational enterprises (MNEs) who have immense power and resources) to control host states' laws; and moral hazards that affect the host states including the underdevelopment of developing host state's judiciaries who do not get to rule on complex investment matters, the reputation of investment arbitration in putting corporate profits ahead of host states' public interest and the perception of bias of arbitrators in favour of investors. The reason that these topics are discussed together is they intertwine with one another when host states make legislative decisions and take action. In short, the following is an example of what host states may think when exploring the possibility of introducing a new type of tax, e.g. a tax on oil exports over a certain threshold when all oil exporters who exceed that threshold are foreign investors (possible violation of national treatment and fair and equitable treatment):

(i) if a foreign investor in the oil export industry brings a claim in arbitration, they are likely to succeed on jurisdiction (see 2.4.2.1);

(ii) because the dispute will proceed to the merits phase, the state faces the risk of losing a substantial amount of money in defending the claim, and if unsuccessful in arbitration, in paying damages to the investor (see 2.4.2.2);

(iii) before the dispute is even concluded, it will be public knowledge that the state is facing a claim for violations of international law and that can divert FDI away from that state (see 2.4.2.2);

(iv) in addition to claimant-friendly awards on jurisdiction, investment arbitration has a reputation of putting corporate profits before the public interest and the public welfare is currently dependent on a boost in tax collections (e.g. to employ medical staff due to a public health crisis), so according to this perception the arbitral tribunal is likely to make its decision by erring on the side of the alleged treaty violation than the public welfare (see 2.4.2.4(ii));

(v) in addition to (iv) above, there is a perception of pro-investor bias by international investment arbitrators and so that is more reason why a loss in arbitration is likely (see 2.4.2.4(iii)) in favour of investors; and

(vi) due to all of the above, the investors will threaten to bring arbitral proceedings before the tax is introduced to stop the state from introducing it, and if it has been introduced, they will threaten arbitration to have the state withdraw the new tax and pay settlement monies for any taxes already taken (see section 2.4.2.3 below).

2.4.1 Brazil's Success in Attracting Foreign Direct Investment and Avoiding International Investment Arbitration

The efficacy of IITs in attracting FDI is a disputed subject.[155] Some authors have affirmed the effectiveness of BITs in attracting FDI[156] and others dispute the same.[157] What is certain is that a country which respects foreign investors' property rights[158] will gain and maintain a good reputation among global investors,[159] and if it has entered into BITs (which contain the minimum a foreign investor can expect from the host state), that further demonstrates an "*ex ante* willingness to respect FDI."[160] Brazil is a prime example of a state that respects foreign investments and has been able to become one of the biggest capital importers of FDI in the world without ratifying one BIT, therefore keeping hold of any sovereignty that it would have parted from by entering into BITs with other states that provide for international investment arbitration.

Despite the rapid increase in the signing and ratification of BITs, Brazil only signed 14 BITs in the 1990s but did not ratify any of them.[161] This has not deterred inward FDI

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[155] Past research in this area has focused on the efficacy of BITs because their quantitative domination in the IIT universe make would make them the most influential type IIT for FDI.
[156] Swenson (n. 78) 14; Allee and Peinhardt (n. 91) 19; Eric Neumayer and Laura Spress, 'Do Bilateral Investment Treaties Increase Foreign Direct Investment to Developing Countries?' (2005) LSE Research Online, 27 <http://eprints.lse.ac.uk/627/> accessed 2 February 2012.
[157] Jennifer Tobin and Susan Rose-Ackerman, 'Foreign Direct Investment and the Business Environment in Developing Countries: The Impact of Bilateral Investment Treaties' (2005) Yale Law School, Centre for Law, Economics and Public Policy, Research Paper No. 293, 31 <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=557121> accessed 2 February 2012; Bruce A. Blonigen and Ronald D. Davies, 'The Effects of Bilateral Tax Treaties on U.S. FDI Activity', (2004) 11:5 *Int'l Tax & Pub. Fin.* 601, 616; Mary Hallward-Driemeier, 'Do Bilateral Investment Treaties Attract FDI? Only a bit…and they could bite', (June 2003) World Bank Development Research Group, 22 <http://elibrary.worldbank.org/content/workingpaper/10.1596/1813-9450-3121> accessed 5 February 2012.
[158] Some foreign investors will not be deterred if the host state does not respect the property rights of its nationals who could have fewer resources than the foreign investor to fight the government, or they could also be worse off than a foreign investor because there is no IIT for a national to bring a claim under.
[159] See discussion on Brazil at 2.4.1 below.
[160] Allee and Peinhardt (n. 91) 14.
[161] UNCTAD, Full List of Brazil's concluded Bilateral Investment Agreements as of 1 June 2013 <http://unctad.org/Sections/dite_pcbb/docs/bits_brazil.pdf> accessed 14 September 2013. Conversely, it appears as though a treaty between Brazil and Paraguay was signed on 27 October 1956 and ratified on 6 September 1957, but is no longer in force as it does not appear in any reference other than the online resource copied here: Foreign Trade Information System, Information on Paraguay: Bilateral Investment

away from Brazil, partly because BITs are not solely responsible for FDI.[162] In 2012, 32 Latin American and Caribbean countries received US$173.361 billion in FDI,[163] 37.65% (US$65.272 billion[164]) of which was received by Brazil. This is in sharp contrast with Argentina, who received 7.24% (US$12.551 billion) of FDI in 2012,[165] despite 54 BITs being in force in that same period.[166]

Investor-state arbitration is one of the primary grievances that developing countries have with BITs which they have ratified, especially Latin American countries, and these reservations were documented in Brazil when it had four BITs tabled together for signing in 1996.[167] Brazil's problem with international arbitration was the fact that it would allow foreign investors to unilaterally bypass the Brazilian national courts.[168] A foreign investor bypassing the Brazilian national courts can be seen as putting the foreign investor in a more advantageous position than a Brazilian investor and that would undermine the Calvo Doctrine,[169] under which foreign investors cannot be afforded more favourable treatment than national investors. Indeed, "South American rules of civil procedure require that all tax disputes be settled by national judicial authorities" and they therefore face a conflict between a "prohibition on submitting tax disputes to arbitration and international commitments to be bound by arbitration when there is an arbitration clause in a treaty."[170] Despite the need for international trade and investment pushing South American countries into ceding on their tax sovereignty by

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Treaties <http://www.sice.oas.org/ctyindex/BRZ/BRZBits_e.asp> accessed 3 June 2012. The likelihood of the treaty being a BIT is unlikely as it is widely reported that the first BIT was signed in 1959 (see The Emergence of International Investment Treaties above).

[162] Hallward-Driemier (n. 157) 20; Leany Lemos and Daniela Campello, 'The Non-Ratificiation of Bilateral Investment Treaties in Brazil: A Story of Conflict in a Land of Cooperation' (2013) Government of the Federative Republic of Brazil and Princeton University, 4 <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2243120> accessed 12 May 2013.

[163] ECLAC, 'Foreign Direct Investment in Latin America and the Caribbean 2012 – Themes of the Report', (June 2013) 4, <http://www.cepal.org/noticias/paginas/1/33941/2013-371_PPT_FDI-2013.pdf> accessed 15 September 2013.

[164] ECLAC, 'Foreign Direct Investment in Latin America and the Caribbean 2012' (June 2013), 51 < http://www.cepal.org/publicaciones/xml/4/49844/ForeignDirectInvestment2012.pdf> accessed 15 September 2013.

[165] Ibid.

[166] UNCTAD, Full List of Argentina's concluded Bilateral Investment Agreements as of 1 June 2013, <http://unctad.org/Sections/dite_pcbb/docs/bits_argentina.pdf> accessed 14 September 2013. This list shows that 57 BITs had been signed as of 1 June 2013 but 3 had net yet entered into force.

[167] Lemos and Campello (n. 160) 18.

[168] *ibid* 19.

[169] Carlos Calvo, *Le Droit International: Théorétique et Practique*, (5th Edition, vol. VI, Paris 1896), 231. Translation by Donald Shea, *The Calvo Clause: A problem of International Law and Diplomacy* (Minnesota University Press 1955) 18-19.

[170] Cruz (n. 7) 540.

entering into IITs with arbitration agreements,[171] Brazil has successfully created a win-win situation for itself with respect to IITs and it seems to be in a special situation because South American states find it exceptionally difficult to attract risk-averse investors who would not invest capital in countries who have ratified BITs without arbitration agreements in them.[172]

Although some BITs that were negotiated with Brazil eliminated international arbitration[173] or required the government's consent to arbitrate,[174] as well as bringing other aspects of the BITs in line with Brazil's public policy,[175] Brazil never ratified any BITs.[176] As is discussed below in section 2.4.2, BITs impose obligations on the host state but do not impose obligations on the foreign investor or his home state. This fact, together with parting with sovereignty, put Brazil off signing BITs, bearing in mind how much (or little) difference a BIT would make to FDI, especially because Brazil viewed BITs as a "by-product of the Washington Consensus under the neo-liberal influence"[177] and drafted under the recommendation of the Organisation for Economic Cooperation and Development (OECD).[178] The issue taken by Brazil with the Washington Consensus and the OECD was that BITs were promulgated by and drafted under recommendations favouring states in the position of a capital exporting home country, and do not impose duties on those home countries,[179] or the investors (such as the responsible exploitation of natural reserves).

Instead of jumping on the BIT bandwagon, Brazil chose to open its economy to foreign investment with domestic laws,[180] and these laws are used to regulate foreign

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[171] *ibid.*
[172] *ibid.*
[173] Lemos and Campello (n. 162) 19.
[174] *ibid* 20.
[175] For example, compensation for expropriation in Brazil can be a 10 year debt payment (*ibid* 19 at footnote 16), rather than the prominent "prompt and adequate compensation" required under BITs and customary international law.
[176] Brazil is a member of the GATT, GATS, and TRIMS Agreement. Brazil has however signed and ratified a number of BTTs to encourage inward FDI.
[177] Dan Wei, 'Bilateral Investment Treaties: An Empirical Analysis of the Practices of Brazil and China', (2012) 33 *Eur J Law Econ* 663, 671.
[178] *ibid*.
[179] *ibid*.
[180] Brazil has a domestic investment regime which was approved by its Congress in the 1990s which mirrors the minimum standards of IITs Lemos and Campello (n. 162) 13), including equal treatment to foreign businesses, meanwhile it also ended state monopolies thus opening huge markets such as telecommunications to its domestic as well as foreign investors.

investment,[181] whereas it was believed by Brazil's policymakers that BITs would have restricted the country's ability to effectively regulate capitals[182] in that active and necessary regulation (such as environmental regulation) could consequently result in an expensive arbitration under a BIT.[183]

Out of the advanced economic development BRIC countries,[184] China has signed 128 BITs,[185] 103 of which have been ratified, making it the country with the most ratified BITs out of the four BRIC countries. Brazil on the other has not ratified any BITs, putting the two countries on two sides of a BIT spectrum. China's FDI inflows in 2012 is estimated to be US$253 billion (18% of global FDI inflows)[186] which makes it the greatest FDI attractor, the United states (with 46 signed BITs and 40 ratified,[187] as well as being a NAFTA member state and having signed FTAs with 20 countries[188]) was in second place with US$175 billion inward FDI, and Brazil was (without any ratified BITs) in third place with US$65 billion, which is a significant feat for the country.

One cannot say what difference will be made (if any) to Brazil's inward FDI if it signs and ratifies BITs, but it has done remarkably well without any BITs,[189] meanwhile preserving its sovereignty by dictating its investment laws itself[190] and having its

[181] Lemos and Campello (n. 162) 20.
[182] *ibid*.
[183] *Compañía del Desarrrollo de Santa Elena S.A. v The Republic of Costa Rica*, ICSID Case No. ARB/96/1 (*Santa Elena*).
[184] Brazil, Russia, India and China.
[185] UNCTAD, Full List of China's concluded Bilateral Investment Agreements as of 1 June 2013 <http://unctad.org/Sections/dite_pcbb/docs/bits_china.pdf> accessed 14 September 2013.
[186] OECD, 'FDI in Figures'. April 2013, 1 <http://www.oecd.org/daf/inv/FDI%20in%20figures.pdf> accessed 14 September 2013.
[187] UNCTAD, Full List of the United States' concluded Bilateral Investment Agreements as of 1 June 2013 <http://unctad.org/Sections/dite_pcbb/docs/bits_us.pdf> accessed 14 September 2013.
[188] Office of the United States Trade Representative (USTR), Free Trade Agreements, <http://www.ustr.gov/trade-agreements/free-trade-agreements> accessed 14 September 2013.
[189] Brazil has recently experienced the biggest dollar outflow since 2002 in the amount of US$12.26 billion in 2013 (Samantha Pearson, 'Brazil: The End of an Era as Outflows Hit 10-Year High *Financial Times* (8 January 2014) <http://blogs.ft.com/beyond-brics/2014/01/08/brazil-the-end-of-an-era/#axzz2reZy7Ne7> accessed 9 January 2014). That was mainly due to the tapering by the United States Federal Reserve of its economic stimulus programme (i.e. quantitative easing) which reversed flows of capital into Brazil which was otherwise doing very well in 2013 (Samantha Person, *Financial Times*). However, government interference in the corporate sector, including the energy and financial sectors, as well as "erratic policy making characterised by price controls, ad hoc benefits for sectors and creative accounting on the fiscal front" have also played a role in the outflux of FDI (Joe Leahy, 'Brazil Goes on a Corporate Charm Offensive' *Financial Times* (São Paulo, 24 January 2014) <http://www.ft.com/cms/s/0/43339c28-851e-11e3-86f7-00144feab7de.html#axzz2reXt2QUb> accessed 25 January 2014.
[190] see n.180 above and Lemos and Campello (n. 162) 13.

conduct assessed in its own national courts by its own national judges. On the arbitration front, the Brazilian Congress passed a pro-arbitration law in 1996 (Brazilian Arbitration Law),[191] which gives a domestic arbitral award the same effect on the parties as a judgement issued by a Brazilian state court.[192] The Brazilian Arbitration Law also recognises and allows for the enforcement of foreign arbitral awards,[193] subject to homologation by the Brazilian Federal Supreme Court,[194] and homologation can only be refused for the usual reasons found in most progressive national arbitration laws, such as requiring a valid arbitration agreement, the correct procedures being followed, the award does not fall foul of the public policy of the state of enforcement, the matter was capable of settlement by arbitration (arbitrable), etc. Recognition and enforcement of a foreign award, like its domestic counterpart, has the same effect on the parties as a judgement by a Brazilian state court.[195] Prior to the enactment of the Brazilian Arbitration Law, the procedure for homologation of a foreign arbitral award was the same as that applied to foreign national court judgments which was a procedure carried out by the Brazilian Federal Supreme Court under Article 102(I)(h) of the Brazilian Constitution,[196] which did not have the typical rules for recognition and enforcement of arbitral awards found in most modern national arbitration laws. Brazil also ratified the all-important New York Convention, as well as the Panama Convention[197] and the Montevideo Convention.[198]

2.4.2 The Threat of Arbitration to Tax Sovereignty as a Trade-Off to Attract Foreign Direct Investment

What is certain about IITs is their effectiveness in increasing the number of claims brought by foreign investors against host states, especially by claimants from capital-exporting developed countries against developing host nations. A country that ratifies a BIT in order to attract investment is at risk of having to settle or defend claims for compensation being brought by foreign investors for either genuine claims or

[191] Brazilian Arbitration Law No. 9.307 of 23 September 1996.
[192] *ibid*, Article 31.
[193] *ibid*, Article 34.
[194] *ibid*, Article 35.
[195] Wei (n. 177) 670.
[196] Constitution of the Federal Republic of Brazil, ratified 5 October 1988.
[197] 1975 Inter-American Convention on International Commercial Arbitration (Panama Convention).
[198] 1979 Inter-American Convention on Extraterritorial Validity of Foreign Judgments and Arbitral Awards (Montevideo Convention).

alternatively for losses the investors would otherwise have assumed as being part of the normal risk in establishing and running a business.[199] The cause of this is the famous asymmetry of BITs, whereby they grant investors of home states rights but do not impose obligations on them, but they impose obligations on host states which are unaccompanied by rights.[200] This is a *prima facie* asymmetry and is easy to recognise in the title of most IITs that include the words "promotion and reciprocal protection of investment". However, this asymmetry exists not because of a pro-investor bias, but because host states can give rights to themselves in their own domestic legislation. In addition, any risk that factually meritless claims may be made by investors should not (and do not) preclude the rights of said investors from making (what they believe to be) genuine claims, because investors, whether individuals or corporate entities, and whether local or foreign, have the right to expect the countries in which they are investing to uphold their rights. Although some investors try to cut their losses (or maybe try to make extra gains) by bringing a claim against a host state, to apply a blanket prohibition of recourse to a fair and just judiciary or tribunal would be a denial of justice, resulting in sovereignty being nothing more than organised robbery.

Over recent years, there has been a steady increase in the number of governments who have responded to one or more investment treaty arbitrations, from 61 at the end of 2005[201] to 95 at the end of 2012,[202] 61 were developing countries, 18 were developed countries and 16 were countries with economies in transition.[203] By the end of 2012, there were a total number of 514 known treaty-based investor-state arbitrations,[204] with the largest number of claims brought against Argentina (52 claims), followed by Venezuela (34), Ecuador (23), Mexico (21) and Czech Republic (20).[205]

A state that exercises its sovereignty by utilising its decision making powers within its territories will (as discussed above) concede some of its sovereignty by having the

[199] Hallward-Driemier (n.157) 7.
[200] Jason Webb Yackee, 'Investment Treaties and Investor Corruption: An Emerging Defense for Host States' (2012) 52:3 *Va. J. Int'l L.*,723.
[201] UNCTAD, 'Latest Developments in Investor-State Dispute Settlement' (2005) IIT Monitor No.4, Doc No. UNCTAD/WEB/ITE/IIT/2005/2, 3
<http://bit.escwa.org.lb/CMSPages/GetFile.aspx?nodeguid=a7831054-0ed6-4040-8480-4b2c7a16116e> accessed 28 June 2012.
[202] UNCTAD ISDS 2013 (n. 92) 4.
[203] *ibid*.
[204] *ibid,* 1.
[205] *ibid* 29.

legitimacy of those decisions debated either in arbitration or in a supranational arena like the WTO. Those compromises can in themselves lead to further concessions that states make when acquiescing to arbitration, such as the possibility of arbitrators taking an expansive (claimant-friendly) approach to matters of jurisdiction and admissibility, economic risks, regulatory chill effects and moral hazard issues all of which are discussed in sections 2.4.2.1 to 2.4.2.4 below. In the context of the foregoing, the reader must keep in mind that what is written in those sections is included for arguments sake on an unquantified and rather unquantifiable possibility that states risk losing some tax sovereignty on the basis expansive jurisdictional awards, economic risks, regulatory chill and moral hazard issues. These are discussed because they can factor into why states, whether they are developed or developing capital importers, or developed or developing capital exporters, include tax exclusions and tax vetoes in their IITs. The reader is also directed to the conclusion of this chapter which contains the major caveat to the foregoing sections.

2.4.2.1 Expansive Jurisdiction Awards

A respondent state could have a claim dismissed early on in proceedings if it is successful in making a preliminary objection, for example under ICSID Rule 41(5), whereby the objector must prove that a claim is manifestly without legal merit,[206] or under a preliminary objection governed by the relevant IIT.[207] Yet even on this premise, a claim that has the legal merit to be tried but for which the factual allegations are of a

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[206] Rule 41(5), ICSID Rules; In *Trans-Global v The Hashemite Kingdom of Jordan*, ICSID Case No. ARB/07/25, the tribunal's Decision on the Respondents Objection under Rule 41(5) of the ICSID Arbitration Rules, the tribunal correctly asserted that the phrase "manifestly without legal merit" is a succinct phrase susceptible to different meanings (at para 75). The tribunal's interpretation was that nothing factual need be considered by the tribunal, even if the factual allegations are frivolous, vexatious or made in bad faith (at para 105). A preliminary objection would only be successful if no legal obligation was imposed on the respondent state by an IIT (no matter what actions the respondent State had taken to harm the claimant's investment). However, where there is a legal obligation imposed on State, a claimant investor may bring a claim for compensation for losses even though those losses may have been or should have been deemed to be part of the investment risk. The arbitral tribunal in *Brandes Investment Partners, LP v Bolivarian Republic of Venezuela*, ICSID Case No. ARB/08/3, Decision on the Respondent's Objection under Rule 41(5) of the ICSID Arbitration Rules, adopted a similar approach to the tribunal in *Trans-Global*, in which they only required *prima facie* plausible facts to be presented by the claimant in the Request for Arbitration (para 69), and that a preliminary objection under ICSID Rule 41(5) would therefore only be granted if a claim is manifestly without legal merit and not on the absence of a factual basis (para 70).

[207] *Pac Rim Cayman LLC v Republic of El Salvador*, ICSID Case No. ARB/09/12, Decision on the Respondent's Preliminary Objections under CAFTA Articles 10.20.4 and 10.20.5 (*Pac Rim* Decision on Preliminary Objections).

frivolous or vexatious nature will go past the preliminary stage of proceedings and will be a costly endeavour for a respondent to submit to.

It is common knowledge that arbitrators tend to take a claimant-friendly approach on preliminary matters of jurisdiction and this assertion was proved by a recent study that examined 140 awards dealing with jurisdictional matters in investment treaty arbitrations up to May 2010.[208] These awards determine (among other preliminary matters) objections to jurisdiction of the arbitral tribunal under provisions such as ICSID Rule 41(5). The study reported a tendency of arbitrators to take an expansive 'claimant-friendly' approach rather than a restrictive 'respondent-friendly' approach on matters of jurisdiction and admissibility,[209] especially under a BIT or the ECT[210] and most notably for claimants from Western capital-exporting states,[211] specifically the United States followed by the United Kingdom and France.[212] This effectively means that respondent-states will most likely fail in an attempt to halt the arbitration from proceeding any further, resulting in costs being incurred which run into millions of pounds, dollars or euros, and even if the claim is of a vexatious or frivolous nature and is the waste of time and money for natural justice (not necessarily a waste of time and money for corporate purposes – see section 2.4.2.3 below), the likelihood is that each party will bear its own costs and pay half of the arbitral tribunal's fees[213] (investor-state arbitration costs usually run into the millions of pounds – see *Economic Risk* next below).

2.4.2.2 Economic Risk

The economic risks of arbitration faced by governments are twofold; (i) there is the monetary cost of arbitration, including legal fees, arbitrators' fees, expert witnesses, venue hire, and recognition and enforcement proceedings; and (ii) there is a negative

[208] Gus Van Harten, 'Arbitrator Behaviour in Asymmetrical Adjudication: An Empirical Study of Investment Treaty Arbitration', (2012) 50 *Osgoode Hall L. J.* 211, 214.
[209] *ibid* 237.
[210] *ibid* 241, 249.
[211] *ibid* 248-249.
[212] *ibid* 241-242.
[213] *Fireman's Fund Insurance Company v United Mexican States*, ICSID AF Case No. ARB(AF)/02/01, Award of 17 July 2006); see section 3.4.3 of Chapter 3.

reputational risk suffered by a state who is respondent in arbitrations, resulting in a decrease of inward FDI.

(i) Monetary Arbitration Costs

The cost of international arbitration has been identified as a major disadvantage of arbitration[214] and costs can run into the hundreds of thousands up to the multiple millions of pounds or dollars.

As already mentioned, most respondent-states are developing nations. Two major problems stemming from arbitration are posed for these countries, firstly, costs incurred on legal fees for a successful defence to a claim (and 'reasonable' costs are not always paid by an unsuccessful claimant to a successful respondent) could be better spent on developing the country and helping its inhabitants; secondly, if the respondent loses on the merits, the arbitral award can be a significant percentage of its gross domestic product (GDP).[215]

(a) In respect of the cost of arbitrators' fees, legal fees and administrative fees, a respondent-state that wins the case can still be liable for very hefty fees. For example, in *Plama Consortium Limited*[216] the arbitral tribunal decided in favour of Bulgaria, ruling that the damage suffered to the claimant was not attributable to any unlawful action by the state[217] and that in any event the claimant obtained its investment in Bulgaria through fraudulent misrepresentation.[218] Despite this, the tribunal ordered the claimant to pay the tribunal's fees and expenses of US$948,000, to pay the respondent's advance on costs of US$460,000

[214] 'International Arbitration: 'Corporate Attitudes and Practices'', (2006) Pricewaterhouse Coopers and Queen Mary University School of International Arbitration, 19 <http://www.arbitrationonline.org/docs/IAstudy_2006.pdf> accessed 15 September 2013.
[215] Kevin P. Gallagher and Elen Shrestha, 'Investment Treaty Arbitration and Developing Countries: A Re-Appraisal', (2011) Global Development and Environment Institute Working Paper No. 11-01, 9 <http://ase.tufts.edu/gdae/Pubs/wp/11-01TreatyArbitrationReappraisal.pdf> accessed 12 September 2013.
[216] *Plama Consortium Limited v Republic of Bulgaria*, ICSID Case No. ARB/03/24, Award of 27 August 2008.
[217] *ibid* at para 305.
[218] *ibid* at paras 143 and 321.

and US$7 million of Bulgaria's legal costs.[219] This left the Bulgarian government, i.e. the Bulgarian taxpayer, liable for the remaining US$6,243,357[220] of the costs for defending a meritless claim. This was at a time of a healthcare crisis due to the shortage of nurses in Bulgaria, and US$6,243,357 would have paid the salaries of 1,796 nurses.[221] Although Bulgaria's legal costs were substantially more than the claimant's US$4.6 million legal costs, resulting in the tribunal deciding that $US7 million would have been reasonable costs for defence, the fact is the claimant brought a meritless claim for over US$122 million for losses it incurred under a contract procured by fraudulent misrepresentation, so it should be the host state's right to incur whatever fees are necessary to defend such a frivolous claim.

(b) With respect to arbitral awards, the cost to a developing nation can be significant. The likelihood of a respondent-state being a developing country is high. For example, by the end of 2012, the United States was the home country in 123 arbitrations (24% of all known investor-state disputes),[222] and 80% of the United States' investment treaties are with developing countries (as classified by the World Bank),[223] statistically therefore most investment arbitrations involving the United States as home state will be against a developing country. Five awards rendered in favour of United States investors (four against Argentina and one against Ecuador) have ranged between US$2.7 to US$5.5 per capita of the Argentinian/Ecuadorian populations.[224] The average award that Canada is liable to pay a United States investor amounts to 0.003% of its annual government expenditure or US$ 12 cents per capita.[225] Arbitral awards made against developing countries as a percentage of government annual

[219] *ibid* at para 324.
[220] Bulgaria's legal fees totalled US$13,243,357.
[221] Pia Eberhardt and Cecilia Olivet, 'Profiting from Injustice' (2012) Corporate Europe Observatory and the Transnational Institute, 15 <http://www.tni.org/sites/www.tni.org/files/download/profitingfrominjustice.pdf> accessed 1 September 2013.
[222] UNCTAD ISDS 2013 (n. 92) 4.
[223] Gallagher and Shrestha (n. 213) 7-8.
[224] *ibid*, 9.
[225] *ibid*.

expenditure amounts to 0.53% or US$ 99 cents per capita.[226] The average award rendered in favour of a United states investor is US$47 million[227] and when excluding awards it has won against Canada (which is the only high-income country against which a United States investor has won an arbitration)[228] that number increases to US$50 million.[229] The average award paid by Canada as a host country respondent in arbitration against a United States investor is US$3.9 million.[230] Argentina on the other hand averages a pay-out of US$107 million against United States investors.[231] Therefore, for developing countries, taking into account the fact that arbitrators are likely to rule in favour of their own jurisdiction, the average size of awards, and the size of awards as a measure against GDP or percentage of annual government expenditure, the threat of arbitration alone is enough to persuade developing nations to settle claims (the 'chilling effect' or 'regulatory chill'),[232] including those which may be brought for losses which would otherwise be considered part of the investment risk.

(ii) Reputational Risk

In short, "one of the costs of arbitration for states is a detrimental impact on its 'investor-friendly' reputation."[233] This can be the case whether the arbitration is on-going, decided in favour of the investor, settled before a final award is made, or even if the arbitration is decided in favour of the host state. The fact that a foreign investor claims against a host state for breach of an investment treaty brings with it a reputation that the host state is a risk to invest in (notwithstanding the investment risk posed by the commercial venture). The host state can (perhaps undeservingly) gain a reputation that it does not respect investors' property rights and does not abide by the

[226] *ibid*.
[227] *ibid*.
[228] *ibid*, 12.
[229] *ibid*, 9.
[230] *ibid*.
[231] *ibid*.
[232] *ibid*, 8.
[233] Kyla Tienhaara, 'Regulatory Chill and the Threat of Arbitration' in Chester Brown and Kate Miles (eds), *Evolution in Investment Treaty Law and Arbitration*, (CUP 2012) 609.

minimum standards of treatment enshrined in international law, even if those actions or inactions could be for bona fide regulation. Of course bona fide regulation does not preclude the necessity for compensation to be paid to an investor for outcomes of that regulation, such as for an expropriation by the state of land owned by the investor for environmental reasons.

Reputational risk has been included under the title 'Economic Risk' because it has a direct bearing on FDI. A 2008 study by Todd L. Allee and Clint Pienhardt (the 2008 study) on the reputational effects of investment treaty disputes on FDI[234] discovered one-third of arbitrations in its analysis resulted in an award against the respondent-state.[235] The same study also discovered that one-quarter of arbitrations were settled,[236] and with settlements construed as a "de facto admission of guilt"[237] by the respondent-state, this could also be viewed negatively by investors when deciding on where to export their capital to. With one-third of awards decided against the respondent and the one-quarter being settled depicting an admission of guilt by the respondent, 60% of arbitrations in the study were therefore decided against the respondent-state. A study of the outcome of arbitrations brought by United States investors by 2011[238] shows 15 awards in favour of the investor (29.4%), 14 settlements (27.5%), and 17 awards in favour of the host state (43.1%). Ignoring the settlements, a respondent-state has a greater than 50% chance of the award being rendered in its favour, but this is not good news for host states, especially those which are developing countries, because a "50% chance of catastrophic economic loss would factor into most risk assessments as a bad bet"[239] and therefore this alone is a risk for countries to cautiously consider when signing and ratifying IITs. If one considers settlements as de facto admissions of guilt and therefore losses for the respondent-state, the win-lose ratio is 56.9% on the host state losing against a United States national. These statistics also raise the possibility that

[234] Allee and Peinhardt (n. 91).
[235] *ibid* 12.
[236] *ibid*, 13.
[237] *ibid*.
[238] Gallagher and Shrestha (n. 215) 8.
[239] *ibid*.

developing countries acquiesce to demands of investors under the threat of arbitration, and therefore also do not include unpublicised settlements entered into before proceedings are commenced.[240]

The transparency of ICSID proceedings was mentioned in section 2.2.3.2 above and included the openness of the nature, timing and outcomes of disputes. The transparency of ICSID is excellent and is rightfully lauded as such, however, because ICSID is the most utilised institution for investment arbitration, this transparency may affect FDI due to reputational effects of investment arbitrations – host state losses and post-commencement settlements become public knowledge. The 2008 study reported that FDI is reduced even when ICSID arbitrations are pending or unresolved[241] and this reduction becomes greater with an ultimate loss, whereby one loss for a state offset "the predicted FDI benefits associated with signing between seven and ten additional BITs."[242]

2.4.2.3 Regulatory Chill

In addition to and because of the above economic risks of a country ratifying either or both IITs with arbitration provisions or the ICSID Convention, the threat of arbitration can also be used by foreign investors against a host state for what is called the *regulatory chill* hypothesis. Regulatory chill is used to describe the threat by investors of commencing arbitration proceedings against a host State if that host state does or does not do certain things that may affect the investments and tax measures are no exception. A host state may then acquiesce to the investors' demands in fear of the economic damage it could suffer as respondent in arbitration proceedings. Regulatory chill and the economic risks outlined above are some of the reasons that countries have either not entered into (Brazil) or are withdrawing from BITs,[243] do not have standing offers to arbitrate in their IITs or domestic investment laws, and/or have not entered into

[240] *ibid*.
[241] Allee and Peinhardt (n. 91) 20-21.
[242] *ibid* 20.
[243] Bolivia terminated its BIT with the United States; Venezuela terminated its BIT with the Netherlands; and Ecuador's president asked the country's national assembly to approve the termination of its BIT with the United States.

or are withdrawing from the ICSID Convention,[244] all in order to avoid bowing to investors' threats, as long as they can still attract FDI.[245] The standing offers to arbitrate in the Georgian,[246] El Salvadoran,[247] and Egyptian[248] investment laws listed above at section 2.2.3.3 have all been amended to remove the standing offer to arbitrate and in the case of Kazakhstan,[249] the provision has been repealed completely.

Regulatory chill is now a fact and no longer a mere hypothesis. It definitely exists, it is used in practice and it makes complete commercial sense for MNEs to use it to their advantage when deemed necessary. The threat of litigation is used in commerce no matter what the investments are worth, be they thousands of pounds up to the multiple billions, and the threat of arbitration in negotiations with a host state on regulatory issues is no exception. Below are two reported examples of regulatory chill experienced by Costa Rica:

(i) In Costa Rica, 2002 was an election year and all three leading candidates for president voiced their opposition to oil exploration in the country. The winner of the election race was Abel Pacheco, and declaring 'peace with nature', he placed a moratorium on future oil and gas exploration and large-scale open pit mining projects.[250] Four years prior to the election, in 1998, a

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[244] Bolivia submitted a notice of denunciation from the ICSID Convention on 2 May 2007 and its withdrawal effective on 3 November 2007 (denunciation is effective 6 months after notice pursuant to Article 71 of the ICSID Convention); Ecuador submitted its notice of denunciation on 6 July 2009 and its withdrawal was effective on 7 January 2010; Venezuela submitted its notice of denunciation on 24 January 2012 and its withdrawal was effective on 25 July 2012.

[245] Although Argentina has been hit by many international investment arbitrations because of a domino effect since the economic crisis it suffered from 1999 to 2002, it still manages to attract FDI, and without recourse to investment arbitration by foreign investors, it is difficult to imagine that it would still attract as much FDI as it has been without those safeguards in place for foreign investors.

[246] Luke Eric Peterson, 'Georgia Amends Foreign Investment Law so as to Remove International Arbitration and Legal Stabilization; One Claim is Pending Under the Law' *Investment Arbitration Reporter* (New York, 2 July 2010).

[247] Luke Eric Peterson, 'As El Salvador Removes ICSID Offer from Domestic Investment Law, a Final Claim Emerges; Meanwhile, Commerce Group Case Ends Due to Lack of Funds' *Investment Arbitration Reporter* (New York, 10 September 2013).

[248] Luke Eric Peterson, 'Growing Number of Governments are Amending Domestic Investment Laws so as to Preclude Unilateral Recourse by Investors to International Arbitration' *Investment Arbitration Reporter* (New York, 10 September 2013).

[249] Luke Eric Peterson, 'Analysis: UNCITRAL Tribunal parts ways with ICSID Tribunal on Validity of Arbitration-Offer in Repealed Kazakh Foreign Investment Statute' *Investment Arbitration Reporter* (New York, 4 August 2013).

[250] Kyla Tienhaara, 'Regulatory Chill and the Threat of Arbitration: A View from Political Science' (2010) Regulatory Institutions Network and Australian National University, 19 < http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2065706> accessed 18 September 2013 (reprinted in Chester Brown and Kate Miles (n. 233); the environmental damage caused to the natural habitats in South

United states based company called MKJ Xploration acquired four concession blocks (two onshore and two offshore), and in November 1998 another United states company called *Harken Energy* acquired an 80% stake in that concession[251] (the Concession). Harken Energy's exploration was halted because of the moratorium as well as its Environmental Impact Assessment (EIA) being below par (confirmed by an independent external review). Harken Energy took the view that its EIA was arbitrarily rejected because of the moratorium and subsequently submitted a request for ICSID arbitration under the concession agreement (the Dominican Republic-Central America FTA (CAFTA-DR)[252] was not in force and there was no BIT between the United states and Costa Rica), and although it claimed to have lost US$9-12 million in exploration activity and other costs, it sought US$57 billion for damages and lost future profits.[253] The concession agreement required exhaustion of local remedies (i.e. litigation in Costa Rica's courts) before arbitration, which could have resulted in the arbitral tribunal declining jurisdiction, but the request for arbitration was nevertheless successful in placing the company in a stronger negotiating position[254] and the claimant dropped the case 17 days after the request for arbitration.[255] The then Costa Rican Environment Minister Carlos Manuel Rodriguez was reported as saying the government would negotiate a settlement between US$3-12 million which would be less costly compared with litigation[256] and that such a settlement would also be better than facing sanctions by the United States government[257] with whom multinational corporations have strong ties to put

America are reportedly disastrous, and in Costa Rica, marine turtle populations, coral reefs and sea grass beds were at stake.

251 Sebastian Tro ëng, Roxana Silman and Cindy Taft, 'Coalition Opposing Coastal Oil Drilling in Costa Rica' *Sea Turtle Conservancy Newsletter* (2000) <http://www.conserveturtles.org/velador.php?page=velart25> accessed 18 September 2013.

252 Dominican Republic-Central America FTA (CAFTA-DR) between the United States, Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua and the Dominican Republic.

253 Tienhaara 2010 (n. 250) 19.

254 *ibid* 20.

255 *ibid.*

256 Reuters, 'Costa Rica Negotiating Oil Claim With Harken Energy' *LatinPetroleum.com* (14 January 2004) <http://www.latinpetroleum.com/cgi-bin/artman/exec/view.cgi?archive=14&num=2774&printer=1> accessed 18 September 2013).

257 Allee and Peinhardt (n. 91) 20.

diplomatic pressure on host states. Costa Rica and Harken Energy ended up settling,[258] but the settlement details are unreported.

(ii) In June 2000, Canadian company *Vannessa Ventures* (Vannessa) acquired two properties in Costa Rica that were being utilised for ten gold mining concessions. Vannessa opened a subsidiary in Costa Rica called *Industrias Infinito S.A.* (Infinito). This was a large-scale open-pit mining conession for which in 2002 a moratorium was in place (as above). Vannessa's EIA was rejected by the Costa Rican authorities and the company claimed that "the political environment that manifests itself in the declarations and actions of the President and Minister may have involuntarily influenced the legal and administrative process and resulted in unfair treatment of Infinito and its shareholders."[259] The company threatened to sue the Costa Rican state under the Canada-Costa Rica BIT for breach of fairness, transparency and non-discrimination and would have sought around US$200 million. A Costa Rican court required the Costa Rican regulator to review the EIA and meanwhile Vannessa dealt with the regulator's qualms with the EIA. Environmentalists then successfully challenged the company's mining concession in 2004 in the Costa Rican courts on the grounds that it was awarded in breach of the Central American Biodiversity Convention[260] as well as Article 50 of the Costa Rican Constitution for a right to a healthy environment.[261] Again, threatening an ICSID arbitration claim for US$240 million plus US$36 million in expenses and compound interest, Vannessa was successful in having its mining concession reinstated and its EIA approved, with Infinito's Chief Executive Officer (CEO) noting that the request for arbitration at ICSID was crucial pressure that "helped" the Costa Rican regulator solve the issue.[262] Vannessa subsequently withdrew its ICSID arbitration request. Although Vannessa faced further protests with its concessions, in July 2010, a Costa Rica government-commissioned study

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[258] *ibid*.
[259] *ibid*, pages 21-22.
[260] Convention for the Conservation of the Biodiversity and the Protection of Wilderness Areas in Central America, adopted 5 June 1992.
[261] Allee and Peinhardt (n. 91) 23.
[262] *ibid*.

> reported that cancelling the company's concessions could risk a claim for US$1.7 billion being brought against the host state, which would have been unaffordable for the government.[263]

The difference in the outcomes of the two above examples in Costa Rica could be down to the fact that Vannessa's claim had more rigour because it was backed up by a BIT, whereas Harken's claim was hollow because it was not supported by a BIT or CAFTA-DR and the concession agreement required exhaustion of local remedies first.[264]

2.4.2.4 Moral Hazard

Governments, non-governmental organisations (NGOs) and the general public in countries, especially those with an ecosystem that requires conservation but also have natural resources that multinational corporations would like to (and do) exploit, such as countries in Latin America including Costa Rica, Ecuador and El Salvador, would without doubt prefer those countries to have a Brazil-type independence from investment treaty arbitration whilst securing requisite inward FDI. It is fundamental that justice is available when an exercise of sovereign power in an unjust manner, for example an expropriation without prompt and adequate compensation would require justice and arbitration has provided that justice for decades now, especially since the formation of the Iran-United states Claims Tribunal (Iran-USCTR).[265]

Although provisions for justice against the host state are necessary, there is a perception within developing countries' governments, NGOs and other concerned parties, that recourse to arbitration can be unjust on the host state. Three such reasons are discussed below.

[263] *ibid* 24.
[264] *ibid* 25.
[265] The Iran-United States Claims Tribunal (Iran-USCTR) was established on 19 January 1981 as an arbitral tribunal to hear claims brought by United States nationals against the Islamic Republic of Iran and by Iranian nationals against the United States, <http://www.iusct.net/> accessed 4 October 2013.

(i) Non-Exhaustion of Local Remedies

Firstly, domestic courts are stripped of the presumption that they are capable of delivering justice;[266] secondly, the host state should be given the opportunity to correct any wrongs done to a foreign investor before they become an international issue;[267] and thirdly, unlike foreign nationals in a general sense (such as tourists), foreign investors are not under a duty to take into account the domestic means to redress wrongs.[268] When large and complex claims are removed from the jurisdiction of domestic courts in developing countries, the improvement of their judicial systems is impeded and it could even result in a downgrade of local institutional quality.[269] Although in some circumstances the independence of the judiciary is questionable either from political pressure or public pressure, the denial of a country of the attempt to rectify an internal problem domestically before making it an issue of international jurisdiction can be perceived as unfair. Of course a foreign investor will not feel obliged to take the risk of being denied justice or take the risk of feeling the brunt of any ill-founded judgments by a domestic court for the reason of helping that country's judiciary improve itself, however, the denial of domestic justice for a foreign investor can itself form an entire claim or part of a claim in arbitration at a later time, as can matters on the merits if they are brought under different laws than those reviewed by the domestic courts (such as international law, i.e. an IIT), because arbitration cannot be used as a court of appeal.[270]

(ii) Investor Interests v Public Interest

Investment arbitration is garnering a reputation for putting corporate profits before the host state public's interests, including on matters such as human

[266] Gus Van Harten, *Investment Treaty Arbitration and Public Law* (OUP, 2007), 110.
[267] *ibid*.
[268] *ibid*.
[269] Kyla Tienhaara, 'The Expropriation of Environmental Governance – Protecting Foreign Investors at the Expense of Public Policy' (PhD Thesis, Vrije Universiteit 2008), 57.
[270] *EnCana* Award at para 142(1).

rights and the environment,[271] with investment lawyers ignoring or denouncing arguments on human rights and sustainable development.

The arbitral tribunal in *Pac Rim Cayman LLC v The Republic of El Salvador*[272] ruled in favour of its jurisdiction under El Salvador's own investment law to decide on the merits of Pac Rim's US$315 million[273] claim against the government not issuing it with a metallic mining permit which the company blames on the government's de facto ban on mining. Although Pac Rim may have a legitimate claim for compensation for the ban, viewing the claim from a non-commercial perspective, El Salvador is a cash-strapped country and its litigation costs stand at over US$5 million, which could have been used to educate 140,000 adults under its National Literacy Program.[274] Further litigation costs, a settlement or at worst a loss in this arbitration would clearly damage its economy. The metallic mining ban has been instilled for water security because fresh water supplies have been ravaged by the metal mining industry.[275] Therefore, if the country is (by regulatory chill) persuaded to discontinue its ban on mining then that is likely to have severe human and environmental repercussions.

Developing countries are not the only states that have decisions of public importance challenged in arbitration by a party seeking to enforce its commercial interests, as with Australia and Philip Morris (see paragraph immediately below). Germany has also been on the receiving end of an offensive from Swedish energy company Vattenfall for the shutdown of two nuclear power plants in its operation[276] as part of Germany's nuclear phase-

[271] Eberhardt and Olivet (n. 221) 7.
[272] *Pac Rim* Decision on Preliminary Objections.
[273] 'Statement of Claim Filed in Arbitration Case Against El Salvador; PacRim Seeks Damages of US $315 Million' (Pacific Rim Mining Corp, 1 April 2013) <http://www.pacrim-mining.com/s/News.asp?ReportID=578430> accessed 12 September 2013.
[274] Emily Achtenburg, 'Pacific Rim Ruling Threatens El Salvador's National Sovereignty, *North American Congress on Latin America*, 8 June 2012 < http://nacla.org/blog/2012/6/8/pacific-rim-ruling-threatens-el-salvador%E2%80%99s-national-sovereignty> accessed 12 September 2013.
[275] Meera Karunananthan, 'El Salvador Mining Ban Could Establish a Vital Water Security Precedent' *The Guardian:* (*Poverty Matters Blog*, 10 June 2013) <http://www.theguardian.com/global-development/poverty-matters/2013/jun/10/el-salvador-mining-ban-water-security> accessed 12 September 2013.
[276] Nathalie Bernasconi-Osterwalder and Rhea Tamara Hoffmann, 'The German Nuclear Phase-Out Put to the Test in International Investment Arbitration? Background to the New Dispute: Vattenfall v

out.[277] One arbitration between Vattenfall and Germany ended with a settlement[278] and another was initiated on 31 May 2012[279] with no significant updates at the time of writing.

Commercial interests also clash with public health. Tobacco company Philip Morris commenced (separate) proceedings against Australia[280] and Uruguay[281] over their new cigarette packaging regulations, with Australia requiring uniform 'plain' packaging for all cigarette brands[282] and Uruguay requiring health warnings to cover 80% of cigarette packages, up from 50%.[283] Both countries have introduced the cigarette packaging rules to curb smoking and its effects on their health care systems.[284] In both cases Philip Morris argue that the packaging rules breach their right to use legally protected trademarks and displaying them in their proper form.[285] Extraordinarily, in both arbitrations, Philip Morris is seeking annulment of the new cigarette packing 'health' law, in addition to damages,[286] and it is highly unlikely that that would be achieved (that would be a significant impediment on the country's sovereignty which would not have been envisaged when signing up to any IITs).

Uruguay's objection to jurisdiction in its dispute with Philip Morris centred on public health being a primordial right and supreme good ('*bien supremo*')

Germany (II)', (2012) International Institute for Sustainable Development Briefing Note, 3 <http://www.iisd.org/pdf/2012/german_nuclear_phase_out.pdf> accessed 7 October 2013.

[277] *ibid* 2.

[278] *Vattenfall AB, Vattenfall Europe AG, Vattenfall Europe Generation AG v Federal Republic of Germany*, ICSID Case No. ARB/09/6, Award of 11 March 2011.

[279] *Vattenfall AB and others v. Federal Republic of Germany, ICSID Case No. ARB/12/12.*

[280] *Philip Morris Asia Limited v The Commonwealth of Australia*, Ad hoc arbitration under the UNCITRAL Rules (*Philip Morris v Australia*).

[281] *Philip Morris Brands Sàrl, Philip Morris Products S.A. and Abal Hermanos S.A. v Oriental Republic Of Uruguay*, ICSID Case No. ARB/10/7, Decision on Jurisdiction of 2 July 2013. (*Philip Morris v Uruguay* Jurisdiction Award).

[282] Australian Tobacco Plain Packaging Act 2011.

[283] *Philip Morris v Uruguay* Jurisdiction Award at para 7.

[284] *Philip Morris v Australia*, Australia's Response to the Notice of Arbitration, 21 December 2011, at para 46; and *Philip Morris v Uruguay* Jurisdiction Award at para 157.

[285] *Philip Morris v Uruguay* Jurisdiction Award at para 7; and *Philip Morris v Australia*, Written Notification of Claim, 27 June 2011, 2.

[286] *Philip Morris v Australia*, Notice of Arbitration, 21 November 2011 at para 1.7; *Philip Morris v Uruguay* Jurisdiction Award at para 123.

and that the country could not bestow rights to foreign investors in conflict with public health.[287]

(iii) Alleged Bias of Arbitrators in International Investment Arbitration

There exists a perception of a pro-investor bias in international investment arbitration, from the negotiation of IITs[288] (and preventing their renegotiation)[289] to systemic bias of arbitrators in decisions on jurisdiction[290] and arbitrator bias in proceedings on the merits of claims.[291]

Arbitrators, unlike domestic court judges who are on salaries, make money from the duration and complexity of arbitrations over which they preside and also have a professional stake[292] in the system whereby they rely on repeat business. A recent empirical analysis of arbitrator bias has discovered: (i) arbitrators with a record of repeat appointments by investors are more likely to affirm jurisdiction than those without such a record; (ii) arbitrators who double up as counsel in different proceedings (i.e. they wear different hats for each role) are more inclined to affirm jurisdiction (without significantly affecting decisions on liability); and (iii) arbitrators with experience of working in international organisations have a higher likelihood of affirming jurisdiction and liability.[293]

A select number of arbitrators are known by insiders as the "inner circle"[294] and a group of 15 "super arbitrators" have also been called an "inner mafia".[295] The 15 "super arbitrators" have decided approximately 55% (247 cases) of all investor-state treaty-based arbitrations, approximately 64% (123

[287] *ibid* at para 155.
[288] Eberhardt and Olivet (n. 221) 8, 29, 44.
[289] *ibid* 28.
[290] Van Harten 2012 (n. 208) 251-252.
[291] Eberhardt and Olivet (n. 221) 48.
[292] *ibid* 35.
[293] Michael Waibel and Yanhui Wu, 'Are Arbitrators Political?' (2011) Unpublished Article, 34 <http://www.wipol.uni-bonn.de/lehrveranstaltungen-1/lawecon-workshop/archive/dateien/waibelwinter11-12> accessed June 24 2012. This also works in reverse, i.e. arbitrators with a track record of appointments by the host State are more likely to decline jurisdiction.
[294] Eberhardt and Olivet (n. 221) 36.
[295] *ibid* 38.

cases) of all investor-state treaty-based arbitrations with a value of at least US$100 million and 75% (12 cases) of investor-state treaty-based arbitrations with a value of at least US$4 billion.[296]

There is strong evidence to show that investment arbitration lawyers and arbitrators (including those who double up as arbitrator or counsel) have advised countries, especially capital-importing developing countries, on their investment treaty negotiations and signings, encouraging them to sign IITs to advance laissez-faire economic policies and to promote arbitration-friendly provisions,[297] resulting in potential lucrative business if they come to represent those states in arbitrations (or when acting against those states). Investment lawyers are also accused of lobbying to kill investment treaty reform which will impede on their ability to make claims against states after "identifying potential hooks for investment claims,"[298] for investors as claimants. Developing countries have even been invited to meetings full of negotiators organised by the United Nations Conference on Trade and Development (UNCTAD) that result in developing states leaving the meetings as signatories to dozens of investment treaties.[299] The lead organiser of such UNCTAD meetings is now a lawyer representing states in investor-state disputes and advises states on treaty drafting.[300]

Investment lawyers are also accused of 'ambulance chasing' by persuading companies to sue countries under investment treaties for the introduction of environmental, public health and tax laws.[301] In fact, investment lawyers are accused of more than just ambulance chasing because by doubling up as arbitrators, they create the accidents and then chase the ambulance, "a bit like ambulance chasing after your friend has put banana peels on the road."[302] Ambulance chasing is of course part and parcel of bringing in big

[296] *ibid* 38; these figures were correct as of 2012 at the time of publication of the referenced source, so it would not have changed much at the time of submitting this thesis.
[297] *ibid* 45.
[298] *ibid* 24.
[299] *ibid* 29.
[300] *ibid* 29.
[301] *ibid* 24.
[302] *ibid* 24, quoting an interview with Gus Van Harten on 30 November 2011.

business, for example, an arbitration commenced under CAFTA-DR against El Salvador's mining ban for which jurisdiction was rejected[303] was almost revived on behalf of the claimants by a Magic Circle firm who helped the claimants seek third party funding for proceedings to overturn the rejection of jurisdiction by the tribunal[304] – notably, one of the 15 super arbitrators is the co-head of international arbitration at that firm.

As a *caveat* to the above, it must be said that despite the above 'concerns', arbitrators are competent, trustworthy, experienced and professional people with integrity. Without such qualities arbitrators would not be able to get their appointments, and one should not forget that a respondent-state gets to appoint an arbitrator itself, so the concerns about arbitrator bias, despite their merit, should not be taken at face value, where friends, contacts and self-interest take second place to the facts of a dispute at hand.[305]

In light of the economic consequences, regulatory chill consequences and overall perception of a pro-investor environment in international investment arbitration, states are increasingly trying to abandon the arbitration system. As already stated above, Bolivia, Venezuela and Ecuador have withdrawn from the ICSID Convention, but they have also terminated BITs.[306] Meanwhile Australia announced in 2011 that it will not include arbitration provisions in its future IITs.[307]

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303 *Commerce Group Corp. and San Sebastian Gold Mines Inc. v The Republic of El Salvador*, ICSID Case No. ARB/09/17, Award of 14 March 2011 at para 140(1).

304 Luke Eric Peterson, 'ICSID Claim Against El Salvador is Revived After Claimants Pursue Third-Party Funding' *Investment Arbitration Reporter* (New York, 1 August 2012).

305 Waibel and Wu (n. 293) 34; whilst the Waibel and Wu study found that arbitrators who also act as counsel for private investors are likely to rule in favour of their jurisdiction (see n. 293), the study did not find a significant effect on their decisions on liability (Waibel and Wu (n. 293) 34).

306 See n. 243 and n 244 above.

307 Eberhardt and Olivet (n. 221) 16; Kyla Tienhaara and Patricia Ranald, 'Australia's Rejection of Investor-State Dispute Settlement: Four Potential Contributing Factors' (International Institute for Sustainable Development: Investor Treaty News, 12 July 2011) <http://www.iisd.org/itn/2011/07/12/australias-rejection-of-investor-state-dispute-settlement-four-potential-contributing-factors/> accessed 5 July 2012.

2.5 Conclusion

It is a fact that tax is an arbitrable matter in investment treaty arbitration. The question of arbitrability arises because tax is a sensitive and fundamental sovereign prerogative of all governments. All government powers are enshrined in the sovereignty of the state. Globalisation has in a metaphorical sense stripped away the borders of countries as they are drawn on maps, with economies so reliant on one another that a mortgage crisis in the United States caused a global economic crisis, the effects of which will be felt for years to come. With globalisation came FDI and subsequently the emergence of IITs for states to promote and protect foreign investment. When a government uses its position as a sovereign and harms foreign investment, the investor reserves his rights to justice, otherwise sovereignty would legalise state robbery. Most IITs, especially BITs, contain arbitration agreements for the investor to bring the host state before an arbitral tribunal who will decide on whether an injustice has occurred or not. The fact that the state is called into question is itself a question of its sovereignty and questioning its sovereignty outside its territorial jurisdiction by foreign judges and not in its own courts by its own national judges is a further impediment to its sovereignty. However, countries accept the curtailment of their sovereignty by participating in IITs and international organisations like the WTO to advance their economies, and agreeing to arbitration has become one of those things that they almost always have to accept to benefit from international cooperation and investment. IITs and their arbitration agreements primarily protect the investors of capital exporting countries (mainly developed countries) who invest in capital importing countries (mainly developing countries).

Arbitration serves to protect investors' rights because of the concept that it is more politically and procedurally neutral than host state courts.[308] While that might actually be the case in some jurisdictions, investor-state arbitration has been considered to be politically and neutrally bias towards investors because: (i) fiscal, public health and environmental policies, all of which are fundamentally important matters to be ruled upon by a government in any civilised society, are arbitrated for the sake of the corporate profits of foreign investors, which should come behind the welfare of the state and not ahead of it; (ii) the threat of arbitration alone can prejudice bona fide regulation in a host state because of regulatory chill which is effective due to the direct (costs of

[308] Park (2001) (n. 85) 231.

arbitration) and indirect (decrease in FDI) economic risks of arbitration; (iii) IITs are drafted to advantage foreign investors by placing obligations only on the host state; and (iv) the arbitrators' backgrounds are often corporation orientated (including working at law firms which are businesses at the end of the day) and have a direct interest in arbitration (to make a profit from their appointments). These factors, however, are not black and white, especially in the case of alleged bias of arbitrators. Certainly arbitrators take an expansive view to jurisdiction because to get to the heart of the legal matters and alleged violations by a state of international law, they need to give themselves jurisdiction to preside over disputes. If we start to see more restrictive jurisdiction awards on the basis of apparently meritless claims, that would imply that arbitrators are presiding over the merits in jurisdictional hearings. The biggest caveat in relation to risks posed to host states from investment arbitration is the section above on alleged bias of arbitrators. Arbitrators work within the confines of the system that currently exists and the system is not at the time of writing perfect.[309] Part of that system is the party appointed arbitrator. Most investor-state arbitrations are decided by a panel of three arbitrators, one chosen by each party and the third by the party appointed arbitrators, which can nullify the possibility of arbitrator bias. If a party (including the host state) has doubts about the independence of an arbitrator, whether a sole arbitrator or part of a panel, that party can utilise rules to question the impartiality of the arbitrator and have her/him disqualified. In addition, because arbitrators rely on reputation and repeat appointments, it is not in their interest to be bias towards either investors or host states. Investors and host states also have the option to have arbitral awards annulled. For example, in an ICSID arbitration, the award will be reconsidered by a different panel to that which presided over the case. In addition, the empirical studies discussed at section 2.4.2 above, whilst fascinating and informative, often rely on proxies and make generalisations that may or may not be true and make "unwarranted inferences on decision making."[310]

Investor-state arbitration serves justice and we are lucky to live in an age where private individuals have recourse against host states under international law which is a departure from the customary international law position that does not give an automatic

[309] See generally Stavros Brekoukalis, 'Systemic Bias and the Institution of International Arbitration: A New Approach to Arbitral Decision-Making' (2013) 4(4) *J. Int'l Dis. Sett.* 553.
[310] *ibid, 565.*

private right to claim against a state. Where, for example, would justice have come from for investors of the United States or Iran without the existence of the Iran-US Claims Tribunal? Systems of law and governance seldom work perfectly, so despite, for example, the risk of a host state paying its costs in an arbitration that it succeeds in (costs which could be used on the welfare of the state), that cost would be insignificant in the grand scheme of its monetary policy; meanwhile, the risk to investors of bringing claims before host state courts which are either patriotic and/or not independent from lawmakers is greater than the economic losses to host states. In respect of the loss of FDI as a result of being respondents in arbitration, states could very easily advertise their take on any disputes while arbitration is on-going and advertise their success post-arbitration, subject of course to the confidentiality of certain aspects of proceedings. The costs spent by host states in defending claims in international arbitration is likely to be a fraction of the GDP which FDI brings into the state, otherwise why would states acquiesce to arbitration in IITs if the FDI would not be worthwhile? Let us not forget also that it is within the sovereignty of states to voluntarily enter into international engagements that restrict their sovereignty.[311] Those international engagements include IITs in which states undertake to perform or refrain from performing particular acts. Why, therefore, should a state enter into IITs to attract FDI, receive that FDI into its jurisdiction, but not expect to be called to justice in the most independent possible forum currently available to us (i.e. arbitration) when there is a claim that it has violated that very tool of international law that brought the investment into its jurisdiction? The simple answer is that states should not expect that and most actually do not expect it. The fact remains that the studies outlined in section 2.4.2 above indicate that host states succeed in arbitrations the majority of the time, which means they have received FDI, successfully defended a claim and get most or all of their legal costs reimbursed. On the topic of results from the empirical studies and the settlements made between investors and states, the studies fail to take into account that settlements are often made in good faith to preserve the status quo of relationships and they also fail to consider that host states may actually be the parties in stronger shoes during negotiation of those settlements. To illustrate, many of those settlements could be the investor dropping the claim and paying the legal costs of the host state. Arguably the most significant aspect which states will find difficult to avoid is the regulatory chill factor which could affect

[311] Jan Paulsson, 'The Power of States to Make Meaningful Promises to Foreigners' (2010) 1(2) *J. Int'l Dis. Sett.* 341, 343.

states' tax sovereignty. States most certainly take regulatory chill into account when signing IITs with arbitration agreements, and just like the decision to cede sovereignty to other member states of the WTO in order to engage and have a voice in the international arena, states also take the decision that ceding sovereignty to arbitral tribunals and to foreign investors as a result of possible regulatory chill is worth the risk in the grand scheme of their economic development. However, tax exclusions are inserted into most IITs for national treatment and most-favoured-nation treatment protection, and an inference can be made that they are willing to bear the risk of regulatory chill in relation to certain aspects of their sovereignty, but not their tax sovereignty.

As for arbitrability, the feeling of tax being non-arbitrable existed because it was untested terrain until only quite recently. There are a number of plausible reasons that tax measures have been seldom arbitrated: (i) from a jurisprudential perspective it is a very sensitive subject and the applicability of IIT protections are subjected to exclusions from matters of taxation, especially the easiest to prove (national treatment and MFN); (ii) investors might have been advised against pursuing treaty violation claims based on taxation because of the difficulty in proving such violations, and this is especially so with respect to apparently bona fide taxation measures which are allegedly expropriatory, so unless the evidence is strong and unless the claim would be for a substantial amount of money, an arbitration might not be worth pursuing and the relationship with the state not worth hindering[312]; (iii) investors and states have probably settled most tax disputes and these settlements are private – we therefore cannot know how many tax arbitrations there would have been if not for such settlements[313]; (iv) states have probably not introduced taxes that they were contemplating the introduction of because of regulatory chill; and (v) the recent emergence of BITs in the 1990s to the present date has gone hand in hand with the emergence of investor-state arbitration, so the emergence of BITs may have lowered or

[312] MNEs usually delve into diplomacy for the sake of winning contracts and being granted concessions, so the arbitration for a small gain would not be worth risking the relationship for.

[313] A good reason for states to settle would be that a loss in arbitration means the tax law/action violates IIT protections and this could lead to other investors in that state bringing claims. Host states would therefore prefer to secretly settle disputes with investors so that they can keep applying the tax measure (e.g. levying the tax on others or not granting tax refunds to others). This also advantages the investor who has settled in comparison to the competition who are still subjected to the taxation measures (e.g. still paying the tax or not receiving tax refunds).

maintained a low incidence of taxation that existed pre-IIT protections, but would, post-IIT protections, likely result in IIT violations, and this has incidentally prevented the prevalence of tax arbitration.

In summary, the sovereign power to tax, just like any other type of legislative power that affects private individuals and corporations, is arbitrable if the IIT or arbitration agreement for the settlement of investor-state disputes allows it to be, and that is a good thing. As I have already written and will repeat again, the sovereignty of the state should not and does not give it the power to do whatever it wants. The arbitral tribunal in *ADC*[314] said the following about the state's right to regulate:

> The Tribunal cannot accept the Respondent's position that the actions taken by it against the Claimants were merely an exercise of its rights under international law to regulate its domestic economic and legal affairs. It is the Tribunal's understanding of the basic international law principles that while a sovereign State possesses the inherent right to regulate its domestic affairs, the exercise of such right is not unlimited and must have its boundaries… the rule of law, which includes treaty obligations, provides such boundaries. Therefore, when a State enters into a bilateral investment treaty like the one in this case, it becomes bound by it and the investment-protection obligations it undertook therein must be honoured rather than be ignored by a later argument of the State's right to regulate.[315]

Finally, there is an amusing paradox between tax and arbitration: when a government is sued in international investment arbitration, "arbitrators have the power to divert taxpayers' money to corporations."[316] In tax arbitration, the foreign investor would be suing to be paid taxpayers' money for being taxed in the first place.

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[314] *ADC Affiliate Limited and ADC & ADMC Management Limited v Republic of Hungary*, ICSID Case No. ARB/03/16, Award of 2 October 2006.
[315] *ibid* at para 423.
[316] Eberhardt and Olivet (n. 221) 35.

Chapter 3 The Treatment of Tax in Expropriation Claims in Investor-State Arbitration

Expropriation in the investment treaty context is a governmental taking of or interference with foreign investment which deprives the investor of the meaningful benefits of ownership and control. Expropriation can be very direct, such as the taking of property by military intervention, or it can occur indirectly through the use of regulatory powers such as the power to tax and other legislative functions of the state. A state can expropriate an investment by directly or indirectly neutralising the enjoyment of property[1] thereby making ownership of the property irrelevant, for example by blocking entrances to a construction site (direct) or revoking previously granted permits to build on that site (indirect).

The current wording of expropriation provisions in most international investment treaties (IITs) are very similar if not identical. Expropriation provisions in IITs mostly read along the lines of:

> Investments of investors of either Contracting Party shall not be nationalised, expropriated or subjected to measures having effect equivalent to nationalisation or expropriation (hereinafter referred to as "expropriation") in the territory of the other Contracting Party except for a *public purpose*… on a *non-discriminatory basis* and against *prompt, adequate and effective compensation*… The investor affected shall have a right, under the law of the Contracting Party making the expropriation, to *prompt review, by a judicial or other independent authority of that Contracting Party, of his or its case*…[2] (emphasis mine).

The process to draft the above text and similar expropriation provisions was achieved by the early attempts of treaty framers to codify customary international law[3] which

[1] James Crawford et al, *ICSID Reports: Volume 9: v.9 – International Convention on the Settlement of Disputes Reports* (CUP 2006) 92.

[2] Article 5(1), Agreement between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the Republic of Argentina for the Promotion and Protection of Investments, signed 11 December 1990, entered into force 19 February 1993 (UK-Argentina BIT).

[3] Campbell McLachlan QC, Laurence Shore and Matthew Weiniger, *International Investment Arbitration – Substantive Principles*, (OUP 2008) 266.

they have successfully achieved.[4] Treaty claims for alleged expropriations and the arbitral awards accompanying them which interpret provisions like the one above have become the principal focus of expropriation jurisprudence.[5] Treaty texts are of course vital, for without a provision on expropriation in an IIT, there can be no claim by an investor, and the success or failure of any claim can fall on the interpretation by an arbitral tribunal on the broadness or narrowness of the treaty text.

The expropriation provision reproduced above, like almost all expropriation texts, outlines the following four requirements which have sufficiently crystallised in treaty texts to the represent the customary international law[6] of when an expropriation will not result in state liability[7]:

(i) it is for a public purpose;
(ii) it is carried out on a non-discriminatory basis;
(iii) it is in accordance with due process of law;[8] and
(iv) it is promptly followed by adequate and effective compensation.[9]

I will refer to (i) to (iii) as 'conduct requirements', (iv) as the 'compensation requirement,[10] and altogether as the 'four requirements'.

More recent bilateral investment treaties (BITs) also show the same characteristics, for example:

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[4] UNCTAD, 'Expropriation' (UNCTAD Series on Issues in International Investment Agreements II, 201, Doc. UNCTAD/DIAE/IA/2011/7) 27 <http://unctad.org/en/docs/unctaddiaeia2011d7_en.pdf> accessed 4 January 2013, (UNCTAD on Expropriation)
[5] McLachlan et al (n. 3) 266.
[6] UNCTAD Expropriation 2012 (n. 4) 27.
[7] *ibid*.
[8] In the UK-Argentina BIT, the due process of law requirement is set out by the BIT requiring the investor be given the right "to prompt review, by a judicial or other independent authority of that Contracting Party, of his or its case" (Article 5(1)).
[9] Some United States BITs, as represented by the US Model BIT 2012, go one step further than the four requirements set out by customary international law by also requiring the expropriation to be carried out under the principles of fair and equitable treatment, however the fair and equitable treatment requirement is likely to be breached in any event if any of the four principle requirements are breached.
[10] The label 'conduct requirements' for requirements (i) to (iii) and the label 'compensation requirement' for requirement (iv) was given to the four requirements by Audley Sheppard, 'The Distinction Between Lawful and Unlawful Expropriation' (2008) 1:1-2 *World Arbitration & Mediation Review* 137, 138.

> Investments or returns of investors of either Contracting Party shall not be nationalized, expropriated or subjected to measures having an effect equivalent to nationalization or expropriation (hereinafter referred to as "expropriation") in the territory of the other Contracting Party, except for a *public purpose*, under *due process of law*, in a *non-discriminatory manner* and provided that such expropriation is accompanied by *prompt, adequate and effective compensation*[11] (emphasis mine).

Some investment treaties also incorporate the words 'direct' and 'indirect' in their expropriation provisions, such as most United States BITs:

> Investments shall not be expropriated or nationalized either *directly* or *indirectly* through measures tantamount to expropriation or nationalization ("expropriation")…[12] (emphasis mine).

The traditional concept and definition of expropriation is a taking of property by the state with the requirement for the expropriating state to pay compensation.[13] That concept stems from the origins of expropriation which is the direct type, i.e. the taking by governmental authorities of tangible assets. The concept now applies to investments in a more general sense and investments are often comprised of both tangible and intangible properties which can be affected by state measures which extend beyond physical acts[14] (physical takings) and include measures which deprive

[11] Article VI, Agreement between Canada and the Czech Republic for the Promotion and Protection of Investments, signed 6 May 2009, entered into force 22 January 2012.

[12] Article III(1), Treaty between the United States of America and the Republic of Ecuador concerning the Reciprocal Encouragement and Protection of Investment, signed 27 August 1993, entered into force 11 May 1997 (US-Ecuador BIT); the United States' BITs and their model BITs including the United States Model BIT 2012 (Article 6(1)) use the words 'direct' and 'indirect' in the expropriation articles, and the practice is not limited to the United States, see for example Article 4(1), Agreement between the Government of the Republic of Finland and the Government of the People's Democratic Republic of Algeria on the Reciprocal Promotion and Protection of Investments, signed 13 January 2005, entered into force 25 February 2007 (Finland-Algeria BIT).

[13] Andrew Newcombe and Lluís Paradell, *Law and Practice of Investment Treaties – Standards of Treatment*, (Kluwer Law International 2009), 322; and McLachlan et al (n. 3) 266.

[14] UNCTAD Expropriation 2012 (n. 4) 6; see also *CME Czech Republic BV (The Netherlands) v Czech Republic*, Arbitration under the UNCITRAL Rules, Partial Award of 13 September 2001 (*CME*), at para 599 in which the claimant was deprived of using its exclusive *licence* to operate a television station.

the investor of the "meaningful benefits of ownership and control"[15] through legislation, regulation or the enforcement or non-enforcement thereof. In addition, the state need not attain something of value to be found liable for an expropriation and legal title can also remain with the investor, whereby the investor need only be deprived of the use and enjoyment of his or its investment.[16] These concepts epitomise indirect expropriation, including measures tantamount to expropriation.[17]

Takings that are expropriatory must be distinguished from non-compensable government takings. Non-compensable government takings are police power regulations that result in the deprivation of property but do not require the payment of compensation. These include measures carried out to maintain public order and morality[18] (a taking for public order can include the confiscation of criminal property or the proceeds of crime), to protect public health and the environment[19] and bona fide general taxation.

Of the four requirements that a government must not violate when expropriating an investment, the compensation requirement, which is a just and equitable condition, is arguably the oldest and most important requirement which can be traced to as far back as ancient Greece.[20] The most universally accepted standard of compensation[21] for expropriation is 'prompt, adequate and effective' compensation.[22] Ideally,

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[15] *Marvin Roy Feldman Karpa v United Mexican States,* ICSID Case No. ARB(AF)/99/1, Award of 16 December 2002 (*Feldman* or *Feldman* Award) at para 100.

[16] *Starrett Housing Corporation, Starrett Systems Inc, Starrett Housing International Inc. v The Government of the Islamic Republic of Iran et al*, Iran - Iran-USCTR, Case No. 24, Interlocutory Award No. ITL 32-24-1 of 19 December 1983: "…it is recognized in international law that measures taken by a State can interfere with property rights to such an extent that these rights are rendered so useless that they must be deemed to have been expropriated, even though the State does not purport to have expropriated them and the legal title to the property formally remains with the original owner."

[17] See 3.2.2 below.

[18] Andrew Newcombe, 'The Boundaries of Regulatory Expropriation in International Law' (2005) 20:1 *ICSID Review-FILJ*, 24 <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=789706> accessed 28 October 2010.

[19] *ibid*.

[20] See section 3.1.1 below.

[21] Nigel Blackaby, Constantine Partasides, Alan Redfern and Martin Hunter, *Redfern and Hunter on International Arbitration* (5th Ed, OUP 2009), 508.

[22] The payment of 'prompt, adequate and effective' compensation is known as the 'Hull Formula', named after its articulator, the United States Secretary of State Cordell Hull. In the aftermath of Mexico's expropriation of United States investors-owned petroleum companies, Mexico's Foreign Minister wrote to Hull on the topic of compensation, claiming that no rule in international law obliges an expropriating state to make payment of immediate or even deferred compensation for expropriations of general and impersonal characters. Hull replied, stating that "[u]nder every rule of law and equity, no government is entitled to expropriate private property, for whatever purposes,

compensation in convertible currency for the full value of the expropriated property will be paid immediately after the expropriation so the investor who suffered the expropriation has the ability to reinvest the money or take it home[23] as soon as possible, thereby keeping financial harm to a minimum. Immediate payment can be feasible in some instances of direct expropriation but seldom feasible with indirect expropriations which can occur incrementally over a period of time and even the existence of indirect expropriation is likely to be debated by the state. 'Prompt' payment, which is characterised as the payment of compensation without delay,[24] is therefore a practical solution in that it gives the host state the necessary flexibility to compensate the investor as soon as possible depending on the circumstances of the individual merits of each expropriation (including whether arbitration is required to determine the very existence of expropriation and therefore the existence of the requirement to compensate).[25] Compensation is 'adequate' when it correlates to the value required by the relevant IIT which can be the market value,[26] the fair market value,[27] the genuine value,[28] the real value[29] or the real economic value.[30] The fair, genuine, and real values are likely to achieve the same effect[31] because they are "generally considered to reflect the same standard of compensation".[32] Compensation is 'effective' when it is "paid in convertible or freely usable

without provision for *prompt, adequate and effective compensation*" (emphasis mine) (Muthucumaraswamy Sornarajah, *The International Law on Foreign Investment*, (3rd Ed, CUP 2010), 414 note 2); OECD, '"Indirect Expropriation" and the "Right to Regulate" in International Investment Law', (2004) OECD Working Papers on International Investment, Doc. No. 2004/4 <http://www.oecd.org/dataoecd/22/54/33776546.pdf> accessed 23 October 2010.

[23] Sornarajah (n. 22) 414.

[24] UNCTAD Expropriation 2012 (n. 4) 40.

[25] The payment of compensation without delay provides flexibility because the existence of expropriation must sometimes be ascertained through arbitration/litigation, and if compensation is determined to be payable by the arbitral tribunal or court, it must then be paid without delay. Prompt payment also does not impede on host state sovereignty because it does not oblige an expropriating state to pay compensation *immediately* because that would be impractical and the state would almost always be in breach if immediate payment was the standard norm.

[26] Article IV(2), Agreement between the Republic of Turkey and the Hellenic Republic Concerning the Reciprocal Promotion and Protection of Investments, signed 20 January 2000, entered into force 24 November 2001 (Greece-Turkey BIT).

[27] UNCTAD Expropriation 2012 (n. 4) 40; Article 1110(2), North American Free Trade Agreement 1994 (NAFTA); Article III, US-Ecuador BIT.

[28] Article 5(1), UK-Argentina BIT; Article 6(c), Agreement on Encouragement and Reciprocal Protection of Investments between the Republic of South Africa and the Kingdom of the Netherland, signed 9 May 1995, entered into force 1 May 1999 (Netherlands-South Africa BIT).

[29] Article 4(2), Agreement Between the Republic of Turkey and Republic of Slovenia on the Promotion and Protection of Investments, signed 23 March 2004, entered into force 19 June 2006 (Slovenia-Turkey BIT).

[30] UNCTAD Expropriation 2012 (n. 4) 40.

[31] *ibid*.

[32] Redfern and Hunter (n. 21) 508

currency"[33] The expropriated investment will often be appraised for compensation purposes at its value immediately before the expropriation took place[34] and compensation will include interest.[35]

The compensation requirement brings with it a debate over whether an expropriation which abides by the conduct requirements but does not compensate the investor should be labelled a lawful or unlawful expropriation. It may seem obvious that host state measures in violation of the law (whether it's the host state's domestic law or international law) is unlawful, including the non-payment of compensation for expropriation, but it is not as clear-cut as that. When that logic is applied to an expropriation that takes place for a public purpose, with due process and no discrimination, but violates the compensation requirement, that expropriation would be labelled as 'unlawful' and some arbitral tribunals have given it that label.[36] The issue surrounding this topic is the air of negativity that comes with the term 'unlawful expropriation' because it denotes wrongdoing and malice by the state, and that that normally denotes a violation of the conduct requirements. The requirement to compensate stems from the origins of expropriation as being the physical taking of property,[37] whereby the direct expropriation of, for example, a farm without adequate compensation for the owner would be theft by the sovereign,[38] and it is fair to say therefore that the failure of a state to compensate for a direct expropriation will make such an expropriation an unlawful one even if it does not violate the conduct requirements,[39] unless it is agreed that compensation shall be paid but there is a disagreement over the value of compensation that is due.[40]

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[33] UNCTAD Expropriation 2012 (n. 4) 40.
[34] Article 1110(2), NAFTA; Article IV(2), Greece-Turkey BIT; Article III, US-Ecuador BIT; Article 5(1), UK-Argentina BIT; Article 6(c), Netherlands-South Africa BIT; Article 4(2), Slovenia-Turkey BIT.
[35] *ibid*.
[36] *Siemens A.G. v Argentine Republic*, ICSID Case No. ARB/02/8, Award of 6 February 2007, at paras 273 and 349; *ADC Affiliate Limited and ADC & ADMC Management Limited v Republic of Hungary*, ICSID Case No. ARB/03/16, Award of 2 October 2006, at para 476; numerous Iran-United States Claims Tribunal (Iran-USCTR) tribunals have considered the compensation requirement to be "relevant to the lawfulness of a taking under customary international law" (Charles N. Brower and Jason D. Brueschke, *The Iran-United States Claims Tribunal* (Brill, 1998), 499).
[37] See section 3.1 below.
[38] See quotation at the beginning of Chapter 2 of this thesis: "In the absence of justice, what is sovereignty but organised robbery?" (Saint Augustine, 13 November 354 – 28 August 430).
[39] UNCTAD Expropriation 2012 (n. 4) 44.
[40] *Compañía de Desarrollo de Santa Elena, S.A. v The Republic of Costa Rica*, ICSID Case No. ARB/96/1, Final Award of 17 Feb. 2000 (*Santa Elena*), at paras 54-59; see section 3.3 below.

An indirect expropriation claim, on the other hand, will almost always be less clear cut than a direct expropriation claim because it will not involve an outright taking[41] and the host state will likely oppose the expropriation claim and contend that the nature of the measure(s) was a bona fide and non-expropriatory use of its sovereign powers for which pre-emptive compensation should not be expected.[42] Indeed, the legitimate actions of a state which are a lawful exercise of its sovereign powers (i.e. they do not violate the conduct requirements) will only require compensation if they are expropriatory, and sometimes investor-state arbitration is required to establish whether those actions are expropriatory or not, and if they are judged to be expropriatory, compensation becomes due when the award is rendered.[43] It is, accordingly, undesirable for an indirect expropriation to be branded unlawful if it violates only the compensation requirement, especially when the existence of expropriation was, pre-arbitration, unknown. Many arbitral tribunals have consequently refrained from branding indirect expropriations that violate only the compensation requirement as 'unlawful'.[44] That is not to say the state should not compensate – it simply means that an expropriation carried out within the confines of the conduct requirements should be labelled as a 'lawful expropriation in lieu of

[41] The existence of an outright taking in direct expropriations is almost unarguable by the expropriating state, unless it is a non-compensable taking such as the confiscation of criminal property.

[42] UNCTAD Expropriation 2012 (n. 4) 43.

[43] *ibid* 44; in *Antoine Goetz and Others v Republic of Burundi*, ICSID Arbitration No. ARB/95/3, Award of 10 February 1999, the arbitral tribunal decided that the Belgium-Burundi BIT under which the claim was brought required compensation within a reasonable period of time and not pre-emptive compensation, therefore, the respondent state, Burundi, could still satisfy the compensation requirement and establish the international legality of its allegedly expropriatory measure (at para 131) (the original text reads: "*C'est dire que la question de la licéité internationale de la décision du 29 mai 1995 reste en suspens. De deux choses l'une, en effet. Ou bien la République du Burundi satisfait dans un délai raisonnable à la condition de l'indemnisation adéquate et effective en versant une indemnité répondant aux critères et aux exigences du paragraphe 2 de l'article 4 de la Convention. En ce cas, la licéité internationale de la décision du 29 mai 1995 se trouvera définitivement établie*".

[44] For example, in *Amoco International Finance Corporation v Government of the Islamic Republic of Iran et al*, IRAN-USCTR Case No. 56, Award No. 310-56-3 of 14 July 1987 (*Amoco*), the expropriation was found to be in violation of only the compensation requirement, and when analysing the damages that must be paid for the expropriation, the arbitral tribunal described the measures as a "lawful expropriation" (at para 195); in *Santa Elena* there was a disagreement between the claimant and the respondent (Costa Rica) on how much compensation was due for the expropriation of land taken for the protection of the environment which met the public purpose, non-discriminatory and due process of law requirements - when analysing the standard of compensation, the arbitral tribunal (and the parties to the arbitration themselves) described the expropriation as lawful, stating that there "… is a duty… to pay compensation in respect of even a *lawful* expropriation" (emphasis mine) (at para 68) and "… the amount of compensation properly payable in respect of a *lawful* taking…" (emphasis mine) (at para 69); in *Southern Pacific Properties (Middle East) Limited v Arab Republic of Egypt*, ICSID Case No. ARB/84/3, Award on the Merits of 20 May 1992 (*SPP*), the respondent (Egypt) cancelled the claimant's tourist development project with the public purpose of preserving and protecting antiquities - the right of the host state to cancel the project was not challenged by the claimant who only claimed for compensation for expropriation - the arbitral tribunal said the measure "constituted a *lawful exercise* of the right of eminent domain" (emphasis mine) (at para 158) and that the claimant is seeking compensation "… for a *lawful expropriation*, and *not* 'reparation' for *an illegal act*…" (emphasis mine) (at para 183).

compensation', with the compensation becoming when it is established that an expropriation has in fact occurred. This can be contrasted with claims when any of the conduct requirements are violated, in which the expropriations will be deemed unlawful[45] whether they are direct or indirect expropriations.

Arbitral tribunals' approach in finding state liability for alleged expropriations can be narrowed down to two questions: (i) has there been an expropriation; and (ii) was one or more of the four requirements (or fewer or more conditions as set out in the applicable IIT) breached by the state? Question (i) comes first because the "practical matter [of] whether there has been an expropriation"[46] must be established before examining whether the state might be liable to the investor under question (ii). For the purposes of answering (i), what is a direct expropriation will be quite obvious, and the discussion in arbitral awards that form most of the current expropriation jurisprudence is on the topic of indirect expropriation because it is not as black and white as direct expropriation and also because for around the past three decades the majority of expropriations have been the indirect type, with the number of direct expropriations declining in the late 1970s and remaining relatively constant at a very low level through to the mid-1980s,[47] with seemingly only three direct expropriations occurring between 1984 to 1986, one by Nicaragua (1984) and two by Peru (1985 and 1986), and none thereafter until at least 1992.[48] Indirect expropriation overtook direct expropriation as the "dominant form of state interference with foreign investment."[49] In fact, "[i]ndirect expropriation has significantly increased the number of cases before international arbitral tribunals"[50] generally, let alone in the context of expropriation. If (i) is answered in the affirmative, the state will be liable to the foreign investor if (ii) is also answered in the affirmative. That said, evidence of government measures, including taxation measures, violating the conduct requirements (which fall under (ii)) will denote unlawful conduct by the host state and such unlawful activity will help to convey to arbitral tribunals that said measures

[45] UNCTAD Expropriation 2012 (n. 4) 44.
[46] McLachlan et al (n. 3) 272.
[47] Michael S Minor, 'The Demise of Expropriation as an Instrument of LDC Policy', (1994) 25(1) *Journal of International Business Studies* 177, 178.
[48] *ibid* 181 at Table 2.
[49] George Chifor, 'Caveat Emptor: Developing International Disciplines For Deterring Third Party Investment In Unlawfully Expropriated Property', (2002) 33 *Law & Pol'y Int'l Bus.* 179, 185.
[50] *Occidental Exploration and Production Company v The Republic of Ecuador,* LCIA Case No. UN 3467, Award of 1 July 2004 (*Occidental* or *Occidental* Award) at para 85.

err on the side of unlawful government action rather than non-compensable government measures[51] and can therefore help to answer (i) by "imparting a degree of circularity to the 'expropriation versus regulation' dichotomy."[52] For example, discriminatory and arbitrary taxation can signify unlawful takings and unlawful deprivation of property, whereas bona fide general taxation will signify lawful takings and lawful deprivation of property.

I will now turn to discuss the recent historical background and development of the expropriation standard which has resulted in the investment treaty provisions we have in modern IITs.

3.1 Historical Background and Development

3.1.1 Pre-Modern Day Literature on Expropriation

The taking of another's property has occurred throughout the history of time, from inter and intra species battles for land or the taking by an alpha male of others' properties, or tribal battles and ancient Greek and Roman wars over land and resources, to modern takings such as the taking of Palestinian land for the establishment and expansion of the Israeli state[53] and the invasion of Iraq in part for the exploitation of its oil resources.[54] The taking of and battles for territories and resources is part of nature and is a well-documented occurrence in the animal kingdom.[55] The 'natural' aspect is not to detract from the shady, and more often than not, wrongful nature of invasions by one sovereign of another sovereign's territories

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[51] *Feldman* Award at para 99.
[52] *ibid*.
[53] Haim Sandberg, 'Expropriations of Private Land of Arab Citizens in Israel: An Empirical Analysis of the Regular Course of Business' (2010) 43 *Israeli Law Review*, 590, 591.
[54] Antonia Juhasz, 'Why the War in Iraq Was Fought for Big Oil', *CNN* (15 April 2013) <http://www.cnn.com/2013/03/19/opinion/iraq-war-oil-juhasz/> accessed 18 April 2013. In Antonia Juhasz's article, she has quoted the following: ""Of course it's about oil; we can't really deny that," said Gen. John Abizaid, former head of U.S. Central Command and Military Operations in Iraq, in 2007. Former Federal Reserve Chairman Alan Greenspan agreed, writing in his memoir, "I am saddened that it is politically inconvenient to acknowledge what everyone knows: the Iraq war is largely about oil." Then [Senator] and now Defense Secretary Chuck Hagel said the same in 2007: "People say we're not fighting for oil. Of course we are."".
[55] See for example International Wolf Centre, '10 Things You Need to Know About Wolves and Delisting' (24 June 2013) < http://www.wolf.org/wolves/learn/basic/faqs/faq.asp> accessed 19 December 2013.

for the purposes of taking land/property, including the taking of private property in those lands – but it has happened in the past and is likely to occur in the foreseeable future. Such actions by sovereign states denotes a lack of (or non-existent) respect for the property rights of invaded populations, however, higher property rights being accorded by a state to its own populations is historical and this is evidenced by the recognition of the right of the state to expropriate but not in lieu of compensation.

The right of a state to expropriate is an inherent aspect of its sovereignty by public and constitutional law[56] and exists even without the written consent thereof in statute or constitution.[57] But it is the *limitations* on a state's right to expropriate, not the *existence* of the right to expropriate, that has concerned legal literature for over 2000 years.[58]

In ancient Greece, the sovereign was able to exercise the right of expropriation but if a taking lacked compensation it "was regarded as inconsistent with the nature of the institution of property".[59] Likewise, in ancient Rome, "expropriation was almost unknown, for the Roman feeling for individual liberty and respect for vested rights allowed expropriation to occur only in the most exceptional circumstances",[60] although "that did not prevent emperors from confiscating property if they felt the need to do so. But such confiscations would tend to be regarded as the hallmark of a 'bad' ruler. Perhaps that is what Mann meant by 'exceptional circumstances'."[61]

On 15 June 1215, the Great Charter of the Liberties of England (Magna Carta) was signed by King John, legislating that individuals' properties such as timber and horses could not be taken by the King's constable or constable's bailiff without the

[56] F.A. Mann, *Outlines of a History of Expropriation, (1959) 75 LQR*, 188, 192.
[57] *ibid*, 193, also quoting Strong J in *Kohl v United States* (1876) 91 U.S. 449, at p. 451: "The right [to expropriate] is the offspring of political necessity and it is inseparable from sovereignty, unless denied to it by its fundamental law".
[58] *ibid* 193.
[59] *ibid*, quoting John Walter Jones, *The Law and Legal Theory of the Greeks* (Clarendon Press, 1956), 198.
[60] Mann (n. 56) 193.
[61] Email from Prof. Kevin Butcher to author (20 December 2013). Kevin Butcher is a Professor of Classics and Ancient History and Head of Department (2013/14) at Warwick University.

owner's consent[62] and without payment.[63] The Magna Carta contained the earliest provisions of the compensation requirement at Chapters 19 and 21 for what were called 'royal requisitions'.[64] In 16th Century England, statutes were enacted which allowed for the compulsory expropriation of land for public purposes[65] (such as for supplying water),[66] which were intrinsic in the construction of cities. These statutes also legislated for "proper compensation to be paid"[67], for example, in the case of the First London Water Act 1543, compensation had to be determined by "three or four indifferent men"[68] and if the level of compensation had not been agreed by those men and the expropriating government authority did not satisfy the owner with compensation, the owner could bring an action for trespass.[69]

In 1766, Lord Camden of the English parliament said "[t]he sovereign authority… cannot take away any man's private property without making him a compensation."[70] At around the same time, another parliamentarian, Sir William Blackstone, said that the law of private property is so great that it cannot be violated even in the public interest without the permission of the owner of a property if his land is to be taken or used, and although the legislature can and does compel the owner to acquiesce to the use or taking, it must not do so "in an arbitrary manner… but by giving him a full indemnification and equivalent for the injury thereby sustained."[71]

Private property protections existed in France in the 14th Century, requiring compensation for damage when fortifications were built,[72] through to the 17th Century when a public purpose and compensation were required for works carried out by the state which impeded on private property.[73] Developments in Germany, Austria and Switzerland took a similar course and the public purpose and

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62 Elizabeth Brubaker, *Property Rights in the Defence of Nature* (Environment Probe 1995) Chapter 12 <http://environment.probeinternational.org/chapter-12-no-expropriation-without-full-compensation/> accessed 19 December 2013.
63 *ibid*; and Mann (n. 56) 194.
64 Mann (n. 56) 194.
65 *ibid*.
66 *ibid*.
67 Sheppard (n. 10) 140.
68 Mann (n. 56) 194.
69 *ibid*.
70 *ibid* 195, quoting Lord Camden as obtained from *Parliamentary History*, XVI, 168.
71 *ibid*, quoting Sir William Blackstone as obtained from *Parliamentary History*, XVI, 139.
72 *ibid* 203.
73 *ibid*.

compensation requirements for expropriation were well established in medieval Italian cities and became general law in Italy by 1600.[74] In continental Europe,[75] from the Middle Ages until the 18th Century, "[n]o case is known in which property was taken… for reasons other than public necessity or without at least the promise of compensation."[76]

The respect for private property in the United States can be traced to 15 December 1791[77] under the Fifth Amendment of the United States Constitution, which provides that "private property [shall not] be taken for public use, without just compensation."[78]

3.1.2 Historical Literature on Tax as Expropriation

The historical literature on taxation as expropriation is scarce but does exist, particularly in the context of taxation as unlawful takings.

In Chapter 2, taxation was described as "what we pay for civilised society"[79] and that "[t]he art of taxation consists in so plucking the goose as to obtain the largest amount of feathers with the least possible amount of hissing."[80] By putting these two statements together, one can derive that taxation itself must be levied and collected in a civil manner by being bona fide and general in nature, and if the taxman goes (or 'plucks') too far, the tax itself becomes an uncivil levy by being arbitrary or punitive, thus making the former statement collapse on itself because something civil cannot rightfully be borne out of something uncivil.

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[74] *ibid* 203-204.
[75] Sheppard (n. 10) 140.
[76] Mann (n. 56) 203.
[77] United States of America Constitution – Amendment 5 – Trial and Punishment, Compensation for Takings <http://www.usconstitution.net/const.html> accessed 12 December 2013.
[78] *ibid*; the text is actually written in a form of old English as: "… not shall private property be taken for public use, without just compensation."
[79] *Compañia General de Tabaco de Filipinas v Collector of Internal Revenue*, (1927) 275 U.S. 87, 100 per Justice Holmes; William W Park, 'Tax Arbitration and Investor Protection' in Chapter 12 of Catherine A. Rogers and Roger P. Alford (eds), *The Future of Investment Arbitration* (2009 OUP), 227.
[80] French Economist and Minister of Finance under King Louis XIV of France, Jean-Baptiste Colbert (1619-1683) (see Chapter 2, (n. 27)).

As established in the introduction of this chapter (and will be further expanded upon at sections 3.3 and 3.4 below), expropriation's original definition was a taking of property but that has now expanded to include the deprivation of the use and enjoyment of property, with the deprivation akin to the property having been taken. Taxation is unique when compared with other police powers such as environmental regulations which impose rules, restrictions and targets on business' activities which can in themselves result in a deprivation of the use and enjoyment of property (potential indirect expropriation), whereas taxation as a taking[81] has the potential of being a direct expropriation (as regards the monies taken) and it can deprive an investor of the benefits of an investment, namely profits, which has the potential of being an indirect expropriation.

The most prominent historical literature on taxation and expropriation comes from United States court cases from over a century ago. In the United States Supreme Court case of *County of Mobile v Kimball*,[82] a distinction between taxation and the expropriation of property was given by Mr. Justice Field:

> "Taxation only exacts contribution from individuals of the State or of a particular district, for the support of the government or to meet some public expenditure authorised by it, for which they receive *compensation* in the protection which government affords,[83] or in the benefit of the special expenditure. But when private property is taken for public use, the owner receives *full compensation*. The taking differs from a sale by him only in that the transfer of title may be compelled and the amount of compensation be

[81] In Mann (n. 56) 212, it was said that "there is a vital difference between taxation and the taking of property… in definition and substance" – it is likely that Mann meant is there is a difference between bona fide general taxation and expropriation, because bona fide general taxation (which is not arbitrary or punitive) is not expropriatory and therefore is not 'a taking of property' in the expropriation sense. My use of 'taking' or 'taking of property' is in the general sense of the term (i.e. not meaning 'expropriation'), and because money is property, when one is taxed (including bona fide general taxation), money is taken.

[82] (1880) 102 U.S. 691.

[83] In Richard A. Epstein's *Takings: Private Property and the Power of Eminent Domain* (Harvard University Press 1985) at 95, Epstein suggests that "*[a]ll* regulations, *all* taxes, and *all* modifications of liability rules are takings of private property prima facie compensable by the state" (emphasis original). Epstein's assessment does not necessarily entail the monetary compensation by the state (that would be counterproductive to collecting tax) but that taxes should not be taken without benefit being given to the public in governance, policing and military protection, public health, environmental protection, education, etc., and is therefore compatible with Mr Justice Field's passage.

> determined by a jury or officers of the government appointed for that purpose. In the one case, the owner bears only a share of the public burdens; in the other, he exchanges his property for its equivalent in money. The two things are essentially different"[84] (emphasis mine).

The above passage shows that: (i) government protections (or 'public benefits') that are funded by taxed money (such as policing and even governance itself) are provided in 'compensation' for the collection of taxes, with the owner of the taxed money bearing only a share of the public burden to pay for those benefits (this is bona fide general taxation); and (ii) the taking of private property for public use (such as privately owned land taken for building a road) must be paid for by the state with 'full compensation' because although the owner of that land will also benefit from the public use (use of the road in the example given), he would have contributed the entirety of the property for the public benefit. The passage, however, fails to address the possibility of a person contributing the entirety of his earnings to the taxman and so it fails to address the possibility of taxation being arbitrary or punitive.

United States case law did eventually recognise that the power to tax can be exceeded by the state if the tax "is a flagrant abuse, and by reason of its arbitrary character is mere confiscation of particular property".[85] The American law on the matter was formulated by Mr. Justice Sutherland representing a unanimous court[86] in *A. Magnano Co. v Hamilton*[87], definitively recognising that the confiscation of property can be disguised through taxation:

[84] *County of Mobile v Kimball* at 703, as quoted by Mann (n. 56) 213 at note 25; a similar passage with similar effect was given by a New York court in *People v Mayor of Brooklyn* (1857) 4 N.Y. 419: "Eminent domain differs from taxation in that, in the former case, the citizen is compelled to surrender to the public something beyond his due proportion for the public benefit. The public seize and appropriate his particular estate, because of a special need for it, and not because it is right, as between him and the government, that he should surrender it. To him, therefore, the benefit and protection he receives from the government are not sufficient compensation; for those advantages are the equivalent of the taxes he pays, and the other public burdens he assumes in common with the community at large. And this compensation must be pecuniary in its character, because it is in the nature of a payment for a compulsory purchase" (see Mann (n. 56) 203).
[85] *Houck v Little River Drainage District* (1915) 239 U.S. 254, per Mr. Justice Hughes at 264.
[86] Mann (n. 56) 213 at note 27.
[87] (1933) 292 U.S. 40.

> "Except in rare and special instances the due process of law clause contained in the Fifth Amendment is not a limitation upon the taxing power conferred upon Congress by the Constitution… That clause is applicable to a taxing statute such as the one here assailed only if the Act be *so arbitrary* as to compel the conclusion that it *does not* involve an exertion of the *taxing power*, but constitutes, in *substance and effect*, the indirect exertion of a different and forbidden power, as for example the *confiscation of property*… Collateral purposes or motives of a legislature in levying a tax of a kind within the reach of its *lawful power* are matters beyond the scope of judicial inquiry… Nor may a tax within the lawful power be stricken down under the due process clause simply because its enforcement may or will result in restricting or even destroying particular occupations or businesses…; unless indeed, as already indicated, its necessary interpretation and effect be such as plainly to demonstrate that the form of taxation was adopted as a mere disguise under which was exercised, in reality, another and different power denied by the Federal Constitution to the state"[88] (emphasis mine).

The judgment above determines that: (i) the intent behind the levying of a tax can be challenged[89]; (ii) the exertion of the taxing power that results in arbitrary levies changes the nature of the tax into an unlawful taking ("constitutes, in *substance and effect*, … a forbidden power" (emphasis mine)); (iii) taxation is capable of unlawfully being adopted as a disguise for the exercise of a different power which includes the taking of property (i.e. indirect/creeping expropriation); and (iv) bona fide general taxation that results in restrictions or the destruction of business is not unlawful.[90]

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[88] *ibid* at 44, as quoted in Mann (n. 56) 213-214 at note 27.

[89] The due process of law provision of the Fifth Amendment to the United States Constitution was invoked in this case, and the Fourteenth Amendment had also been invoked in case law when a "proposed tax will deprive [an owner] of [his] property without due process of law in violation of the Fourteenth Amendment" (*Browning et al v Hooper et al* (1926) 269 U.S. 396, at 400.

[90] For example, if a company in England and Wales will enter financial difficulties because of national insurance contributions that it is liable to pay, that bona fide general tax cannot be disputed as unlawful.

Similar principles were established in Germany, where bona fide taxation that prejudiced the solvency of a business was lawful[91] but the imposition of a tax that completely eliminated profits or required recurrent resort to disposing of capital resulting in the destruction of business[92] was challengeable as being an unlawful exercise of the power to tax.

It is clear from the above that taxation was deemed capable of constituting an unlawful taking of property[93] by domestic courts since over 100 years ago. International tribunals within the past century, however, did consider fiscal measures and more specifically taxation as being capable of having an expropriatory nature[94] and investors were left without recourse to arbitration from arbitrary taxation.[95]

In *Kügele*,[96] an ethnic German in Upper Silesia took the Polish State[97] to arbitration at the tribunal set up by the Geneva Convention, named the Upper Silesian Arbitral Tribunal (*Tribunal Arbitral de la Haute Silésie*) which was independent of the local courts and the diplomatic protection of the investor's home state.[98] Poland imposed a licence fee[99] on a brewery owned by an Upper Silesian German, which he claimed was a confiscatory tax which forced him to close his business. He therefore filed for compensation at the Arbitral Tribunal for Upper Silesia, claiming that the tax was what is now called an indirect expropriation. The arbitral tribunal decided against the brewery owner on the reasoning that imposition of a tax recognises he trades in the business, and if he pays the tax, he may carry on trading in the business, and therefore "the increase of the tax cannot be regarded as… taking away or impairment of the right to engage in the trade".[100] The President of the Upper Silesian Arbitral

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[91] Mann (n. 56) 214.
[92] *ibid*.
[93] Mann (n. 56) 213.
[94] Park in Rogers and Alford (n. 79) 235
[95] William Park, 'Arbitrability and Tax' in Loukas A. Mistelis and Stavros L. Brekoulakis (eds), *Arbitrability: International & Comparative Perspectives* (Kluwer Law International 2009), 187.
[96] *Kügele v Polish State*, Arbitration before the Upper Silesian Arbitral Tribunal, 5 February 1932 (*Kügele*), reprinted as Case No. 34 in Hersch Lauterpacht (ed), *International Law Reports: Volume 6 – Annual Digest of Public International Law Cases 1931-1932* (CUP 1945) 69.
[97] Upper Silesia (which is now part of Poland) was divided between Germany and Poland by the League of Nations through a Geneva Convention in 1922. Some Polish-speakers remained in what was the German side and some German-speakers remained in what was the Polish side of Upper Silesia.
[98] Park in Rogers and Alford (n. 79) 236.
[99] The equivalent today is an excise duty.
[100] Lauterpacht (n. 96) 69.

Tribunal, Georges Kaeckenbeeck wrote an article in 1936 stating that the exercise by a state of its tax power "whatever the sacrifice it may impose on individuals" does not require compensation by the standards of international law[101] and that the grounds for compensation in tax expropriation claims is for the alleviation of exceptional hardship rather than for reparation of a wrong.[102] Kaeckenbeeck also pressed the point that a state which receives foreign investors into its territory does not insure those investors against losses accruing to them as a result of legislative changes and shifts in policies, "however radical these may be."[103] This doctrine allowed sovereignty to be a form of robbery because it prevented justice – the positive thing is that it has since been discredited[104] and investors generally do have access to justice for arbitrary taxation (see section 3.5 below).

3.1.3 Influential Texts in the Development of Modern Expropriation Provisions

Certain international conventions and other texts which have been intrinsic in the development of the identical or very similar language in expropriation provisions in modern IITs are discussed next, and although the 1950 European Convention on Human Rights (ECHR) is the only binding text of those discussed, the others have been influential in the development of the expropriation doctrine.[105]

3.1.3.1 1950 European Convention on Human Rights

Property rights are codified under Article 1 of Protocol 1 of the ECHR. There are three distinct but connected rules under Article 1 of Protocol 1 of the ECHR.[106] The first rule lays down the principle of the peaceful enjoyment of possessions, whereby

[101] Georges Kaeckenbeeck, 'The Protection of Vested Rights in International Law' (1936) 17 *Brit. Y.B. Int'l L.*1, 16.
[102] *ibid*
[103] *ibid*; see section 3.4.3 below on investment treaties not being insurers of business risks.
[104] Park in Mistellis and Brekoulakis (n. 95) 187; it is still correct that host states do not act as insurers of foreign investors and their investments and IITs do not act as insurance policies (see 3.4.2 and 3.4.3 below), but this is only applicable now with respect to business risks and not 'radical' governmental and political decisions.
[105] OECD (2004) (n. 22) 6.
[106] *National & Provincial Building Society, Leeds Permanent Building Society and Yorkshire Building Society v United Kingdom*, ECtHR Application No. 117/1996/736/933-935, Judgment of 23 October 1997, at para 78.

every natural and legal person is entitled to the peaceful enjoyment of their possessions.[107]

The second rule covers the deprivation of property, making the deprivation of property conditional on being in the public interest and "subject to the conditions provided for by law and by the general principles of international law."[108]

The third rule recognises the necessity for states to interfere with property rights and Article 1 of Protocol 1 therefore does not "impair the right of a State to enforce such laws as it deems necessary to control the use of property in accordance with the general interest or *to secure the payment of taxes* or other contributions or penalties"[109] (emphasis mine).

The three rules are connected with one another because "the second and the third rules are concerned with particular interferences with the right to peaceful enjoyment of property and should therefore be construed in the light of the general principle enunciated in the first rule."[110]

International laws aim to balance people's rights with the rights of the state to govern. Consequently, the ECHR recognises people's rights to property as well as the rights of governments to enforce laws that may affect peoples' use or enjoyment of their properties. The embodiment of this balance in the ECHR has served to shape IITs that also recognise the ability of the state to intervene with private property for legitimate public policy purposes. If international conventions and treaties did not recognise the right for states to govern then they would fail to garner signatories because potential signatories would assess those laws as impeding too much on their sovereignty and open up Pandora's box for claims by individuals and companies against the state for bona fide governance.

For that reason, the ECHR recognises the sovereign power to enforce tax laws, and the same principle is followed in modern IITs. Under the ECHR at the European

[107] Article 1 of Protocol 1, ECHR.
[108] *ibid.*
[109] *ibid.*
[110] *National & Provincial Building Society* at 78.

Court of Human rights (ECtHR), "[i]n so far as the tax sphere is concerned … the [ECtHR's] well-established position is that States may be afforded some degree of additional deference and latitude in the exercise of their fiscal functions under the lawfulness test",[111] the lawfulness test being striking a fair balance between the legitimate state interest in enforcing the tax debt and the protection of the applicant's rights set forth in Article 1 of Protocol 1.[112]

A state can therefore be found liable under the ECHR by a court with jurisdiction[113] for enforcing its sovereignty in an unfair manner.[114]

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[111] *OAO Neftyanaya Kompaniya Yukos v Russia*, ECtHR Application No. 14902/04, Judgment of 17 January 2012 (*Yukos v Russia*), para 559; see also *National & Provincial Building Society* at para 80: "a Contracting State… when framing and implementing policies in the area of taxation, enjoys a wide margin of appreciation and the [ECtHR] will respect the legislature's assessment in such matters unless it is devoid of reasonable foundation".

[112] *ibid* at para 646.

[113] Courts with jurisdiction to rule on ECHR violations are national courts of the European host states and the ECtHR. International human rights laws and HCtHR cases have however been used in assessing whether expropriations have occurred (*Técnicas Medioambientales Tecmed, S.A. v. United Mexican States*, ICSID Case No. ARB(AF)/00/2, Award of 29 May 2003 (*Tecmed* at para 122 note 140); international human rights law is sometimes used by host states to justify their actions (*Siemens* at para 75 – Argentina claimed the human rights incorporated into its constitution would be disregarded by recognising the claimant's property rights in the social and economic conditions of Argentina during its 1998-2002 economic crisis); human rights laws (unless incorporated into an investment treaty) are non-investment treaty obligations, and are held in the same vain as other non-investment treaty obligations such as environmental protection obligations which have been dismissed as irrelevant to determining the legal character of expropriation (*Santa Elena* at para 71; see also Ioana Knoll-Tudor, 'The Fair and Equitable Treatment Standard and Human Rights Norms', in Pierre-Marie Dupuy, Fransesco Francioni and Ernst-Ulrich Petersmann (eds.), *Human Rights in International Investment Law and Arbitration* (OUP 2009) 339); it is, however, possible for human rights to be taken into account by arbitral tribunals without overreaching their jurisdiction by applying inapplicable laws (i.e. they can do so without risking revision or annulment of award proceedings under Articles 51 and 52 of the ICSID Convention respectively or under Article V of the New York Convention) if: (i) the arbitration is at ICSID, which permits tribunals to apply international law in the absence of an agreement of the applicable law by the parties to the arbitration agreement giving rise to the arbitration; (ii) the IIT directs arbitral tribunals to apply international law (e.g. Article 1131, NAFTA); (iii) human rights violations trigger investment law violations, because investment arbitration tribunals only have jurisdiction to preside over investment disputes (Eric De Brabandere, 'Human Rights Considerations in International Investment Arbitration' (2013) Grotius Centre for International Legal Studies Working Paper 201/001-IEL, 13 <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2230305> accessed 28 December 2013); or (iv) when non-parties to an arbitration raise human rights issues in *amicus curiae* submissions (Luke Eric Peterson and Kevin R. Gray, 'International Human Rights in Bilateral Investment Treaties and in Investment Treaty Arbitration' (2003) International Institute for Sustainable Development Research Paper, 20 <http://www.iisd.org/pdf/2003/investment_int_human_rights_bits.pdf> accessed 28 December 2013.

[114] As part of the Yukos affair (see section 3.5.1.6 below), Yukos brought claims against the Russian state at the ECtHR (*Yukos v Russia* (n. 111)). Tax assessments made against Yukos in 2004 for the year 2000 fell outside a three-year statutory time-bar set out in Article 113 of the Russian Tax Code (*Yukos v Russia* at para 561 and 564), but because the tax assessments for the year 2000 were subject to criminal proceedings, a 14 July 2005 decision by Russia's Constitutional Court changed the interpretation of the rules on statutory time-limits to tax assessments subjected to criminal proceedings (*Yukos v Russia* at para 565). The ECtHR judged the change in interpretation to be a violation of

3.1.3.2 1959 Draft Convention on Investments Abroad

The 1959 Draft Convention on Investment Abroad (the Abs-Shawcross Draft Convention)[115] was summoned by lawyers and European business people under the guidance of Hermann Abs who was Chairperson of the Deustche Bank in Germany, and Lord Shawcross, former Attorney-General of the United Kingdom.[116] The Abs-Shawcross Draft Convention contains a provision on expropriation in Article III:

> "No Party shall take any measures against nationals of another Party to deprive them *directly* or *indirectly* of their property except under due process of law and provided that such measures are not discriminatory or contrary to undertakings given by that Party and are accompanied by the payment of just and effective compensation" (emphasis mine).

The word *expropriation* is not used in the draft text, and interestingly neither is *nationalisation*, words which come together in nearly every provision on

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Article 1 of Protocol 1 notwithstanding the margin of appreciation for states to exercise their powers for the collection of taxes (*Yukos v Russia* at para 574). In addition, the unlawful tax assessment for the year 2000 led to Yukos being fined as a repeat offender in 2001 for its 2001 tax assessments, resulting in a 100% increase in fines payable (i.e. a double fine) (*Yukos v Russia* at para 575). The double fine was also a violation by Russia of Article 1 of Protocol 1 (*Yukos v Russia* at para 575); and with respect to measures utilised by Russia to enforce Yukos's tax debt, including attachment and freezing orders, seizure orders and orders to pay enforcement fees (*Yukos v Russia* at para 646) and the sale of the Yukos's main production unit (OAO Yuganskneftegaz (YNG)) in bankruptcy proceedings (which claimant claimed the was unlawful, arbitrary and disproportionate to the legitimate aims of those measures sought (*Yukos v Russia* at para 621) because as the company's main oil production unit (*Yukos v Russia* at para 619) YNG should have been auctioned last under domestic legislation rules and because it was sold at a low price to a sham bidder (*Yukos v Russia* at para 621)), were all said to be interference with the applicant company's rights under Article 1 of Protocol 1 (*Yukos v Russia* at para 646). These measures constitute the enforcement of "such laws as [they] deem necessary to secure the payment of taxes or other contributions or penalties" (Article 1 of Protocol 1), but the court had to determine whether the Russian state authorities complied with the lawfulness test under the ECHR. The court found that the Russian authorities lacked flexibility in their enforcement of the laws with respect to enforcement of the tax debt (*Yukos v Russia* at para 656) which at the time of auction stood at some EUR 11.061 billion (*Yukos v Russia* at para 645), and "given the pace of the enforcement proceedings, the obligation to pay the full enforcement fee and the authorities' failure to take proper account of the consequences of their actions, the Court finds that the domestic authorities failed to strike a fair balance between the legitimate aims sought and the measures employed" (*Yukos v Russia* at para 657) resulting in a violation of Article 1 of Protocol 1 (*Yukos v Russia* at para 658).

[115] Reprinted in UNCTAD, 'International Investment Instruments: A Compendium', (2000) Volume V - Non-Governmental Instruments, Doc. No. UNCTAD/DITE/2(Vol.V), 332-335 <http://www.unctad.org/sections/dite/iia/docs/Compendium//en/137%20volume%205.pdf> accessed 14 October 2010.

[116] *ibid* 302.

expropriation in IITs and are altogether referred to as *expropriation*.[117] The Abs-Shawcross Draft Convention instead uses the term 'deprive'. Deprivation is one of the tests used in finding an indirect expropriation (see sections 3.2.3 and 3.4.4 below). Another term commonly used to describe expropriation is 'taking', for example, the term 'direct takings' is sometimes used instead of 'direct expropriation'. Takings and deprivations both effectively amount to the same result and that is because an investor is deprived of his property when it is taken and is also deprived of his property when he is prevented from using/enjoying it, and the two terms have been used interchangeably.[118] The Abs-Shawcross Draft Convention does not contain a provision for measures equivalent or tantamount to nationalisation or expropriation.[119]

3.1.3.3 1961 Draft Convention on the International Responsibility of States for Injuries to Aliens

The codification of the customary international law on expropriation was attempted by the 1961 Draft Convention on the International Responsibility of States for Injuries to Aliens[120] (1961 Harvard Draft).[121] Article 10 of the 1961 Harvard Draft is titled *Taking and Deprivation of Use or Enjoyment of Property*, which outlines the following rules:

1. The taking, under the authority of the State, of any property of an alien, or of the use thereof, is *wrongful*:
   (a) If it is not for a public purpose clearly recognised as such by a law of general application in effect at the time of the taking, or

[117] For example, Article 1110(1) of NAFTA states: "No party may… nationalize or expropriate an investment of another party or take measures tantamount to nationalization or expropriation of such an investment ("expropriation")".
[118] Section 192, Restatement (Second) Foreign Relations Law of the United States 1965 (Second Restatement). The exact definition of *taking* in the Second Restatement is: "conduct attributable to a state that is intended and does, effectively deprive an alien of substantially *all* the benefit of his interest in property even though the state does not deprive him of his entire legal interest in the property" (emphasis mine); see discussion on levels of deprivation at sections 3.2.3 and 3.4.4 below.
[119] Measures equivalent or tantamount to nationalisation or expropriation are now included in almost every modern IIT and as discussed at section 3.2.2 below, measures tantamount/equivalent to expropriation is another term for indirect expropriation.
[120] Newcombe and Paradell (n. 13) 329.
[121] Louis B. Sohn and R. R. Baxter, 'Responsibility of States for Injuries to the Economic Interests of Aliens', 1961) 55 *A.J.I.L.* 545-584.

(b) If it in violation of a Treaty.

2. The taking, under the authority of the State, of any property of an alien, or the use thereof for a public purpose clearly recognised as such by a law of general application in effect at the time of the taking is wrongful if it is not accompanied by prompt payment of compensation in accordance with the highest of the following standards:

   (a) compensation which is no less favorable than that granted to nationals of such State; or

   (b) just compensation in terms of the fair market value of the property or of the use thereof; or

   (c) if no fair market value exists, just compensation in terms of the fair value of such property or of the use thereof…

3. (a) A "*taking of property*" includes not only an *outright* taking of property but also any such *unreasonable interference* with the use, enjoyment, or disposal of property as to justify an inference that the owner thereof will not be able to use, enjoy, or dispose of the property *within a reasonable period of time* after the inception of such interference… (emphasis mine)

Article 10(1) and (2) embody the concept of direct expropriation and this is confirmed by the 1961 Harvard Draft's Explanatory Note where it is written that indirect takings fall under Article 10(3),[122] making indirect takings the embodiment of indirect expropriation. The Explanatory Notes provide examples of methods states might use to *take* property and these include, inter alia, eminent domain, requisition, pre-emption, expropriation and nationalisation.[123] The main contributor to an expropriation to be regarded as wrongful is the non-payment of adequate compensation to the investor or restitution of the property *ceteris paribus*.[124] The Explanatory Notes also give examples of state measures that cause an 'interference' with the use, enjoyment or disposal of property, such as making it impossible for a foreign investor to operate a factory which he owns by blocking the entrances to the factory to allegedly maintain order[125] or the state forbids the foreign investor to sell

[122] *ibid* 555.
[123] *ibid*.
[124] *ibid* 556; *Ceteris paribus* is Latin for "all other things being equal or held constant" – i.e. restitution of the property in condition no worse than at the time it was taken.
[125] *ibid* 559.

his property thereby depriving that property of its value.[126] Whilst the 1961 Harvard Draft provides these examples, they are not limiting examples and this is conveyed by the text's recognition of the need for "unreasonableness of an interference with the use, enjoyment, or disposal of property"[127] to be decided according to the international legal standard recognised by the principal legal systems of the world which is "best worked out by international tribunals",[128] and this has since been worked out by international arbitral tribunals and the international legal standard continues to develop.

Article 10(3)(a) sets a *time* requirement whereby a period of time must lapse for an expropriation[129] to exist, said time being an unreasonable duration until the investor is once again able to use his property. The Explanatory Notes leave it to the adjudicator to determine when restriction on the use of property ceases to be temporary and falls to become an unreasonable period of time, for example, if "an objective observer would conclude that there is no immediate prospect that the owner will be able to resume the enjoyment of his property."[130]

Article 10(2) of the 1961 Harvard Draft also recognised the requirement of prompt compensation and its sub-articles provided a means of calculating adequate compensation, with Article 10(2)(a) interestingly employing the national treatment principle in calculating adequate compensation.

On the topic of taxation, Article 10(5) provides that an uncompensated taking of property or the deprivation of the use and enjoyment of property of a foreign investor resulting from the execution of tax laws shall not be considered wrongful if "…it is not an unreasonable departure from the principles of justice recognized by the principal legal systems of the world…[131] and… it is not an abuse of powers… for the purpose of depriving an alien of his property."[132]

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[126] *ibid*.
[127] *ibid*.
[128] *ibid*.
[129] i.e. the "*taking of property*" including an *outright* taking of property or *unreasonable interference* with the use, enjoyment, or disposal of property.
[130] Article 10(3)(a), 1961 Harvard Draft.
[131] *ibid*, Article 10(5)(c).
[132] *ibid*, Article 10(5)(d).

3.1.3.4 1967 Draft Convention on the Protection of Foreign Property

The 1967 Organisation for Economic Co-operation and Development Draft Convention on the Protection of Foreign Property[133] (1967 OECD Draft Convention) states:

> "No Party shall take any measures depriving, directly or indirectly, of his property a national of another Party unless the following conditions are complied with:
>
> i. The measures are taken in the public interest and under due process of law;
> ii. The measures are not discriminatory; and
> iii. The measures are accompanied by provision for the payment of just compensation. Such compensation shall represent the genuine value of the property affected, shall be paid without undue delay, and shall be transferable to the extent necessary to make it effective for the national entitled thereto."[134]

Like the Abs-Shawcross Draft Convention, the text of the 1967 OECD Draft Convention refers to direct and indirect deprivation and does not mention measures equivalent or tantamount to 'deprivation'. The notes and comments on Article 3 do however call deprivation "expropriation" or "nationalisation", with indirect deprivation said to constitute "*any* measures taken with the *intent* of wrongfully depriving the national concerned of the substance of his rights and *resulting* in such loss (e.g. prohibiting the national from selling his property or forcing him to do so at a fraction of the fair market price) (emphasis original)."[135] By using the words 'any measures', the text can be seen as broad enough to consider the concept of creeping expropriation and actually refers to 'creeping nationalisation'.[136] The notes and comments also outline how *wrongful interference* by a state on an investor's property

[133] 'O.E.C.D. Draft Convention on the Protection of Foreign Property', (1967) 7 *ILM* 117-143.
[134] Article 3, 1967 OECD Draft Convention.
[135] *ibid*.
[136] OECD *ILM* (n. 133) 125-126; see section 3.4.5 below on creeping expropriation.

(be it unreasonable or discriminatory) can amount to an indirect deprivation, and although such deprivation may seem temporary, there comes a point where "there is no immediate prospect that the owner will be able to resume enjoyment of his property."[137] The notes and comments tell us that 'creeping nationalisation'[138] falls under Article 3 and this was a new method of expropriation at that time.[139] Creeping nationalisation is defined in the text as lawful measures that are applied in a way to ultimately deprive the foreign investor of the use or enjoyment of his property without the state committing any acts which are noticeably an outright deprivation.[140] Examples include "excessive or *arbitrary taxation*" (emphasis mine) as well as the "prohibition of dividend distribution coupled with compulsory loans; imposition of administrators; prohibition of dismissal of staff; refusal of access to raw materials or essential export or import licences."[141]

The recognition by the drafters of the 1967 OECD Draft Convention that the new method of expropriation (new at that time), 'creeping expropriation' (or 'creeping nationalisation' as it was referred to in the Convention's text), can be deployed by excessive or arbitrary taxation, was profound recognition and that assertion remains the same today.

3.1.3.5 Draft Multilateral Agreement on Investment

The OECD guided the negotiations of the Multilateral Agreement on Investment (MAI) in 1995. The negotiations for the MAI were discontinued early in April 1998 before the text could be finalised and it therefore remains a draft text (Draft MAI). The intention was to have the MAI as "a free-standing international treaty open to both OECD countries and non-OECD countries."[142] The definition of expropriation contained in the Draft MAI is as follows:

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[137] OECD *ILM* (n. 133) 125.
[138] Now referred to as *creeping expropriation*.
[139] OECD *ILM* (n. 133) 125-126; the text says creeping nationalisation had been "recently practiced by certain States."
[140] *ibid* 126.
[141] *ibid*.
[142] OECD Directorate for Financial and Enterprise Affairs, 'Multilateral Agreement on Investment', <http://www.oecd.org/document/22/0,3343,en_2649_33783766_1894819_1_1_1_1,00.html> accessed 27 November 2010.

"A Contracting Party shall not expropriate or nationalise *directly or indirectly* an investment in its territory of an investor of another Contracting Party or take any measure or measures having *equivalent effect* (hereinafter referred to as "expropriation") except:
a) for a purpose which is in the public interest,
b) on a non-discriminatory basis,
c) in accordance with due process of law, and
d) accompanied by payment of prompt, adequate and effective compensation in accordance with Articles 2.2 to 2.5 below…"[143] (emphasis mine).

The expropriation article of the Draft MAI contains, by in large, the type of expropriation provision that we now find in most IITs and that is because it was being drafted in the 1990s boom of BITs which by that stage many BITs had been signed and ratified by states across the globe. The Draft MAI therefore includes a provision on *direct and indirect* expropriation (and uses the word expropriation in the article itself), and includes "measures having equivalent effect" to direct or indirect expropriation.[144] An interpretative note to the expropriation provision states that expropriation, nationalisation and "measures *tantamount* to expropriation or nationalisation" are measures that require compensation regardless of the labels applied to them and this is the case "even if title to … property is not taken."[145] The same note also elaborates that this type of expropriation provision does not establish a new requirement that compensation is payable for losses that an investor or investment incurs through regulation and revenue raising (i.e. taxation).[146]

The Draft MAI also contains a tax exclusions/inclusions article at Article VIII under which the expropriation article of the Draft MAI applies to taxation measures (Article VIII(2)). Taxation measures include:

143 Section VI, Article 2.2.1, Draft MAI (OECD Negotiating Group on the Multilateral Agreement on Investment (MAI), 'The Multilateral Agreement on Investment- Draft Consolidated Text' (22 April 1998) Doc. No. DAFFE/MAI(98)7/REV1 <http://www.oecd.org/daf/mai/pdf/ng/ng987r1e.pdf> accessed 27 November 2010.
144 See section 3.2.2.2 for the meaning behind 'measures equivalent/tantamount to expropriation'.
145 Draft MAI (n. 143) 143.
146 *ibid*.

(i) any provision relating to taxes of the law of [a] Contracting Party or of a political subdivision thereof or a local authority therein, or any administrative practices of [a] Contracting Party relating to taxes; and

(ii) any provision relating to taxes of any convention for the avoidance of double taxation or of any other international agreement or arrangement by which the Contracting Party is bound.[147]

The interpretive notes also recognise some taxation measures as being capable of constituting an expropriation, though taxes in the general sense will not constitute expropriation, especially if they are "within the bounds of internationally recognised tax policies and practices."[148]

3.2 Expropriation Provisions in Modern Investment Treaties

The text of expropriation provisions is fairly uniform across most BITs and multilateral investment treaties (MITs) but small variations in the texts themselves or any supplementary protocols or letters of exchanges do exist and these differences can result in a broader or narrower definition of expropriation. Because an arbitral tribunal will have a duty to examine the expropriation provision applicable to the specific dispute before it, if those variations have any weight assigned to them (and therefore the expropriation articles are construed as either broad or narrow) the outcome of the same expropriation claim can be different under various IITs. The differences and any relevant interpretations of IIT articles are discussed next.

3.2.1 'Measures' and 'Taxation Measures'

The majority of IITs do not define 'measures' but those that do provide a definition define it broadly as "any law, regulation, procedure, requirement, or practice"[149]. The Draft MAI contains a definition of 'taxation measures' which includes "any provision relating to taxes of the law of the Contracting Party or of a political

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[147] Article VIII(5)(b), Draft MAI.
[148] Draft MAI (n. 143) 86.
[149] Agreement between the Government of the Republic of Costa Rica and the Government of Canada for the Promotion and Protection of Investments, signed 18 March 1998, entered into force 29 September 1999 (Canada-Costa Rica BIT).

subdivision thereof or a local authority therein, or any administrative practices of the Contracting Party relating to taxes" and taxes are taken to include "direct taxes, indirect taxes and social security contributions."[150]

For investment treaty and arbitration purposes, anything that is an action or inaction attributable to the host state will be a measure and likewise anything that is an action relating to taxation (e.g. the levying of taxes) or inaction relating to taxation (e.g. the refusal to grant tax refunds) will be a taxation measure attributable to the host state. However, whether those measures are expropriatory will only be decided "based on the facts of specific cases."[151] Some BITs even provide examples of measures that can amount to an expropriation, such as the US-Egypt BIT[152] which lists the "levying of taxation"[153] as one such measure. According to the Letter of Submittal of the US-Egypt BIT, the state parties "agree to international law standards for expropriation" and the meaning of expropriation in the BIT is "broad and flexible [and] includes any measure which is 'tantamount to expropriation or nationalization.'"[154] The Letter of Submittal of the US-Morocco BIT[155] also sets out the broadness and flexibility of what can constitute an expropriation, whereby the definition of expropriation is said to be "broad and flexible" enough to allow "essentially any *measure* regardless of *form*, which has the effect of *depriving* an investor of his management, control or economic value in a project"[156] (emphasis mine). Therefore, because taxation can be used both in theory and in practice to effectively expropriate an investment, tax measures will be 'measures' for the purposes of investors' claims under expropriation provisions contained in investment treaties.

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[150] Article VIII(5)(b), Draft MAI; social securities are likely to be interpreted by an arbitral tribunal as taxes – *Hellenic Electric Railways Ltd v Government of Greece,* Ad Hoc Arbitration, Geneva, Award of 18 March 1930, in which the arbitral tribunal rejected the distinction between social security contributions and taxes.

[151] *Feldman* Award at para 102; the United States Model BIT 2012 at Annex B para 4(a) states that "[t]he determination of whether an action or series of actions by a Party, in a specific fact situation, constitutes an indirect expropriation, requires a case-by-case, fact-based inquiry…."

[152] Treaty between the United States of America and the Arab Republic of Egypt Concerning the Reciprocal Encouragement and Protection of Investments, with a Related Exchange of Letters and a Supplementary Protocol, signed 11 March 1986, entered into force 27 June 1992 (US-Egypt BIT).

[153] *ibid*, Article III.

[154] *ibid*, under the heading 'The U.S.-Egypt Treaty'.

[155] Treaty between the United States of America and the Kingdom of Morocco Concerning the Encouragement and Reciprocal Protection of Investments, with Protocol, signed 22 July 1985, entered into force 29 May 1991 (US-Morocco BIT).

[156] *ibid* Letter of Submittal.

The tribunal in *EnCana*[157] summarised what taxes, tax measures and tax laws are under the international law of IITs. Under the *EnCana* definition, tax includes not only direct taxes (including income tax, corporation tax, capital gains tax) but indirect taxes too (such as excise duties and VAT).[158] Tax measures relate not only to the actual provisions of the law that impose taxes, but all "aspects of the tax regime which go to determine how much tax is payable or refundable…"[159] and a "taxation law is one which imposes a liability on classes of persons to pay money to the State for public purposes."[160] Measures are taxation measures if they "are part of the regime for the imposition of a tax"[161] and measures providing relief for taxation are also tax measures to the same extent as measures that impose taxes.[162] Taxation measures therefore extend to laws that provide "relief from taxation"[163] as well as a "law imposing an obligation on a supplier to charge VAT… 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."[164]

3.2.2 Different Headings of Expropriation – Under Which Does Tax Fall?

'Direct expropriation' and 'indirect expropriation' are noticeably different by name and what constitutes a direct expropriation and an indirect expropriation is discussed in sections 3.3 and 3.4 of this chapter respectively. However, whether measures equivalent or tantamount to expropriation is a part of indirect expropriation or is a separate concept must be examined here because the different wording of expropriation articles has led to the same being addressed in arbitral awards.

[157] *EnCana Corporation v Republic of Ecuador*, LCIA Case No. UN3481, Award and Partial Dissent of 3 February 2006 (*EnCana*, *EnCana* Award or *EnCana* Dissent).
[158] *EnCana* Award at para 142(2).
[159] *ibid* at para 142(3).
[160] *ibid* at para 142(4).
[161] *ibid*.
[162] *ibid*.
[163] *ibid*.
[164] *ibid*.

3.2.2.1 Tantamount v Equivalent

I will firstly dispose of the question of whether a difference might be construed between measures tantamount to expropriation and measures equivalent to expropriation.[165] A quick reference to the Oxford Dictionary will show us the definition of 'tantamount to' is "equivalent in seriousness to; virtually the same as"[166] and 'equivalent to' is "having the same or a similar effect as."[167] It is extremely unlikely that an arbitral tribunal will, all things being the same, decide an expropriation claim differently because the expropriation article in the IIT contains the word tantamount instead of equivalent and vice versa. The *Pope & Talbot*[168] and *S.D. Myers*[169] tribunals both deduced that the words *tantamount* and *equivalent* are synonyms of each other,[170] with the *S.D. Myers* tribunal following the same thought process as I have done.[171] The *S.D. Myers* tribunal concurred with the *Pope & Talbot* tribunal "that something that is 'equivalent' to something else cannot logically encompass more."[172]

Therefore, 'measures tantamount' and 'measures equivalent' are the same and will be used interchangeably for the remainder of this chapter.

3.2.2.2 Indirect Expropriation v 'Measures Tantamount'

NAFTA is a free trade agreement (FTA) with investment treaty provisions and Chapter 11 of NAFTA effectively qualifies as a MIT. The signatories to NAFTA are

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[165] McLachlan et al (n. 3) 273.
[166] Oxford Dictionary Online <http://oxforddictionaries.com/view/entry/m_en_gb0844240#m_en_gb0844240> accessed 23 November 2010.
[167] Oxford Dictionary Online, <http://oxforddictionaries.com/view/entry/m_en_gb0271460#m_en_gb0271460> accessed 23 November 2010.
[168] *Pope & Talbot, Inc. v Government of Canada*, NAFTA Arbitration, Interim Award of 26 June 2000 at para 104.
[169] *S.D. Myers, Inc. v Government of Canada* (NAFTA Arbitration), First Partial Award of 13 November 2000 at para 285.
[170] *Pope & Talbot* Interim Award at para 104; *S.D. Myers* First Partial Award at para 285.
[171] Referring to the Oxford Dictionary.
[172] *S.D. Myers* Partial Award at para 286.

the United States, Canada and Mexico. Article 1110 is titled 'Expropriation and Compensation' and says the following:

> "No Party may *directly* or *indirectly* nationalize or expropriate an investment of an investor of another Party in its territory *or* take a measure tantamount to nationalization or expropriation of such an investment ("expropriation")…"[173] (emphasis mine).

The NAFTA text appears to differentiate between direct and indirect expropriation on the one hand and measures tantamount to expropriation on the other with the inclusion of the word "or" at Article 1110(1). The arbitral tribunal in *Waste Management*[174] gave Article 1110(1) that interpretation, stating that "an indirect expropriation is … a taking of property"[175] in the same way direct expropriation is, and these are to be distinguished from a measure that is tantamount to expropriation which requires the measure(s) to have an effect on property which makes formal distinctions of ownership irrelevant"[176] and need not involve the "actual transfer, taking or loss of property by any person or entity."[177] The tribunal determined that the phrase "take a measure tantamount to nationalization or expropriation of such an investment" was included in Article 1110(1) "to add to the meaning of the prohibition" against nationalisation and expropriation which is "over and above the reference to indirect expropriation."[178]

The *Waste Management* tribunal, by giving "measures tantamount" a meaning which is over and above indirect expropriation could be seen as creating a new category of expropriation. In *Metalclad*,[179] which was also a NAFTA arbitration, the government of the United States (the home state) made a written submission to the arbitral tribunal in which it "rejected the suggestion that the term "tantamount to

[173] Article 1110(1), NAFTA.
[174] *Waste Management Inc. v United Mexican States*, ICSID Case No. ARB(AF)/00.3, Award of 30 April 2004.
[175] *ibid* at para 143.
[176] *ibid*.
[177] *ibid*.
[178] *ibid* at para 144.
[179] *Metalclad Corporation v United Mexican States*, ICSID Case No. ARB(AF)/97/1, Award of 30 August 2000.

expropriation" was intended to create a new category of expropriation not previously recognised in customary international law."[180]

Jurisprudence on 'measures tantamount' under Article 1110(1) of NAFTA generally does not agree with the *Waste Management* definition, whereby it is generally held that 'measures tantamount' fall under the indirect expropriation heading. In *S.D. Myers*, the arbitral tribunal found that the addition of 'measures tantamount' to treaty texts was to embrace the concept of creeping expropriation,[181] and creeping expropriation is part of indirect expropriation (see section 3.4.5 below on creeping expropriation). In *Metalclad*, the claimant claimed that Mexico had interfered with the operation of its investment and that the interference constituted a "measure tantamount to expropriation."[182] In its award, the *Metalclad* tribunal combined the concepts of indirect expropriation and measures tantamount to expropriation by not drawing a distinction between the two,[183] finding that Mexico "must be held to have taken a measure tantamount to expropriation"[184] and concluding that Mexico had "indirectly expropriated" the claimant's investment.[185] The non-distinction by the *Metalclad* tribunal has been interpreted as the tribunal combining indirect expropriation and 'measures tantamount' together.[186] In *Feldman*, the arbitral tribunal deemed indirect expropriation and 'measures tantamount' to be "functionally equivalent"[187] Despite the dissonance between the NAFTA tribunals' interpretations of Article 1110(1) and the lack of a singular definition, the findings that 'measures tantamount' are part of indirect expropriation are greater in number and are in line with the interpretation under other IITs as discussed next.

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[180] *Metalclad* Award at para 27.
[181] *S.D. Myers* Partial Award at para 286; see Creeping Expropriation at section 3.4.5 below.
[182] Rachel D. Edsall, 'Indirect Expropriation under NAFTA and DR-CAFTA: Potential Inconsistencies in the Treatment of State Public Welfare' (2006) 86 *B.U.L. Rev.* 931, 941.
[183] Metalclad Award at paras 104, 107 and 111-112; Edsall (n. 182) 942 at note 77.
[184] *Metalclad* Award at para 104.
[185] *Ibid* para 112.
[186] Edsall (n. 182) 942 at note 77.
[187] *Feldman* Award at para 100.

Investment treaties which the United States is a party to[188] that are "based on the 1994 U.S. prototype BIT"[189] (i.e. United States Model BIT 1994) contain a provision on expropriation as follows:

> "Neither Party shall expropriate or nationalize a covered investment either directly or *indirectly through* measures tantamount to expropriation or nationalization ("expropriation")…"[190]

The above provision does not make 'measures tantamount' a separate concept to indirect expropriation and instead it integrates the two together. This is made clear by reading the provision which does not contain the word "or" after "directly or indirectly", i.e. it does not read as "directly or indirectly *or* through measures tantamount…" Of course, following on from the examination of the expropriation provision in NAFTA, even if the above provision did contain the word "or", that would not make 'measures tantamount' a distinct concept on its own (because it is not a distinct concept under NAFTA, as discussed above), however the fact that it does not separate indirect expropriation from 'measures tantamount' does help to drive the point that they are one and the same. The Letters of Submittals that precede the provisions of the United States BITs which contain the above provision state that the articles on expropriation incorporate into the treaties the "customary international law standards for expropriation"[191] and that the obligations brought about by the above article apply to indirect expropriations "through measures 'tantamount to

[188] Treaty between the Government of the United States of America and the Government of the State of Bahrain concerning the Encouragement and Reciprocal Protection of Investment, with Annex and Protocol, signed 29 September 1999, entered into force 31 May 2001 (US-Bahrain BIT); Treaty between the Government of the United States of America and the Government of the Republic of Bolivia concerning the Encouragement and Reciprocal Protection of Investment, with Annex and Protocol, signed 17 April 1998, entered into force 6 June 2001 (US-Bolivia BIT); Treaty between the Government of the United States of America and the Government of the Hashemite Kingdom of Jordan concerning the Encouragement and Reciprocal Protection of Investment, with Annex and Protocol, signed 2 July 1997, entered into force 13 June 2003 (US-Jordan BIT); Treaty between the Government of the United States of America and the Government of the Republic of Azerbaijan concerning the Encouragement and Reciprocal Protection of Investment, with Annex, signed 1 August 1997, entered into force 2 August 2001 (US-Azerbaijan BIT); Treaty between the Government of the United States of America and the Government of the Republic of Georgia concerning the Encouragement and Reciprocal Protection of Investment, with Annex, signed 7 March 1994, entered into force 17 August 1997 (US-Georgia BIT).

[189] McLachlan et al (n. 3) 276.

[190] *ibid*.

[191] *ibid*.

expropriation or nationalization'"[192]. Finally, as regards United States BITs, Article 6 of the United States Model BIT 2012 (US Model BIT 2012) states:

> "Neither Party may expropriate or nationalize a covered investment either *directly* or *indirectly* through measures equivalent to expropriation or nationalization ("expropriation")…"[193] (emphasis mine).

The above model article also does not contain the word 'or' between the words "indirectly" and "through measures equivalent to…". Annex B to the United States US Model BIT 2012 states that Article 6 is "intended to reflect customary international law"[194] and in doing so it addresses two situations, one of which is direct expropriation[195] and the other is "indirect expropriation, where an action or series of actions by a Party has an effect equivalent to direct expropriation without formal transfer of title or outright seizure."[196] This further confirms that 'measures tantamount' and indirect expropriation are one and the same. Evidently, the *Metalclad* tribunal's assessment that 'measures tantamount' are over and above indirect expropriations is not the internationally accepted standard. This assessment is also made clear by IITs which do not contain the words 'direct' and 'indirect' in their expropriation articles, but nevertheless do provide for the two different headings of expropriation. Such IITs include most United Kingdom BITs,[197] the Association of Southeast Asian Nations (ASEAN) Agreement for the Promotion and

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[192] *ibid*.
[193] Article 6, US Model BIT.
[194] Annex B para 1, US Model BIT 2012.
[195] Annex B para 3, US Model BIT 2012.
[196] Annex B para 4, US Model BIT 2012.
[197] Article 5(1), Agreement between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the Arab Republic of Egypt for the Promotion and Protection of Investments, signed 11 June 1975, entered into force 24 February 1976 (UK-Egypt BIT) – this was the first BIT adopted by the United Kingdom; Article 5(1), Agreement between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the Republic of Mozambique for the Promotion and Protection of Investments, signed 18 March 2004, entered into force 27 February 2007 (UK-Mozambique BIT) – an interesting point is these two BITs which were signed and adopted three decades apart have almost identical provisions, whereas the US-Morocco BIT (signed 22 July 1985, entered into force 29 May 1991) and the US-Egypt BIT (signed on 11 March 1986, entered into force 27 June 1992) were separated by only one year but contrasted significantly in their expropriation provisions, with the US-Egypt BIT providing examples of measures that can be expropriatory in the article itself and the US-Morocco BIT containing a more conventional expropriation provision similar to expropriation provisions in most modern IITs.

Protection of Investments[198] (ASEAN Agreement)[199] and the Energy Charter Treaty[200] (ECT).[201] For example, the ECT provides that:

> "Investments of Investors of a Contracting Party in the Area of any other Contracting Party shall not be *nationalized, expropriated* or <u>subjected to a measure or measures having effect equivalent to nationalization or expropriation</u>…"[202] (emphasis mine).

For the ECT, the *italicised* words signify direct expropriation and the <u>underlined</u> words (i.e. 'equivalent to') signify indirect expropriation. This interpretation was confirmed by the tribunal in *Electrabel*[203] who said that the ECT "provides investments of investors with protection from both direct and indirect expropriation, with the 'effect' of the latter [i.e. indirect expropriation] defined as 'equivalent to nationalisation or expropriation'."[204]

Most United Kingdom BITs are very similar to the ECT, such as the UK-Mozambique BIT:

> "Investments of Nationals or Companies of either Contracting Party shall not be *nationalised, expropriated* or <u>subjected to measures having effect equivalent to nationalisation or expropriation</u>…"[205] (emphasis mine).

The same interpretation as the *Electrabel* tribunal's interpretation of Article 13(1) of the ECT applies to the UK-Mozambique BIT and other similar treaties of other countries. The UK-Mexico BIT[206] resembles most United Kingdom BITs except that

[198] ASEAN Agreement for the Promotion and Protection of Investments, signed 15 December 1987.
[199] Article VI(1), ASEAN Agreement.
[200] Energy Charter Treaty 1994.
[201] See also Article 4(1), Slovenia-Turkey BIT; Article 6(1), Agreement between the Republic of Chile and the Republic of Tunisia on the Reciprocal Promotion and Protection of Investments, signed 23 October 1998, not entered into force as of 1 June 2013 (Chile-Tunisia BIT).
[202] Article 13(1), ECT.
[203] *Electrabel S.A. v The Republic of Hungary*, ICSID Case No. ARB/07/19, Decision on Jurisdiction, Applicable Law and Liability of 30 November 2012.
[204] *ibid*, VI-14 at para 6.51.
[205] Article 5(1), UK-Mozambique BIT.
[206] Agreement between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the United Mexican States for the Promotion and Reciprocal Protection of Investments, signed 12 May 2006, entered into force 25 July 2007 (UK-Mexico BIT).

its expropriation provision contains the words ‘direct’ and ‘indirect’, presumably added to satisfy the Mexican counterparty. The Mexico-UK BIT provides that:

> “Investments of investors of either Contracting Party shall not be *nationalised or expropriated, either directly* **or** <u>indirectly through measures having effect equivalent to nationalisation or expropriation</u> (“expropriation”) in the territory of the other Contracting Party except for a public purpose, on a non-discriminatory basis, in accordance with due process of law and against compensation”[207] (emphasis mine).

The above provision contains the direct expropriation provision first (in *italics*) and contains the indirect provision second (after the word ‘or’ in **bold**) and ‘measures equivalent’ are part of the indirect expropriation provision (<u>underlined</u>) which is evident from the reading of the text, i.e. “… indirectly through measures having effect equivalent to…”. If the UK-Mexico BIT wanted to try and make ‘measures equivalent’ a separate concept to indirect expropriation, it would have added the word “or” after the word “indirectly” and it therefore would have read as “… directly or indirectly *or* through measures…”

This analysis shows that expropriation provisions, whether they expressly refer to ‘direct’ and ‘indirect’ expropriation or separate or join indirect expropriation with ‘measures tantamount’ are not broader or narrower in scope than each other. The term ‘expropriation’ in international law is prevalent as direct or indirect expropriation, with the NAFTA and other IITs’ provisions that refer to ‘direct’ and ‘indirect’ expropriation being more specific with their language whilst IITs such as the ECT which do not refer to ‘direct’ and ‘indirect’ expropriation are simply not as specific, therefore the NAFTA etc. and ECT etc. expropriation articles are just as broad as one another.[208]

Under the Vienna Convention on the Law of Treaties[209] (Vienna Convention), “[a] treaty shall be interpreted in good faith in accordance with the ordinary meaning to

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[207] *ibid*, Article 7.1.
[208] McLachlan et al (n. 3) 272-273.
[209] Vienna Convention on the Law of Treaties 1969.

be given to the terms of the treaty in their context and in the light of its object and purpose."[210] Therefore, treaty drafters, by inserting an expropriation provision, shall be determined to have incorporated the expropriation provision as it is traditionally used, i.e. providing for direct and indirect expropriation, and if the treaty aims to be more broad or more narrow in its scope than the common expropriation provisions in IITs, it must state so in the text and/or accompanying letters of submittal and incidental documents which will make the different and uncommon intention obvious from the outset. Likewise, if there is a question mark on the intention of the provision, that can be cleared up by the state parties to the IIT, as the United States did in *Metalclad* by confirming that that the 'measures tantamount' text was not intended to create a new category of expropriation which was not previously recognised in customary international law.[211] 'Measures tantamount' therefore falls under indirect expropriation in NAFTA and all other IITs unless otherwise stated by the treaty, of which there are none.

3.2.2.3 Expropriation Headings That Taxation Measures Fall Under

Taxation measures can fall under both the direct and indirect expropriation headings and claimants will claim under both headings so as not to restrict their statements of claim. The arbitral tribunals then have the opportunity to distinguish between the headings accordingly. I will now discuss why taxation can fall under both direct and indirect expropriation headings.

(i) Direct Expropriation

It was made clear in the introduction to this chapter that the concept of expropriation came about through the direct taking of tangible assets by the state. Taxation measures, whether they are the levying and collection of taxes or the refusal to refund taxes, have a direct correlation with a physical taking of physical assets (i.e. cash), whereby under the former example cash is taken and under the latter example the cash is not given back. Taxes have therefore

[210] Article 31(1), Vienna Convention.
[211] *Metalclad* Award at para 27.

previously been described as a "form of property seizure."[212] Taxation can conceptually be used to directly expropriate an investment and in *EnCana*[213] the arbitral tribunal focused primarily on the direct expropriation tax claim.

(ii) Indirect Expropriation

Taxation lends itself perfectly to the concept of indirect expropriation, especially the creeping type, because tax measures can be used to deprive the investor of the use and enjoyment of the investment including the repatriation of profits, and these are the embodiment of indirect expropriation, i.e. measures which have the effect of a taking of property whereby the investor's investment is rendered useless.

In addition, tax measures can be applied repeatedly and incrementally with each measure not in itself being a substantial deprivation, but have the cumulative effect of depriving the investor of the reasonably expected benefits of the investment (creeping expropriation). The Third Restatement of the Law of Foreign Relations of the United States[214] (Third Restatement) recognised the ability of taxation to achieve such a goal, where it defined creeping expropriation as "taxation and regulatory measures designed to make continued operation of a project uneconomical so that it is abandoned"[215] and stated that "[a] state is responsible… for an expropriation of property… when it subjects alien property to taxation… that is confiscatory, or that prevents, unreasonably interferes with, or unduly delays, effective enjoyment of an alien's property or its removal from the state's territory…"[216] A state will not, however, be liable for expropriation where there is a loss of property or economic disadvantage which results from bona fide general taxation.[217]

Interestingly, the arbitral tribunal in *Feldman* asserted that tax measures, if expropriatory, can only be an indirect expropriation and not direct expropriation.[218]

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212 William W. Park, 'Arbitration and the Fisc: NAFTA's "Tax Veto"' (2001) 2 *Chi. J. Int'l L.*, 231.
213 *EnCana Corporation v Republic of Ecuador*, LCIA Case No. UN3481, Award and Partial Dissent of 3 February 2006.
214 Third Restatement of the Law of Foreign Relations of the United States 1987.
215 *ibid*, §712, Reporter's Note 7.
216 *ibid*, §712 comment (g).
217 *ibid*.
218 *Feldman* Award at para 101.

Although a claim for alleged expropriation by taxation is more likely to fall under indirect expropriation because of the nature of taxation, that does not preclude the possibility that a claim under direct expropriation can be made. Whether taxation measures are argued to be direct or indirect expropriation will depend on the measures themselves, the circumstances of the case and how the claim is framed by the claimant. For example, if a claimant alleges that it has a right to tax refunds, it can attempt to streamline its claim to define its investment as the tax refunds themselves or returns to investments or claims to money (*EnCana*), and if the host state has refused to grant the refunds, that can theoretically amount to a direct expropriation.[219] Therefore it is not entirely accurate to say that taxation measures that have the effect of expropriation will only be indirect expropriation.

3.2.3 Levels of Deprivation in IITs for Indirect Expropriations and the Impact on Tax Expropriation Claims

As we shall see in the discussion on deprivation at section 3.4.4 below that the extent of deprivation required to succeed in an indirect expropriation claim can vary between arbitral tribunals, however the internationally accepted standard is a 'substantial deprivation'.[220] This is because the effect of an indirect expropriation

[219] In *CME*, the claimant's (CME's) 99% owned subsidiary had the exclusive right to use a licence to operate a television station (*CME* at para 107). CME claimed its investments were the shares in the subsidiary and its indirect ownership of the assets of the subsidiary and an asset included the exclusive right to use the licence (*CME* at para 4). The arbitral tribunal agreed that the assets held by the subsidiary including the licence were investments of the claimant under the relevant BIT (*CME* at para 376). The exclusive right to operate the licence was revoked by the host state (Czech Republic) and the claimant's subsidiary's contribution towards the licence changed to "the use of the know-how of the Licence" (*CME* at para 593). That resulted in the destruction of the claimant's subsidiary's operations which was left as a company with assets but no business (*CME* at para 591). Czech Republic argued that the claimant was not deprived of its investment because there was no physical taking of property by the state or because the licence was kept untouched (*CME* at para 591). That defence was judged by the tribunal to be "irrelevant" (*CME* at para 591) and the tribunal concluded that the change to claimant's use of the licence was "nothing else than the destruction of the legal basis… of the Claimant's investment" (*CME* at para 593) and that the deprivation of the subsidiary's exclusive use of the licence qualifies as expropriation (*CME* at para 609). Although *CME* was an indirect expropriation claim, the concept of the licence as being an investment and the deprivation of its exclusivity being an expropriation can apply to taxation, e.g. the right to tax refunds can be an investment or the right to not be taxed in the first instance can be an investment (but only if there is an agreement with the host state to that effect). So if a company has paid a tax that will be refunded at a later stage and the state refuses to give the refund (i.e. the cash), then there might be a claim for direct expropriation. Similarly, if an investor is excepted from paying taxes (i.e. there is no need to go through the refund route because the tax is not paid in the first place), and that tax advantage is revoked, the revocation of that tax advantage can theoretically be an indirect expropriation.

[220] Newcombe and Paradell (n. 13) 344.

must be equivalent to a direct expropriation,[221] the result of which would be a substantial or a total impairment of property rights. Most investment treaties remain silent on the level of deprivation required to find a state liable for expropriation and this gives arbitral tribunals the scope to use the substantial deprivation standard or to deviate from it at their own judgment on a case-by-case basis. Some BITs which the United States is a party to do mention 'deprivation' in their Letters of Submittal and it is worth addressing the impact that can occur as a result of such provisions because the parties to such BITs may have displaced the customary international law standard for expropriation (which is not a mere deprivation)[222] by doing so.

The Letters of Submittal of the US-Ukraine BIT[223] which is based on the United States Model BIT 1992 contains a definition of creeping expropriation and in its definition a creeping expropriation is said to occur when measures "… result in a *substantial deprivation* of the benefit of an investment without taking of the title to the investment"[224] (emphasis mine). The US-Ukraine BIT therefore codified the customary international law standard of deprivation required for state liability in expropriation and will restrict arbitral tribunals from deviating from the accepted standard. The US-Morocco BIT's Letter of Submittal states that any measure "which has the effect of *depriving* an investor of his management, control or economic value in a project"[225] (emphasis mine) may constitute an expropriation.

The US-Egypt BIT also contains a provision on 'deprivation'. The US-Egypt BIT describes expropriation as:

> "No investment or any party of an investment of a national or a company of either Party shall be expropriated or nationalized by the other Party or a political or administrative subdivision thereof or subjected to any other

[221] UNCTAD Expropriation 2012 (n. 4) 127; this is supported by the Annex B(4)) of the 2012 US Model BIT which provides that an indirect expropriation "has an effect equivalent to direct expropriation"; see also *GAMI* at para 126: "the affected property must be impaired to such an extent that it must be seen as "taken.""
[222] McLachlan et al (n. 3) 279.
[223] Treaty between the United States of America and Ukraine concerning the Encouragement and Reciprocal Protection of Investment, with Annex, and Related Exchange Letters, signed 4 March 1994, entered into force 16 November 1996 (US-Ukraine BIT).
[224] *ibid*, Letter of Submittal.
[225] US-Morocco BIT, Letter of Submittal.

> measure, direct or indirect (including, for example, *the levying of taxation,* the compulsory sale of all or part of such an investment, or impairment or *deprivation* of management, control or economic value of such an investment by the national or company concerned), if the effect of such other measure, or a series of such other measures, would be tantamount to expropriation or nationalization (all expropriations, all nationalizations and all such other measures hereinafter referred to as "expropriation")"[226]… (emphasis mine).

The US-Egypt BIT, like the US-Morocco BIT, requires a 'deprivation' of the enjoyment of the investment.

Whether requiring a 'deprivation' is more or less restrictive than an IIT which requires a substantial deprivation or one which remains silent can be interpreted at two extremes. At one end, by requiring only a 'deprivation', an IIT could allow an arbitral tribunal to lower the internationally accepted standard of substantial deprivation by requiring only some deprivation[227] for a finding of state liability (and the tribunal would already have the capacity to deviate when an IIT is silent on deprivation). At the other end, an IIT that requires a 'deprivation' could allow an arbitral tribunal to increase the barrier to finding an expropriation from the internationally accepted standard of substantial deprivation to a 'complete' or 'total deprivation',[228] whereas a tribunal is unlikely to increase the barrier if the IIT is silent on deprivation because silence would usually denote the incorporation of customary international law. It is for these reasons that by signing an IIT with such a provision the parties may have displaced the customary international law standard for expropriation. Although the codification of the 'substantial deprivation' standard is undesirable because it lacks flexibility, a positive can be taken in its certainty, whereas parties to an expropriatory action claim under the US-Egypt BIT or the US-Morocco BIT (or other like IITs) would be subjected to flexibility but also to uncertainty.[229] Overall, the codification of the level of deprivation is undesirable because expropriatory action must be "based on the facts of specific cases"[230] and

[226] Article III, US-Egypt BIT.
[227] McLachlan et al (n. 3) 279.
[228] *ibid*.
[229] *ibid*.
[230] *Feldman* Award at para 102.

although the substantial deprivation level is the deprivation standard most commonly used in expropriation claims, arbitral tribunals have at times found it necessary to lower that standard to what is called a 'partial deprivation'[231] and for that reason, the deprivation suffered in a dispute could be judged differently by two different tribunals examining the same case under the same treaty.

Indeed, the most recent United States Model BIT (2012) acknowledges the requirement for "a case-by-case, fact-based inquiry"[232] taking into account:

(i) The economic impact of the government action, but an economic impact alone will not establish an indirect expropriation having occurred;
(ii) The extent the government action interferes with distinct, reasonable investment-backed expectations; and
(iii) The character of the government action.[233]

The US Model BIT 2012 also provides an exception where state measures will not be expropriatory, albeit in "rare circumstances", and this is when a state takes non-discriminatory regulatory action to "protect legitimate public welfare objectives" including "public health, safety, and the environment."[234] The US Model BIT 2012 also defines "customary international law" which applies to expropriation provisions of their BITs as "a general and consistent practice of States that they follow from a sense of legal obligation."[235] The US Model BIT 2012 evidently provides arbitral tribunals with guidelines on how to determine whether an expropriation has occurred, and allows arbitral tribunals to not be confused by certain terms and characterisations whose interpretations would vary between person to person and therefore between arbitral tribunals, for example, it does not use the words "deprivation" or "substantial deprivation". A deprivation alone may mean a complete deprivation or a mere deprivation, and the US Model BIT 2012 says economic impact alone is not enough to find an expropriation, but it must be coupled with

[231] See section 3.4.4 below; *S.D. Myers* at para 283; *GAMI Investments Inc. v United Mexican States* (NAFTA Arbitration), Final Award of 15 November 2004 (*GAMI*), 126.
[232] Annex B, para. 4(a), United States Model BIT 2012.
[233] *ibid*.
[234] *ibid*, Annex B, para (4)(b).
[235] *ibid*, Annex A.

interference with reasonable investment-backed expectations of the investor(s) and the character of the government action. This provides arbitral tribunals with clarity (unlike the aforementioned United States BITs), without being restrictive.

In tax arbitrations, the application of the substantial deprivation standard will result in most claims for tax expropriation being dismissed. That is because tax expropriation claims are seldom based on the investments becoming useless and most will still function and generate revenues and profits. To that end, if the substantial deprivation standard is codified in IITs or even if only 'deprivation' is codified (which can be interpreted by an arbitral tribunal as requiring a complete deprivation) then that will restrict arbitral tribunals from finding a partial deprivation in tax arbitrations under those IITs. Therefore, an IIT's silence on the deprivation standard will be all the more vital if a claimant attempts a partial tax expropriation claim, and this is especially important if the claimant has no claim under national treatment protection which does not require a substantial deprivation (a national treatment claim only requires less favourable treatment of the foreign investor/investment compared with a comparable host state investor/investment, and the state will be found liable even if the claimant has not made much losses).[236]

That said, an IIT that does *not* contain a provision on deprivation and an IIT that does contain the word 'deprivation' are both likely to be interpreted as requiring a substantial deprivation because that is the customary international law standard. In any event, expropriatory action must be "based on the facts of specific cases."[237]

3.2.4 Inclusions, Exclusions and Vetoes to the Application of Expropriation in Matters of Taxation

Most IITs permit the application of expropriation provisions to tax matters,[238] making tax expropriation arbitrable in the majority of IITs. Whilst most IITs contain tax exclusions to national treatment protection, some also restrict the application of tax measures to expropriation by including tax exclusions to the entire IIT and

[236] See section 4.2.6 of Chapter 4 (National Treatment Tax Exclusions).
[237] *Feldman* Award at para 102.
[238] UNCTAD Expropriation (n. 4) 133.

therefore capture expropriation within such exclusion.[239] Some IITs attempt to block the deliberation of tax in expropriation claims through 'tax vetoes'.[240] The NAFTA, DR-CAFTA, ECT, Canada-Ecuador BIT and Japan-Mexico BIT are examples of said IITs,[241] containing provisions preventing a foreign investor from commencing proceedings against a state claiming expropriation by taxation without the express or implied consent of the tax authorities of his home state.[242]

Under the above treaties, an investor can only commence such a claim by first submitting a notice to arbitrate to the tax authorities of the home and host states. If within six months of the notice of intent to arbitration, the tax authorities jointly determine the tax or taxation measure is not an expropriation, the investor is precluded from commencing the claim.[243] If the tax authorities fail to reach a joint determination within six months, the investor may commence the claim[244] (express consent of the home state tax authority to continue with the claim[245]). If the tax authorities fail to come to a determination at all within six months, then the investor may commence the arbitration[246] (implied home state consent[247]). The Canada-Ecuador BIT also applies the same methodology for a contractual claim by the investor against the host state for breach of an agreement with the host state[248] such

[239] Article 5, Agreement between the Government of the Argentine Republic and the Government of New Zealand for the Promotion and Reciprocal Protection of Investments, signed 27 August 1999 (not entered into force as of 1 June 2013) (Argentina-New Zealand BIT); Article 8, Agreement between the Government of New Zealand and the Government of the Republic of Chile for the Promotion and Protection Of Investment, signed 22 July 1999 (not entered into force as of 1 June 2013) (Chile-New Zealand BIT); Article 5, New Zealand and China Agreement on the Promotion and Protection of Investments (with exchange of notes), signed 22 November 1988, entered into force 25 March 1989 (China-New Zealand BIT); Article 8, Agreement between the Government of Hong Kong and the Government of New Zealand for the Promotion and Protection of Investments, signed 6 July 1995, entered into force 5 August 1995 (Hong Kong-New Zealand BIT).

[240] Article 2103(6), NAFTA; Article 21.3(6), DR-CAFTA; Article 21(5), ECT; Article XII(4) Canada-Ecuador BIT; Article 170(4)(b), Agreement between Japan and the United Mexican States for the Strengthening of the Economic Partnership (Japan-Mexico BIT).

[241] *ibid*.

[242] *ibid*.

[243] NAFTA, Article 2103(6); DR-CAFTA, Article 21.3(6); and Canada-Ecuador BIT, Article XII(4).

[244] NAFTA, Article 2103(6); DR-CAFTA, Article 21.3(6); and Canada-Ecuador BIT, Article XII(5).

[245] The host state's tax authority will of course contend the tax or taxation measure is not expropriatory, so if the two tax authorities do not come to a conclusion on the matter then of course in the home State's opinion there has been an expropriation, which in essence is an express consent for the investor to commence the claim.

[246] NAFTA, Article 2103(6); DR-CAFTA, Article 21.3(6); and Canada-Ecuador BIT, Article XII(5).

[247] Silence on the part of the host State grants the investor the right to commence the arbitration, therefore this is an implied consent.

[248] Canada-Ecuador BIT,Article XII(3).

as a concession agreement which includes a tax stabilisation clause (or for breach of a standalone tax stabilisation agreement).

An arbitral tribunal can and is likely to reject jurisdiction over a tax expropriation claim if the investor does not fulfil the procedural requirements of a tax veto article.

The express provision that facilitates to block the arbitration of tax disputes demonstrates the politically sensitive interaction between revenue raising and national sovereignty.[249] The expropriation tax veto exists for three main reasons:

(i) to serve as a screening process to block the commencement of proceedings for bona fide taxation. The tax authorities of both the home and host state sort through claims to conclude whether the tax measure is bona fide taxation or arbitrary, confiscatory, or has some element pointing towards expropriation. If both tax authorities fail to reach a unanimous decision that a tax measure is not an expropriation then the claimant can proceed with a claim in arbitration;

(ii) to give the host state a sense of sovereignty retention, whereby it has the opportunity to convince the tax authority of the home state that the tax measure was not in breach of an investment treaty or contractual agreement with the investor. The ability of the host state to delay the arbitration may itself provide some satisfaction to the host state and give it more time to prepare its arbitration defence and compromise with the adjacent tax authorities and/or the claimant(s);

(iii) perhaps most importantly but most overlooked in tax arbitration literature, it is there to prevent or limit investors' use of regulatory chill to control the tax policies of the host state.

3.3 Direct Expropriation

[249] Park (2001) (n. 212) 232.

Direct expropriation is easy to recognise. It often involves the state taking direct actions such as seizing property by police or military power, transferring title in the property to itself or a third party,[250] and formalising likely The obviousness of a direct expropriation means that the state's intent to take from or deprive the investor of his property rights is not masked. It can entail a taking such as "a compulsory transfer of property rights"[251] or a deprivation such as "governmental authorities take over a mine or factory, depriving the investor of all meaningful benefits of ownership and control."[252] Although direct expropriation is often referred to as *direct takings*[253] (and expropriation is sometimes referred to generally as 'takings'), it can be a taking or a deprivation and the terms 'taking' and 'deprivation' are largely synonymous with each other in this context.[254] As far as tax expropriation is concerned, tax can be a taking (by taking money from the investor/investment (tax money)) or it can be used to deprive the investor of the investment (e.g. tax assessments can be made against a company that result in a tax debt which the tax authorities demand payment of immediately, and if it is not possible for the company to immediately satisfy that debt, the company's assets are frozen – the freezing of assets will be a deprivation of property because they cannot be used). Despite takings and deprivation being synonymous in the context of expropriation, the term 'taking' gives the impression that legal ownership of the investment is taken or that the state has acquired something of value, which is not actually necessary, and that is why the tribunal in *Tippetts*,[255] preferred the term 'deprivation' instead of 'taking' when referring to expropriation and I adopt that view also. In fact, when legal title is taken, the investor is deprived of his investment, and if legal title is not taken (such as the freezing of assets), the investor is still deprived of the use and enjoyment of the investment (the meaningful benefits of ownership and control) and that is the case whether an expropriation is direct or indirect. In the theory of tax expropriation (both direct and

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[250] *Enron Corporation and Ponderosa Assets L.P. v Argentine Republic*, ICSID Case No. ARB/01/3, Award of 22 May 2007, at para 243: "… the Tribunal does not believe there can be a direct form of expropriation if at least some essential component of property rights has not been transferred to a different beneficiary, in particular the State"; and *Sempra Energy International v Argentine Republic*, ICSID Case No. ARB/02/16, Award of 28 September 2007 (*Sempra* Award) at para 280.
[251] *Amoco* at para 108.
[252] *Feldman* Award at para 100.
[253] *ibid*.
[254] *Tippetts, Abbett, McCarthy, Stratton v TAMS-AFFA Consulting Engineers of Iran, the Government of the Islamic Republic of Iran et al,* Iran-USCTR, Award No. 141-7-2 of 22 June 1984 (*Tippetts*), at Part III section 1 of the Award.
[255] *ibid*.

indirect), a tax can be expropriatory because of the 'taking' of money and it can be expropriatory if the investor is 'deprived' of a tax benefit. The labels, essentially, do not matter. What is of importance is the nature of the measure and the context in which that measure has occurred.

We can derive from this definition of direct expropriation that a direct expropriation can occur even though the investor retains legal title in the investment.[256]

The Hong Kong-Netherlands BIT[257] recognises the above line of reasoning by referring to expropriation as deprivation:

> "Investors of either Contracting Party shall not be *deprived* of their investments nor subjected to *measures having effect equivalent to such deprivation* in the area of the other Contracting Party…"[258] (emphasis mine)

The Hong Kong-Netherlands BIT's expropriation provision is not the specific type, i.e. it does not refer to direct and indirect expropriation by name, but the reasoning in section 3.2.2.2 above applies in the same way.[259]

The taking of property and ownership rights are easily recognisable types of direct expropriation and require 'positive intent' to "establish a causal link between the measure in question and the title to property."[260] They require direct malice or *culpa*.[261] When a direct expropriation occurs, there can be no doubt that something of value has been taken by the state.

The appropriation of private property is the most common type of direct expropriation.[262] In *Santa Elena*, Costa Rica expropriated land that was intended to

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[256] Section 192, Second Restatement.
[257] Agreement on the Encouragement and Protection of Investments between the Government of Hong Kong and the Government of the Kingdom of the Netherlands, signed 19 November 1992, entered into force 1 September 1993 (Hong Kong-Netherlands BIT).
[258] Article 5(1), Hong Kong-Netherlands BIT.
[259] "Shall not be deprived of their investments" is the direct expropriation provision and "measures having effect equivalent to such deprivation" is the indirect expropriation provision.
[260] *Sempra* Award at 282.
[261] Newcombe and Paradell (n. 13) 340; *culpa* is Latin for mistake or fault.
[262] Newcombe and Paradell (n. 13) 340.

be turned into a resort by majority United States investors. The expropriation took place by an expropriation decree on 5 May 1978 (the 1978 Decree) with Article 1 of the 1978 Decree stating:

> "the property owned by the Compañia de Desarrollo Santa Elena S.A. described in the third whereas clause of this decree, is hereby expropriated."[263]

Although the expropriation took place in 1978, and was not contested by Santa Elena, the level of compensation could not be agreed upon by the two parties, and the nearly twenty year delay from the date of the 1978 Decree to the ICSID proceedings was due to intermittent inactivity and intensive legal proceedings between the parties in the national courts of Costa Rica.[264] The land was appropriated from Santa Elena for environmental purposes as the ecological features of the property were unique and in need of protection from the type of development planned by Santa Elena[265] and land needed to be used in addition to the Santa Rosa National Park to maintain stable populations of feline species such as pumas and jaguars,[266] the chosen land being the property of the Claimant. This direct expropriation occurred for environmental purposes, but that still requires compensation just as any other type of expropriation does, no matter how beneficial to society[267] and the parties did not contest this.[268] Expropriation does not have to be malicious, it is a government's right to expropriate private property, so long as such expropriation is accompanied by just compensation as required by international law.[269]

The taking by a state of entire industries and sectors of the economy occurs through nationalisation,[270] essentially the twin of expropriation but on a larger scale. In 1952, nationalisation was defined by the Institut de Droit International as:

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263 *Santa Elena* Award at para 18.
264 *ibid* at para 20.
265 *ibid* at para 46.
266 *ibid* at para 18, quoting the 1978 Decree.
267 *ibid* at para 72.
268 *ibid* at para 73.
269 *Norway v United States of America*, PCA, Award of 13 October 1922 (*Norwegian Shipowners' Claims*). at 332, commenting on the Fifth Amendment of the United States Constitution and the requirement for compensation in the public international law of all civilised countries.
270 Newcombe and Paradell (n. 13) 324.

> "The transfer to the State, by a legislative act and in the public interest, of property or private rights of a designated character, with a view to their exploitation or control by the State, or the their direction to a new objective by the State."[271]

In the early to middle of the 20th Century, nationalisation was a relatively new legal term because nationalisations were relatively rare.[272] Although nationalisations are historically ancient, they did not occur in the number and magnitude that they did in the 20th Century, with the Mexican nationalisation of its oil industry in 1938[273] and the Anglo-Persian Oil Company nationalisation in Iran.[274] The state's power to nationalise or expropriate foreign-owned property in its territory is embedded in its sovereignty, unless the state has stripped itself of such rights through an IIT or any other binding international obligation.[275] If we look at any BIT, for example, Article III(1) of the US-Ecuador BIT prohibits expropriation or nationalisation of investments directly or indirectly through measures tantamount to expropriation, unless it complies with the conduct and compensation requirements. These exceptions provide the rules for a legal expropriation or nationalisation to take place, and if they are not adhered to, for example if compensation is not paid, an investor could claim that an applicable treaty has been violated and if the arbitral tribunal agrees, the state will be held to account.

3.4 Indirect Expropriation

Indirect expropriation is now the basis of most arbitral disputes relating to expropriation.[276] It is also known as creeping, constructive and *de facto* expropriation, and measures tantamount to expropriation also fit into this category.[277] Indirect expropriations "effectively neutralize the benefit of the property of the

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[271] *ibid* 324 note 14, quoting from M Domke, 'Foreign Nationalizations: Some Aspects of Contemporary International Law' (1961) 55 *A.J.I.L.* 585, 588.
[272] D. Edward Re, 'The Nationalization of Foreign-Owned Property', (1951) 36 *Minn L. Rev* 323, 325.
[273] Lee Stacy, *Mexico and the United States*, (Marshall Cavendish Corp, 2003), 604.
[274] Edward (n. 272) 323.
[275] *ibid* 326.
[276] Chifor (n. 49) 183-184.
[277] See 3.2.2.2 above.

foreign owner [and] are subject to expropriation claims. This is undisputed under international law".[278]

3.4.1 The Form of Measure vs. Impact of Measure

In *Tippetts* the arbitral tribunal judged "the form of the measures of control or interference [to be] less important than the reality of their impact"[279] This means the impact on an investor/investment will go to show an expropriation has occurred, rather than what form of measure is used. To further illustrate this point, the tribunal in *Pope & Talbot* rejected the argument put forward by Canada that non-discriminatory regulations cannot be expropriatory. The tribunal rejected the argument because an exception for regulatory measures would create "a gaping loophole in international protections against expropriation."[280] This would be a return to the now discredited doctrine mandated by the Upper Silesian Arbitral Tribunal,[281] namely that "police or taxation power whatever sacrifice it may impose on individuals, requires no compensation by the international standard."[282] Regulatory measures taken in the public interest can and do result in expropriations and do not allow States to avoid paying the subsequent compensation. In *Santa Elena*[283] the government of Costa Rica expropriated land based on environmental regulations and were liable to pay compensation. Had Canada's argument in *Pope & Talbot* been accepted by the tribunal, it would have even gone against the grain of justice as old as ancient Greek and Roman doctrines. The *Pope & Talbot* tribunal was right to reject Canada's argument because no investor, home or foreign, should lose their investment because the state has committed expropriation through its law and regulation making power. Regulatory measures with an impact parallel to direct taking are *de facto* expropriatory, and states cannot escape liability by labelling measures as regulation (including taxation) in the public interest.[284] Finally, a state cannot escape its responsibilities by cloaking its sovereign acts as commercial or

[278] *CME* Partial Award at para 604.
[279] *Tippetts* Award at Part III Section 1.
[280] *Pope and Talbot* Interim Award at para 99.
[281] See *Kügele* at 3.1.2 above.
[282] Kaeckenbeeck (n. 101) 16.
[283] *Santa Elena* Award at para 111.
[284] Newcombe and Paradell (n. 13) 341.

mercantile,[285] for example by using a state-run entity;[286] as long as expropriatory actions are attributable to the state, it will be liable.

3.4.2 State Intent vs. Effect of State Conduct

For most arbitral tribunals, the *effect* of a measure on an investment is what is fundamental to finding liability for expropriation, not the *intention* of the state. In *Metalclad*, the tribunal decided that expropriation:

> … includes not only open, deliberate and acknowledged takings of property, such as outright seizure or formal or obligatory transfer of title in favour of the host State, but also covert or incidental interference with the use of property which has the *effect* of depriving the owner, in whole or in significant part, of the use or reasonably-to-be-expected economic benefit of property even if not necessarily to the obvious benefit of the host State[287] (emphasis mine).

Clearly, the *Metalclad* tribunal decided that if state interference with property has the effect of a complete or significant deprivation, such interference can leave the state open to an expropriation claim even if the allegedly expropriatory measures do not obviously benefit it (lack of intent).

In *CME*, the arbitral tribunal confirmed the *Metalclad* determination that the effect of an interference with the use of an investor's property that deprives the investor of the

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[285] *ibid*.
[286] Noah Rubins and N. Stephan Kinsella, *International Investment, Political Risk and Dispute Resolution: A Practitioner's Guide* (OUP 2005) 67; *Salini Construttori S.p.A. and Italstrade S.p.A. v Kindom of Morocco*, ICSID Case No. ARB/00/4, Decision on Jurisdiction of 23 July 2001, at para 35; Emmanuel Gaillard and Jennifer Younan (eds.), *State Entities in International Arbitration – IAI Series on International Arbitration No. 4* (Juris Publishing 2008) 35; expropriatory actions by the state do not include breach of contract by a state if unaccompanied by any sovereign actions – it is assumed a foreign investor risks breach of contract by a state as with any commercial actor. However, if a state uses its sovereign powers and does not act solely as a commercial party, for example by enacting a law nullifying its contractual obligations by that stating it has no contractual liability, that could count as a expropriatory action: Newcombe and Paradell (n. 13) 352, citing *Consortium R.F.C.C. v. Kingdom of Morocco*, ICSID Case No. ARB/00/6, Award of 22 December 2003 at 65, and *SGS Société Généralé de Surveillance S.A. v Republic of Philippines*, ICSID Case No. ARB/02/6, Decision on Objections to Jurisdiction of 29 January 2004 at 161.
[287] *Metalclad* Award at para 103.

use or reasonably expected economic benefit is expropriatory.[288] The *CME* tribunal further stated that a state's actions as well as its refusal to take action (i.e. inaction) can and will result in an expropriation,[289] which was unlike the *Olguin*[290] tribunal, who required "a teleologically driven action"[291] to find an expropriation. The *Olguin* tribunal decided that no matter how shocking omissions might be, on their own they are insufficient for an expropriation to have taken place[292] because intention to expropriate was key.[293] The *Metalclad* Award was rendered in 2000 and both the *CME* and *Olguin* Awards were rendered in 2001, which shows the inconsistencies that can arise between arbitral tribunals on a case-by-case basis. But which reasoning ought to be is preferred, the *Metalclad/CME* test or the *Olguin* test? It has been asserted that the "*Olguin* 'teleologically driven' test is to be preferred" because it recognises "that investment treaties do not give foreign investors a guarantee of investment success"[294] (the 'insurance policy'[295]) and it recognises that "an assessment of indirect expropriation in any of its forms has not somehow been disconnected from a requirement of State conduct of some sort."[296] I agree with the insurance policy point because it is true that no investment should be guaranteed success by any government backing, but that should only be in respect of business risks and not losses attributable to the compensable conduct of the host state. To illustrate, the *CME* and other tribunals who have concluded that the effect has greater weight than the intent[297] have concluded so with good reason, predominantly because

[288] *CME* Partial Award at para 606.
[289] *ibid* at para 607; in this case the Czechoslovakian Media Council's actions and inactions consequently amounted to an expropriation (see (n. 219) above).
[290] *Eudoro Armando Olguin v. Republic of Paraguay*, ICSID Case No. ARB/98/5, Award of 26 July 2001.
[291] *ibid* at para 84.
[292] *ibid*.
[293] The tribunal in *Sea-Land Service, Inc. v The Islamic Republic of Iran, Ports and Shipping Organisation,* Award No. 135-33-1 of 22 June 1984, 6 Iran-USCTR 149, came to a similar conclusion, requiring at the very least proof of deliberate governmental interference in a company's use and benefit of its investment. (6 Iran-USCTR 149, 166); Maurizio Brunetti, 'The Iran-United States Claims Tribunal, NAFTA Chapter 11, and the Doctrine of Indirect Expropriation' (2001) 2 *Chi. J. Int'l L.* 203, 207.
[294] McLachlan et al (n. 3) 292.
[295] See also 3.4.3 below.
[296] *ibid*.
[297] Cases in which the acknowledgment of the effect of government actions being characteristic of expropriation over and above intent include: *Tippetts,*: "…a government's liability to compensate for expropriation of alien property does not depend on proof that the expropriation was intentional"; *Phelps Dodge International Corp. v Government of the Islamic Republic of Iran*, IRAN-USCTR Case No. 99, Award No. Award No. 217-99-2 of 19 March 1986 , stating at para. 22 that a state feeling compelled to protect its interests does not relieve it "of the obligation to compensate Phelps Dodge [claimant] for its loss."

the *Olguin* doctrine, by requiring *culpa*, gives respondent states an exceedingly robust and almost fail-proof 'benefit of the doubt' defence. In *Vivendi II*,[298] Argentina unsuccessfully argued that absent proof of bad faith, actions of the State must be presumed to be regulatory[299] (i.e. non-compensable government takings). The *Vivendi II* tribunal made two crucial points in this respect: (i) proving intent is advantageous, but "the effect of the measure on the investor, not the state's intent, is the critical factor"[300]; and (ii) "international tribunals, jurists and scholars have consistently appreciated that states may accomplish expropriations in ways other than by formal decree; often in ways that may seek to cloak expropriative conduct with a veneer of legitimacy."[301] Even if it is a genuine overlooking by the State, an investor should not suffer as a result.

Crucially, a state's "mere declaration that expropriation is not intended is not determinative of the issue"[302] and even state conduct in good faith can result in an expropriation as an unintended consequence.[303] For example, if the use of Property X is so closely connected to Property Y and Property Y has been expropriated and that makes the investment in Property X useless, then the investment in Property X may have been indirectly expropriated as a result.[304] Because Property X would not have been adversely affected without "state conduct of some sort,"[305] even if it was not the state's intention for Property X to be affected (e.g. the state was not even aware of the link between the properties), the losses would be attributable to state conduct and not business risks for which the investor should be indemnified.

3.4.3 Legitimate and Reasonable Expectations of the Investor

A foreign investor is expected to be able to exercise his tangible and intangible rights acquired under host state law.[306] This is to be balanced with the rule that IITs are not

[298] *Compañiá de Aguas del Aconquija S.A. and Vivendi Universal v. Argentine Republic*, ICSID Case No. ARB/97/3, Award of 20 August 2007 (*Vivendi II*).
[299] *Vivendi II* Award at para 7.5.20.
[300] *ibid*.
[301] *ibid* at para 7.5.20.
[302] G. C. Christie, 'What Constitutes a Taking of Property Under International Law', (1962) 38 *Brit. Y.B. Int'l L.* 307, 337.
[303] *ibid*.
[304] *ibid*.
[305] McLachlan et al (n. 3) 292.
[306] Newcombe and Paradell (n. 13) 350.

designed to guarantee investment success[307] and a foreign investor must not rely on them for that purpose. In *Maffezini*[308] the arbitral tribunal were clear that "Bilateral Investment Treaties are not insurance policies against bad business judgments"[309] and therefore with every investment there is a risk of not achieving a specific financial or economic target, including investments made under the auspices of an IIT. Similarly, unfortunate economic circumstances at a specific moment in time will not give rise to compensation under a claim of expropriation.[310] In *Fireman's Fund*[311] the claimant insurance company (Fireman's Fund) made a debenture investment in a bank in poor financial condition. When the risk did not pay off, Fireman's Fund claimed the Mexican government deprived them of the use and value of their investment, and did so in a discriminatory and arbitrary manner.[312] The arbitral tribunal found the claimant made "an almost valueless"[313] investment due to the financially poor condition of the bank they invested in, a condition that "was not caused by any government act or omission, but rather by the economic circumstances prevailing at the time."[314] Meanwhile, the Mexican government's failure to enter into a binding agreement to improve the bank's poor condition and possibly the debenture investment did not deprive the Claimant of economic use or value of their investment because the investment was already valueless and useless at the time of the government's failure,[315] therefore the claim of expropriation was rejected.

Nevertheless, circumstances do apply when a State's failure to act for a specific investment will be found to be expropriatory, for example when express commitments and representations have been made by the host state and the state then acts contrary to those commitments.[316] Measures indiscriminately enacted for a public purpose which affects a foreign investor will not be deemed to be

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[307] *MTD Equity Sdn. Bhd. and MTD Chile S.A. v Republic of Chile*, ICSID Case No. ARB/01/7, Award of 25 May 2004, at para 178.
[308] *Emilio Agustin Maffezini v. Kingdom of Spain*, ICSID Case No. ARB/97/7, Award of 13 November 2000.
[309] *ibid* at 64.
[310] This will not, however, prevent an investor from attempting a claim, as every tribunal has the right to determine a claim without precedents.
[311] *Fireman's Fund Insurance Company v United Mexican States*, ICSID Case No. ARB(AF)/02/01 Award of 17 July 2006.
[312] *ibid* at para 5.
[313] *ibid* at para 199.
[314] *ibid*.
[315] *ibid*.
[316] Newcombe and Paradell (n. 13) 350.

expropriatory, "unless specific commitments had been given by the regulating government to the then putative foreign investor *contemplating* investment that the government would refrain from such regulation"[317] (emphasis mine).[318] The word 'contemplating' provides guidance that if a state gives certain commitments *before* the foreigner makes his investment, the host state could be liable for expropriation for violating those commitments, but if no commitments have been made prior to investment, the investor's business risk includes the risk that the laws and regulations in the host state will change during the life of the investment.

3.4.4 Extent of Deprivation

The accepted international standard of deprivation required to find liability for an indirect expropriation is a substantial deprivation,[319] which is not always the term used - it has been called radical deprivation and substantial interference. The *Tecmed* tribunal required the claimant to be "*radically deprived* of the economical use and enjoyment of its investments"[320] (emphasis mine). The tribunal in *M.C.I.*[321] required a definite "*substantial interference* on the part of the State that affects the use and enjoyment of the protected investment"[322] (emphasis mine). The *Telenor*[323] tribunal studied the decisions of cases under ICSID and general public international law, concluding the magnitude of interference is agreed to be enough to "substantially… deprive the investor of the economic value, use or enjoyment of its investment."[324] The *LG&E*[325] tribunal confirmed the international standard, requiring the impact of a governmental measure on a business to be "substantial in order that compensation

[317] *Methanex Corporation v. United States of America*, NAFTA Arbitration, Award of 3 August 2005, Part IV, Chapter D, para.7.
[318] Even discriminatory regulation will not be expropriation unless it meets the requisite standards required by international law that are discussed in this section 3.4. As written at the head of this chapter, measures that violate the conduct requirements can indicate that said measures err on the side of unlawful expropriation and not bona fide state regulations (see *Feldman A*ward at para 99 and (n.51) above).
[319] Newcombe and Paradell (n. 13) 344.
[320] *Tecmed* Award at para 115.
[321] *M.C.I. Power Group L.C. and New Turbine Inc. v. Republic of Ecuador,* ICSID Case No. ARB/03/6, Award of 31 July 2007.
[322] *ibid* at para 300.
[323] *Telenor Mobile Communications A.S. v Republic of Hungary,* ICSID Case No. ARB/04/15, Award of 13 September 2006.
[324] *ibid* at para 65.
[325] *LG&E Energy Corp., LG&E Capital Corp., LG&E International Inc. v Argentine Republic*, ICSID Case No. ARB/02/1, Decision on Liability of 3 October 2006.

may be claimed for the expropriation."[326] In *Tippetts*, the tribunal required a state measure to deprive the investor of fundamental rights of ownership and "that the deprivation is not *merely ephemeral*"[327] (emphasis mine). A substantial deprivation does not mean the investor need be completely deprived of the use and economic benefits of the investment, but the deprivation must be "in whole or in significant part."[328]

A finding of substantial deprivation will be decided on a case-by-case basis, which Christie[329] suggested nearly 50 years ago as "probably the only method"[330] to decide what kind of interference constitutes an expropriation. This is because expropriation is fact-based and dependent on the judgment of the tribunals who do not bind one another. With no precise definition on an indirect expropriation to this day, "the more arduous but realistic approach suggested by Professor Christie is the way forward."[331]

The contrast between tribunal decisions on substantial deprivation can be exemplified by looking at the *Pope & Talbot*, *S.D. Myers* and *GAMI*[332] decisions. In *Pope & Talbot*, the tribunal referred to the claimant's Counsel as "correctly" conceding "that under international law, expropriation requires a 'substantial deprivation'"[333] and with reference to the test for expropriation (and therefore substantial deprivation), the tribunal required "that interference is sufficiently restrictive to support a conclusion that the property has been '*taken*' from the owner"[334] (emphasis mine). This gives the impression that the *Pope & Talbot* tribunal required deprivation to be equivalent to property being taken in its entirety, which would be better defined as a 'complete deprivation' of property. The *GAMI* tribunal also questioned whether that was the thinking behind the *Pope & Talbot*

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326 *ibid* at 191.
327 *Tippetts* Award at Part III at Part 1.
328 *Metalclad* at para 103.
329 Christie (n. 302).
330 *ibid* at 338.
331 Jan Paulsson and Zachary Douglas, 'Indirect Expropriation in Investment Treaty Arbitrations', in N. Horn & S. Kröll (eds), *Arbitrating Foreign Investment Disputes: Procedural and Substantive Legal Aspects*, (Kluwer Law International 2004).
332 *GAMI Investments Inc. v United Mexican States*, NAFTA Arbitration, Award of 15 November 2004.
333 *Pope & Talbot* Interim Award at para 102.
334 *ibid*.

definition.[335] The *Pope & Talbot* tribunal referred to the Third Restatement[336] under which an indirect expropriation occurs if it "prevents, unreasonably interferes with, or unduly delays, effective enjoyment of an alien's property."[337] By referring to the Third Restatement, it is unlikely the *Pope & Talbot* tribunal required a complete deprivation, although that is not unheard of.[338]

In contrast, the *S.D. Myers* tribunal said in some contexts and circumstances a deprivation may amount to an expropriation "even if it were partial or temporary"[339] but did not elaborate on the point and the temporary measures in that case were not expropriatory.[340] The tribunal in *GAMI* built on the *S.D. Myers* decision by giving an excellent example of why state action affecting only part of an investment should be considered expropriatory, stating that "the taking of 50 acres of a farm is equally expropriatory whether that is the whole farm or just a fraction."[341] As long as the "*affected* property" is impaired[342] to find an expropriation, not the whole property. The *GAMI* reasoning is better referred to as 'partial deprivation'.

The point here is the extent of deprivation that one tribunal views as ephemeral based on the substantial deprivation reasoning can easily be viewed as substantial or complete by another tribunal based on the *GAMI* reasoning. For that reason, a deprivation affecting part of an investment can deprive the investor of that part either significantly and even completely.[343]

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[335] *GAMI* at para 126.
[336] Section 712 comment (g), Third Restatement
[337] *ibid*; *Pope & Talbot* reference made at para 102.
[338] In *Santa Elena* , with respect to the period of time involved in the process of expropriation, the tribunal said that expropriation can be gradual and done in small steps to the point "that the owner has truly lost *all* attributes of ownership" (emphasis mine) (at para 76).
[339] *S.D. Myers* First Partial Award at para 283.
[340] *ibid* at paras 284 and 288.
[341] *GAMI* at para 126.
[342] *ibid*.
[343] See also R Dolzer and C Schreuer, *Principles of International Investment Law* (2nd Ed, OUP 2012) at 119; *Waste Management* Award at para 141; and *Middle East Cement Shipping and Handling Co. S.A. v Egypt*, ICSID Case No. ARB/99/6, Award of 12 April 2002, in which the tribunal accepted that a licence granted to the investor for the bulk importation and storage of cement was an investment (at para 101) under the Egypt-Greece BIT, and that the revocation of the licence amounted to an expropriation of the licence (as an investment) (at para 107).

In addition, a dispute under an IIT that specifies guidance on deprivation has the potential to displace the international standard[344] although it is unlikely that it would. We have seen United States BITs using the words deprivation[345] alone, substantial deprivation,[346] or avoiding the word deprivation completely.[347] An arbitral tribunal faced with a BIT using only the word deprivation would be unlikely to lower the barrier to finding an expropriation or raise it to require a complete deprivation, with most tribunals likely to adopt the accepted international standard of 'substantial deprivation'.

3.4.5 Creeping Expropriation

A creeping expropriation is an indirect expropriation, and 'measures tantamount' have been said to specifically cater for creeping expropriation,[348] although in actual fact 'measures tantamount' covers indirect expropriation generally,[349] and creeping expropriation is within its ambit. Whilst a *de facto* expropriation (indirect) expropriation occurs through: (i) a single and unique measure and quite obvious measure, such as a plot of land being expropriated through the expropriation of shares in a company that owns only that land; or (ii) a group of measures taking place in a close period of time or simultaneously,[350] creeping expropriation is an even more subtle form of indirect expropriation and occurs when a series of state actions take place over a prolonged period of time. Although each action alone is not enough to be considered expropriation and probably might not even be obviously leading up to expropriation, when combined, the actions have the effect of expropriation – namely a substantial deprivation of investment.

Creeping expropriation is defined by the Letters of Submittal to some United States BITs as a series of measures taken that result in an expropriation of an investment without taking title.[351]

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344 McLachlan et al (n. 3) 279.
345 US-Egypt BIT and US-Morocco BIT.
346 US-Ukraine BIT.
347 See for example US Model BIT 2012.
348 *S.D. Myers* Partial Award at para 286.
349 See 3.2.2.2 above and *LG&E* Decision on Liability at para 188.
350 *ibid.*
351 See (n. 188): US-Bahrain BIT; TUS-Bolivia BIT; US-Jordan BIT; US-Azerbaijan BIT; US-Georgia BIT.

In *Telenor*, creeping expropriation was defined as a series of acts over a period of time which alone are of insufficient gravity to constitute an expropriatory act, but "together produce the effects of expropriation."[352] Creeping expropriation is said to be identified in retrospect because expropriatory intent is difficult or impossible to recognise at a level of host state government,[353] and the effect of a combination of state measures over time will reveal an expropriation. The isolated state measures,[354] whether legal or not, may seem harmless, do not point towards a potential expropriation and "may not be expropriatory in themselves"[355] but in hindsight it becomes evident the accretion of those State measures resulted in an expropriation.[356] A plea of creeping expropriation is based on an investment existing at one point in time, and the temporal State actions erode the investor's rights to the investment, thereby violating the international standard of protection against expropriation.[357]

References have also been made to creeping expropriation in international conventions. The 1967 OECD Draft Convention calls it "creeping nationalisation", defined as state measures applied in such a way to ultimately deprive the alien of the use or enjoyment of his property, without committing any acts that are manifestly an outright deprivation.[358] The International Law Commission's 2001 Articles on Responsibility of States for Internationally Wrongful Acts (ILC Articles) describes a creeping expropriation as a composite act which results from a state breaching its international obligations through a series of acts or omissions which are in aggregate wrongful,[359] and the breach extends from the period of the first action or omission to as long as the actions or omissions are repeated whilst remaining not in conformity with the state's international obligations.[360] Any cocktail of measures can amass into a creeping expropriation, generally including "*taxation*, regulation, denial of due

[352] *Telenor* at para 63.
[353] W. Michael Reisman & Robert D. Sloane, 'Indirect Expropriation and Its Valuation in the BIT Generation' (2004) 74 *Brit. Y.B. Int'l L.* 115, 124.
[354] Including actions and non-actions *CME* Partial Award at para 607.
[355] Reisman and Sloane (n. 352) 124.
[356] *ibid*.
[357] *Generation Ukraine, Inc. v Ukraine*, ICSID Case No. ARB/00/9, Award of 16 September 2003, at para. 20.22.
[358] OECD *ILM* (n. 133) 126; see also 3.1.3.4 above.
[359] Article 15(1), ILC Articles.
[360] *ibid* Article 15(2).

process, delay and non-performance, and other forms of government malfeasance, misfeasance and nonfeasance"[361] (emphasis mine). It is possible to be more specific with the general measures, to include "excessive or arbitrary taxation; prohibition of dividend distribution coupled with compulsory loans; imposition of administrators; prohibition of dismissal of staff; refusal of access to raw materials or essential export or import licences;"[362] or "non-payment, non-reimbursement, cancellation, denial of judicial access, actual practice to exclude, non-conforming treatment, inconsistent legal blocks, and so forth."[363]

3.5 Tax as Expropriation in International Investment Arbitration

So far in this chapter, the reader has gained a historical background into expropriation and tax as expropriation; investment treaty provisions covering expropriation; and the not so basic 'basics' of expropriation which will allow the reader to understand the phraseology of the expropriation standard and the matters that need to be addressed to find state liability for tax expropriation. The remainder of the chapter will now analyse how the international standard of expropriation has been applied to alleged tax expropriations. In order to do so, the facts of recent arbitrations that form the bulk of tax expropriation jurisprudence must be outlined to properly form an understanding of how the principles have applied to the merits of claims.

3.5.1 Tax Expropriation Arbitrations

3.5.1.1 Feldman

Feldman concerned the alleged breach by Mexico of a tobacco exporting company's right to a refund of excise duties paid on cigarettes that were exported out of Mexico. Marvin Feldman, a United States national, was the sole owner and controller of Corporación de Exportaciones Mexicanas, S.A. de C.V. (CEMSA), and he brought a

[361] Reisman and Sloane (n. 352) 121.
[362] OECD *ILM* (n. 133) 126.
[363] *Waste Management,* Dissenting Opinion of Keith Highet at paras 17-18.

claim against Mexico under Article 1110 of NAFTA.[365] CEMSA was a company established under Mexican law and engaged in buying, reselling and exporting cigarettes.[366] Mexico's *Impuesto Especial sobre Producción y Servicios* (IEPS) which translates to '*Special Tax on Production and Services*' levied taxes on the production and sale of cigarettes, however, in some circumstances, a 'zero tax rate' was applied to exported cigarettes.[367] The zero-tax rate applied to exported cigarettes from 1990 to 1997 to generally to countries that had income tax rate above 30% (i.e. not low income tax jurisdictions, or, 'tax havens').[368] In most instances, when cigarettes were bought in Mexico and the purchase price included the tax, the tax amounts paid could be rebated on export.[369]

As a reseller of cigarettes, CEMSA paid cigarette producers a price that included the excise duties, and when exporting the same, it received a rebate on taxes paid. CEMSA started trading in 1990 and received tax rebates in full from 1990 to 1991.[370] In 1991, Mexico amended the IEPS[371] to grant refunds only to exporting producers of cigarettes and not to exporting resellers such as CEMSA.[372] CEMSA contested the constitutionality of the amendments before the Mexican courts (the *Amparo* action),[373] and before a final resolution was determined in that case, the Mexican Congress again amended the IEPS effective 1 January 1992, which allowed CEMSA to receive tax rebates. The Mexican Supreme Court ruling on the *Amparo* action judged the 1991 amendment to be unconstitutional by violating the principles of tax equity and non-discrimination by permitting tax rebates to only producers and their distributors, opining that CEMSA should therefore receive the 0% tax rate on cigarette exports.[374] The Supreme Court did not discuss or rule whether CEMSA

[365] Claims were also filed in the same arbitration under NAFTA Article 1102 (National Treatment) and Article 1105 (Minimum Level of Treatment).
[366] *Feldman* Award at para 10.
[367] *ibid* at para 7.
[368] *ibid* at para 8.
[369] *ibid*.
[370] *ibid* at para 9; Feldman contended the tax refunds were for cigarettes but Mexico contended the refunds were for exports of beer and alcoholic beverages.
[371] Amendment of Article 2(3) of the IEPS.
[372] *Feldman* Award at para 10.
[373] CEMSA initiated an *Amparo* action in February 1991 in the Mexican courts (at para 11). The decision in April 1991 by the Fifth District Judge of in Administrative Matters dismissed CEMSA' *Amparo* in part, but importantly ruled that Mexico's *Secretaría de Hacienda y Crédito Público* (SHCP) (Ministry of Finance and Public Credit) did not have the authority to issue the implementing fiscal regulations in 1991 which denied CEMSA the refunds.
[374] *Feldman* Award at para 16.

should be granted rebates notwithstanding the inability to produce itemised invoices.[375] In 1993, CEMSA's cigarette exporting business was shut down again because CEMSA could not comply with a condition of the tax laws requiring the IEPS tax paid on cigarettes to be itemised "separately and expressly on their invoices."[376] It is the producers and not the resellers of cigarettes who have access to the itemised invoices,[377] and CEMSA was once again unable to receive tax refunds. CEMSA contested the tax law in the national courts of Mexico and in August 1993 the Supreme Court of Justice ruled in CEMSA's favour, finding the IEPS refunds to only producers and their distributors was unconstitutional, discriminatory and violated principles of tax equity.[378] However, the court did not explicitly rule that CEMSA would be entitled to rebates despite its inability to produce invoices detailing the taxes paid separately.[379] Therefore, the tax authorities in Mexico recognised CEMSA as entitled to tax rebates but continued to demand the invoice requirements as per Article 4 of the IEPS.[380] According to CEMSA, Mexican tax officials negotiated an oral agreement with CEMSA in 1995 to grant the refunds and confirmed and implemented the same in 1996.[381] Despite the existence of an oral agreement being denied by Mexico and with neither party producing conclusive evidence to prove or deny the claim,[382] CEMSA did receive tax refunds from June 1996 to September 1997 for a total of sixteen months.[383] CEMSA believed its apparent oral agreement with tax officials was the reason for it being granted rebates,[384] meanwhile Mexico claimed the method of its tax authorities was to pay the tax refunds upon requests, and then audit the tax returns to determine whether the IEPS laws had been complied with.[385]

CEMSA was dealt a major blow by Mexico on or before 1 December 1997 when rebates to CEMSA were terminated.[386] Refunds of excise duties in the amount of US

[375] *ibid* at para 16.
[376] Feldman Award at para 15; the itemisation was required by Article 4 of the IEPS.
[377] *ibid* at para 15.
[378] *ibid* at para 16.
[379] *ibid*.
[380] *ibid* at para 17.
[381] *ibid* at para 18.
[382] *ibid*.
[383] *ibid* at para 19.
[384] *ibid*.
[385] *ibid*.
[386] *ibid* at para 20.

$2.35 million paid on exports during the period October-November 1997 were declined[387] and amendments to the IEPS[388] effective 1 December 1997[389] made tax rebates for taxes paid on cigarettes available only to the 'first sale'[390] – this meant when CEMSA purchased cigarettes from producers or distributors in Mexico, the producers would be entitled to the tax refund, and when CEMSA subsequently exported the cigarettes for resale, they would not be entitled to a tax refund. The IEPS amendments also obliged exporters of certain goods (including cigarettes) to register on the Sectorial Exporters Registry (SER) to be entitled to apply for the zero-rate tax on exports.[391] CEMSA was subsequently refused registration on the SER as an authorised exporter of cigarettes and alcoholic beverages,[392] the repercussions being Mexican Customs authorities not issuing export documentation to export goods from Mexico.[393] Mexico claimed the refusal to accept CEMSA on the SER was due to an on-going audit of CEMSA's claims for tax refunds.[394] On 14 July 1998, Mexico's *Secretaría de Hacienda y Crédito Público* (SHCP) (Ministry of Finance and Public Credit) began an audit of CEMSA, resulting in a demand that CEMSA repay approximately US$25 million that it received as tax refunds for taxes paid on cigarettes during a twenty-one month period from January 1996 to September 1997, including interest and penalties.[395]

CEMSA was thereafter unable to engage in the business of reselling and exporting Mexican cigarettes and was "deprived completely and permanently of any potential economic benefits from that particular activity."[396] At the same time as all the above events occurred, at least two other companies in Mexico who were under Mexican ownership were also exporters and resellers of cigarettes,[397] and they were granted rebates and were not audited (see section 4.3.1 of Chapter 4). Feldman, the owner of CEMSA, brought the Mexico to arbitration claiming a violation of Article 1110 of

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[387] *Ibid*.
[388] IEPS Articles 11 and 19.
[389] *Feldman* Award at para 21.
[390] *ibid*.
[391] *ibid*.
[392] *ibid*.
[393] *ibid*.
[394] *ibid*.
[395] *ibid* at para 22.
[396] *ibid* at para 109.
[397] *ibid* at para 23 – the companies were called Mercados I and Mercados II, part of "the Poblano Group".

NAFTA for the expropriation of his as well as a claim for violation of national treatment a claim for arbitration under NAFTA Article 1120 at the ICSID Additional Facility rules on April 30th 1999, claiming Mexico had breached its obligations under NAFTA Article 1110 by "expropriating his investments without providing prompt, adequate and effective compensation",[398] in particular claiming the denial of IEPS rebates on cigarette exports resulted in "an indirect or "creeping" expropriation… and were tantamount to expropriation… They were also arbitrary, confiscatory and discriminatory, [and] a violation of the Claimant's right to due process."[399] As explained in section 3.2.2 above, indirect expropriation and 'measures tantamount' are the same, and at section 3.4.5 that creeping expropriation falls under indirect expropriation. Similarly, the *Feldman* arbitral tribunal deemed indirect expropriation and 'measures tantamount' to be functionally equivalent"[400] and with Feldman alleging that Mexico carried out a creeping expropriation of his investment, the tribunal determined the claim fell under the category of indirect expropriation.[401]

3.5.1.2 EnCana and Occidental

EnCana was a claim brought by a Canadian company under the Canada-Ecuador BIT and *Occidental*[402] was a claim brought by a United States company under the US-Ecuador BIT, both against the state of Ecuador. Occidental Exploration and Production Company (OEPC) entered into a participation contract in Ecuador with the state-owned company, Petroecuador, for the exploration and exploitation of oil in Ecuador. These are the same cases discussed in Chapter 3, but a different light shall be shed on them in this chapter. EnCana was a beneficiary of four participation contracts entered into by its wholly-owned subsidiaries AEC Ecuador Limited (AEC) and City Oriente Limited (COL). Although *EnCana* and *Occidental* are two distinct cases, they revolve around the same change in laws by Ecuador and similar

[398] *ibid* at para 24(a). Feldman at the same time filed a claim under NAFTA 1105 (Minimum Standard of Treatment) claiming Mexico failed to accord CEMSA fair and equitable treatment and full protection and security. An additional request was made at a later date under the same arbitration for a breach of NAFTA Article 1102 (National Treatment) by Mexico failing to accord CEMSA with treatment no less favourable than that it accords, in like circumstances, to its own (Mexican) investors.
[399] *Feldman* Award 30 at para 89.
[400] *ibid* at para 100.
[401] *ibid* at para 101.
[402] *Occidental Exploration and Production Company v The Republic of Ecuador,* LCIA Case No. UN 3467, Award of 1 July 2004 (*Occidental* or *Occidental* Award).

interpretations of the laws by and actions of Ecuador's tax authority, the *Sericio de Rentas Internas* (SRI).

Ecuador's Hydrocarbons Law as amended in 1993 provided the basis for oil exploration and exploitation in Ecuador. The Hydrocarbons Law allowed the contractor the power to explore and exploit hydrocarbons "on its account and risk all the investments, costs and expenses required for exploration, development and production.[403] Up until 30 April 1999,[404] foreign oil companies in Ecuador were reimbursed by the Ecuadorian state for the value-added-tax (VAT) paid on purchases necessary for oil exploration.[405] Prior to the changes in the Ecuadorian tax policy, exporting producers of goods and services were entitled to receive tax credits in full for VAT paid on locally purchased or imported goods that would become part of their fixed assets, raw materials, inputs and services.[406] As part of the reform of the Ecuadorian tax regime, the SRI was created as Ecuador's tax authority. The Ecuadorian tax law governing the participation contracts was the Internal Tax Regime Law (ITRL). Article 69A of ITRL came into force on 30 April 1999, and stated that natural persons or companies that have paid VAT on local purchases or imported goods used in the manufacture (*fabricación*) of goods to be exported are entitled to a refund. Despite the enactment of this law, the SRI passed denying resolutions to reject the refunds to foreign oil companies[407] as well as annulling original resolutions which granted refunds to the oil companies. The SRI based its denial of VAT refunds on two grounds. The first basis rested on the assumption that VAT reimbursement was accounted for under "Factor X" of the participation contracts.[408] Factor X is a formula in the participation contracts which sets the participation percentages that Petroecuador and the oil companies are respectively

[403] *EnCana* Award at para 26, citing Ecuador's Hydrocarbons Law as amended in 1993, unnumbered Article inserted in Chapter III after Article 12.
[404] On 30 April 1999, Ecuador's Internal Tax Regime Law (ITRL) was amended, thereby affected oil exploration companies.
[405] Devashish Krishan, 'Introductory Note to EnCana Corporation v Republic of Ecuador', (2006) 45 *ILM* 895.
[406] Article 65 of the Ecuadorian Tax Law (pre-30 April 1999); Elihu Lauterpacht and Christopher Greenwood, *International Law Reports: Volume 138* (CUP 2010) 70.
[407] EnCana was claiming on behalf of its Ecuadorian subsidiaries who were denied VAT credits/refunds; they will be referred to as a whole as EnCana. In the EnCana Award, the subsidiaries are referred to as the Companies, and EnCana as the Claimant.
[408] *EnCana* Award at para 23; *Occidental* Award at para 99.

entitled to.[409] Factor X did make reference to taxes in EnCana's contract,[410] outlining that any changes in the tax regime would result in adjustments of the participation percentages to absorb the increase or decrease in taxes, maintaining the economic balance of the contracts,[411] otherwise known as a tax stabilisation clause or economic stabilisation clause. However, reference was made to several types of taxes including income tax and labour participation percentages, but never VAT. Similarly, Factor X in the OEPC contract outlined that Ecuador "shall receive income tax and other taxes in accordance with pertinent laws"[412] and like the EnCana contract it had a provision on economic stability.[413] However, neither contract contained provisions on VAT and its reimbursement.[414] The second basis for the SRI's denial of VAT refunds lay in its interpretation of the amended Article 69A of ITRL, which entitled natural persons or companies to refunds for VAT on locally purchased or imported goods "employed in the *fabricación* of exported products".[415] According to the SRI, petroleum was not considered to be a manufactured good[416] for the purposes of Article 69A, with the right to refunds "inapplicable to activities concerning the exploitation of non-renewable natural resources owned by the State of Ecuador".[417]

OEPC and EnCana brought arbitration proceedings separately and each on their own merits. The majority of commentary on the facts of the tax expropriation claims from these two cases will be based on *EnCana* because expropriation was the only claim that the *EnCana* tribunal had jurisdiction over and so it formed the 'merits of the claim' commentary of that award. The *Occidental* tribunal on the other hand ruled in favour of their jurisdiction to hear OEPC's claims under national treatment and fair and equitable treatment protections,[418] and although they entertained the tax expropriation claim, it was dismissed in the *Occidental* award without much discussion.[419] We will see from Chapter 4 that the merits of OEPC's national treatment claim was based largely on the same facts as EnCana's expropriation

[409] *Occidental* Award, at para 97 and *EnCana* Award at para 31.
[410] *EnCana* Award at para 34.
[411] *EnCana* Award at para 34.
[412] *Occidental* Award at para 98; referencing the Occidental Contract at 8.5.2. "Other Income".
[413] *ibid* at para 98.
[414] *Occidental* Award at para 143; *EnCana* Award at para 150.
[415] SRI Resolution 293(e); *EnCana* Award at para.83.
[416] *ibid*, SRI Resolution 293(f).
[417] *ibid*, SRI Resolution 293(r).
[418] *Occidental* therefore forms a major part of Chapter 4.
[419] *Occidental* Award at paras 78 to 92.

claim, such as Ecuadorian nationals being granted VAT refunds for exported goods that ought to have also not been considered as 'manufactured' if petroleum did not fit that classification also. Another reason for the focus on the *EnCana* Award is the level of detail it goes into regarding communications between the SRI and Petroecuador as well as the detail of SRI's submissions in the dispute.

EnCana's Ecuadorian subsidiaries, AEC Ecuador Ltd (AEC) and City Oriente Limited (COL), were denied VAT refunds at the time of the notice of arbitration[420] of approximately US$80,000,000.[421] Prior to the SRI's denying resolutions, the EnCana subsidiaries did have some tax credits granted to them. In the period between March 2000 and March 2001, AEC applied for and was granted tax refunds for VAT paid on inputs used in the production of oil for export between May 1999 and August 2000 (the "Original Resolutions").[422] AEC then made further applications for refunds to SRI for VAT paid in the period of January 1998 to April 1999 and September 2000 to May 2001, whilst COL applied for refunds for the period January 1999 to December 2000. Most of these claims for VAT refunds were granted.[423] Similarly, OEPC applied for and was granted refunds for VAT paid in the period July 1999 to September 2000.[424] In mid-2001, SRI amassed an auditing team to study the tax refunds granted after the change in the law, with a specific onus on the refunds made to oil companies[425] and this also included refunds to OEPC. SRI wanted to determine whether VAT was considered a cost factor in the participation contracts, and whether the change in tax laws as regards to VAT would set off the economic stability provision in the participation contracts.[426] After many exchanges between SRI and Petroecuador, there was a lack of clarity as to whether VAT was considered a cost expense in the participation contracts. By one letter on 11 July 2001 from Petroecuador to the tax authorities, Petroecuador stated that bidders for participation contracts are "cognizant of all national legislation applicable to hydrocarbon matters, including tax legislation, and could discern which taxes directly increase the cost of the project and which have an indirect effect since they

[420] *EnCana* Award at para 1.
[421] *ibid*.
[422] *Ibid* at para 60.
[423] *ibid* at para 63.
[424] *Occidental* Award at para 32.
[425] *EnCana* Award at para 64.
[426] *ibid* at para 65.

are *reimbursable*, *as in the case of VAT*"[427] (emphasis mine). Despite the letter not being explicitly clear on whether oil companies consider VAT to be reimbursable under Factor X or under law, the letter was relied on by SRI to issue further denying resolutions for VAT refunds.[428]

Ecuador's Hydrocarbons Law made clear the costs and expenses were part of the risk and investment the contractor assumes.[429] Article 16 of the Hydrocarbons Law contained a provision on economic stability, which required adjustment of the participation percentages to restore the economy of the contract "when the tax system applicable to the contract has been modified" which effectively puts the investor in the same position as before any modifications occurred.[430] The position of the SRI at this point was oil companies like EnCana's subsidiaries and OEPC should not be receiving any refunds from the SRI, because as per the Hydrocarbons Law, VAT is included as a cost in the participation contracts, and should therefore not be refunded by the tax authorities, but reimbursed via Petroecuador. Whether the participation contracts included reimbursement of VAT had to be clarified with Petroecuador clearly and in writing, so after conversations between SRI's Director and Petroecuador's President, SRI asked for confirmation in writing that VAT was included as a cost in the participation contracts, because Petroecuador confirmed in those conversations that VAT was included within the costs of the oil companies, specifically citing OEPC as having "clearly included the VAT" as a cost in their contract.[431] However, by letter on 20 November 2001, Petroecuador refused to confirm whether EnCana included VAT as a cost.[432] At the time of receipt of the

[427] *ibid* at para 66.
[428] *ibid* at para 67.
[429] Standalone Article after Article 12, Ecuador Hydrocarbons Law.
[430] *EnCana* Award at para 69.
[431] *ibid* at para 72. Although Occidental will be discussed separately, the Ecuador participation contracts used the same template which were then negotiated between Petroecuador and the respective oil companies. It can be taken from the *EnCana* Award that Petroecuador orally informed SRI that AEL and COL (EnCana) did include VAT as a cost in the participation contracts, thereby refunded via Factor X, but Petroecuador specifically cited OEPC as including VAT in their contract as a cost "clearer [than] in any other company" – para 72.
[432] *ibid* at para 71; Dr Rodolfo Barniol, the then President of Petroecuador, to Dr de Mena, the then Director General of SRI, by letter, said: "It is not mandatory to submit a description of their [the bidders of participation contracts i.e. the EnCana subsidiaries] economic, financial, technical, market studies, etc. For this reason, Petroecuador cannot certify whether the bids of interested companies consider VAT as a cost."

letter from Petroecuador, SRI had already denying resolutions to EnCana's subsidiaries[433] and to OEPC.[434]

However, at this stage of the enigma, SRI had not yet needed to determine the meaning of *fabricación* in Article 69A of ITRL, because they assumed EnCana's subsidiaries were entitled to VAT refunds via Factor X and the Hydrocarbons Law.

EnCana's tax expropriation claim against Ecuador was brought on the premise of direct and indirect expropriation,[435] and OEPC claimed the same.[436]

3.5.1.3 Burlington

Burlington[437] was a claim brought under the US-Ecuador BIT by Burlington Resources Inc. (Burlington) against Ecuador for the alleged expropriation by Ecuador of Burlington's investments in two oil exploration blocks, Block 7 and Block 21. Burlington invested in the participation contracts for the oil blocks through its wholly-owned subsidiary, Burlington Oriente.[438] Burlington contracted into the participation contracts for Blocks 7 and 21 in mid-2001[439] as a minority contractor, holding 42.5% of Block 7 and 46.25% of Block 21, with the remainder in both blocks held by Perenco.[440]

Under the participation formulae, the contractors were entitled to between 65% and 76.2% of oil produced in Block 7 and between 60% and 67.5% of oil produced in

[433] *ibid* at paras 73 and para 78.
[434] *Occidental* Award at para 32.
[435] *EnCana* Award at para 171.
[436] In *Occidental*, the tribunal did not spill much ink on the tax expropriation claim. It is clear, however, from reading the arbitral award that OEPC claimed that Ecuador expropriated all of or part of its investment (*Occidental* Award 28 at para 81), and from Ecuador's arguments, the expropriation claim was for both direct and indirect expropriation: "the Respondent argues that direct expropriation has not occurred… Neither has there been any indirect expropriation…" (*Occidental* Award at para 82).
[437] *Burlington Resources Inc. v Republic of Ecuador*, ICSID Case No. ARB/08/5, Decision on Liability of 14 December 2012 (*Burlington* or *Burlington* Award).
[438] *Burlington* Award at paras 6 and 14.
[439] *ibid* at para 14.
[440] *ibid* at para 15; Perenco have brought their own claim against Ecuador for which the final award is still pending: *Perenco Ecuador Limited v Republic of Ecuador*, ICSID Case No. ARB/08/6.

Block 21, with the relevant percentage depending on the daily average production of oil in barrels in year.[441]

The dispute arose from Ecuador's want of a greater participation in oil revenues when the price for oil increased exponentially from the time most participation contracts in Ecuador (not only for Blocks 7 and 21) were negotiated and executed. Ecuador maintained that the contracts were based on an oil price projection of US$15/bbl (per barrel)[442] with which the contractors could cover their expenses and obtain a reasonable return on their investments.[443] Burlington acquired interests in Blocks 7 and 21 in September 2001 when the price of oil was US$20.15/bbl.[444] Prices began to rise in 2002 and by June 2008 the price of Oriente crude was US$121.66/bbl.[445] Although oil prices fell to below US$30/bbl at the end of 2008 and the beginning of 2009, they increased again and stabilised in the region of US$60-70/bbl in 2009-2010.[446]

Ecuador wanted an increased share in the revenues which were over and above what it believed to be unprecedented and unexpected increases in the price of oil when the contracts were negotiated or executed. For example, Ecuador submitted in the arbitration that it wanted a greater share of revenues from oil prices over US$15/bbl[447] for Block 7 (US$15/bbl being the projected price of oil in Annex V of the Block 7 contract), or a greater share of revenues when the price of oil exceeded the price on execution of the participation contracts.[448] Of course these two submissions were inconsistent with one another, because by enacting Law No. 2006-42 on 19 April 2006 (Law 42), Ecuador took a greater percentage of oil revenues when the oil price was over the price at the date of execution of the relevant participation contracts.

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[441] *ibid* at paras 18 and 19.
[442] *ibid* 54-55 at para 138.
[443] *ibid*; the price of oil on when the Block 7 contract was executed on 23 March 2000 was US$25.11 per barrel (*Burlington* Award at para 291).
[444] *ibid* at para 23.
[445] *ibid* at para 24.
[446] *ibid*.
[447] The parties' oil price projections at US$15/bbl was referenced in Annex V of the Block 7 participation contract (*Burlington* Award at para 272).
[448] Ecuador Law No. 2006-42 of 19 April 2006 (Law 42).

According to Ecuador, the "unprecedented price increase affected the economic equilibrium"[449] of the contracts, which in turn (in Ecuador's view), meant that the contracts needed readjusting,[450] especially because the state, as the owner of the oil, should be the main beneficiary of extra revenues and windfall profits from high oil prices.[451] Ecuador submitted that the contractor's share of production includes a 'P' factor, which is "the oil price projections estimated over the life of the contract".[452] However, the arbitral tribunal did not find a link between the economies of the contracts and any price assumptions, and "that the contractor was entitled to the economic value of its oil participation share irrespective of the price of oil…"[453] Importantly, the contracts for Blocks 7 and 21 were distinguished with a participation contract for a block named the Tarapoa Block, which clearly provided that:

> "If the price of crude oil in the Block exceeds USD 17 per barrel, the surplus of the benefit brought about by the price increase in real terms (calculated at constant values of [1995]) will be distributed between the Parties in equal shares."[454]

Although a clause like that in the Tarapoa contract was specifically discussed during Block and 21 contract negotiations, the contractors rejected its inclusion.[455] The non-inclusion of a price-based oil revenue distribution clause "was not the product of inadvertence but a deliberate choice of the contracting parties."[456]

Before enacting Law 42, Ecuador tried, unsuccessfully, to negotiate the so-called economic disequilibrium with the contractors,[457] with Burlington outright refusing the requests for a change in distribution of revenues.[458] As a result of unsuccessful attempts at negotiating a change in participation percentages for oil revenues over a specific price, Ecuador enacted Law 42 which amended Ecuador's Hydrocarbons

[449] *Burlington* Award 54 at para 136.
[450] *ibid* at para 137.
[451] *ibid*.
[452] *ibid* at para 279.
[453] *ibid* at para 281.
[454] Clause 8.1 of the Tarapoa Contract (*Burlington* Award at para 294).
[455] *Burlington* Award at para 299.
[456] *ibid*.
[457] *ibid* at para 139.
[458] *ibid*.

law. Law 42 required oil companies to pay to the state "50% of the amount, if any, by which the market price of oil [exceeded] the price of oil at the time the [participation contracts] were executed"[459] (Law 42 at 50%). Law 42 referred to oil revenues which exceeded the price of oil at the time the participation contracts were executed as 'extraordinary revenues'. The 50% was increased to 99% on 18 October 2007 by Ecuador Decree 662 (Law 42 at 99%). Under the threat of litigation from oil companies,[460] Ecuador then passed the *Ley de Equidad Tributaria* (LET) (Tax Equity Act) on 28 December 2008 in order to open new negotiations with oil companies.[461] If oil companies took advantage of the LET, the state's participation in extraordinary revenues would drop from 99% to 70%. Burlington and Perenco did not take advantage of the LET.[462]

Burlington initiated arbitration proceedings against Ecuador on 21 April 2008.[463] Burlington made Law 42 payments to Ecuador under protest from their introduction in mid-2006 until May 2008, and in June 2008, Burlington, through a tax consortium (Consortium) set up with Perenco, began making Law 42 payments to a segregated account in the United States and not remitting the same to Ecuador.[464] As a result, on 19 February 2009, Ecuador initiated *coactiva* proceedings (administrative proceedings) against the Consortium[465] (and therefore Burlington)[466] and began to seize Burlington's share of oil production in March 2009.[467] As part of the *coactive* proceedings, from March 2009 to mid-2010, Burlington's share of oil production was auctioned off to the sole bidder, Petroecuador, at below market prices.[468] On 16 July 2009, Burlington and Perenco ceased operation of Blocks 7 and 21 and on the same day Ecuador took possession of the blocks.[469] Finally, Ecuador terminated the participation contracts for the blocks in July 2010 under what was called a *caducidad*

[459] *ibid* at para 32.
[460] 'Ecuador: Diversification and Sustainable Growth in an Oil-Dependent Country' (31 March 2010) World Bank, LCR PREM Report No. 46551-EC, 29.
[461] *Burlington* Award at para 142.
[462] *ibid*.
[463] *ibid*.
[464] *ibid* at para 185.
[465] *ibid* at para 56.
[466] *ibid* at par 186.
[467] *ibid*.
[468] *ibid*.
[469] *ibid*.

process[470] (the *caducidad* process leads to a *declaratoria de caducidad del contracto* ('declaration of nullity of the contract')).

Burlington brought its expropriation claim on the premise that Ecuador's measures individually and in the aggregate constituted an unlawful expropriation of its investment.[471] The individual measures were the enactment of Law 42 at 50% and at 99%, the *coactiva* proceedings that resulted in the seizure of Burlington's share of oil production, the takeover of Blocks 7 and 21, and the *caducidad* declarations (i.e. contract terminations).[472]

The focus here is on Law 42. In the *Burlington* award on jurisdiction[473] and in the final award, Law 42 was deemed to be a tax law for the purposes of the US-Ecuador BIT.[474] Although Law 42 was not a tax law under Ecuadorian law "in a very narrow… technical sense"[475] because it amended Ecuador's Hydrocarbons Law which is not a tax law,[476] under the *EnCana* definition of taxation[477] Law 42 was a tax law. That was because: (i) Law 42, as indicated by its name, was a *law*; (ii) it imposed a *liability* on a *class of persons* (oil companies with participation contracts with Petroecuador/Ecuador) to *pay money* to the *state*; and the money paid/collected were available for the state to use for *public purposes*.[478] Burlington made Law 42 payments to Ecuador and then to the segregated United States account through the Consortium which was used to pay income taxes for Blocks 7 and 21.[479] With respect to (ii) and payments being made to the state, it is important to note that, unlike participation revenues that were paid to Petroecuador, and more like all tax payments, Law 42 payments went "directly into the account of the State" and not "in the account of Petroecuador".[480]

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[470] *ibid*.
[471] *ibid* at para 254 and at para 337.
[472] *ibid* at para 337.
[473] *Burlington Resources Inc. v Republic of Ecuador*, ICSID Case No. ARB/08/5, Decision on Jurisdiction of 2 June 2010 (*Burlington* Jurisdiction Award).
[474] *Burlington* Jurisdiction Award at para 167; *Burlington* Award at para 31.
[475] *Burlington* Jurisdiction Award at para 133.
[476] *ibid*.
[477] See 3.2.1 above.
[478] *Burlington* Jurisdiction Award 36 at para 166.
[479] *ibid*.
[480] *ibid* at para 132.

To demonstrate how arbitral tribunals can differ significantly in their findings, *Occidental II*[481] is a case in point. When assessing quantum, the *Occidental II* tribunal agreed to take into account the Law 42 payments made by OEPC to Ecuador,[482] because the claimants contended Law 42 was unlawful and the payments made under the law should be taken into account on assessment of damages.[483] Upon examining Law 42, the *Occidental II* tribunal decided that Law 42 was not "a royalty, a tax, a levy or any other measure of taxation under the Participation Contract"[484] but was "a unilateral decision of the Ecuadorian Congress to allocate to the Ecuadorian State a defined percentage of the revenues earned by contractor companies… that hold participation contract [*sic*]."[485] Luckily, for the purposes of this thesis, the *Burlington* tribunal did hold Law 42 to be a tax law which permits its examination in this thesis.

3.5.1.4 Archer Daniels, Cargill and Corn Products

Archer Daniels,[486]*Cargill*,[487] and *Corn Products*[488] were three cases brought by United States investors against Mexico under Article 1110 of NAFTA. The claims centred on the amendment by Mexico of the IEPS tax law of Mexico being amended to their detriment. On 30 December 2001 with effect on 1 January 2002, Articles 1, 2, 3 and 8 of the IEPS were amended to impose a 20% excise tax on soft drinks and syrups (the sweetener tax), with the same tax applied on services utilised to transfer and distribute soft drinks and syrups.[489] Soft drinks and syrups that contained

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[481] *Occidental Petroleum Corporation* and *Occidental Exploration and Production Company* v *Republic of Ecuador*, ICSID Case No. ARB/06/11, Award of 5 October 2012 (*Occidental II* or *Occidental II* Award); in *Occidental II*, the claimants succeeded in convincing the tribunal that Ecuador violated the US-Ecuador BIT by failing to accord the claimants fair and equitable treatment, treatment no less than that required by international law, indirect expropriation and by breaching customary international law (*Occidental II* Award at para 876).
[482] *ibid* at para 462.
[483] *ibid* at paras 461and 462.
[484] *ibid* at para 509.
[485] *ibid* at para 510.
[486] *Archer Daniels Midland Company and Tate & Lyle Ingredients Americas Inc. v United Mexican States,* ICSID Case No. ARB(AF)/05/05, Award (Redacted Version) of 21 November 2007 (*Archer Daniels* or *Archer Daniels* Award).
[487] *Cargill Incorporated v United Mexican States*, ICSID Case No. ARB(AF)/05/2, Award (Redacted Version) of 18 September 2009 (*Cargill* or *Cargill* Award).
[488] *Corn Products International Inc. v United Mexican States*, ICSID Case No. ARB(AF)/04/01, Decision on Responsibility (Redacted Version) of 15 January 2008 (*Corn Products* or *Corn Products Award*).
[489] *Archer Daniels* Award at para 2.

sweeteners other than cane sugar were levied with the tax, and soft drinks and syrups sweetened with only cane sugar were excluded from the tax. Cargill, through its Mexican subsidiary, Cargill de Mexico S.A. de C.V. (CMSC) sold high fructose corn syrup (HFCS) which is an alternative to sugar, in Mexico.[490] Similarly, Archer Daniels Midland Company (Archer Daniels) Tate & Lyle Ingredients America (TLIA) also sold HFCS in Mexico through their joint venture Mexican company, Almidones Mexicanos S.A. de C.V. (ALMEX).[491] Corn Products Inc. (CPI) was in the same HFCS business and had the greatest market share for HFCS in Mexico before the sweetener tax took effect.[492] CPI sold HFCS in Mexico through its Mexican subsidiary, Corn Products Ingredientes (CPIng).[493]

HFCS is an alternative and cost-effective sweetener, and when it became available in Mexico, Mexican producers of soft drinks and syrups substituted cane sugar with HFCS,[494] and Coca Cola productions in Mexico blended HFCS with cane sugar[495] thereby using less cane sugar than previously. Sugar in both Mexico and the United States benefitted from a "State supported price",[496] it was a "politically active industry and of considerable social significance in certain parts of each country"[497] and HFCS threatened the sugar industry by being an aggressive competitor of sugar.[498]

The sweetener tax was introduced by Mexico on the back of failed negotiations with the government of the United States to allow surpluses of Mexican sugar to be sold on the United States market.[499]

The sweetener tax originated from a proposal by some members of the Mexican Congress on with a report by the Committee on Treasury and Public Credit of the Mexican Congress reporting the tax should be introduced "with the objective of not

[490] *Cargill* Award at para 1.
[491] *Archer Daniels* Award at para 8.
[492] *Corn Products* Award at para 119.
[493] *ibid* at para 2.
[494] *Archer Daniels* Award at para 49.
[495] *Archer Daniels* Award at para 54.
[496] *Archer Daniels* Award at para 55.
[497] *ibid*.
[498] *Archer Daniels* Award at para 56.
[499] *ibid* at paras 71 to 79; *Corn Products* Award 18 at paras 33 and 37; *Cargill* Award at para 81 to 99.

causing a major injury to the sugar industry."[500] When the tax proposal was introduced to the Mexican Congress, a Representative at the Mexican Congress said the legislators were "committed to protecting the domestic sugar industry… To that effect, it is proposed the tax on soft drinks apply only to those which [utilise] fructose in substitution for sugar."[501] The United States initiated World Trade Organisation (WTO) Dispute Settlement Proceedings with regard to the sweetener tax being contrary to the General Agreement on Tariffs and Trade 1994 (GATT).[502] The Panel decided[503] with regard to HFCS that the tax resulted in dissimilar treatment to HFCS in comparison with directly competitive or substitutable products thereby inconsistent with Article III(2) second sentence of the GATT;[504] HFCS is afforded less favourable treatment than like products of national origin, inconsistent with Article III(4) of the GATT;[505] and imported soft drinks and syrups sweetened with sweeteners other than cane sugar (including HFCS) "were subject to internal taxes in excess of those applied to like domestic products,"[506] inconsistent with Article III(2) first sentence of the GATT.[507] The United States and Mexico agreed that Mexico had until 1 January 2007 to implement the WTO ruling[508] and the sweetener tax was repealed by the Mexican Senate on 20 December 2006.[509]

All claimants in the three arbitrations against Mexico claimed that Mexico had indirectly expropriated their investments in violation of Article 1110 of NAFTA,[510] as well as national treatment at Article 1102, performance requirements at Article

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[500] *Archer Daniels* Award at para 80, quoting Cámara de los Diputados, affo II, No.6, 21 December 2002, at p.692.
[501] *ibid*, quoting Minutes of Legislative Debate, 21 December 2001, pp. 711-712.
[502] Consultations requested by United States on 16 March 2004.
[503] WTO, *Mexico – Tax Measures on Soft Drinks and Other Beverages*, adopted on 24 March 2006.
[504] *ibid*, 161 at para 9.2(a)(ii); GATT Article III(2) second sentence reads: "..no contracting party shall otherwise apply internal taxes or other internal charges to imported or domestic products in a manner contrary to the principles set forth in [Article III] paragraph 1 [internal taxes and other internal charges, and laws, regulations and requirements… should not be applied to imported or domestic products so as to afford protection to domestic production]".
[505] *ibid*, at para 9.2(a)(iii); GATT Article III(4): "The products of the territory of any contracting party imported into the territory of any other contracting party shall be accorded treatment no less favourable than that accorded to like products of national origin in respect of all laws, regulations…"
[506] *ibid*, para 92(iv).
[507] GATT Article III(2) first sentence "The products of the territory of any contracting party imported into the territory of any other contracting party shall not be subject, directly or indirectly, to internal taxes or other internal charges of any kind in excess of those applied, directly or indirectly, to like domestic products."
[508] *Archer Daniels* Award at para 96.
[509] *ibid*.
[510] *Archer Daniels* Award at para 104; *Cargill* Award at para 320; and *Corn Products* Award at para 81.

1106, and Cargill also claimed under fair and equitable treatment principles at Article 1105.

3.5.1.5 Link-Trading

Link-Trading[511] was claim brought by a United States and Moldovan joint venture company against the Department for Customs Control of Republic of Moldova (Moldova) under the US-Moldova BIT.[512] Link-Trading was established in July 1996 under the laws of the Republic of Moldova. Its principal line of business was the sale to retails consumers products that it imported into the Free Economic Zone of Chisinau[513] (the FEZ). In November 1996 Link-Trading registered as a resident in the FEZ,[514] exempting it at that time from import duties and VAT on goods it imported into the FEZ,[515] and the company began operations at the beginning of 1997.[516] When it began trading at the beginning of 1997, Link-Trading's customers had the right to a partial exemption from excise duties and VAT[517] with the limits set annually by the Law on State Budget of the Republic of Moldova (the Budget Law). At the beginning of 1997, the partial exemption entitled Link-Trading's customers up to US $600 tax-free on the goods they purchased within the FEZ per month.[518] On 21 March 1997, the Budget Law for 1997 was adopted, and it reduced the tax exemption to Link-Trading's customers to US$400. Subsequently on 27 December 1997, the Budget Law for 1998 was adopted, further reducing the partial exemption for consumers to US$250. Finally, Law No. 96 of 16 July 1998 amended the Budget Law for 1998 and completely eliminated the partial exemption for consumers of retailers in the FEZ, effective 6 August 1998.[519] The Moldovan Department for Customs Control issued Order No. 466 on 21 October 1998 demanding the residents

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[511] *Link-Trading Joint Stock Company v Department for Customs Control of the Republic of Moldova*, UNCITRAL Arbitration, Final Award, 18 April 2002 (*Link Trading* or *Link Trading* Award).
[512] Treaty between the United States of America and the Republic of Moldova concerning the Encouragement and Reciprocal Protection of Investment, with Protocol and Related Exchange of Letters, signed 21 April 1993, entered into force 25 November 1994 (US-Moldova BIT).
[513] *Link Trading* Award at para 1.
[514] *ibid* at para 2.
[515] *Ibid* at paras 3-4; State Budget Law for 1996 (Moldova), Annex 11, (adopted on December 14th 1995).
[516] *Ibid* at para 2.
[517] *Ibid* at paras 3-4; Moldova Ministry of Finance, Regulation No. 05/1-07/507, Article 1(1)(8), 11 April 1996.
[518] *ibid* at para 3.
[519] *ibid* at para 5.

of the FEZ, the Link-Trading included, to collect customs duties and VAT for the state by adding to the price of their goods sold to customers for import into Moldovan territory (outside the FEZ) and to remit the amounts to the state.[520] Link-Trading protested the government measures, claiming expropriation took place on 8 August 1998[521] when a letter[522] was sent to the Administration of the FEZ detailing the amended Budget Law for 1998. As part of the new Budget Law, although partially tax-exempt shopping was removed in the FEZ, people had the right to import certain consumer products from their travels abroad partially tax-free based on quantitative quotas.[523] Link-Trading argued that Moldova had violated guarantees of tax stability it had given the claimant for a 10 year period, by changing the customs and tax treatment of Link-Trading's customers, thereby substantially depriving Link-Trading of its business through measures tantamount to expropriation for which compensation was due under the US-Moldova BIT.[524] The implementation of the final tax measure coincided with failings of the business shortly thereafter.[525]

Link-Trading's argument that it had a 10-year guarantee against changes in the tax laws was primarily based on Moldova's Law No. 625,[526] as well as Law 998 on Foreign Investment,[527] Law of the Free Zones 1451–XII,[528] and the Minister of Finance Regulation No. 05/1–07/507.[529] Article 7 of Law No. 625 stated that if new laws were adopted which deteriorated the circumstances of activity of residents of the FEZ with regard to the customs and tax regime, then those residents of the FEZ would be entitled to be subjected to the law of Moldova which was in force on the date of their registration in FEZ for a period of ten years.[530]

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[520] *ibid*.
[521] *ibid at* para 7.
[522] Department for Customs Control of the Republic of Moldova, Letter No. 5830005, 8 August 1998.
[523] *Link-Trading* Award at paras 5 and 65.
[524] Article III(1), US-Moldova BIT.
[525] *Link-Trading* Award at para 51.
[526] Republic of Moldova, Law No. 625 of 3 November 1995, Article 7; *Link-Trading* Award at para 33.
[527] Republic of Moldova, Law 998 on Foreign Investment of 1 April 1992, Article 43(1); *Link-Trading* Award at para 38.
[528] Republic of Moldova, Law of the Free Zones 1451–XII of 25 May 1993; *Link-Trading* Award at para 35.
[529] Republic of Moldova, Minister of Finance Regulation No. 05/1–07/507 of 11 April 1996, Article 1.1.8; *Link-Trading* Award at para 37.
[530] Republic of Moldova, Law No. 625 of 3 November 1995, Article 7.

Moldova countered the 10-year guarantee claims by arguing that the guarantee in Article 7 of Law No. 625 was restricted in application to the Customs Regime and Tax Regime contemplated in Law No. 625 itself, and those regimes were set out in Articles 5 and 6 of Law No. 625.[531] This law therefore did not cater to the partial exemption contained in the Budget Law for retail customers of the Claimant's imported goods.[532] The Respondent also asserted that the Minister of Finance Regulation No. 05/1–07/507 was not a law, and rights which did not derive from a law could not exist.[533]

The stability provision that protected businesses from changing laws contained in Law No. 998 on Foreign Investment, Article 43(1), did not include protection from changes in the customs and tax regime according to Article 43(2) of that Law which stated that "Section 1 does not apply to customs, tax…"[534]

Link-Trading contended that the tax amendments were discriminatory, unfair and arbitrary, to which Moldova countered that the amendments were in fact normal regulatory measures, were fair by their nature, and were not arbitrary or discriminatory in their application.[535] Furthermore, the changes in law including the gradual decreases in the partial tax exemption from US$600 to US$250 and subsequently the revocation of such exemption were commercial risks "assumed by the Claimant at the time of its investment."[536] Furthermore, according to Moldova, the business setbacks of Link-Trading were attributed to the Russian financial crisis in August 1998, when the Moldovan currency was devalued by more than 100%, and Moldova supported this argument by saying Link-Trading continued business through most of 1999 despite the amended Budget Law.[537]

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531 *Link-Trading* Award at para 46.
532 *ibid* at para 47.
533 *ibid* at para 48.
534 *ibid* at para 49; Republic of Moldova, Law 998 on Foreign Investment of 1 April 1992, Article 43(2).
535 *Link-Trading* Award at para 50.
536 *ibid* at para 45.
537 *ibid* at para 51.

3.5.1.6 Goetz I and Goetz II

In *Goetz I*,[538] the claimants owned a company called Affinage des Métaux (AFFIMET)[539] which was incorporated under Burundian law.[540] On 31 August 1992, Burundi established a free zone regime.[541] In January 1993 AFFIMET applied for[542] and in February 1993 it was granted a free zone certificate (Certificate) by Burundi's authorities to operate in the free zone.[543] Companies operating in the free zone benefitted from tax and customs duties (together referred to as 'tax' or 'taxes') exemptions.[544] AFFIMET's Certificate was suspended by Burundi from 17 August 1993[545] until 10 January 1994.[546] In the ensuing arbitration, the claimants sought reimbursement of the taxes paid by AFFIMET to Burundi during the period of suspension.[547] The Certificate was then withdrawn from AFFIMET on 29 May 1995,[548] effective 13 August 1996.[549] The claimants brought an action for expropriation under Article 4 of the Belgium-Luxembourg-Burundi BIT[550] for revocation of the Certificate because the revocation forced AFFIMET from conducting its business activities.[551] The arbitral tribunal found in favour of the claimants and gave Burundi the option of compensating the claimants for the expropriation in order to make the expropriation lawful[552] or restoring the Certificate to AFFIMET.[553] Given the choice, Burundi chose to compensate the claimants and the compensation was agreed in a Memorandum of Understanding (MoU) between the parties that was attached to the *Goetz I* Award. The compensation entailed a

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538 *Antoine Goetz and Others v Republic of Burundi*, ICSID Case No. ARB/95/3, Award of 10 February 1999 (*Goetz I or Goetz I* Award).
539 The claimants owned 999 of 1000 shares, with a Rwandan national holding the other single share (*ibid* para 87 at footnote 28).
540 *ibid* at para 3.
541 Burundi Decree -Law No. 1/30 of 31 August 1992; *ibid* at para 1.
542 *Goetz I* Award at para 4.
543 *ibid* at para 5.
544 *ibid* at para 1.
545 *ibid* at para 10.
546 *ibid* at para 11.
547 *ibid* at paras 15.3, 19 and 59.
548 *ibid* at para 15.
549 *ibid* at para 124.
550 Convention entre L'Union Economique Belgo-Luxembourgeoise et la Republique du Burundi concernant L'Encouragement et la Protection Reciproques des Investissements, signed 13 April 1989, entered into force 12 September 1993 (Belgium-Luxembourg-Burundi BIT).
551 *Goetz I* Award at para 124.
552 *ibid* at para 135.
553 *ibid*.

payment of almost US$3 million for taxes and other charges paid to Burundi between 20 August 1993 to 10 January 1994 and 29 May 1995 to 13 August 1996.[554] Although the MoU specified the compensation as being for taxes and other charges, the arbitral award did not focus on the suspension and revocation of the tax exemptions (as a result of the suspension and revocation of the Certificate) as being expropriatory, focusing only on the revocation of the Certificate as being expropriatory because AFFIMET had to cease operations as a result. Despite the foregoing, *Goetz I* is not irrelevant in the context of tax expropriation because in addition to the MoU that was agreed by the parties and attached to the *Goetz I* award was an agreement called the Special Convention on the Operation of AFFIMET (Special Convention). Article 4 of the Special Convention gave AFFIMET certain exemptions from paying taxes, including an exemption from paying taxes on imports,[555] a full exemption from household and property taxes,[556] a total exemption on profit tax for 10 years of the company's operations[557] and a tax exemption on exports (including existing and future direct and indirect royalties).[558] Burundi did not stick to the Special Convention, and among other issues between the parties, another arbitration was commenced, resulting in *Goetz II*.[559] In *Goetz II*, among the issues was Burundi's non-compliance with Article 4(4) of the Special Convention, namely the tax exemption on exports.[560] The tax exemptions on exports were suspended by Burundi from April to June 2002 without any given reasons,[561] and this, together with a string of other measures,[562] according to the claimants, forced the closure of AFFIMET in 2002 and constituted an indirect expropriation.[563]

[554] *ibid* at Article 1 of Memorandum of Understanding.
[555] *Goetz I* Award at Special Convention, Article 4(1).
[556] *ibid*, Article 4(2).
[557] *ibid*, Article 4(3).
[558] *ibid*. Article 4(4).
[559] *Antoine Goetz and Others & et S.A. Affinage des Metaux v Republic of Burundi*, ICSID Case No. ARB/01/2, Award of 21 June 2012 (*Goetz II or Goetz II Award*).
[560] *ibid* at para 189.
[561] *ibid* at para 190(d).
[562] The other measures were: (i) the closure of AFFIMET premises for 24 hours in February 2000; (ii) the impound of AFFIMET materials by customs from June to September 2000 without apparent reason; and (iii) the blocking of export of AFFIMET goods between March and August 2001 (*ibid* at para 190(a)-(c)).
[563] *ibid* at para 191.

3.5.1.7 El Paso

In *El Paso*,[564] the United States claimant company (El Paso International Energy Company (El Paso)) owned shares in four companies constituted under Argentinian Law: Compañías Asociadas Petroleras (CAPSA) (45%); Capex (28.06% shareholding[565] as a result of CAPSA's 60.36% shareholding in Capex); SERVICIOS (99.2% shareholding) and Constanera (12.335% shareholding)[566] (collectively referred to as the Argentinian Companies). El Paso's shares in the Argentinian Companies were protected investments[567] under the US-Argentina BIT[568] and Argentina brought a claim for expropriation under the BIT, as well as claims for violation of discriminatory treatment, fair and equitable treatment and full protection and security protections.[569]

The dispute arose out of measures and lack thereof taken by Argentina to contain and counteract the Argentine economic crisis of 1998-2002. Among the measures taken by Argentina for contingency and recovery purposes was the enactment of Public Emergency Law No. 25,561 of 2 January 2002[570] (Public Emergency Law). The Public Emergency Law devalued the Argentinian Peso (the Peso) by abolishing the parity between the Peso and the US Dollar[571] and authorised the Argentinian government to impose withholding taxes on hydrocarbon exports.[572]

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[564] *El Paso Energy International Company v Argentine Republic*, ICSID Case No. ARB/03/15, Award of 31 October 2011. (*El Paso* or *El Paso* Award).
[565] *ibid* at para 183 at footnote 102.
[566] *ibid* 2 para 7.
[567] *ibid* 64 at para 214.
[568] Treaty between the United States of America and the Argentine Republic concerning the Reciprocal Encouragement and Protection of Investment, with Protocol, signed 14 November 1991, entered into force 20 October 1994 (US-Argentina BIT).
[569] *El Paso* Award at para 49.
[570] *ibid* at para 95.
[571] *ibid*.
[572] *ibid*; the Public Emergency Law also "… converted US dollar obligations into pesos at the rate of 1:1, a measure known as "pesification"; … effected the conversion, on that basis, of dollar-denominated tariffs into pesos; … eliminated adjustment clauses established in US dollars or other foreign currencies as well as indexation clauses or mechanisms for public service contracts, including tariffs for the distribution of electricity and natural gas; … [and] required electricity and gas companies to continue to perform their public contracts…" (*ibid*).

El Paso complained that Argentina was responsible for expropriation by taxation in three aspects: (i) by imposing withholding taxes;[573] (ii) by not taking into account inflation for tax depreciation purposes[574] (hence the mention of lack of measures in the immediately preceding paragraph) and (iii) by limiting tax deductions that the Argentinian Companies could make when considering the devaluation of the Peso was unreasonable[575] (this was another non-measure complained of).

The two last claims were "based on the idea that a foreign investor has a right to certain tax deductions."[576] In short, these 'deduction claims' centred on the calculation of amounts that companies can deduct from their incomes and assets for tax assessment purposes. Both arose as a result of the Public Emergency Law. The last claim was based on the devaluation of the Peso, and the second claim was based on the onset of inflation as a result of the devaluation of the Peso, with inflation reaching 118% in 2002.[577] Under Argentina's Income Tax Law, the value of companies' fixed assets was depreciated annually according to their estimated life expectancy.[578] El Paso contended that Argentina's non-recognition of inflation for tax depreciation purposes was unreasonable and confiscatory.[579] Argentina stressed that Law No. 24,073 of 4 February 1992 "froze all applicable indices and provisions for inflation adjustment purposes, including those related to tax depreciation…"[580] The laws relating to inflation and tax deprecation were therefore in place since 1992, and El Paso was therefore complaining about "no change in the law."[581]

As for the withholding taxes, El Paso claimed they constituted a direct expropriation of CAPSA and Capex's export revenues[582] and an indirect expropriation of CAPSA and Capex's revenues by artificially depressing domestic prices of crude and liquefied petroleum gas (LPG) thus resulting in less revenue for CAPSA and

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[573] *ibid* at para 282.
[574] *ibid* at para 283.
[575] *ibid* at para 284.
[576] *ibid* at para 285.
[577] *ibid* at para 283.
[578] *ibid* at para 111.
[579] *ibid* at para 283.
[580] *ibid* at para 287.
[581] *ibid* at para 295, quoting El Paso's Memorial at 366.
[582] *ibid* at para 282, and 267 at para 728.

Capex.[583] The petroleum prices on the domestic market were artificially depreciated by the imposition of the withholding taxes because the withholding taxes created an 'export parity'.[584] An export parity is created when the price of exported petroleum on foreign markets drops as a result of the imposition of the withholding taxes. Domestic buyers will then refuse to buy petroleum at a price that is higher than the price of exported petroleum after deduction of export costs which include the withholding taxes. El Paso alleged that CAPSA and Capex therefore had to sell crude oil and LPG at prices "that were significantly lower than those prices that would have prevailed in the domestic market in the absence of the Export Withholdings."[585]

El Paso also claimed that all measures (including non-tax measures) taken by Argentina forced it to sell its shares in the Argentinian Companies at a considerable loss.[586]

3.5.1.8 Yukos

There are a number of cases relating to the expropriation of Yukos Oil Company (Yukos) by the Russian state. Yukos-related arbitrations which have rendered final award are *Quasar*[587] and *RosInvest*.[588] Other cases with awards pending are *Yukos Universal*,[589] *Hulley*,[590] and *Veteran*.[591] The claimants in *Yukos Universal*, *Hulley* and *Veteran* are all companies "owned by Cyprus-based GML (formerly Group

[583] *ibid*.
[584] *ibid* at para 728.
[585] *ibid*.
[586] *ibid* at para 258.
[587] *Quasar de Valores SICA V S.A., 0RGOR DE V AWRES SICA V S.A., GBI 9000 SICA V S.A., ALOS 34 S.L. v The Russian Federation*, SCC Case No. 24/2007, Award of 20 July 2012 (*Quasar* or *Quasar* Award).
[588] *RosInvest Co. UK Limited v The Russian Federation*, SCC Case No. V 079/2005, Award on Jurisdiction of 1 October 2007 (*RosInvest* Jurisdiction Award); *RosInvest Co. UK Limited v The Russian Federation*, SCC Case No. V 079/2005, Final Award of 12 September 2010 (*RosInvest* or *RosInvest* Award).
[589] *Yukos Universal Limited (Isle of Man) v Russian Federation*, ECT Arbitration, PCA Case No. AA 227, Interim Award on Jurisdiction and Admissibility of 30 November 2009 (*Yukos Universal* or *Yukos Universal* Jurisdiction Award).
[590] *Hulley Enterprises Limited (Cyprus) v Russian Federation*, ECT Arbitration, PCA Case No. AA 226, Interim Award on Jurisdiction and Admissibility of 30 November 2009 (*Hulley* or *Hulley* Jurisdiction Award).
[591] *Veteran Petroleum Limited (Cyprus) v Russian Federation*, ECT Arbitration, PCA Case No. AA 228, Interim Award on Jurisdiction and Admissibility of 30 November 2009 (*Veteran* or *Veteran* Jurisdiction Award).

Menatep), which is, in turn, owned by a cluster of seven Guernsey-based trusts."[592] The latter three arbitrations are pending final awards and are being heard in parallel proceedings. GML was Yukos' major shareholder.[593] As *Quasar* and *RosInvest* are the only Yukos cases whose arbitration proceedings have rendered final awards at the time of writing, the treatment of tax as expropriation in only those two Yukos cases will be examined in this chapter, and any analysis will revolve around the treatment of Yukos by Russia rather than the claimants in the specific cases as they and their investments (shares in Yukos) were not directly targeted by the Russian state but indirectly suffered as a result of the state directly targeting Yukos.

RosInvest was brought under the UK-Russia BIT[594] and *Quasar* under the Spain-Russia BIT.[595] Claimants in both arbitrations were minority shareholders in Yukos.

In a nutshell, Yukos was once Russia's biggest oil company[596] and the largest taxpayer in Russia[597] until it was subjected to tax audits and reassessments for the years 2000 to 2004 by the Russian Tax Ministry. These assessments in turn resulted in asset freezes that made paying the tax debts insurmountable tasks, which in turn resulted in the seizure of Yukos's shares in its subsidiaries and the auctioning of those companies (one of which was worth between US$15 billion and US$57.7

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592 Luke Eric Petersen, 'Despite Khodorkovsky Release, Majority Owners of Yukos Have No Plans to Drop $113 Billion Arbitration Claim Against Russian Federation as a Final Ruling Looms' *IA Reporter* (24 December 2013) < http://www.iareporter.com/articles/20131224> accessed 24 December 2013.

593 Matteo M. Winkler, 'Arbitration Without Privity and Russian Oil: The Yukos Case before the Houston Court (2006) 27:1 *U. Pa. J. Int'l Econ. L.*115, 116

594 Agreement between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the Union of Soviet Socialist Republics for the Promotion and Reciprocal Protection of Investment, signed 6 April 1989, entered into force 3 July 1991 (UK-Russia BIT); interestingly, the claimant in *RosInvest* was allowed to import the expropriation provision of the Denmark-Russia BIT (Agreement between the Government of the Kingdom of Denmark and the Government of the Russian Federation concerning the Promotion and Reciprocal Protection of Investments, signed 4 November 1993, entered into force 26 August 1996) using the most-favoured-nation provision of the UK-Russia BIT. RosInvest sought to do this because under the UK-Russia BIT, the arbitrators would not have jurisdiction to decide whether there was an expropriation and whether it was legal (*Rosinvest* Jurisdiction Award 73 at para 114 and 74 at para 118), and would have jurisdiction only in matters such as those concerning amount or payment of compensation due for an expropriation.

595 Agreement between Spain and the Union of Soviet Socialist Republics for the Promotion and Reciprocal Protection of Investments, signed 26 October 1990, entered into force 28 November 1991 (Spain-Russia BIT).

596 'Yukos Ten Years On' (*The Yukos Library*, 2013) < http://www.theyukoslibrary.com/en/the-yukos-affair-ten-years-on/> accessed 10 January 2014.

597 *Quasar* at para 102.

billion[598] and accounted for 60% of Yukos's total oil production[599] and was auctioned off for US$9.8 billion to settle the year 2000 tax reassessment of US$3.5 billion) to settle the tax debts. Meanwhile, Yukos' CEO, Mikhail Khodorkovsky, was charged and imprisoned on fraud and tax evasion charges, as was his business partner and president of GML (formerly Group Menatep), Platon Lebedev. Other Yukos executives fled from Russia, and Yukos' staff lawyers and external independent counsel were arrested and charged with embezzlement.[600] To put some perspective on the tax assessments, the assessments together with taxes already paid by Yukos for the years 2000 to 2003, amounted to more than 90% of Yukos' annual consolidated gross revenues for those years.[601] From an alternative perspective, Yukos's net income from 2000 to the third quarter of 2003 was US$13 billion, and with the last of Russia's tax assessments included, the total tax assessments with fines and surcharges for 2000 to 2004 amounted to more than US$24 billion.[602]

Despite the above summary, it will be helpful and interesting to go into the detail of the Yukos affair. On 28 April 2003, the Tax Ministry's specialised top level division that was instituted for large oil companies completed a six month audit of Yukos finding only minor tax liabilities[603] which Yukos paid in full.[604] Yukos' tax affairs were, therefore, in the eyes of the Russian Tax Ministry (Tax Ministry), in order. Later that year, things began to change for Yukos and its top level executives. On 2 July 2003, Platon Levedev was arrested[605] and has since been convicted of fraud, tax evasion, embezzlement and money laundering.[606] On 25 October 2003, Mikhail

[598] OAO Yuganskneftegaz (YNG) was: (i) valued by the *Quasar* claimants as at least US$15 billion (*ibid* at para 84); (ii) sold at auction for US$9.4 billion which was just over half of its appraisal value by Russia's own advisors (*ibid* at para 163); (iii) valued before its auction by investment bankers at US$22 billion (*RosInvest* Jurisdiction Award at para 2, quoting the claimant's Request for Arbitration); and (iv) valued by Russian-state-owned oil company Rosneft, YNG's ultimate post-auction owner, at US$57.7 billion (*Quasar* Award at para 84).
[599] *Quasar* Award at para 162.
[600] *ibid* at para 162.
[601] *RosInvest* Jurisdiction Award at para 2, quoting the claimant's Request for Arbitration.
[602] *Quasar* Award at para 47, quoting the claimants' Statement of Claim.
[603] *RosInvest* Award at para 494.
[604] *Quasar* Award at para 47.
[605] Winkler (n. 592) 116; and *Lebedev v Russia*, ECtHR Application No. 4493/04, Judgement of 25 October 2007.
[606] Lebedev is due for release from prison: Kathrin Hille, 'Khodorkovsky's Pusiness Partner to be Freed from Jail' *Financial Times* (Moscow, 23 January 2014) < http://www.ft.com/cms/s/0/c4ec7e7a-8414-11e3-b72e-00144feab7de.html#axzz2rw7RaNeE> accessed 24 January 2013.

Khodorkovsky was arrested[607] and was also convicted of fraud, tax evasion, embezzlement and money laundering.[608] Khodorkovsky crossed swords with the Russian government by: confronting President Putin "with a thinly veiled allegation of top-level corruption in a televised meeting in February 2003";[609] trying to build a private oil pipeline to China which contravened state policy[610] and would have undermined the state's monopoly over the oil exportation infrastructure;[611] and he/Yukos tried to sell a majority stake in Yukos to ExxonMobil (an American oil company)[612] which would have put a lot of Russian oil under foreign (and more particularly, American) control. Politics aside, the wealth that Yukos could generate for the Russian state by being part of state-owned oil company Rosneft would of course be a lot more significant than the taxes it paid to the state, albeit being the largest taxpayer in Russia. By taking Yukos, Russian oil truly would be mostly under state control.

In *McCulloch v. Maryland*,[613] Chief Justice Marshall said "… the power to tax involves the power to destroy…"[614] The Yukos affair is certainly an apt example of the abuse of that power.

Following the arrest of Khodorkovsky and despite the six month tax audit of Yukos by the Tax Ministry's special division, on 8 December 2003, a re-audit of Yukos' was announced[615] and it lasted only three weeks with the report released on 29 December 2003 finding Yukos's liable for an additional US$3.5 billion in taxes for 2000[616] (Y2000 taxes).

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[607] Winkler (n. 592) 116; and *Quasar* Award 26 at para 47.
[608] Khodorkovsky was released from prison on 20 December 2013, a few months earlier than his August 2014 release date: Courtney Weaver, Kathrin Hille and Neil Buckley, 'Mikhail Khodorkovsky Arrives in Germany After Putin Pardon' *Financial Times* (London and Moscow, 20 December 2013) <http://www.ft.com/cms/s/0/d93bdafc-6951-11e3-89ce 00144feabdc0.html?siteedition=uk#axzz2rK4MjrLn> accessed 20 December 2013.
[609] Neil Buckley, 'One Day in the Life of Mikhail Khodorkovsky' *Financial Times* (24 October 2013) <http://www.ft.com/cms/s/2/a9adb49e-3c39-11e3-b85f-00144feab7de.html#axzz2rK4MjrLn> accessed 26 October 2013.
[610] *ibid*.
[611] *RosInvest* Award at para 4, quoting the Claimant's Post-Hearing Reply Brief of 4 May 2010.
[612] *ibid*; and Neil Buckley (n. 608).
[613] (1819) 17 U.S. 327.
[614] *ibid*, Chief Justice Marshall at 431.
[615] *Quasar* Award at para 47, quoting claimants' Statement of Claim.
[616] *Quasar* Award at para 47, quoting claimants' Statement of Claim.

The reassessments that resulted in extra tax liabilities for Yukos came from the Tax Ministry's 'discovery that Yukos was using trading companies (that it owned) in low tax regions to sell oil to the ultimate non-Yukos purchaser. i.e. Yukos sold oil to its trading companies at low prices, and these companies also traded between themselves, and then the oil was finally sold on the market to companies independent from Yukos (at market price). The inter-trading and selling of oil from the trading companies meant that: (i) Yukos paid less tax on the low price it sold oil to its trading companies than it would have done selling at the market price; and (ii) the trading companies in the low-tax regions paid low tax on the sale of oil at market price, with the profits eventually ending up in the pockets of Yukos/Yukos' shareholders. It was a legitimate use of the tax system used by companies to minimise their tax liabilities. The low-tax region was called the Republic of Mordovia (Mordovia) and under the Law of the Republic of Mordovia on Conditions of Efficient Use of the Social and Economic Potential of the Republic of Mordovia, the region was empowered to apply a tax regime to specific entities, supervise compliance under that regime and set out the record keeping required of taxpayers.[617]

Yukos, having been granted tax concessions in Mordovia, set up its trading entities who never fell short of legal requirements that granted benefits.[618] Despite this, the Tax Ministry's Y2000 audit (and subsequent audits) punished Yukos for using the low-tax region as it did and claimed it was unaware of the utilisation of the region by Yukos. This punishment was on the basis that the tax benefits available in Mordovia were rules of good faith that were exploited by Yukos,[619] especially since the tax benefits for Yukos were disproportionate to its investment in the region.[620] This finding was despite: (i) Mordovia's entitlement to supervise compliance with the tax laws in its territory (and it did not see fit to make a 'proportionate investment' rule);[621] (ii) the Tax Ministry's undoubted awareness of Yukos' use of trading companies[622] and its billions in tax savings published in its annual financial

[617] *ibid* at para 53.
[618] *ibid* at para 54.
[619] *ibid*.
[620] *ibid*.
[621] *ibid*.
[622] *ibid* at para 67; the need for legislative reform was identified as early as 2001 (*Quasar* Award at para 57).

statements;[623] and the Tax Ministry's special oil company division's audit of the trading companies in Mordovia expressed no concern over their role and Yukos's control over them.[624]

As a result of the Tax Ministry's 'discoveries', the trading companies were labelled as 'shams' and all intra-group transactions with those companies as 'sham transactions' because they were in breach of the 'good faith' use of the tax system.[625] Yukos, however, had complied with the written word of the tax law.[626] As a result of the Tax Ministry's stance, Yukos became liable for: (i) VAT-related levies, fines and interest at US$13.5 billion[627] (for VAT the trading companies had actually paid for on exported oil and for which they were due refunds for because there is 0% tax on exports – the Tax Ministry also did not allow Yukos to benefit from the VAT refund requests submitted by the trading companies nor did it allow Yukos to submit its own refund documentation even though it was now viewed as the seller/exporter);[628] and (ii) by declaring the trading companies as shams, Russia assessed Yukos as being liable for US$9.4 billion (including US$1.5 billion in repeat offender fines) of profit tax – tax which the trading companies had for years filed tax returns and paid billions thereto.[629]

On 14 April 2004, the Tax Ministry issued a resolution demanding payment of the Y2000 taxes by 16 April 2004.[630] On 15 April 2004, the Tax Ministry petitioned the Moscow Arbitrazh Court for the recovery of the amounts due and a wide ranging asset freeze to secure the Y2000 liability was awarded.[631] Yukos could have paid the Y2000 taxes if not for the 15 April 2004 asset freeze[632] because it needed to sell or borrow against the frozen assets.[633] The deadline for voluntarily paying the Y2000 taxes expired on 16 April 2004 and on 22 April 2004, Yukos unsuccessfully

[623] *RosInvest* at para 451.
[624] *ibid* at para 494.
[625] *Quasar* Award at para 66.
[626] *RosInvest* Award at para 460.
[627] *RosInvest* Award at para 426.
[628] *RosInvest* Award at paras 424-425.
[629] *RosInvest* Award at para 4, quoting the Claimant's Post-Hearing Reply Brief; *Quasar* Award at para 75.
[630] *Quasar* Award, at para 47, quoting claimants' Statement of Claim.
[631] *ibid* at para 89, quoting claimants' Statement of Claim.
[632] *ibid* at para 89.
[633] *ibid* at para 90.

petitioned the Moscow Arbitrazh Court to unfreeze its assets on the basis that the freeze was unlawfully disproportional and asked the courts to freeze its shares in a company called Sibneft instead, an apparently reasonable offer since the shares in Sibneft were worth more than the Y2000 taxes[634] at US$4.6 billion.[635] On 17 May 2004 Yukos appealed the rejection of its 22 April 2004 petition and the Moscow Arbitrazh Court of Appeal rejected the appeal on 2 July 2004.

The asset freeze gave Russia the power to choose how Yukos would satisfy its tax liabilities because the bailiffs had the final decision against which assets the debt could be enforced.[636] Yukos also tried to settle or discharge the Y2000 tax liability with the Tax Ministry who ignored its pleadings.[637] On 30 June 2004, the Russian courts issued a writ of execution for the Y2000 tax against Yukos and the bailiffs gave Yukos five days to pay up, whereas the Tax Ministry could take up to three years to act on the writ.[638] Yukos attempted to deliver a package to the bailiffs that permitted execution against Yukos' Sibneft shares but deliver was not taken.[639] The bailiffs, on 14 July 2003, decided to seize Yukos' shares in OAO Yuganskneftegaz (YNG),[640] which accounted for 60% of Yukos' oil production capacity.[641] The Tax Ministry had also begun audits for Yukos; 2001-2003 tax years. Before and after the bailiff decision to take the YNG shares, Yukos attempted, three times, to settle with the Tax Ministry, offering US$8 billion for any and all known and possible (from the ongoing audits of the 2001-2003 tax years) outstanding taxes, fines and interest for the years 2000 to 2003, which were not responded to.[642] Yukos also requested a deferral of six months or payments in instalments.[643] None of Yukos' attempts to negotiate or settle were rejected, they were simply were not responded to.[644] On 6

[634] *ibid* at para 89, quoting claimants' Statement of Claim.
[635] *ibid* at para 99, quoting claimants' Statement of Claim.
[636] *ibid* at para 98.
[637] *ibid* at para 99.
[638] *ibid* at para 84.
[639] *ibid* at para 99, quoting the claimants' Statement of Claim.
[640] *ibid* at para 99, quoting the claimants' Statement of Claim.
[641] 'Yukos, Putin and the Oligarchs: Method and Madness - The Tragicomic Destruction of Yukos, and its Legacy' *The Economist* (29 December 2004) <http://www.economist.com/node/3524905> accessed 14 June 2012.
[642] *ibid* at para 99, quoting the claimants' Statement of Claim; letters were sent by Jean Chretien (former Prime Minister of Canada) to then Russian Prime Minister Fradkov on 6 July 2004 and 15 July 2004, and to then and current President Putin on 30 July 2004.
[643] *ibid* at para 99, quoting the claimants' Statement of Claim.
[644] *ibid* at para 102; the *Quasar* tribunal found it highly suspicious and contrary to good faith that the state would ignore the settlement offers of the largest taxpayer in the country (at para 102) and the

August 2004, Yukos mounted a successful legal challenge to have the YNG seizure set aside[645] but the Tax Ministry successfully appealed the decision on 23 August 2004.

Between 2 September 2004 and 9 December 2004, Tax Ministry reassessments for Yukos' 2000 to 2003 tax years were issued, which, together with Yukos' 2004 tax liability, amounted to US$20.6 billion in taxes, fines and punitive interest.[646] Yukos faced double fines for the 2001 to 2003 tax reassessments for being a repeat offender[647] (the normal fine was 20%).[648]

The bailiffs ordered the Russian Federal Property Fund who were in charge of the YNG auction to sell enough shares to cover the combined tax liabilities for 2000, 2001 and 2003, despite Yukos having, by that time, settled the 2000 assessments in full and a portion of the 2001 assessments.[649] The bailiffs responded to that fact by merging the 2002 assessments for collection by sale of the YNG shares along with the 2001 and 2003 assessments, and ordered the sale of all YNG shares to do so.[650]

The YNG auction took place on 19 December 2004 and lasted only 10 minutes, with only one bidder buying all the YNG shares[651] for US$9.3 billion.[652] The buyer, BaikalFinansGroup (BFG), a company with no physical presence at its registered address and incorporated only days before the YNG auction, was bought by state-owned Rosneft on 22 December for US$360, together with the voting shares in YNG, before the YNG payment price had to be paid.[653]

ECtHR found that Russia "should have given very serious consideration to the other options" (*Yukos v Russia* (n. 111) at 654).

[645] 'Timeline' (*The Yukos Library*) < http://www.theyukoslibrary.com/en/library/timeline/> accessed 14 June 2012. (The Yukos Library: Timeline).

[646] *RosInvest* Award at para 4, quoting the Claimant's Post-Hearing Reply Brief; and The Yukos Library: Timeline (*ibid*).

[647] *RosInvest* Award at paras 69- 70.

[648] *ibid* at para 444.

[649] *ibid* at para 70.

[650] *ibid*.

[651] *ibid.*

[652] *Quasar* Award at para 104, quoting claimants' Statement of Claim.

[653] *RosInvest* Award at para 76.

As recognised by the ECtHR, the auction of YNG "was capable of dealing a fatal blow to [Yukos'] ability to survive the tax claims and to continue its existence."[654] The appropriation by Rosneft, and the Russian state as the ultimate beneficiary, was described by President Putin's own chief economic adviser, Andrei Illarionov, as "expropriation of private property" and deserving of the prize for "swindle of the year".[655] Even Rosneft said its purchase of YNG was "the most monumental bargain in Russia's modern history."[656]

As a result of the freezing orders on Yukos' assets, Yukos defaulted on a US$1 billion loan issued by a consortium led by Société Générale (SocGen), who obtained an English court judgment to enforce the outstanding US$472 million of that loan.[657] SocGen, applied to enforce the English judgment in the Russian courts, but in doing so, it entered into an agreement with Rosneft who discharged the US$472 million in full, with SocGen agreeing to pursue bankruptcy proceedings against Yukos.[658] It was done in this way for appearance's sake because Russia did not want to put begin the liquidation of Yukos when the state itself had stopped Yukos from discharging its SocGen debt (with the asset freeze).[659] Therefore, when the Moscow Arbitrazh Court accepted the SocGen consortium's bankruptcy petition, "Rosneft assumed Yukos' debt from the consortium and, with the court's approval, stepped into the shoes of the consortium in the bankruptcy proceedings."[660] Rosneft and the Russian state were now the only significant creditors of Yukos.[661] The *Quasar* tribunal saw the bankruptcy sequence of events as being at odds with bankruptcy law and was actually "the use of insolvency as a device for gaining control of assets rather than satisfying debt."[662] In July 2006, Yukos kept fighting for survival. The Tax Ministry and Rosneft, together holding 94% of votes at the first creditors meeting on 20 and 25 July 2006,[663] rejected Yukos' proposals to "immediately sell off $15.7 billion worth of core assets, and use $1.5 billion held in the Netherlands to pay off other

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654 *Yukos v Russia* (n. 111) at 653.
655 'Russia: The Outspoken Silenced - Marginalising One of the Few Liberals Left in the Kremlin' *The Economist* (6 January 2005) <http://www.economist.com/node/3542090> accessed 14 June 2012.
656 *RosInvest* Award at para 503.
657 *Quasar* Award at para 134.
658 *ibid*.
659 *ibid*.
660 *ibid* at para 135.
661 *ibid*.
662 *ibid*, quoting the *Quasar* Claimants' expert witness' (Prof. Jay Westbrook's) report.
663 *ibid* at para 142.

creditors - including Rosneft as the Societe Generale consortium's assignee. This would have left Yukos with core assets valued at $20.5 billion, which the Yukos management team explained could generate some $3 bil1ion per year to pay off the remaining recognised claims."[664] Instead, the decision was put forward to liquidate Yukos' remaining assets.[665] The choices of Yukos' main creditors were, according to the *Quasar* tribunal "clearly… part of an overall confiscatory scheme."[666] On 1-4 August 2006, Yukos was declared bankrupt.[667] The auction of the remainder of Yukos' assets resulted in 93% of Yukos being under the control of the Russian Federation,[668] although Rosneft did borrow US$22 billion from the world's leading financial institutions to buy the assets.[669]

According to the claimant in *RosInvest*, the Tax Ministry also levied taxes against other oil companies for using the same tax planning strategies but not to the same level as applied to Yukos;[670] and the other oil companies were able to settle their debts on reasonable terms when compared with the transfer of Yukos' assets to a state-owned company.[671] The claimant's expert witness in *RosInvest,* Professor Peter Maggs, reported on the treatment of Yukos, in which he said: "The treatment of Yukos by the Russian tax authorities was inconsistent with the treatment of other comparable taxpayers. The authorities developed, and secured court approval of totally new theories of tax liability for the Yukos case. Even though a number of other large oil companies had made extensive use of trading companies in low tax regimes, these companies were not subjected to ruinous tax consequences."[672]

The central theme of the Yukos arbitrations was why Russia treated Yukos as it did if the true intention was a bona fide assessment and collection of taxes.[673] This relays the substantial difference between the Yukos arbitrations and the ECtHR case of

[664] *ibid* at 143.
[665] *ibid* at para 144.
[666] *ibid* at para 147.
[667] The Yukos Library: Timeline (n. 644).
[668] *Quasar* Award at para 157.
[669] *ibid* at para 155, quoting Russia's Statement of Defence.
[670] *RosInvest* Award at para 537.
[671] *ibid*.
[672] *ibid* at para 539, quoting Maggs Report I at 173.
[673] *Quasar* Award at para 41.

Yukos v Russia[674] because the ECtHR case focused on whether Russia violated specific provisions of the ECHR, with no consideration of whether Russia expropriated Yukos and the foreign investments (foreign held shares) through its actions.[675]

In *RosInvest*, although the claimant did not contend that the retroactive tax assessments made against Yukos caused a substantial deprivation (focusing on the auctions as being expropriatory),[676] the tax elements were nevertheless assessed by the *RosInvest* tribunal together with all other actions attributed to the state, including the conduct (not the decisions)[677] of the Russian courts in the context of denial of justice.[678] Interestingly, according to the claimant in *RosInvest*, Russian judges "who ruled in favour of Yukos were removed from the case or the bench, those who ruled against [Yukos] were awarded the Order of Friendship and the Medal for Service to the Fatherland."[679]

The tribunal in *Quasar* was "concerned with whether Yukos' tax delinquency was actually a pretext for the seizing of Yukos' assets and the transfer of them to Rosneft or one of its affiliates."[680]

3.5.2 Tax Arbitration: Form of Measure vs Impact of Measure

This section concerns the analysis of whether a state acting under its sovereign power to tax can get away with its measures not being analysed for expropriation purposes.

In *Feldman*, the claimant (Feldman) contended that if the form of government measure used to carry out an expropriation happens to be tax laws that are applied in such a way to accomplish an expropriation does not convert the ensuing

[674] *Yukos v Russia* (n. 111).
[675] *Quasar* Award at para 42.
[676] *RosInvest* Award at para 262.
[677] The *RosInvest* tribunal emphasised that arbitral tribunals are not appellate bodies of national courts and "that the threshold of the international delict of denial of justice is high and goes far beyond the mere misapplication of domestic law" by host state courts (*RosInvest* Award at para 275).
[678] *RosInvest* Award at para 273.
[679] *ibid* at para 71.
[680] *Quasar* Award at para 160.

expropriation into valid regulation.[681] Feldman claimed the tax laws were used to drive CEMSA out of the cigarette export business by: (i) declining tax refunds to CEMSA; (ii) Mexico's tax officials' non-compliance with *Amparo* decision which in the claimant's view meant that CEMSA was entitled to the zero-tax rate notwithstanding not being able to fulfil the itemised invoice requirement as required by Article 4(III) of the IEPS and the tax authorities' strict application of the invoice requirement was contrary to the court decision and CEMSA's rights to tax rebates;[682] (iii) retrospectively ordering the repayment by CEMSA of rebates already paid to it (with fines and penalties on top) for cigarette exports between April 1996 and September 1997 as well as denying applications for rebates for exports October and November 1997;[683] and (iv) refusing CEMSA's applications to register on the SER (with the Mexican authorities claiming the tax debt was the reason for the refusal).

The *Feldman* tribunal acknowledged the ability of tax measures to be expropriatory, albeit only as indirect expropriation.[684] The tribunal recognised that governmental authorities can force companies out of business with confiscatory taxation, but at the same time, states must have the freedom to act in the broader public interest with new or modified tax regimes.[685] The *Feldman* tribunal did not give a hard-and-fast rule on when the power to tax results in a compensable taking under international law, stating that it requires a case-by-case analysis.[686]

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[681] *Feldman* Award at para 91.

[682] *ibid* at para 91; Mexico countered the proposition of non-compliance with the *Amparo* action by contending that the detailed invoice requirement was not dealt with in the *Amparo* decision, and therefore the tax authorities made the zero-tax rate available to CEMSA but were nevertheless subject to the fulfilment of all requirements of the tax law (*ibid* at para 92). According to Mexico, the tax officials "did not, and could not have, abrogated from the other requirements of the [IEPS] law, including but not limited to providing invoices with tax amounts separately stated..." (*ibid* at para 93). The tribunal confirmed that the *Amparo* decision did not deal with the invoice requirement because the claimant failed to challenge it during the *Amparo* proceedings (*ibid* at para 122). The invoice requirement received inconsistent court decisions thereafter, with the Mexican Circuit Court deciding the invoice requirement was not inconsistent with the principles of tax equity (*ibid* at para 94), and a Mexican court of appeal apparently holding (on 29 March 2002, during the course of the arbitration) "that the Claimant did have a constitutional right under the IEPS law in force in 1996-1997 notwithstanding his inability to produce invoices showing the tax amounts separately, on the ground that the invoice "formality" discriminates among different taxpayers (producers and exporters) who carry on the same activity" (*ibid* at para 83).

[683] *Feldman* Award at para 91.

[684] *ibid* at para 101; see section 3.5.3 below.

[685] *ibid* at para 103.

[686] *ibid* at para 102.

By not throwing the case out just because the government measure in question centred around the state's sovereign power to tax, the *Feldman* tribunal gave precedence to the impact of the government measure over and above the form of measure, with an analysis of the facts required to determine whether those tax powers were used to unlawfully expropriate an investment.

In *EnCana*, the tribunal found that "taxation is in a *special category*"[687] (emphasis mine) from an expropriation perspective. The tribunal was clear that tax laws, which are a legal liability on a class of persons to pay money to the state, are not takings of property.[688] 'Takings' in this context means 'expropriation' in the traditional sense. The tribunal said that taxes cannot be 'takings' because otherwise the power to tax which is a "universal State prerogative",[689] would be impossible to utilise on account of "a guarantee against expropriation".[690] Notwithstanding, if the tax measure is "extraordinary, punitive in amount or arbitrary in its incidence",[691] it could it be expropriatory. This means that if the impact of a tax measure has the former qualities, it can be expropriatory, despite the allegedly unlawful state conduct being shielded by the sovereign prerogative to tax.

In *Occidental*, Ecuador claimed that taxation cannot be expropriatory,[692] but the arbitral tribunal disagreed, stating that taxation can indeed be expropriatory just as other regulatory measures can.[693] But, like all claims for expropriation, the impact of the tax measure must "meet the standards required by international law" [694] to be expropriatory. This proves again that in investor-state arbitration, the merits of tax as expropriation will be examined and not disregarded by arbitral tribunals just because the form of state measure used for an alleged expropriation is a tax measure.

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687 *EnCana* Award at para 177.
688 *ibid*.
689 *ibid*.
690 *ibid*.
691 *ibid*.
692 *Occidental* Award at para 82.
693 *ibid* at para 85.
694 *ibid* at para 86.

The *Burlington* tribunal recognised that tax is a non-compensable taking[695] and said it is "by definition an appropriation of assets by the State."[696] Despite the non-compensable characteristic of tax, as well as its being an essential prerogative of sovereignty,[697] the tribunal determined that a state can be liable for violating protections granted under international law (i.e. under an IIT) and specifically for the purposes of the case under the expropriation protection of the US-Ecuador BIT through tax measures.[698] The tribunal said that under customary international law, "taxes may not be discriminatory and they may not be confiscatory."[699] The tribunal determined that confiscatory taxation correlates to expropriatory taxation,[700] and the terms 'confiscatory taxation' and 'expropriatory taxation' can be used interchangeably.[701] Referring to the 1961 Harvard Draft[702] and its provision that "the execution of tax laws is not wrongful provided that the tax "is not an abuse of [...] powers [...] for the purpose of depriving an alien of his property""[703] as well as the Third Restatement which "provides that states are responsible for "expropriation [...] when it subjects alien property to taxation [...] that is confiscatory […]"",[704] the *Burlington* tribunal entertained the submissions by the claimant that Law 42 was expropriatory. However, in deciding whether Law 42 was expropriatory/confiscatory or permissible under international law, the impact of the tax was the most important factor in distinguishing so.[705] Essentially, the *Burlington* tribunal decided that the characterisation of an allegedly expropriatory measure as a tax will not prevent a finding that the state has breached international law if the impact of the tax is confiscatory.

The *Archer Daniels* tribunal said that expropriations can occur through measures other than direct takings, specifically citing taxation as an example of such

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695 *Burlington* Award at para 391.
696 *ibid*.
697 *ibid*.
698 ibid at para 392.
699 *ibid* at para 393.
700 *ibid* at para 394.
701 *ibid*; the *Burlington* tribunal referred to the interchangeable use of 'confiscatory taxation' and 'expropriatory taxation' in Thomas Wälde and Abba Kolo, Investor-State Disputes, 'The Interface Between Treaty-Based International Investment Protection and Fiscal Sovereignty' (2007) 35(8/9) *Intertax* 424, 441.
702 See 3.1.3.3 above.
703 *Burlington* Award at para 394.
704 *ibid*.
705 *ibid* at para 395.

expropriations.[706] The tribunal was, in effect, saying that taxation can be indirect expropriation. Indeed, Article 2103(6) of NAFTA contains a tax veto clause, which, as discussed in Chapter 2 of this thesis, indicates that tax as expropriation is an arbitrable matter which in itself is recognition of the capability of tax to be expropriatory. Although the *Cargill* and *Corn Products* tribunals did not assess the form of measure against the impact of the measure, they recognised the tax veto in NAFTA,[707] with the *Cargill* tribunal pointing out that the United States tax authorities "would not… agree that the [sweetener tax] was not an expropriation"[708] which paved the way for arbitration under Article 1110.[709]

In *Link-Trading*, the tribunal, whilst recognising Moldova's right to regulate its customs and make changes as it deems necessary, said that an abuse of the tax power can be tantamount to expropriation.[710] The arbitral tribunal recognised that tax can be expropriatory on two bases: (i) under the provisions of the relevant IIT, which in *Link-Trading* was Article X of the US-Moldova BIT (the tax exclusions article), under which the application of the expropriation provision of the BIT (Article III(1)) was not excepted to taxation measures;[711] and (ii) if taxes are abusive takings.[712] Abusive takings were defined as unfair and inequitable treatment of the investment by the state; measures that are arbitrary and discriminatory in their character or their implementation; or measures that are contrary to an obligation that the state has given to the investor/investment[713] (i.e. a violation of legitimate expectations).

The *El Paso* tribunal reiterated the sovereign right of states to enact taxes that are deemed appropriate at any particular time[714] and there is a presumption of validity in favour of said taxes and the tax exclusion clause at Article XII of the US-Argentina BIT embodied that idea by restricting the effect of the BIT on the state's tax powers.[715] Those limitations did not and do not include tax as expropriation[716] which

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[706] *Archer Daniels* Award at para 238.
[707] *Cargill* Award at para 16; *Corn Products* Award at note 70.
[708] *Cargill* Award at para 17.
[709] *ibid*.
[710] *Link-Trading* Award at para 68.
[711] *Link-Trading* Award at para 63.
[712] *ibid* at para 64.
[713] *ibid*.
[714] *El Paso* Award at para 290.
[715] *ibid*.

is why the tribunal went on to examine whether Argentina's tax measures constituted expropriation.[717] As shall be seen in the sections below, the *El Paso* tribunal required tax measures to violate legitimate expectations and/or be substantial deprivations by resulting in the neutralisation of an investor's property rights.

In *RosInvest*, the tribunal was clear that, despite the normal application of domestic tax laws in a host state is not in itself expropriation, the mere fact that host state measures take the form of tax law application and enforcement does not prevent a tribunal from examining whether those tax measures are expropriatory under an IIT.[718] Similarly, the *Quasar* tribunal, upon finding that Russia's tax measures were a pretext to expropriation (see 3.5.4 below), said that their finding does not mean that "ostensible tax measures are in fact compensatory takings" and "the presumption must be that measures are bona fide, *unless* there is convincing evidence that, upon a true characterisation, they constitute a taking"[719] (emphasis mine).

It is clear from the analysis of the above tax arbitrations that host states cannot avoid arbitrating the question of tax expropriation on the premise that their measures concern the sovereign power to tax. All of the arbitral tribunals recognised the power to tax but that the power has to be balanced with the rights of investors under international law. Essentially, all the tribunals above found that taxes can have expropriatory impacts, and so the labelling of allegedly expropriatory measures as taxation measures will not prevent a tribunal from examining the facts of the case.

3.5.3 Tax Arbitration: Direct Expropriation

This section analyses when certain tax measures might amount to a direct expropriation.

In *El Paso*, although the claimant claimed Argentina's tax measures constituted a direct and indirect expropriation, the tribunal did not distinguish between the two in their award, and their dismissal of El Paso's are discussed in the sections below.

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[716] *ibid* at para 292-292.
[717] *ibid*.
[718] *RosInvest* Award at para 628.
[719] *Quasar* Award at para 181.

EnCana was the only case from those described at 3.5.1 above that was analysed extensively in the context of direct expropriation. This was despite the *Feldman* tribunal's viewpoint that tax measures by their nature can amount only to indirect expropriation.[720]

As discussed at times throughout this chapter, taxation can amount to a direct expropriation because it can be a *taking* of money. This is made possible in the context of tax refunds because the money (property) is already in the hands of the state, and if the money is considered to be an investment under the IIT, if it is taken, or most likely, not given back in the form of tax refunds, then it might have been directly expropriated.

In *EnCana*, EnCana argued that, through its subsidiaries, it had been wrongly denied of its right to tax refunds, in breach of Ecuadorian law,[721] and that breach amounted to a direct expropriation. Under the Canada-Ecuador BIT, as with most IITs, an investment is widely defined. The BIT defines investment as "any asset owned or controlled either directly, or indirectly through an investor of a third State, by an investor of a Contracting Party in the territory of the other Contracting Party and includes… (iii) money [and] claims to money."[722] The examples of an investments at Article I(g) of the BIT are not exhaustive and do not form a restrictive genus by the insertion of the words "in particular, though not exclusively" before citing the examples of investments, making the definition of investment very broad.[723] Article VIII of the BIT (expropriation provision) states that "Investments or *returns* of investors of either Contracting Party shall not be… expropriated…"[724] (emphasis mine). 'Returns' is defined in the BIT as "all amounts yielded by an investment and in particular, though not exclusively, includes profits, interest, capital gains, dividends, royalties, fees *or other current income*" (emphasis mine).[725] The *EnCana* tribunal decided the BIT contained a very broad definition of an investment is and what a return is, therefore tax refunds fell within the BIT's definitions. In *Occidental*,

[720] *Feldman* Award at para 101.
[721] *EnCana* Award at para 179.
[722] Article I(g), Canada-Ecuador BIT.
[723] *EnCana* Award at para 182..
[724] Article VIII(1), Canada-Ecuador BIT
[725] Article I(j), Canada-Ecuador BIT; EnCana Final Award, para 117.

OEPC tried to persuade the tribunal that rights to VAT refunds were investments in themselves[726] under the definition of investment in the US-Ecuador BIT which includes "a claim to money… associated with an investment"[727] but this was rejected by the tribunal[728] who said that "[h]owever broad the definition of investment might be under the Treaty it would be quite extraordinary for a company to invest in a refund claim."[729] The tribunal did not, however, preclude the possibility of a refund claim being a claim to money,[730] and that is actually what was found in the affirmative by the *EnCana* tribunal within the ambit of the Canada-Ecuador BIT.

The next hurdle was to determine whether either or both the prospective and retrospective denial of VAT refunds could amount to an expropriation under the BIT.

The *EnCana* tribunal determined that the prospective denial of VAT refunds for future transactions which is based on changes to the tax regime is within Ecuador's normal state prerogative as is determining and varying the levels of taxes.[731] So, prospective denials could not be an expropriation and were not examined as such. The right of an investor to be paid VAT refunds which had been denied in retrospect, i.e. those "accrued in respect of past transactions",[732] did fall under the BIT's broad scope of "amounts yielded by an investment."[733] Therefore, Ecuador's retrospective denial of VAT refunds fell under the tribunal's jurisdiction to be heard as a claim for expropriation under Article VIII(1)[734] and Article XII(4)[735] of the BIT.[736]

As to the applicable law to decide the expropriation claim, the tribunal decided that the tax laws of Ecuador must be applied to the necessary extent to answer the claim[737] because the tax measure was created by Ecuadorian authorities and laws.[738]

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[726] *Occidental* Award at para 81.
[727] Article I(1)(a)(iii), US-Ecuador BIT.
[728] *Occidental* Award at para 86.
[729] *ibid*.
[730] *ibid*.
[731] *ibid* at para 183.
[732] *ibid*.
[733] *ibid*; quoting Article I(j), Canada-Ecuador BIT, "returns".
[734] Expropriation. provision.
[735] Article XII(4) contained a tax veto provision which permitted the application of Article VIII (expropriation) to taxation measures subject to the tax authorities of both states not agreeing within 6 months that there has been an expropriation.
[736] *EnCana* Award at para 183.
[737] *ibid* at para 184.

Ecuador's Interpretative Law No. 2004-41 of 11 August 2004[739] (the Interpretative Law) gave an interpretation of Article 69A of ITRL, clearly stating that "petroleum is not a good that is fabricated" for the purposes of Article 69A ITRL, thereby ruling out VAT refunds for inputs in oil exploration and exploitation under Article 69A. The right to refunds to be decided by the tribunal was for periods before and after the Interpretative Law was enacted because the denying resolutions that made the basis of the dispute were for trading periods before the passing of the Interpretative Law[740] but EnCana made a claim for VAT refunds in the arbitration (through its Statement of Claim) for its subsidiary AEC for periods when tax was paid after the enactment of the Interpretative Law.[741] For the post-Interpretative Law claims to tax refunds, the Interpretative Law would have to be unconstitutional for the tribunal to decide the issue, but the tribunal refused to determine the Interpretative Law's constitutionality, declaring that the constitutionality of Ecuador's laws had to be determined through the methods provided under Ecuador's Political Constitution.[742] Therefore, the Interpretative Law was presumed to be constitutional and the claims for expropriation of tax refunds after the enactment of the Interpretative Law were rejected.[743]

The questions to then be determined by the tribunal were whether the EnCana subsidiaries had a right to VAT refunds under Ecuadorian law for the period before the Interpretative Law was enacted, especially those periods covered by the denying resolutions, and if so, whether that right was expropriated by Ecuador.[744] The tribunal acted on the assumption that EnCana did have a right to VAT refunds under Ecuadorian law on the basis that the *Occidental* tribunal determined so, even though the *Occidental* decision was not binding on the *EnCana* tribunal.[745] The *EnCana* arbitrators also assumed that SRI made a policy decision "to do everything within its

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[738] *ibi*d at para 184.
[739] *ibid* at para 95.
[740] *ibid* at para 185.
[741] *ibid*.
[742] *ibid* at para 186.
[743] *ibid* at para 186 and 187.
[744] *ibid* at para 188.
[745] *ibid* at para 189; see Chapter 4 for a more in depth analysis of the *Occidental* decision on the rights to refunds.

power to deny refunds to the oil companies."[746] They then analysed whether the denial of EnCana's right to VAT refunds and the SRI's policy actioned by the denying resolutions was expropriatory within the meaning of the BIT.[747]

The *EnCana* tribunal adopted the position that when a tax law is not itself a violation of rights, but the tax legislation is breached by a governmental body, including the tax authorities, that does not equate to an outright taking of property (or an indirect expropriation) unless it is accompanied by a denial of due process (i.e. no access to Ecuadorian courts through legal or practical means).[748]

The *EnCana* tribunal said that a tax authority has the right under international law to take a position (even if it is wrong in law) regarding tax claims by individuals/companies as long as that position is made in good faith and the authority is ready to defend its stance in the courts.[749] The policy of a tax authority is not reviewable under expropriation provision in IITs "unless that policy in itself amounts an actual and effective repudiation of legal rights."[750] The legal right to tax refunds can be repudiated, according to the *EnCana* decision, if: (i) the refusal is not merely wilful; (ii) the aggrieved party has access to the courts; and (iii) the courts' decisions are independent of the state and cannot be overridden or repudiated by the state.[751]

Applying the above criterion set out by the *EnCana* tribunal, prior to the Interpretative Law, oil companies could and did challenge the SRI's decisions in Ecuador's courts and succeeded on some occasions; when it lost, the SRI complied with the court decisions without delay;[752] the SRI's director (Dr. de Mena - who personally oversaw the VAT refund situation of oil companies and was in contact with Petroecuador's President to determine whether or not VAT refunds were included in Factor X of the participation contracts) acted in good faith and this was

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[746] *ibid* at para 190.
[747] *ibid* at para 191.
[748] *EnCana* Award at para 192-195; the *EnCana* tribunal arrived at this decision by adopting the position by the *Waste Management* tribunal that "the mere non-performance of a *contractual* obligation" (emphasis mine) does not equate to a taking of property or a measure tantamount to expropriation (*Waste Management* Award at para 174).
[749] *EnCana* Award at para 194.
[750] *ibid* at para 195.
[751] *ibid* at para 194.
[752] *ibid* at para 196.

not denied by EnCana[753]; and the decisions of Ecuador's decisions were not bipartisan, biased against oil companies or non-independent.[754]

On analysis of the above, EnCana's claim that its VAT payments were directly expropriated by Ecuador was rejected[755] because the SRI's policy on VAT refunds "never rose to the level of repudiation of an Ecuadorian legal right."[756]

The *EnCana* decision tells us that tax measures will not amount to direct expropriation unless they are accompanied by a violation of the conduct requirements, namely due process. This is of course a deviation from the usual rule that the conduct requirements' role is to differentiate between lawful and unlawful expropriation. Although a violation of due process can help to prove that a state's measures err on the side of expropriation rather than non-compensable government takings, the fact that due process is not violated, in my opinion, does not bar a state measure from being expropriation, it just happens to be a lawful expropriation without compensation.

There could have been an interesting divergence between the *EnCana* decision and the *Occidental* decision had the *Occidental* tribunal proceeded with the line of reasoning that tax refunds were claims to money. The *Occidental* tribunal said that the claim to money would still have "to meet the standard required by international law" to be expropriatory.[757] This means that it would have to meet the level of substantial deprivation and the access to due process or lack of it would not have been a determinative issue. It goes without saying that on a substantial deprivation analysis, the retrospective denial of tax refunds was a substantial deprivation of the claim to those moneys. On a direct expropriation front, the tax money was not given back by Ecuador's treasury, therefore it was taken. The *Occidental* tribunal presumably did not go into the analysis because they had the national treatment (and

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[753] *ibid*; the *Occidental* tribunal also said the SRI's decisions appeared to be founded on reason and fact, not prejudice or preference (*Occidental* Award at para 163). The SRI tried to bring some resemblance of order to the variety of contradictory practices, rules and regulations dealing with the VAT refund issue (*Occidental* Award at para 163).
[754] *EnCana* Award at para 196; in addition, Ecuador's Tax Court and Supreme Court had differences of opinion which suggested proper due process (at para 196).
[755] *ibid* at para 197.
[756] *ibid*.
[757] *Occidental* Award at para 86.

fair and equitable treatment) protection to find Ecuador liable under (see Chapter 4), and so, unlike the *EnCana* tribunal, the *Occidental* tribunal "could afford to reject the expropriation claim – a frequently used satisfaction provided by tribunals to otherwise losing respondents, as it had been able to construct a jurisdictional and merits reasoning for the national treatment claim."[758]

3.5.4 Tax Arbitration: Intent vs Effect

This section analyses whether the state's *intent* to expropriate using tax measures can, on its own, lead to a finding of expropriation, or whether the tax measures must actually have the *effect* of expropriation regardless of the state's intent.

In *Feldman*, the arbitral tribunal recognised that Mexico had "opposed the Claimant's business activities at every step of the way, notwithstanding a few periods when the rebates were granted."[759] The business referred to by the tribunal was the claimant's cigarette business. CEMSA, the claimant's company, was effectively precluded from exporting cigarettes and lost all profits derived from that business, which could suggest the existence of an expropriation.[760] But, the right of the claimant/his company to export goods, a right which was purportedly 'taken' by the state, was a right the claimant never possessed.[761] In addition, CEMSA traded in the exported alcoholic beverages business and these goods were also eligible for zero-rate taxes (subject to the equivalent itemised invoices being obtained).[762] The claimant remained free to pursue the export of the cigarettes business as well as other related export activities for which he could and did fulfil legal requirements for by obtaining the necessary invoices from manufacturers of alcoholic beverages[763] to be granted tax rebates.[764] Therefore, together with a lack of deprivation (see 3.5.6 below), even if the intent of the Mexican tax authorities was to completely prevent the claimant from trading in the cigarette export business (it was and it did), the

[758] Wälde and Kolo (n. 699) 445.
[759] *Feldman* Award at para 149.
[760] *ibid* at para 152.
[761] *ibid*; the reader is reminded that CEMSA could not obtain a permit to export cigarettes on the premise that audits were being carried out for tax refunds paid to the company over the years without the requisite invoices being submitted to the tax authorities.
[762] *ibid* at para 124.
[763] *ibid* at para 122.
[764] *ibid* at para 152; in addition to alcoholic beverages, the claimant had also in the past exported photographic supplies (at para 142).

effect on the entirety of the investment (i.e. on CEMSA) was not expropriatory because CEMSA was free to pursue other continuing lines of export trading[765] which were unaffected by the tax authority's measures on the cigarette business and thus CEMSA itself was not expropriated.[766]

In *Cargill*, the arbitral tribunal's finding regarding the sweetener tax and the claimant's business in Mexico was similar to that in *Feldman*. The HFCS business was not CMSC's only business in Mexico,[767] and although the claimant argued that the discriminatory sweetener tax resulted in a near-total loss of the business income stream from HFCS,[768] the sweetener tax's effect on the subsidiary in its entirety (not only on the HFCS business) had to meet the requisite levels of deprivation (i.e. substantial).[769] Effect, again, took primacy over intent.

In *Archer Daniels*, the claimants stressed that the WTO Panel Report, Mexican officials' proclamations and a Mexican Supreme Court pronouncement that the sweetener tax was discriminatory demonstrated that the tax amounted to a taking.[770] The claimants also said the sweetener tax had the effect of expropriation.[771] The tribunal recognised that the effect-based doctrine was what other tribunals had relied on, namely that the tax would have to substantially interfere with the investment and would have to deprive the investor of all or most benefits of the investment.[772] So, pointing to the claimants' contention that the sweetener tax was discriminatory and therefore expropriatory, the tribunal said that "no expropriation occurs unless the measure's degree of interference is substantial… [and] the alleged discriminatory character of the Tax – standing alone – is not a sufficient criterion for an expropriation."[773]

The *Corn Products* tribunal did not differ from the intent vs effect reasoning, also stating that "[i]t is not the case that, because a measure which affects property rights

[765] *ibid at para 152*.
[766] *ibid.*
[767] *Cargill* Award at paras 197-199.
[768] *ibid* at para 368.
[769] *ibid.*
[770] *Archer Daniels* Award at para 232.
[771] *ibid* at para 240.
[772] *ibid*.
[773] *ibid* at para 251.

is discriminatory, it is therefore an expropriation."[774] Rather, for the *Corn Products* tribunal, if a tax measure is expropriatory, the host state cannot justify the expropriatory measure if it is discriminatory.[775]

The *Burlington* tribunal recognised that the intent of a state is a factor that can help to distinguish between permissible and confiscatory taxation.[776] In this respect, the state's intent to deprive an investor and force the investor into abandoning its investment or selling at a distress price would indicate the existence of expropriation.[777] The *Burlington* tribunal, however, determined that the effect of the tax measure plays a primary role over and above the intent,[778] attributing its thinking to the decision in *Tippetts*. Intent can of course help to confirm the outcome of the effects test.[779] In addition, the *Burlington* tribunal said that taxes are illegal if they are discriminatory, but even so, they would still have to meet the substantial deprivation test to be expropriatory in spite of their being illegal.[780] This is a similar thought to what was written at the outset of this chapter, namely that a violation of the conduct requirements can help to determine whether a measure errs on the side of expropriation, but does not actually mean that an expropriation has occurred. As discussed at 3.5.6 below, Burlington was unsuccessful in its tax expropriation claim because it was not substantially deprived of its investment through the tax measures. In this regard and in the context of the *coactiva* proceedings not being expropriatory, the tribunal reiterated that the dispositive consideration was the "effects of the measures, rather than their underlying motivation".[781]

The *Burlington* tribunal took the view that Ecuador's Law 42 at 50% did not have an expropriatory intent.[782] Its intent was to replicate in the participation contracts the effect of the price adjustment clauses similar to those in the *Tarapoa* contract.[783] On the other hand, the intent behind Law 42 at 99% was to force Burlington to "abdicate

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[774] *Corn Products* Award at para 90.
[775] *ibid*.
[776] *Burlington* Award at para 401.
[777] *ibid*.
[778] *ibid*.
[779] *ibid*.
[780] *ibid* at para 402.
[781] *ibid* at para 482.
[782] *Burlington* Award at para 432.
[783] *Burlington* Award at para 432.

its rights under the [participation contracts]."[784] Despite the state's expropriatory intention, the tribunal said the intent behind the tax measure cannot on its own make up for the lack of substantial deprivation.[785] Again, effects came out on top of intent.

In *Link-Trading*, the tribunal focused on both the intent of the tax measures and their effects (discussed at 3.5.6 below), but did not expressly pitch intent against effect. An analysis of the award shows that the tribunal focused more on the importance of the effect because under the US-Moldova BIT, the claimant had to prove "the causal link between the measures complained of and the deprivation of its business."[786] The tribunal did, however, analyse whether the measures complained of were discriminatory, and they were not for the following reasons: (i) the changes in the tax regime impacted other retailers in the FEZ and not only the claimant;[787] and (ii) in comparison to retailers outside the FEZ in Moldova, the claimant was not treated less favourably and as a matter of fact the claimant had benefits over those retailers because it imported goods into the FEZ duty-free and tax-free, deferring payment of the applicable taxes until the final resale, whereas local retailers outside the FEZ would have paid those charges upon import.[788] The tax laws therefore did not put the claimant in a worse competitive position than other nationalities of retailers and the substance of the tax measures were not dissimilar to policies of many countries, despite the unfavourable change for the claimant.[789]

In the Yukos cases, on the use of tax havens, the *Quasar* tribunal said that "[a]s a matter of fairness, tax authorities should not seek to shift the blame for the undesired policy to Russian businesses who took advantage of the policy".[790] The tax authorities were aware of the tax advantages derived by big businesses and engaged in debates on the subject[791] and were aware that Yukos used a tax optimisation strategy (or could have easily known about it).[792] The *RosInvest* and *Quasar* tribunals

[784] *ibid* at para 455.
[785] *ibid*.
[786] *Link-Trading* Award at para 87.
[787] *ibid* at para 71.
[788] *ibid*.
[789] *ibid* at para 72.
[790] *Quasar* Award at para 57, quoting Vladimir Samoylenko, 'Government Policies in Regard to Internal Tax Havens in Russia' (2004) *Tax Notes International* 34.
[791] *Quasar* Award at para 57.
[792] *Quasar* Award at para 52.

judged the tax authorities' contentions that they were not aware of the use of the low tax regions as being unpersuasive.[793] The whole point of the tax regions was to "attract economic activity"[794] and the regions "were authorised to grant… tax advantages by dispensation from the federal government by reason of their special development needs within the framework of macroeconomic policy."[795] There were two business options for companies to conduct their affairs and these were exclusively tax driven, namely the choice between remaining in a high-tax jurisdiction or remaining in a low-tax jurisdiction.[796] Making a choice was not an abuse of the tax system[797] because the taxpayer is entitled to choose between the relevant options[798] and the Russian Tax Ministry shifted the blame for undesired tax policy to the taxpayer instead of reforming legislation.[799]

The *RosInvest* tribunal decided that: (i) the interpretation of Russian law to make up a good-faith/bad-faith doctrine in the use of low-tax regions and relying on that to label Yukos and the trading companies as shams without economic substance was a novel application of Russian law and was not used before or against other comparable tax payers;[800] (ii) the proportionality principle (on how much a company invests in the low-tax region in proportion to its gains) was not part of any law;[801] (iii) the interpretation of the VAT law was formalistic;[802] and (iv) the doubling of repeat offender fines resulting in US$3.8 billion of tax liability on their own were not used in any comparable cases.[803] For those reasons, the *RosInvest* tribunal found that the tax measures taken by Russia were not bona fide and were discriminatory.[804] The tax assessments, according to the tribunal, when considering that they resulted from a three week audit and not a comprehensive six month audit and that no other comparable company was treated the same "can hardly be accepted as bona fide

[793] *RosInvest* Award at para 451; and *Quasar* Award at para 57.
[794] *Quasar* Award at para 60.
[795] *ibid*.
[796] *ibid* at para 74.
[797] *ibid*.
[798] *ibid* at para 69.
[799] *ibid* at para 57.
[800] *RosInvest* Award at para 449.
[801] *ibid* at para 450.
[802] *ibid* at para 452.
[803] *ibid* at para 453.
[804] *ibid* at para 454.

treatment."[805] Overall, the *RosInvest* tribunal found the: (i) the VAT assessments and fines were extraordinary and not bona fide and not non-discriminatory taxation measures;[806] (ii) Yukos used ambiguous legislation that allowed the use of low tax regions to its advantage but done so in an open and transparent way, and the application of so-called good faith and proportionality principles by the Tax Ministry to make Yukos liable for profits of the trading companies was not bona fide and was in fact discriminatory treatment, especially in view of other companies using the same methods and not being treated as Yukos was treated;[807] (iii) the repeat offender fines for US$3.8 billion for Yukos' conduct that pre-dated the findings that it was a first-time offender was part of a cumulative effort in destroying Yukos;[808] (iv) the YNG auction and purchase of YNG by BFG was a front for Rosneft that was organised in a manner to ensure state control of Yukos' prized asset – "in short the Tribunal is convinced that the auction of YNG was rigged";[809] and (v) the bankruptcy auctions, although not foul of Russian law, were initiated and conducted by SocGen in association with Rosneft which therefore fitted in with "the obvious general pattern and obvious *intention* of the totality scheme to deprive Yukos of its assets"[810] (emphasis mine). Russia's intent was therefore to expropriate Yukos, and that intent was also made obvious by the discrimination against the company, whereas no other company was subjected to the same relentless attacks as Yukos was despite using almost identical 'tax avoidance' measures.[811] Russia's intent was put into effect by the tax measures and consequent auctions and liquidation proceedings, whereby Yukos' assets were expropriated by removing them from the company and from certain individuals' control[812] (obviously mainly Khodorkovsky and Lebedev).

On Russia's Tax Ministry's assessment of alleged sham transactions, the *Quasar* tribunal said that "[r]ather than [being] a part of the foundation of undoing a sham transaction, this seems to be an indicium of a sham tax assessment."[813] The *Quasar* tribunal also decided that Russia was hostile towards Yukos by first invalidating the

[805] *ibid* at para 497.
[806] *ibid* at para 620(a).
[807] *ibid* at para 620(b).
[808] *ibid* at para 620(c).
[809] *ibid* at para 620(d).
[810] *ibid* at para 620(e).
[811] *ibid* at para 621.
[812] *ibid* at para 621.
[813] *Quasar* Award at para 79.

trading companies' exports and making Yukos liable for VAT in excess of US$13.5 billion on the basis of being the true seller, and then not allowing Yukos to apply for the VAT refunds – Russia tried to have it both ways.[814] Also, by not giving Yukos a moment to catch its breath and dispose of its assets in an orderly fashion to cover the tax assessments, the Tax Ministry did not act like a legitimately operating tax authority would.[815] This included the Tax Ministry's refusal to wait for three years before acting on the writ of execution (it acted immediately, giving Yukos five days to pay its tax debts). Although tax authorities should seek to collect monies expeditiously, that aim should be balanced with rational care and the right of the taxpayer.[816] Such rationality was accorded to Rosneft when it became liable for YNG's tax debts with a scheduled quarterly payment over five years agreed to by the Tax Ministry.[817] The failure of the Tax Ministry to work with or even respond to Yukos' multiple settlement requests was "disturbing to say the least"[818] and if the real *intent* was to collect legitimately-owed taxes, Russia could have come to a satisfactory conclusion that did not involve the liquidation of Yukos.[819] The quick sale of an asset the size of YNG and the lack of investigation by Russia before dismantling a company of Yukos' magnitude[820] proved the *intent* and *effect* of the tax assessments was to subjugate Yukos rather than to collect taxes.[821] Therefore, the real goal behind the tax assessments against Yukos was a ploy to expropriate Yukos and not to legitimately collect taxes.[822] The *Quasar* tribunal determined that Russia expropriated Yukos[823] – it purposely did not say whether the expropriation was lawful or unlawful because its mandate was only to decide whether there had been an expropriation.[824]

[814] *Quasar* Award at para 80.
[815] *Quasar* Award at para 170.
[816] *ibid* at para 174.
[817] *ibid* at para 175.
[818] *ibid* at para 103.
[819] *ibid*; an investigation would have been required to decide whether Yukos could actually pay its tax debts over a period of time – which, with the increase in oil prices, such a scenario would have been plausible (*ibid*).
[820] *ibid*.
[821] *ibid*.
[822] *ibid* at para 177.
[823] *ibid* at para 186.
[824] *ibid*; it is obvious that the expropriation was unlawful because it was discriminatory, fell foul of due process and was discriminatory. It can be argued that it was in the public interest, but I am not saying that it was.

3.5.5 Tax Arbitration: Legitimate and Reasonable Expectations of the Investor

In *Feldman*, under Mexico's IEPS law, the presentation of detailed invoices to receive tax refunds had been a condition since from 1 January 1987 and this spanned through the time the claimant, Feldman, invested in Mexico in April 1990 until 1 January 1998 when the law was amended to allow tax rebates only to the first sale of cigarettes in Mexico.[825] Therefore, the invoice requirement was always written law, and although it was not always applied,[826] it was not expropriatory and was a reasonable legal requirement backed up by rational policy – i.e. the Mexican tax authorities could straightforwardly, accurately, and without overstatement, analyse and process the tax amounts for which rebates were sought.[827] Indeed, without the invoices, the claimant was unable to know and declare precisely the amounts of tax rebates CEMSA would be owed,[828] and had on some occasions used formulas to estimate the tax refund amounts, which were accepted in 1992, but were grossly overstated in later years.[829] The fact that the tax law's invoice requirement was always law since Feldman's investment in Mexico but had not been enforced could not give him a legitimate expectation that enforcement of the tax laws would not change. As noted by the tribunal, "tax authorities in most countries do not act in a consistent and predictable way."[830] Therefore, a line of conduct by tax authorities (i.e. their enforcement or non-enforcement of tax laws) cannot give an investor a legitimate expectation that such conduct would continue and there can be no expropriation on those grounds.

In *EnCana*, part of the indirect expropriation claim was based on a legitimate expectation to receive VAT refunds. The *EnCana* tribunal recognised that a tax expropriation can occur if specific commitments have been made by the host state as regards tax measures,[831] such as a tax stabilisation clause.[832] Without a commitment being made by a host state to an investor/investments, the host state is entitled to

[825] *Feldman* Award at para 119.
[826] *ibid*.
[827] *ibid* at para 129.
[828] *ibid* at para 130.
[829] *ibid* at para 131.
[830] *ibid* at para 113.
[831] *EnCana* Award at para 173.
[832] *ibid*.

change its tax laws as it sees fit, with the investor having "neither the *right* nor any *legitimate expectation* that the tax regime will not change, perhaps to its disadvantage, during the period of investment"[833] (emphasis mine). There was no such commitment made by Ecuador in *EnCana*. Therefore, if the economic benefit from the investment is reduced by taxation, in the absence of a specific commitment made by the host state to the investor, tax measures will not be expropriatory.

Similarly, in *Cargill*, the tribunal rejected the notion that an investor could have reasonable investment-backed expectations that the tax law will remain stable unless such expectations arise from contract or quasi-contractual bases.[834]

In *Link Trading*, the tribunal determined that tax measures which violate obligations given by the state to an investment can be abusive,[835] and abusive tax measures can amount to expropriation.[836] In that case, however, the tribunal agreed with Moldova's position on the 10-year guarantee, concluding that Moldova did not make any specific obligations to maintain the customs and tax regimes applicable to the claimant's customers buying in the FEZ.[837] The claimant could not, therefore, have had a legitimate expectation that the tax regime would not change and so there was no expropriation on that basis.

In *El Paso*, El Paso claimed that "[i]nvestors have a reasonable and legitimate expectation to be able to adjust their fixed assets for tax purposes in periods of high inflation."[838] This argument was rejected by the tribunal because there is no a duty on a state to adapt its tax regime in foreign investors' best interests.[839] Therefore, the calculation of taxes which is merely unfavourable to a foreign investor does not equate to expropriation.[840]

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[833] *EnCana* Award at para 173.
[834] *Cargill* Award at para 290 (this point arose in the disposition of the fair and equitable treatment claim – the decision was not repeated in the expropriation section of the award).
[835] *Link-Trading* Award at para 64.
[836] *ibid*.
[837] *Link-Trading* Award at para 86.
[838] *El Paso* Award at para 295, quoting El Paso's Memorial at 362.
[839] *ibid*
[840] *ibid*.

In *Occidental II*, the arbitration concerning the same Law 42 of Ecuador that resulting in the *Burlington* arbitration, the tribunal found Law 42 to be in breach of the participation contracts and therefore flouted the claimants' legitimate expectations. In that arbitration, however, Law 42 was not considered to be a tax.[841]

The analysis of the above tax arbitrations has shown that arbitral tribunals are willing to find a state liable for expropriation if a legitimate expectation has been breached, but investors cannot have legitimate expectations that the tax regime, both in terms of tax laws and enforcement of those laws, will not change, unless there is a contractual/quasi-contractual obligation thereto. So, the state's power to tax, including its power to amend and create new tax laws, supersedes investors' expectations that are based on anything other than contract/legal obligations given by the state to the investor/investment. In addition, even where legitimate expectations have been breached through a repudiation of contract rights, arbitral tribunals can still require a substantial deprivation of an entire investment.[842]

3.5.6 Tax Arbitration: Extent of Deprivation

In *Quasar*, the tribunal found the VAT assessments made against Yukos for $13.5 billion and the subsequent disapproval for Yukos to apply for VAT refunds were "confiscatory to a degree which comes close to validating the claims [of expropriation] in their entirety on this basis alone".[843] The tribunal determined that the asset freeze in April 2004 was not a violation of international law on its own, but the timing and effect of the freeze in preventing Yukos from discharging its tax debts counted as part of the creeping expropriation.[844]

The *RosInvest* tribunal determined that Yukos was substantially/totally deprived of its assets and the taking of Yukos' assets as a result of the tax measures constituted an expropriation of the *RosInvest* claimant's shares in Yukos.[845] The cumulative

[841] *Occidental II* at para 527; it would have been a very interesting discussion in this thesis if Law 42 was considered to be a tax in *Occidental II*, especially as regards legitimate expectations, which was not discussed in *Burlington*.
[842] *Burlington* award at para 453.
[843] *Quasar* Award at para 82.
[844] *Quasar* Award at para 95.
[845] *RosInvest* Award at paras 624- 625.

effect of Russia's tax measures were judged as being an unlawful expropriation of Yukos' assets.[846]

In *Feldman*, one factor considered by the tribunal in rejecting the claim for expropriation was the fact that the claimant remained in control of his investment (CEMSA) at all times and had the potential to pursue other business activities through CEMSA as he had previously done.[847] The *Feldman* tribunal reiterated that measures which are indirectly expropriatory require a resulting substantial deprivation which makes "formal distinctions of ownership irrelevant."[848] In the circumstances of that case, the claimant remained in control of CEMSA and in the past had used the company to export alcoholic beverages for which he was able to obtain the necessary itemised invoices and therefore receive tax refunds.[849] The tribunal determined that because Feldman/CEMSA was able to concentrate on that line of business which he/CEMSA was not deprived of, there was no substantial expropriation of the entire investment. This brings up the question of whether the tribunal would have found Mexico liable for expropriating CEMSA if the cigarette exports were the company's only line of business, or if the tribunal considered the notion of partial expropriation. It is clear that, had the cigarette business been CEMSA's only income, or had the tribunal considered the notion of partial deprivation, there still would not have been an expropriation because the investor had no legitimate expectation of receiving tax refunds as the tax law requiring an itemised invoice was present before the claimant made his investment and there can be no legitimate expectation that tax authorities would not shift the enforcement of tax laws.

In *EnCana*, the tribunal considered the claims to money to be investments/returns of investments only in respect of the direct expropriation claim. For the indirect expropriation analysis, EnCana's investment was taken to be its investment in the subsidiaries.[850] Despite the financial harm endured by EnCana through its subsidiaries being denied tax refunds, as well as having to pay back to Ecuador tax

[846] *ibid* at para 633.
[847] *Feldman* Award at para 142.
[848] *Waste Management* Award at para 143; and McLachlan et al (n. 3) 272.
[849] *Feldman* Award at para 142.
[850] *EnCana* Award at paras 172 and 178.

refunds already given, EnCana continued to function profitably and was able to engage in its normal range of undertakings, i.e. extracting and exporting oil.[851] The *EnCana* tribunal said that tax measures must be extraordinary, punitive in amount or arbitrary in their incidence just to be *considered* as indirect expropriation[852] because an otherwise stance would result in the "universal State prerogative [of taxation being] denied by a guarantee against expropriation"[853] because taxation would always be seen determined to be a taking of property.[854] The decision in *EnCana* was that the change in VAT laws or their interpretation was not expropriatory because they did not bring EnCana's subsidiaries to a standstill or render the value "derived from their activities so marginal or unprofitable as effectively to deprive them of their character as investments."[855] Therefore, the denial of tax refunds in the "amount of 10% of transactions associated with oil production and export"[856] was not a substantial deprivation (denial of the benefits of investment in whole or significant part) of EnCana's investment[857] and the indirect expropriation claim was thus rejected.

In *Occidental*, the same grounds for rejecting EnCana's indirect expropriation claims applied, primarily that Ecuador's tax measures did not "meet the standards required by international law"[858] to be considered an expropriation that requires compensation. Ecuador did not deprive OEPC of the use or reasonably expected economic benefit of their investment and the tax measures did not affect a significant part of the investment.[859] The tribunal asserted that had the requirements for a finding of expropriation been more lenient (i.e. less than substantial deprivation), OEPC's expropriation claim would nevertheless have failed,[860] but the tribunal did not expand on this point. We can presume this means that, should substantial deprivation be taken to be the denial of the benefits of an investment in whole or significant part, and it is impossible to put a universal figure on it, but say 90% of

[851] *EnCana* Award at para 174.
[852] *ibid* at para 177.
[853] *ibid*.
[854] *ibid*.
[855] *EnCana* Award at para 174.
[856] *ibid* at para 177.
[857] *ibid*.
[858] *Occidental* Award at para 86.
[859] *ibid*, para 89.
[860] *ibid*.

profits,[861] a lesser level of deprivation at 50% would still not have been deprivation enough in this case because the denial of refunds were likely to be in the region of 10% of transactions associated with oil production and export.[862]

In *Burlington*, the tribunal assessed the deprivation of Law 42 at 50% and at 99% in real impact terms, i.e. "had Law 42 payments not been made, the corresponding amounts would have become additional income for Burlington, to which the ordinary income tax and employment contributions would have applied."[863] The real impact was therefore around 60% of the actual tax.[864] Burlington argued that Law 42 at 50% had a devastating impact on its investment.[865] Law 42 at 50% applied between April 2006 and October 2007. In 2006, Burlington made net profits of US$44.18 million,[866] and when taking into account that Law 42 at 50% applied for three quarters of 2006, Burlington made approximately US$33.14 million in profits during the period of Law 42 enforcement in 2006, diminishing Burlington's profits by around 40%.[867] During the 10 months of 2007 of Law 42 enforcement at 50% plus the two months at 99%, Burlington paid US$87.74 million in Law 42 taxes[868] and its profits stood at US$30.95 million.[869] Burlington would have made approximately US$52.64 million in profits had it not been subjected to Law 42 taxes. Its profits diminished by approximately 62.9% in 2007.[870] On the basis of these figures, the *Burlington* tribunal did not think Law 42 at 50% substantially deprived Burlington of the value of its investment.[871]

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[861] Companies will seldom invest in a country if 90% of their profits will be taxed by the state because the 10% of retains profits would not be worth the investment risk and effort. In *Burlington*, Ecuador's denial of Burlington to 62.3% and 73.9% of the value of a barrel of oil was not considered to be a substantial deprivation (see below).

[862] In *EnCana*, the claims to refunds amounted to 10% of transactions associated with oil production and export (*EnCana* Award at para 177) and the amount claimed by EnCana was US$78,347,323. The amount awarded in *Occidental* (for violation of national treatment, fair and equitable treatment and full protection and security) was US$73,181,369. The *EnCana* amount claimed and the *Occidental* amount awarded are very close. Therefore, it is a safe assumption that the value of VAT refunds in *Occidental* would also have been in the region of 10% of transactions associated with oil production and export.

[863] *Burlington* Award at para 424.

[864] *ibid* at para 424.

[865] *ibid* at para 420.

[866] *ibid* at para 425.

[867] *ibid*.

[868] *ibid* at para 426.

[869] *ibid*.

[870] *ibid*.

[871] *ibid* at para 430.

Burlington argued that Law 42 at 99% destroyed the value of its investment.[872] Law 42 at 99% applied from November 2007 to March 2009, and therefore applied for the entire 12 months of 2008 which made an analysis of its impact in that year possible.[873] In 2008, Burlington made US$203.09 million in Law 42 tax payments. Burlington's accounts did not show profits for 2008 but this appeared to the tribunal to be due to a high rate of amortisation.[874] On a per barrel of oil basis, Law 42 at 99% deprived Burlington of 62.3% of a barrel of Oriente crude[875] and 73.9% of a barrel of Napo crude.[876] This diminished Burlington's profits considerably, but that did not make its investment in Ecuador worthless and unviable[877] and the investment "preserved its capacity to generate a commercial return."[878] The Law 42 tax at 99% was therefore, in the opinion of the majority tribunal,[879] not a substantial deprivation and not expropriatory on the foregoing bases.[880]

In *Archer Daniels*, the tribunal also required a substantial deprivation of the investment. The loss of profits suffered by the joint-venture company (ALMEX) from 1 January 2002 until 31 December 2006 due to the imposition of the sweetener tax, including diminished profits from lost sales of HFCS in Mexico, "was not sufficiently restrictive to conclude the tax had effects similar to an outright expropriation."[881] In addition, the tax did not deprive the investors of the "fundamental rights of ownership or management of their investment" because they were at all times in control of ALMEX's production, sales and distribution.[882]

In *Cargill*, the claimant's HFCS business was not its only income stream.[883] The tribunal, therefore, required the sweetener tax to deprive the claimant from the investment in the Mexican subsidiary, not only the subsidiary's HFCS business. For that reason, the sweetener tax's effect on Cargill's HFCS business in Mexico did not

[872] *ibid* at para 434.
[873] *ibid* at para 435.
[874] *ibid* at para 445; Amortisation is when the capital investment is accounted for/spread over 3-5 years instead of the year the investment was actually made.
[875] *ibid* at para 448.
[876] *ibid* at para 449.
[877] *ibid* at para 456.
[878] *ibid*.
[879] See 3.5.7 below on dissenting opinion in *Burlington*.
[880] *ibid* at para 457.
[881] *Archer Daniels* Award at para 246.
[882] *ibid* at para 245.
[883] *Cargill* Award at paras 197-199 and 368.

equate to a "radical deprivation" of the claimant's overall investment[884] in the Mexican subsidiary.

In *Link-Trading*, the arbitral tribunal did not find the claimant had made a valid causal link between the amendment of the tax regime and the downturn in its business.[885] The claimant contended its business was expropriated on 8 August 1998 when the partial exemption for its customers was removed, however, its sales actually increased in September 1998 and then continued to increase albeit at a decreased level through September 1999.[886] Additionally, the timing of the business' downturn with the Russian financial crisis of 1998, resulting with in the Moldovan Leu dropping sharply against the US Dollar from September 1998 until September 1999, was actually a stronger causal link.[887] Therefore, there was insufficient proof that the claimant's business suffered a substantial deprivation and so it was not expropriated, primarily because of the insufficient evidence that the downturn of its business was a direct result of the tax amendments and not the devaluation of the Moldovan currency resulting in a decline in the claimant's customers' buying power.[888]

Importantly, the *Link-Trading* tribunal said that whilst the amended tax regime could have contributed to the claimant's losses, that was insufficient to prove an expropriation as having occurred, and if it were, tax expropriation would be a concept without limits, as most tax measures have cost impacts on customers.[889]

In *Goetz II*, the arbitral tribunal referred to the abundant investment arbitration case law, confirming that an investor must be deprived not only of expected profits of an investment, but that the deprivation must result in either a loss of control of the investment or the rendering of the investment as purposeless.[890] The *Goetz II* tribunal therefore ruled that the measures taken by Burundi that were complained of by the claimants, including the suspension of the tax exemptions, were not expropriatory

[884] *ibid* at para 368.
[885] *Link-Trading* Award at para 91.
[886] *ibid* at para 90.
[887] *ibid*.
[888] *ibid* at para 91.
[889] *ibid*.
[890] *Goetz II* Award at para 194.

because they did not lead to a loss of control of the company/investment (AFFIMET) or the inability to use the company/investment.[891]

In *El Paso*, the tribunal considered the export withholding taxes to be "*reasonable governmental regulation within the context of the [Argentinian] crisis*[892]" (emphasis original). The withholding taxes that applied to hydrocarbon exports at rates between 4.76% 16.67%[893] had only a limited impact on El Paso's property rights[894] and could not constitute an expropriation[895] and "cannot have caused a forced sale constituting an expropriation of El Paso's shares in the Argentinean companies subjected to… [the] … withholdings".[896] In addition, the withholding taxes were levied on extraordinary revenues made by the oil exporting sector as a result of the devaluation of the Peso, not as a result of increased efficiency.[897] Argentina's expert witness therefore said "it made total economic sense to have a 'compensated devaluation' by relying on export taxes to raise revenues in the sectors that had most benefited from the devaluation."[898] The *El Paso* tribunal agreed, saying it was logical to establish a tax on those extra substantial revenues.[899]

On analysis of the above cases, arbitral tribunals, predictably, required tax measures to have a substantial deprivation on the investor/investment to be expropriatory. This comes as no surprise because the threshold for the level of deprivation required under international law to find an expropriation is extremely unlikely to be lowered in most arbitrations, especially tax arbitrations. As noted by the *EnCana* tribunal, tax measures are in a special category when it comes to expropriation. If anything, the level of deprivation in tax expropriations must be not only substantial, but total. This is why the only cases in the history of investor-state arbitration under modern IITs in which tax measures on their own have been found to be expropriation has been the Yukos cases of *RosInvest* and *Quasar*. This is because, in addition to states being

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[891] *ibid* at para 196.
[892] *El Paso* Award at para 297.
[893] *ibid* at para 297.
[894] *ibid* at para 298.
[895] *ibid*.
[896] *ibid*.
[897] *ibid* at para 297.
[898] *El Paso* Award at para 297, quoting Argentina's expert witness Nouriel Roubini in Argentina's Counter Memorial at 153.
[899] *ibid*.

sensitive when it comes to arbitrating their regulatory powers, the labelling of tax measures as expropriation if they amount to anything less than a total deprivation might be seen as too great an impeachment on the power to tax and lead to a backlash against arbitrators for putting foreign investors' profits over and above the sovereignty of host states and their need to act in their public's interest.

3.5.7 Tax Arbitration: Dissenting Pro-Expropriation Opinions

The dissenting arbitrator in *Burlington*, Orrego Vicuña, concluded that Law 42 at 50% and 99% was expropriatory.[900] In his opinion, no reasonable business person would conclude that paying 50% of revenue income, or more substantially, 99% thereof, would be profitable or valuable.[901] For those reasons, finding a buyer would be near-impossible because of the effect of the state's tax measures on the viability of the business.[902] The arbitrator found Law 42 (and especially at 99%) was beyond any standard of reasonableness and the fact that Ecuador rolled the figure back to 70% under the LET was proof of unreasonableness in itself.[903] According to the arbitrator, although not unprecedented, a 50% tax on income "is very substantial".[904] A 99% tax, on the other hand, was determined to be "not just an expropriation but a confiscation".[905] Although the arbitrator did not expand on the difference between 'expropriation' and 'confiscation', it is in our opinion reasonable to assume, on the basis that the arbitrator expressed that a 50% tax is substantial deprivation (and therefore expropriation), that he meant a 99% tax is total deprivation and, therefore, confiscation. Finally, the arbitrator very briefly touches upon a human rights argument to make the case for substantial deprivation, stating that a 50% tax means the individual or entity works half of its time for the state, and at 99%, nearly all of its time for the state (albeit that in the circumstances of the case Burlington kept a certain minimum income).[906] This raises a human rights issue of "freedom of the individual in a democratic society."[907] This is profound, because a substantial

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[900] *Burlington* Dissent at para 23.
[901] *ibid* at para 25.
[902] *ibid*.
[903] *ibid* at para 26.
[904] *ibid* at para 27.
[905] *ibid*.
[906] *ibid*.
[907] *ibid*.

deprivation can be defined as the deprivation of the use, control and enjoyment of investment, all of which are restricted under extreme taxation as was the case with Law 42 (99%).

The dissenting arbitrator in *EnCana*, Dr. Horacío Grigera Naón, disagreed with the majority tribunal's findings in *EnCana* and concluded that Ecuador's actions were an expropriation under the Canada-Ecuador BIT. In relation to the direct expropriation claim, the arbitrator found the majority decision to require a breach of the conduct requirements including access to domestic courts in Ecuador created an exhaustion of local remedies requirement as a pre-condition to accessing substantive rights under international law (i.e. the BIT)[908] which did not exist under the BIT. The majority tribunal, in requiring such exhaustion of local remedies consisting of a final determination by local courts, which was not required by the BIT, suggested the existence of a public international law hard-and-fast rule which is binding on arbitral tribunals.[909] The application of the laws pertaining to VAT refunds to oil companies for manufactured goods was rather ambiguous and different courts in Ecuador at various times decided differently on the issue.[910] The arbitrator explicitly stated that a final determination of the issue but Ecuador's courts was not required,[911] although since the *EnCana* tribunal relied *arguendo* on the *Occidental* finding that oil companies were due VAT refunds, they would have seen in the *Occidental* award that part of the *Occidental* tribunal's decision was based a 'final' decision by the Special Taxation Chamber of Ecuador's Supreme Court in a specific case, deciding that Article 69A of the ITRL did grant VAT refunds to oil exporters.[912] Of course, as stated above and repeated here, the *Feldman* tribunal correctly stated that "tax authorities in most countries do not act in a consistent and predictable way."[913] Therefore, even if some courts in Ecuador had ruled against the SRI, that clearly did not oblige the SRI (or certainly it did not make the SRI) act consistently regarding tax refunds to oil companies. There could therefore never be a 'final determination' of the issue, and so the majority's apparent requirement of a final determination by

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908 *EnCana* Dissent, at para 8.
909 *ibid* at para 9.
910 *Occidental* Award at paras 140 and 141.
911 *EnCana* Dissent at para 10.
912 *Occidental* Award at para 141.
913 *Feldman* Award at para 113.

local courts, even if a determination need only relate to EnCana or its subsidiaries, would be a total barrier to investment arbitration or at the very least an unnecessary delay not required by the BIT.

I will summarise and discuss here the dissenting arbitrator key points. Firstly, the tribunal's assumption *arguendo* that EnCana through its subsidiaries did have a right to VAT refunds, but then requiring a prior determination of the validity of the state's objections to the granting of the refunds to be obtained from the courts of Ecuador under its own laws, gave the assumption little practical significance.[914] The majority effectively required the claimant to pursue local remedies "before related claims under international law were ripe for a decision on the merits at the international level."[915] Although the majority tribunal did not want to be turned into an Ecuadorian tax court and "pick and choose between different and conflicting national court rulings in order to arrive at a view as to what the local law should be,"[916] the dissenting arbitrator asserted that an international arbitral tribunal is entitled to study the host state laws and their interpretation by the host state courts and authorities at a specific point in time to come to a determination on whether the host state's conduct, licit or illicit under its own laws, resulted in a treaty violation, whether the conduct began to have harmful effects on the foreign investor and/or its investments, and on the extent the harmful effects of the state's conduct.[917] The host State's laws, administrative acts, practices and "other conduct attributable to the host State at the moment they had the effect of operating the deprivation of property" are facts or a cluster of facts for the tribunal to consider when determining whether there has been an infringement of the investor's protection under international law.[918]

If the income yield of an investment is negatively affected by "incoherent, unprincipled or contradictory host state conduct regarding the existence of tax burdens or the absence of tax benefits" it could directly give rise to a claim for expropriation which will not need to be addressed before the host state court unless required by the BIT, which was not the case in *EnCana*, nor will the aggrieved party

[914] *EnCana* Dissent at para 8.
[915] *ibid* at para 9.
[916] EnCana Award at footnote 138.
[917] *EnCana* Dissent at para 11.
[918] *ibid* at para 12.

have to go beyond what is specifically required by the BIT to seek redress.[919] The arbitrator correctly asserted that denial of justice at the national courts of the host state had no role to play in this case.[920] The fact that state conduct is under review at local level does not, under international law, prevent an arbitral tribunal from establishing the meanings and effects of state conduct under an IIT[921] (unless prevented by the relevant IIT). Indeed, the Canada-Ecuador BIT specifically states that an "investor may submit a dispute to arbitration… only if… the investor has waived its right to initiate or continue any other proceedings in relation to the measure that is alleged to be in breach of this Agreement [the BIT] before the courts or tribunals of the Contracting Party concerned or in a dispute settlement procedure of any kind."[922] Simultaneously, the BIT does allow the investor to have a prompt review of its expropriation claim and value of its investment or returns by the judiciary or other independent authority of the host state,[923] but the investor need not go through an appeals process to complete the review[924] and exhaust local remedies, a so called "finality rule".[925] Therefore the mere fact that the investor had access to Ecuador's courts was a nonsensical barrier to finding an expropriation in light of the relevant BIT as the investor had the right to seek recourse under the arbitration agreement contained in the BIT without exhaustion of local remedies.

On the issue of investments that can be expropriated, the arbitrator stated that the BIT and its definition of investment did not distinguish between tangible or intangible property, but that protected ownership under international law, and most probably under comparative and constitutional law, requires the asset to be "susceptible of economic value for the actual or purported holder of rights on such asset."[926] The arbitrator was effectively reiterating that the *nature* of the asset which has allegedly been expropriated should not play a role in the tribunal coming to different conclusions when it must determine entitlement issues and the "reciprocal roles of national and international law and jurisdictions in connection with such

[919] *ibid* at para 25.
[920] *ibid* at para 27.
[921] *ibid.*
[922] Canada-Ecuador BIT, Article XIII(3)(b); and ibid, para 29.
[923] Canada-Ecuador BIT, Article VIII(2); and EnCana Partial Dissent, para 31.
[924] *EnCana* Dissent at para 31.
[925] *ibid* at para 32.
[926] *ibid* at para 14.

issues."[927] The arbitral tribunal should not have been, in the arbitrator's view, apprehensive to consider that the ambiguity of Ecuador's tax law and the conduct of the SRI could have resulted in an expropriation of EnCana's investment.

For the above reasons, the arbitrator believed the entitlement issues raised by the investor should have primarily been considered against the investor's rights under the BIT, which included its rights under Article VIII(1) (expropriation).[928] The dissent primarily focused on EnCana's legitimate expectations, a right acquired through the BIT under its definition of investment, including "other property, tangible or intangible, […] acquired in the expectation or used for the purpose of economic benefit or other business purposes."[929] The economic impact the arbitrator believed tax burdens which were unaccounted for when the investment was made could constitute a taking under Article VIII of the BIT where the negative economic impact of the unexpected tax burden can be projected for years to come.[930] amendments long as the This is a form of ownership because of its financial value, and is a legitimate expectation directly protected by the BIT, and once the investment has been made in accordance to the national law of the host state, if the legitimate expectation to returns, in this case, tax refunds, suffers due to conduct attributable to the host state, that conduct will be reviewed in accordance with the BIT, irrespective of the level of protection offered at the national level of the host State.[931] I do not agree with this view of the arbitrator because as the *EnCana* tribunal asserted (presumably unanimously as the dissenting arbitrator did not state that he disagreed with paragraph 177 of the *EnCana* award) and other tribunals have in some shape or form agreed, changes in the tax regime are expropriatory if they are extraordinary, punitive in amount or arbitrary in their incidence,[932] correctly asserted, host states have the discretion to amend their tax regime, and this is limited only by such changes not being arbitrary, punitive in amount or extraordinary. I will nevertheless continue to summarise the dissenting opinion's points on legitimate expectations as

[927] *ibid*.
[928] *ibid* at para 15.
[929] Canada-Ecuador BIT, Article I(g)(vi). The text of Article I(g)(vi) actually has a double negative using the word 'not' twice. Removal of the double negative results in the positive text I have included in the text, as did the dissenting arbitrator at para 18 of the dissent.
[930] *EnCana* Dissent at para 19.
[931] *ibid* at para 20.
[932] *EnCana* Award at para 177.

they are both important and interesting to analyse, especially since the arbitrator made a link between legitimate expectations of the investor and discriminatory conduct by the host state.

Dr. Naón opined that an investor's *rights* and *expectations* are created upon the investment being accepted by the host state according to its laws, and although the investor bears commercial and legal risks, the investor does not bear the risks that international law puts on the host state, including liability for discriminatory conduct that results in a detriment to the investor.[933]

The arbitrator then analysed why Ecuador's measures were discriminatory in his opinion. Firstly, he was confident that SRI's interpretation of Article 69A of ITRL, and the support that interpretation received by Ecuador's Congress with the publication of the Interpretative Law of 2004, was discriminatory, and because it lead to a deprivation of property, was a discriminatory measure contrary to Article VIII(1) of the BIT.[934] Of course this is a violation of a conduct requirement and does not entail an expropriation as having occurred, but as stated at the introduction to this chapter, discrimination can help to prove that government measures err on the side of expropriation rather than non-compensable government takings. Secondly, the arbitrator believed that EnCana had a legitimate expectation of receiving VAT refunds on its investment based on other non-manufacturing export sectors of the economy being on the receiving end of such benefits[935] (this is the link between legitimate expectations and discrimination).This expectation went hand-in-hand with the lack of specific laws (pre-2004) making clear that the oil and gas companies were exempted from receiving VAT refunds,[936] and such laws ought to have governed the rule that petroleum companies would not be reimbursed VAT, rather than the administrative actions of the SRI deciding the matter.[937] Furthermore, EnCana and its subsidiaries were not included in the exchanges between SRI and Petroecuador and

[933] *EnCana* Dissent at para 23.
[934] *ibid* at para 40.
[935] *ibid* at para 41.
[936] *ibid*.
[937] *ibid*; Ms. de Mena, the then Director of SRI, admitted that a law should have governed the premise that oil and gas companies would not receive VAT refunds, rather than the administrative determinations of SRI (*ibid*). Additionally, the SRI governing such a rule was carried out without clarity and known fact to any potential investors.

"were not and could not be privy to the internal exchanges, changes in position and possible misunderstandings" between the SRI and Petroecuador, who discussed whether VAT was absorbed by Factor X in the participation contracts or not.[938] The arbitrator viewed the sequence of events between the SRI and Petroecuador as resulting in misunderstandings for the SRI which in turn resulted in conduct attributable to Ecuador causing discriminatory frustration of EnCana's legitimate return expectations by "finally denying VAT refunds to EnCana's subsidiaries."[939]

According to the SRI's Director, it had always been Ecuador's policy to deny refunds of VAT to oil companies. However, SRI did authorise the VAT refunds to EnCana's subsidiaries between 8 March 2000 and 16 March 2001 through nine Granting Resolutions, which it granted in compliance with what it believed to be Ecuadorian Law.[940] This gave the impression that EnCana's expectations to receive VAT refunds were in fact legitimate in law according to Article 69A of the ITRL. The SRI Director's reasons for granting the refunds was a processing mistake during the vast amount of VAT refund applications submitted following the enactment of Article 69A. However, in his dissent, the arbitrator said such an excuse is hardly credible, especially if the policy of not granting refunds to oil companies existed prior to Article 69A, and a more likely reason for the granting resolutions was the reasonable interpretation of the tax laws which were interpreted to grant VAT refunds to oil and gas exporters, the same rights afforded to other non-manufactured product exporters.[941]

Exporters of non-manufactured products other than oil and gas, including exporters of "flowers, broccoli, tea, timber, bananas, shrimp, [and] fresh fish sectors" were all eligible for VAT refunds in Ecuador.[942] The oil and gas sector, entirely composed of foreign companies, was not granted such right to VAT refunds, unlike the aforementioned sectors, who were not exclusively owned by foreign companies.[943] This reasoning led to the *Occidental* decision that Ecuador violated the national

938 *ibid*.
939 *ibid*.
940 *ibid* at para 42.
941 *ibid*.
942 *ibid* at para 40.
943 *ibid*.

treatment protection contained in the US-Ecuador BIT (see Chapter 4). The only non-foreign oil company in Ecuador at the time of the *EnCana* case was Petroecuador, who were either not subject to VAT, or if they were, the refunds to them were covered by funds from the government of Ecuador, with foreign oil companies not enjoying the same arrangement.[944] The singling out of oil companies by the SRI prior to the Interpretative Law of 2004 certainly had a very discriminatory nature to it, and Ecuador could have been liable for the SRI's conduct. In terms of any expropriation claims post-enactment of the Interpretative Law of 2004, the majority tribunal decided there could be absolutely no claim for expropriation post-enactment, however, the dissenting arbitrator saw the Interpretative Law of 2004 as being valuable in determining whether Ecuador's VAT refund policy towards oil exporters infringed the expropriation provision of the BIT either through the Interpretative Law on its own or in conjunction with the SRI's policy against oil companies (pre-enactment of the Interpretative Law).[945] The Interpretative Law *prima facie* has a discriminatory nature to it. Its clarification of Article 69A ITRL excludes oil companies from receiving VAT refunds because "petroleum is not manufactured, but is extracted from respective deposits."[946] Meanwhile, the exporters of non-manufactured products such as flowers and bananas did receive VAT refunds. There are no public policy or public interest motives provided in the Interpretative Law to distinguish between petroleum exporters and other non-manufacturing exporters,[947] a factor that edges towards the law being discriminatory.

At the Ecuadorian Tax court proceedings before the enactment of the Interpretative Law of 2004, the question of Ecuador's conduct being contrary to Article VIII of the Canada-Ecuador BIT was raised.[948] The national courts of Ecuador have a right to decide on the issue because the BIT was part of Ecuadorian Law as it had been ratified by the government of Ecuador. EnCana's Ecuadorian subsidiaries, AEC and COL, claimed at the Tax Court that SRI's conduct against petroleum companies was discriminatory to which SRI rebuffed only on the basis of avoiding oil companies 'double dipping' on tax refunds – i.e. the discriminatory application of Article 69A

[944] *ibid*.
[945] *ibid* at para 44.
[946] EnCana Award at para 95.
[947] EnCana Dissent at para 43.
[948] *ibid* at para 45.

ITRL was not denied, but *justified* to avoid oil exporters from receiving VAT refunds from both the SRI and via the participation contracts with Petroecuador.[949] However, Petroecuador did eventually confirm to the SRI that VAT was not included as part of Factor X in the participation contracts[950] and EnCana would therefore not receive VAT reimbursements via Petroecuador.

The SRI's interpretation and application of Article 69A ITRL was not reviewed by the Tax Court in relation to the expropriation provisions of the BIT,[951] whereby under Article VIII(2) they could have made a 'prompt review' of Article 69A ITRL or SRI's interpretation of it, and overruled the legislation or its interpretation by virtue of being "incompatible with international law as incorporated into Ecuadorian law."[952] This puts in doubt the majority tribunal's correctness for ruling that the national courts of Ecuador were open for the parties to decide on the dispute, resulting in a good faith finding of Ecuador and therefore declining EnCana's expropriation claim. Although the domestic courts were open to the aggrieved party, the courts reviewed the tax laws according to national legislation, not the international law under the BIT. Therefore the majority tribunal's decision to not want to be turned into a tax court of appeal, or court of appeal of any kind, had no real basis, especially since the tribunal was asked to consider the alleged violation of the claimant's rights under international law (even though that was intrinsically linked to the claimant's rights under domestic law) which was a matter that was not considered by the domestic courts.

For an expropriation to be lawful, the measures must abide by the conduct requirements. The dissenting arbitrator evaluated whether the denial of tax refunds had a legitimate public purpose. The arbitrator stated that "raising public monies" was not reason enough to validate the public purpose of a tax measure.[953] That is a fair assessment by the arbitrator because all claims of tax expropriation would fail on

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[949] *ibid* at para 47.
[950] EnCana Award at para 71; Dr Rodolfo Barniol, the then President of Petroecuador, to Dr de Mena, the then Director General of SRI, by letter, said: "It is not mandatory to submit a description of their [the bidders of participation contracts i.e. the EnCana subsidiaries] economic, financial, technical, market studies, etc. For this reason, Petroecuador cannot certify whether the bids of interested companies consider VAT as a cost."
[951] *EnCana* Dissent at para 48.
[952] *ibid* at para 51.
[953] *ibid* at para 52.

a raising public monies defence. In *EnCana*, a genuine public purpose would have been to avoid EnCana's subsidiaries from double dipping on tax refunds,[954] however, this was a defunct public purpose as Petroecuador and the Interpretative Law of 2004 ruled out VAT being refunded via the participation contracts,[955] unless the participation contracts were renegotiated to include the refunds. Another public purpose which potentially existed in the Interpretative Law of 2004 and through SRI's interpretation of Article 69A ITRL was the promotion of a specific interpretation of Article 69A ITRL, thus avoiding damage to Ecuador's economic interests should that provision not be interpreted in a certain way.[956] However, the Tax Courts referred EnCana and Petroecuador to the negotiation table to amend their production sharing agreement to include the reimbursement of VAT. Such renegotiation ruling in itself assigned an economic value to the investor from tax refunds and the host state would be in the same economic position whether Article 69A was interpreted as allowing VAT refunds to oil exporters or not. This therefore ruled out the economic interests of Ecuador as being a public purpose for the refusal of VAT refunds to EnCana.[957]

The arbitrator concluded that the "Tax Court decisions and other conduct attributable to Ecuador" had the practical effect of referring EnCana and its subsidiaries to renegotiate the production sharing agreements with Petroecuador,[958] thereby recognising EnCana's right to the economic value of VAT refunds, confirming EnCana's legitimate expectations to a return protected under the BIT, and these estimated returns did not include the burden of paying VAT.[959] The VAT refunds were a legitimate expectation when EnCana made its decision to invest in its subsidiaries in Ecuador, and this legitimate expectation affected the projected returns significantly.[960] The Interpretative Law of 2004 worked to confirm EnCana's legitimate expectation of a VAT refund, because the law sought to clarify the

954 *ibid* at para 53.
955 There was the confusion between SRI and Petroecuador when SRI denied three refund claims by EnCana before the letter from Petroecuador to SRI which refused to confirm whether VAT was included as a cost in the participation contracts, SRI did genuinely believe the VAT was included as a cost. However, at the Tax Court proceedings, it was known VAT was not included as a cost in the participation contracts.
956 *EnCana* Dissent at para 54.
957 *ibid* at para 55.
958 *ibid* at para 61.
959 *ibid.*
960 *ibid* at para 74; US$72,354,141 and US$5,993,182 as of June 2004.

meaning of Article 69A ITRL, which prior to the Interpretative Law's enactment, a reasonable interpretation of the law (on which EnCana's apparent legitimate expectation was based), was that oil exporters were entitled to VAT refunds on their inputs.[961] The Tax Court decisions, the Interpretative Law and the President of Ecuador in a letter to the Director of SRI, all instructed Petroecuador and EnCana to renegotiate the participation contracts.[962] However, this was not a clear legal remedy to re-establish EnCana's entitlements under the BIT, because it was based on a consensual process to change the "fundamental bases on which, not only the investor's returns were projected but, more than that… the investor's very decision to invest."[963] This method to compensate EnCana tackled not only the VAT refunds at issue, but involved the renegotiation of the contractual and legal rights of EnCana as a whole, which the arbitrator viewed as a 'pretend remedy' to covertly refuse "any meaningful remedy at all."[964] The Interpretative Law, the instructions to SRI from the President of Ecuador and the instructions from the Tax Courts, all required the renegotiation of the participation contracts, but none of them provided any bases for the renegotiation to take place with an obvious outcome, with the tax burden being difficult to factor into the participation contracts.[965] Additionally, the Ecuadorian Supreme Court decided it was improper for the SRI and the Interpretative Law to rely on private contracts to determine issues of tax revenues owing to the Ecuadorian state[966] because those avenues were outside of the control of the tax laws and the Ecuadorian tax authorities.[967] This Supreme Court decision added further confusion to the determination of the issue of tax refunds because EnCana's recourse was uncertain from the outset by having to renegotiate the participation contracts without an obvious outcome and was made more arduous by court determinations condemning such recourse.

Therefore, the dissenting arbitrator deemed EnCana's investment had been expropriated contrary to Article VIII(1) of the Canada-Ecuador BIT by conduct

[961] *ibid* at para 63.
[962] *ibid* at para 64.
[963] *ibid* at para 65.
[964] *ibid*.
[965] *ibid* at para 66, quoting evidence provided at the hearings – Keplinger cross-examination, transcript Day 1, at 47: The VAT burden "is a very tricky item to capture in the participation factors."
[966] *ibid* at para 67.
[967] *ibid*.

attributable to the host state. Firstly, SRI's reasons for denying the VAT refunds were flawed. SRI initially presumed the participation contracts included a reimbursement of VAT as a cost, which it was proven that they did not. Secondly, failing the first presumption, SRI's interpretation of Article 69A ITRL was discriminatory towards oil exporters, all of which were owned by foreign investors, except for Petroecuador. Thirdly, the Interpretative Law of 2004 which confirmed and put into writing SRI's interpretation of Article 69A ITRL was therefore also discriminatory towards oil exporters. Fourthly, whilst the Canada-Ecuador BIT did not require EnCana to seek redress at national level in Ecuadorian courts, EnCana did take up that option and although those courts were open and not blatantly biased against EnCana's subsidiaries, the courts did not consider whether Ecuador failed to adhere to its obligations under international law. Therefore the majority tribunal should have evaluated Ecuador's laws on the backdrop of the BIT and this would not have turned the tribunal into a court of appeal because the dispute would have been decided under different laws than those considered at domestic level.

The majority tribunal found that the accessibility of the Ecuadorian courts and the the sincerity of the SRI's Director (whose sincerity was contested by EnCana) had an all-round effect of good faith by the Ecuadorian state and thus nullified the claims that a direct expropriation had occurred. The dissenting arbitrator found that these two good faith arguments, coupled with the fact that the BIT does not mandatorily require a claimant to seek redress at national level, had two powerful insights. The first insight is that the national courts being impartial from government agency and executive interference made no difference to the decisions at national level with regards to EnCana's claims under international law because the claims under the ambit of the BIT were ignored by the courts. Therefore the impartiality and availability of the Ecuadorian courts made no difference to the redress EnCana sought at the international arbitration arena, so this should not have been relied upon in the majority tribunal's decision making. Further to this first point, because the BIT did not mandatorily require EnCana to seek redress at national level,[968] the availability of the national courts to the claimants should not have bound the arbitral tribunal's own decision making process, no matter how competent the Ecuadorian

[968] EnCana did take the option under Article VIII(2) for a prompt review when they brought proceedings before the Tax Courts.

courts were. If EnCana's subsidiaries did not make any claims in the national courts of Ecuador, the arbitral tribunal would not have sent them away to seek redress away at Ecuador's courts, and likewise, the fact that they sought a prompt review at national level under Article VIII(2) of the BIT should not have been a detriment to their claims – i.e. if a finding of expropriation would have been plausible had the courts shown bad faith towards the claimants, what would have been the result had the claimants not sought justice at the national courts in the first instance? This notion of good faith or bad faith therefore should not have affected the majority tribunal's reasoning in finding or dismissing the claim of a direct expropriation. Additionally, because the Tax Courts actually ignored the claims under the BIT, whilst that does not show bad faith, it should have proven to the majority tribunal that the decision on expropriation was theirs to make, rather than reject EnCana's claims on the grounds of good faith of Ecuador's courts. Indeed, it is not as though EnCana lost at national level on claims falling under Article VIII of the BIT, and sought a make-shift appeals court under international arbitration, i.e. the type that would trigger a fork-in-the-road provision had one existed in the BIT (which it arguably did under Article XIII(b)). Similarly, had the claims under Article VIII been considered by the Tax Courts, and had they been dismissed, that still should not have limited the feasibility of EnCana's claims at arbitration.[969]

The second insight is that the interpretation of Article 69A by SRI, which includes its Director at the time, despite their good faith, should not have meant the majority tribunal rule against EnCana. If a state, in good faith (and therefore by omission) discriminates against a specific company or sector of the economy, they should still be liable to pay compensation. The *Metalclad* tribunal as quoted above and quoted again stated that "covert or incidental interference with the use of property which has the effect of depriving the owner, in whole or in significant part, of the use or reasonably-to-be-expected economic benefit of property even if not necessarily to the obvious benefit of the host State"[970] will result in an expropriation, with the effect of

[969] This is true unless the claims for expropriation under the BIT were the primary basis at the Ecuadorian court proceedings. If they were the primary focus of Ecuadorian court proceedings, the claimant therefore loses his right to claim in international arbitration according to Article XIII(b) of the Canada-Ecuador BIT, which allows a dispute to be submitted to international arbitration only if the claimant waives the right to initiate proceedings in the courts of the other Contracting Party or any other dispute settlement procedures – this does not include a prompt review under Article VIII(2).
[970] *Metalclad* Award at para 103.

the measure the primary focus to find an expropriation, rather than the intent of the state. Therefore, a finding of expropriation could have been the outcome despite the Ecuadorian authorities' good faith. The *Metalclad* reasoning was considered in the indirect expropriation section of the majority tribunal's ruling, however, they did not consider elements of the *Metalclad* reasoning such as the effect of a measure in the context of a direct expropriation. Of course it is important not to give investors a guarantee of investment success via IITs,[971] however, on the basis of the arbitrator's dissent in *EnCana*, the effect of an interpretation of a law (Article 69A ITRL) or a law itself (Interpretative Law of 2004) which detriments the returns that an investor legitimately expects could fall under the ambit of a *Metalclad* style reasoning. However, the *EnCana* tribunal seem to have adopted an *Olguin* style reasoning by focusing on the intent of the state rather than the effects of state measures.

The majority tribunal responded to the arbitrator's dissent in the *EnCana* award with five affirmations. Firstly, the tribunal assumed *arguendo* that SRI took a policy decision to deny VAT refunds to the oil industry by whatever means at its disposal.[972] This assumption was diminished by the good faith of SRI's then Director, which was not contested by EnCana. The Director took decisions in good faith on matters where the laws were unclear and unsettled,[973] and had the Director acted in bad faith, the outcome of the tribunal's findings would have been a finding of state responsibility.[974] That means the majority tribunal did use an *Olguin* reasoning by relying on the intent of the state to determine if a measure is expropriatory rather than focusing on the effects of that measure.

Secondly, any claim of an indirect expropriation of the subsidiaries themselves by the rejection of VAT refunds was not plausible at all because EnCana remained in complete control of the companies and they operated profitably.[975] The tribunal also reiterated that there was no denial of a legitimate expectation to a tax refund because when the investment by EnCana was made to purchase what became its Ecuadorian

[971] See *supra* (n. 307), *MTD Equity* at para 178.
[972] EnCana Award at foonote 138.
[973] *ibid* at para 196(c).
[974] *ibid* at footnote 138.
[975] *ibid*.

subsidiaries, no claims to VAT refunds were being asserted or allowed.[976] When EnCana invested in its subsidiaries in 1999, they had not been making applications for VAT refunds since 1997 when the Ecuadorian interpretation of Article 87 of their Law on Hydrocarbons removed an exception for oil companies to be exempt from paying various taxes.[977] The tribunal had to decide whether the denial by an executive agency acting in good faith of a complementary public law right, contained within an uncertain and recently updated domestic taxation regime, was expropriatory or not, and they answered in the negative. The crucial point was the ability of executive agencies to make decisions on questionable local laws in good faith, with national "courts available to resolve the resulting dispute" and the executive complies with judicial decisions not in their favour.[978] The majority tribunal reiterated that Article VIII of the Canada-Ecuador BIT "does not convert the tribunal into an Ecuadorian tax court" to arrive at a view of what the Ecuadorian tax regime should be by picking and choosing "between different and conflicting national court rulings."[979]

Thirdly, the majority tribunal would only find Ecuador to be in breach of Article VIII of the BIT if an expropriation was 'perfected'. Therefore, with the taxpayer and tax collector both unable to definitively determine whether the right to a tax refund existed given the uncertainty of the updated tax laws, the fact that the SRI made a determination on the ambiguous law and without abuses of authority did not result in an expropriation in the majority's view, whether or not that determination was right or wrong according to the local law.

Fourthly, the tribunal assumed EnCana's stand on the local law was correct and did not examine EnCana's interpretations of the laws, therefore even with the assumption that SRI had interpreted the laws incorrectly, the claim for direct expropriation still failed on the basis of good faith and open justice at national level.

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[976] *ibid*.
[977] *ibid* at para 58; EnCana's claim of a creeping expropriation and unreasonable interference with its and its subsidiaries' abilities to make use of and benefit from their economic entitlements by the sudden denial of tax refunds was in relation to the retraction of the granted refunds – see *ibid* at para 171.
[978] *ibid*.
[979] *ibid*.

Finally, unlike the dissenting arbitrator, the majority tribunal believed the national courts of Ecuador directing EnCana and Petroecuador to renegotiate the participation contracts should not be dismissed as a guise to elongate and deny VAT refunds to EnCana. The foreign investor would be able to reject that offer and seek solutions at litigation or arbitration, but the majority tribunal would not take an untested offer to renegotiate the participation contracts as evidence of expropriation.

In my opinion, if, when the investment in Ecuador was made, the subsidiaries (and/or other oil companies) were not receiving VAT refunds, then there could not be a legitimate expectation of receiving tax refunds because legitimate expectations are made on making the investment. Even if certain rights exist when making an investment, states must and do amend their tax regimes and so absent a tax stabilisation clause or a law stabilising certain tax advantages for a specific period of time, there cannot be a legitimate expectation that the tax regime will not change to the investor's detriment. It is also unlikely that EnCana would have refrained from investing in Ecuador if the subsidiaries were not receiving tax refunds at the time of acquisition. Legitimate expectations of investors has in some respects found greater credence in the context of minimum standard of treatment, namely the fair and equitable treatment standard (FET).[980] In the recent *Micula* award[981] the tribunal clearly emphasised that in the context of FET, absent a stabilisation clause, investors must expect legislation to change.[982] Like the national treatment standard, FET does not require a substantial deprivation of investment, and therefore claimants could potentially have a greater chance of success for breach of legitimate expectations in relation to the tax regime applicable to them under the FET standard. In fact, stabilisation clauses aside, a shift in the tax regime applicable to investments can result in a violation of FET if the investments were made on the basis of receiving tax incentives (and others) under a legislative regime for a specific period of time.[983] A repudiation of or a substantial change to those incentives will violate FET if: (i) the state has made a promise or assurance; (ii) the promise or assurance is relied on

[980] See *El Paso* Award at paras 350-364; *Ioan Micula, Viorel Micula, S.C. European Food S.A, S.C. Starmill S.R.L. and S.C. Multipack S.R.L. v Romania*, ICSID Case No. ARB/05/20, award of 11 December 2013 (*Micula* Award), at paras 527-529.
[981] *ibid.*
[982] *ibid* at para 666.
[983] *ibid* at para 677 to 686.

by investors as a matter of fact; and (iii) such reliance was reasonable.[984] As the tribunal in *Micula* stated: "it cannot be fair and equitable for a state to offer advantages to investors with the purpose of attracting investment in an otherwise unattractive region… and then maintain the formal shell of the [incentive] regime but eviscerate it of all (or substantially all) content."[985]

Therefore, in line with *Micula*, EnCana could not have had a legitimate expectation to tax refunds because there was no legitimate expectation of VAT refunds based on facts and circumstances in Ecuador or host state guarantees at the time the investment was made. In 1999, when EnCana invested in Ecuador, oil companies were not exempt from paying certain taxes, including VAT. If the dissenting arbitrator was correct in assuming that the granting of some VAT refunds to EnCana was not a processing mistake by the SRI but a reasonable interpretation of Article 69A ITRL, that 'reasonable interpretation' did not on its own entitle EnCana to a legitimate expectation. Laws, regulations and their interpretations are subject to change, sometimes in favour of an investor and then to the disadvantage of that same investor. The uncertainties of legal regimes are part of investment risk. Therefore, the introduction of a law that advantages an investor does not create new rights for that investor to legitimately expect from then on throughout the remaining life of the investment. Governments must be free to create or modify tax regimes to act in the broader public interest.[986]

On the indirect expropriation claim, even if EnCana was entitled to VAT refunds, the deprivation it suffered was not substantial deprivation in terms of the value of its investment as a whole. When EnCana submitted a Notice of Arbitration on 13 March 2003, approximately US $80 million of VAT refunds were denied to EnCana.[987] On 13 September 2005, EnCana released a statement that it agreed to sell all of its shares in its Ecuadorian subsidiaries to a joint venture of Chinese petroleum companies for US $1.42 billion cash.[988] Whilst US $80 million is a considerable amount of money,

[984] *ibid* at para 668.
[985] *ibid* at para 687.
[986] *Feldman* Award at para 103.
[987] *EnCana* Final Award, para 1.
[988] EnCana Corporation, '2005 News Releases: EnCana to sell its oil and pipeline business in Ecuador to Andes Petroleum Company for US$1.42 billion', 13 September 2005

the alleged expropriation was for 5.6% of EnCana's investment when considering the Chinese acquisition, and was therefore not a substantial deprivation and did not make ownership useless. According to the Third Restatement, to determine whether an action attributable to the state which results in a loss to a foreign national requires compensation, such action including taxation, state liability must be determined in light of all of the circumstances, and in light of all of the circumstances, I believe the EnCana tribunal decided the indirect expropriation dispute correctly. However, even the indirect expropriation claim could have been decided differently had it fallen to a panel of arbitrators who acknowledge the existence of partial deprivation to amount to an expropriation, such as the *S.D. Myers* tribunal who said in some contexts and circumstances a deprivation may amount to an expropriation "even if it were partial or temporary"[989] or the *GAMI* tribunal who said that the "affected property must be impaired"[990] to find an expropriation, not the whole property.

My thoughts on the direct expropriation claim are set-out below in the conclusion to this chapter.

3.6 Conclusion

In this chapter, the fundamentals of expropriation were acknowledged and discussed. The primary reason was to build up to the analysis of the arbitration of tax expropriation claims under modern investment treaties. It was necessary to engage the vast topic of expropriation to understand the fundamentals and principles that have shaped and continue to shape this monumental subject and crucial investment treaty protection with the end goal of evaluating how it applies to tax. This encompassed discussions on the history of the sovereign power to expropriate; the history of tax as expropriation; the development of the expropriation standard on an international level that has resulted in the almost uniform expropriation provisions in modern IITs; an analysis of the provisions of IITs, the differences between them and how they can impact on the arbitration of expropriation claims and specifically how

<http://www.encana.com/news/newsreleases/2005/P1161204545248.html> (accessed 14 December 2010).

989 *S.D. Myers* Award at para 283.

990 *GAMI* Award at para 126.

they can apply to the arbitration of tax expropriation claims; jurisdictional issues raised as a result of IIT provisions, namely tax vetoes; and an analysis of decisive arbitral awards that have helped construct the jurisprudence on what constitutes an expropriation. It was also important to explain the labels that are applied to expropriations and which labels can therefore apply to tax expropriation. With this I found the opportunity to examine and wage an opinion on and simplify some uncertainties in expropriation literature which have the ability to confuse those who are unlearned on the topic. This includes explaining whether indirect expropriation and measures tantamount to expropriation are two separate concepts or one and the same, of which the latter was ascertained;[991] conducting a discussion on the difference and synonymity between the terms 'taking' and 'deprive' which can confuse a reader because of the different ways they are used in various academic materials;[992] and opining on the difference between lawful and unlawful expropriation, concluding that expropriations that are on the right side of the conduct requirements but violate only the compensation requirement are lawful expropriations in lieu of compensation so long as compensation is withheld because the existence of expropriation must first be ascertained, because the parties cannot decide the amount of compensation that must be paid to the aggrieved investor, or for some other legitimate good faith reason depending on the facts of the case.[993]

On the subject of tax expropriation, it is clear that the sovereign power to tax is capable of crossing the line from non-compensable government takings into compensable expropriation. This was recognised from over a century ago at a domestic court level, and despite the non-recognition of that fact by international arbitral tribunals of old,[994] tax expropriation claims are now being in international investment arbitration, albeit with little success.

When an arbitral tribunal finds a state liable for an investment treaty breach that means the state has violated international law, and that goes for all treaty protections. But when a state is found liable for expropriation, especially unlawful expropriation within the meaning I have given it, that denotes a violation of international law of the

[991] Section 3.2.2.2 above.
[992] Sections 3.1.3.2 and 3.3 above.
[993] See opening section to this chapter.
[994] Section 3.1.2 above, namely *Kügele* (n.96) and Kaeckenbeeck (n. 101).

highest order in the investment arbitration context. This is because a state will be liable for expropriation when there has been a physical and/or legal appropriation of property or a substantial deprivation of the use and enjoyment of investment, except for the extremely rare circumstances when partial deprivation qualifies as expropriation. The only other treaty protection that is comparable with expropriation in terms of the conduct that can result in a treaty violation and the reputation that comes from liability under it is fair and equitable treatment. But even fair and equitable treatment does not require a substantial deprivation to be breached, and so a state found liable for expropriation on the one hand will come off looking worse than a state found liable for violating the fair and equitable principle on the other.

A state that attains something of value by unlawfully expropriating an investment and fails to pay prompt, adequate and effective compensation and is found liable for such conduct is in effect found liable for the theft of foreign investment. That is why, bearing in mind that arbitration of the state's power to tax is already a sensitive topic, the arbitration of tax expropriation claims runs the risk that, if liable, a state will be in violation of international law for its tax authority's conduct as a robber baron writ large. Of course, "[t]ax authorities are not robber barons writ large"[995] and so if a tax authority conducts itself as such, it will be within the reach of justice under expropriation provisions of IITs for arbitrary, punitive or extraordinary taxation, subject of course to any tax exclusions or tax vetoes that prevent the tribunal's jurisdiction.

Some of the most recent arbitral awards on tax as expropriation have recognised the sovereign power to tax, its non-compensable nature as a police power of the state and the assumption of legitimacy of the tax measures in question.[996] Arbitral tribunals have also determined that a "… a blanket exception for regulatory measures would create a gaping loophole in international protections against expropriation."[997] Therefore, the arbitration of tax expropriation claims is permissible, but "a mere loss in value of the investment, even if important, is not an indirect expropriation."[998] As established throughout this chapter and especially at sections 3.2.3, 3.4.4 and 3.5.6, a

[995] *EnCana* Award at para 141(1).
[996] *El Paso* Award at para 290; *Burlington* Award at para 391.
[997] *Pope & Talbot* Interim Award at para 99.
[998] *El Paso* Award at para 249.

finding of expropriation under customary international law requires substantial deprivation. That is true no matter which regulatory powers of the state are being debated, but rest assured that if it is the state's tax powers that are the subject of the arbitration, arbitral tribunals will be even more careful and strict in their application of the substantial deprivation standard because, from the expropriation perspective, "taxation is in a special category."[999] Foreign investors therefore face an uphill struggle in establishing their case.

For the above reasons, only two tax expropriation cases from those examined ended with awards in favour of the foreign investor, namely *RosInvest* and *Quasar*, which were brought on the backdrop of the expropriation by Russia of the Yukos Oil Company, which was at the time Russia's largest company and taxpayer. The expropriation of Yukos was an extraordinary affair that involved political prisoners, the control of natural resources, and most vitally for the purpose of this thesis, extraordinary tax assessments, tax penalties and novel interpretations of Russia's tax laws, coupled with the freezing of assets to prevent the payment of the arbitrary and punitive tax assessments (also resulting in the default of a loan), the subsequent seizure and auction of the shares in YNG (and purchase by the state-owned oil company Rosneft), and finally ending with the liquidation of Yukos and the purchase of most of its assets by Rosneft at auction. The *RosInvest* and *Quasar* cases therefore ticked all the boxes required not only for a tax expropriation, but an unlawful one at that. They had: intent *and* effect; they had *total* deprivation (over and above substantial deprivation); and Russia's actions breached the conduct requirements which can help to prove that in the balance of things the government measures err on the side of expropriation and rather than bona fide taxation. In contrast with the Yukos cases, *Burlington* involved the taxing by Ecuador of hundreds of millions of dollars in oil revenues that the state was not entitled to under the participation contracts yet there was no substantial deprivation because the investments continued to yield profits.

The *EnCana* case is perhaps the epitome of the unwillingness of an arbitral tribunal to find a state liable for tax expropriation and helps to reinforce the notion that the

[999] *EnCana* Award at para 177.

customary international law standard of substantial deprivation is replaced with a requirement of total deprivation. The *EnCana* tribunal, in the direct expropriation claim, recognised tax refunds as investments or returns of investments/claims to money which had been withheld from the claimant/claimant's companies, but put itself in a position to find those tax refunds to have been substantially or completely expropriated. Having positioned itself for finding an expropriation, the *EnCana* tribunal then barred itself from finding an expropriation by adding an extra hurdle, namely that the due process and non-discrimination (conduct) requirements must be breached for a finding of tax expropriation. That hypothesis simply is not how a finding of expropriation works – as already explained and reiterated throughout this chapter, a violation of the conduct requirements can help to prove that state regulations have been used in a manner that justifies their labelling as compensable government takings, but the first question must always be: "*has there been an expropriation?*" and if there has been an expropriation then a violation of a conduct requirement will denote an *unlawful* expropriation – that is the real role of the conduct requirements. So, in *EnCana*, the claimant's investment in the direct expropriation claim was streamlined by the tribunal to meaning the tax monies taken and subsequently retained by the state, which the claimant was entitled to the return of, effectually a debt claim against the state. The *EnCana* tribunal itself recognised that "… a law which cancels a liability the State already has to an investor… is capable of amounting to expropriation."[1000] There can be no doubt on that very basis that the tax money had been expropriated by Ecuador, albeit without any *culpa*, but it is the effect and not the intent that must stand to reason in establishing an expropriation.

The analysis of the treatment of tax expropriation claims in investor-state arbitration has shown that arbitral tribunals are strict in their interpretation of the customary international law principles in finding state liability for tax expropriation. Rather than lowering the threshold of substantial deprivation to partial or temporary deprivation, arbitral tribunals are actually inclined to increase that threshold for tax claims as well as require a violation of the conduct requirements. The difference between the Yukos cases and *Burlington* was a total deprivation of Yukos' assets and therefore the

[1000] *EnCana* Award at para 183.

shares of the claimants, whereas in *Burlington* the claimant's profits were diminished considerably by the tax on oil revenues but not totally. The similarities between the Yukos cases and the *EnCana* direct expropriation claim were a total deprivation of the investments concerned, with the fundamental difference being no violation of the conduct requirements in *EnCana*. Without a total deprivation and violation of the conduct requirements, a state is likely to be found to have expropriated an investment only if it has entered into an agreement with the investor giving the investor a legitimate expectation that the alleged expropriatory conduct will not occur.

Overall, arbitral tribunals are willing to entertain tax expropriation claims whether they are big or small and amount to considerable losses or minor losses relative to the investments at hand. Arbitral tribunals are likely, however, to find in favour of the host state, unless there has been a total deprivation of investment coupled with a violation of the conduct requirements, thereby making the alleged tax measures expropriatory in both intent and effect. This also puts into disarray the hypothesis which exists in academic literature on arbitration that the system is pro-investor and puts corporate profits ahead of the sovereignty and welfare of the state.[1001] It is clear from the cases discussed in this chapter that not only did arbitral tribunals faced with tax expropriation claims recognise the special character of tax and the importance of the sovereign prerogative to tax, their decisions also reflected that special character as regards expropriation.

[1001] See generally section 2.4.2 of Chapter 2.

Chapter 4 The Treatment of Tax in National Treatment Claims in Investor-State Arbitration

"Equality consists in the same treatment of similar persons."[1]

The national treatment obligation contained in most international investment treaties[2] (IITs) seeks to enforce equal treatment of host state investors and investments and foreign investors and investments[3] in *like circumstances*, thereby prohibiting nationality based discrimination. National treatment guarantees foreign investors are treated equally before the law, administratively in law (administrative equality) and are protected equally from the law (formal equality).[4] National treatment has developed into a key element of international trade[5] and could be "the single most important standard of treatment in international investment agreements."[6]

The wording of national treatment provisions in most modern day IITs, predominantly multilateral investment treaties (MITs) and bilateral investment treaties (BITs), have almost identical aspects in that they require the treatment of investors and/or investments of other contracting states to be no less favourable than the treatment accorded to nationals of the host state regarding the management, maintenance, use, enjoyment or disposal of their investments. The national treatment articles in IITs differ in the following ways:

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[1] Aristotle, *Politics*, (4th Century BC), translated by Benjamin Jowett in *Aristotle Politics* (2005 Digireads.com Publishing) 184.

[2] UNCTAD, 'Bilateral Investment Treaties 1995-2006: Trends in Investment Rulemaking', 33 at note 44 (2007), Document No. UNCTAD/ITE/IIT/2006/5 <http://unctad.org/en/docs/iteiia20065_en.pdf> accessed 2 April 2012 – noting that from the BITs concluded in the decade of research between 1995-2006, at least 52 BITs did not contain a national treatment provision. This is a fraction compared to the 2500 BITs in conclusion by 2005. Additionally, all countries that concluded BITs without a national treatment provision had concluded in those same BITs a most-favoured-nation (MFN) clause, and had previously concluded BITs with a national treatment provision, thereby enabling the national treatment provision to be imported from the other BITs.

[3] For ease of reading and writing, foreign investors and foreign investments will be used interchangeably in this context.

[4] Andrew Newcombe and Lluís Paradell, *Law and Practice of Investment Treaties – Standards of Treatment*, (Kluwer Law International 2009) 151.

[5] Christopher Dugan, Don Wallace Jr, Noah Rubins and Borzu Sabahi, *Investor-State Arbitration*, (OUP 2008), 398.

[6] UNCTAD, 'National Treatment' (1999) Doc No. UNCTAD/ITE/IIT/11 (Vol. IV), Executive Summary <http://unctad.org/en/docs/psiteiitd11v3.en.pdf>. accessed 2 April 2012.

(i) by combining most-favoured-nation treatment (MFN)[7] with national treatment;

(ii) by applying national treatment to establishment rights[8] (i.e. the foreign investor is not made to go through extra hurdles to establish an investment in comparison to a host state national) and some apply national treatment post-establishment only;[9]

(iii) by specifying that the national treatment standard shall apply to investors or investments in *like* circumstances, or similar wording to that effect; and/or

(iv) some treaties contain national treatment articles specifically in relation to taxation and other fiscal measures.

The above differences will be addressed at 4.2 below.

The national treatment standard as it is today was developed through centuries of treaty drafting to encompass the centuries of change and development in trade and investment. The historical background and development of national treatment is discussed next.

4.1 Historical Background and Development

4.1.1 Pre-Modern Day Agreements

The origin of the national treatment principle has been traced back to ancient Hebrew law.[10] The use of national treatment became more prominent during and after the 11th

[7] MFN requires a host state to treat investors and investments of the other state party in a manner no less favourable than the treatment afforded to investors and investments of a third state.

[8] Article 1102(2), North American Free Trade Agreement (NAFTA) – each party to accord national treatment with respect to "the *establishment*, acquisition, expansion, management, conduct, operation, and sale or other disposition of investments" (emphasis mine).

[9] Article 3(2), Agreement between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the Republic of Argentina for the Promotion and Protection of Investments, signed 11 December 1990, entered into force 19 February 1993 (UK-Argentina BIT).

[10] Michael Trebilcock, 'The National Treatment Principle in International Trade Law' (2004) Paper 8 American Law & Economics Association Annual Meetings, 1 <http://law.bepress.com/cgi/viewcontent.cgi?article=1007&context=alea> accessed 1 April 2012.

Century, where it surfaced in agreements between Italian city states,[11] as well as in commercial treaties concluded between England and continental powers and cities in the 12th Century,[12] in addition to Hanseatic League treaties at that time and thereafter.[13] Comprehensive BITs in the 17th and 18th Centuries featured national treatment, especially shipping treaties,[14] in which a second treaty between Prussia and the United States[15] became a pioneer of national treatment in shipping,[16] affording equal treatment "to that accorded to the to the ships of the contracting nation itself."[17] The 19th and 20th Centuries witnessed national treatment becoming a standard provision in trade treaties[18] and was included in other types of treaties including the *1883 Paris Convention for the Protection of Industrial Property*[19] (Paris Convention) and the *1886 Berne Convention for the Protection of Literary and Artistic Works*[20] (Berne Convention). National treatment also featured in *The Calvo Doctrine*, formulated by Argentinian diplomat Carlos Calvo in his six-volume commentary, *Le Droit International: Theorique et Pratique*, appearing in five editions between 1868 and 1896. The Calvo Doctrine promoted the equality between nationals and aliens, and the doctrine emerged not because nationals were afforded preferential treatment in comparison to foreign investors, but because foreign investors from the United States and Europe would invoke diplomatic protection

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[11] *ibid*; and Michael M. Hart, 'The Mercantilist's Lament: National Treatment and Modern Trade Negotiations', (1987) 21:6 *J.W.T.L.* 38.
[12] Trebilcock (n. 10) 1.
[13] *ibid*; and Newcombe and Paradell (n. 4) 152.
[14] Trebilcock (n. 10) 1.
[15] Articles II-VIII, Treaty of Commerce and Navigation between Prussia and the United States of America, concluded 1 May 1828, entered into force 14 March 1829, available at: <http://www.archive.org/stream/cu31924017529250/cu31924017529250_djvu.txt> accessed 12 April 2012.
[16] Wallace McClure, 'German-American Commercial Relations', (1925) 19 *A.J.I.L* 689, 692.
[17] *ibid*.
[18] Newcombe and Paradell (n. 4) 152.
[19] Paris Convention for the Protection of Industrial Property of 20 March 1883, whereby Article 2 is titled "National Treatment for Nationals of Countries of the Union", and Article 2(1) states the following: "Nationals of any country of the Union shall, as regards the protection of industrial property, enjoy in all the other countries of the Union the advantages that their respective laws now grant, or may hereafter grant, to nationals; all without prejudice to the rights specially provided for by this Convention. Consequently, they shall have the same protection as the latter, and the same legal remedy against any infringement of their rights, provided that the conditions and formalities imposed upon nationals are complied with."
[20] Berne Convention for the Protection of Literary and Artistic Works of 9 September 1886, whereby Article 5 is titled "Rights Guaranteed" and whereby Article 5(1) states that: "Authors shall enjoy, in respect of works for which they are protected under this Convention, in countries of the Union other than the country of origin, the rights which their respective laws do now or may hereafter grant to their nationals, as well as the rights specially granted by this Convention."

against the host states in Latin America[21] and were therefore placed in more favourable positions than nationals of host Latin American countries. The Calvo Doctrine states that “the responsibility of Governments toward foreigners cannot be greater than that which these Governments have towards their own citizens.”[22] It is in this regard that the Calvo Doctrine promoted national treatment as a protectionist measure in favour of nationals, rather than the usual purpose which is to protect foreigners.

Prior to World War I (WWI), especially during the years 1860 to 1913, international trade flourished on account of international treaties[23] such as that between Prussia and the United States.[24] National treatment and most-favoured-nation (MFN) clauses brought about low trade barriers and scarce trade discrimination, especially as regards tariffs and aspects that result in high import tariffs such as quantitative restrictions, voluntary restraint agreements and exchange controls.[25] The treaty networks built prior to WWI were devastated by the war, with high tariffs, import quotas, licencing requirements and foreign-exchange controls imposed thereafter.[26] This lasted until after World War II (WWII), with multilateral interwar period efforts “to contain protectionist pressures”[27] failing to reach concrete agreements on both domestic and international economic scales,[28] but nevertheless helping to shape national treatment provisions for future international treaties to come.

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[21] Centre for International Environmental Law, ‘International Law on Investment: The Minimum Standard of Treatment (MST)’, (August 2003) 1 <http://www.ciel.org/Publications/investment_10Nov03.pdf> accessed 16 November 2010.
[22] *ibid*, quoting Carlos Calvo, *Le Droit International: Théorétique et Practique*, (5th ed, vol. VI, Paris 1896), 231, translation by Donald Shea, *The Calvo Clause: A problem of International Law and Diplomacy* (Minnesota University Press 1955) 18-19.
[23] Kerry A. Chase, *Trading Blocs – States, Firms and Regions in the World Economy* (Michigan University Press, 2005), 51.
[24] Treaty of 1828 between United States of America and Kingdom of Prussia, ratified and exchanged on 14 March 1829.
[25] Douglas A. Irwin, ‘The GATT in Historical Perspective’, (1995) Vol. 85(2) *Am. Econ. Rev.* 323 (Papers and Proceedings of the Hundredth and Seventh Annual Meeting of the American Economic Association, Washington DC, 6-8 January 1995).
[26] *ibid*.
[27] *ibid*.
[28] *ibid* 324.

4.1.2 Interwar Multilateral Agreement Efforts

The most significant interwar multilateral agreement effort came in the form of the *Draft Convention on the Treatment of Foreigners 1929* (1929 Draft Convention) which was considered at the 1929 Paris International Conference on the Treatment of Foreign Nationals (Paris Conference). The 1929 Draft Convention was not adopted.[29] Had it been adopted, it would have implemented far reaching national treatment obligations.[30] Foreign nationals would have been entitled "to conduct commercial transactions of every kind"[31] on the same terms as nationals.[32]

Article 7 would have entitled foreign nationals to "complete equality, *de jure* and *de facto*" on par with nationals of the host state.[33] Article 12 of the 1929 Draft Convention, titled 'Fiscal Treatment', required national treatment specifically for taxation purposes. Home state nationals would have been entitled to the "same treatment and protection by the fiscal authorities and tribunals as nationals" of the host state with respect to "taxes and duties of every kind or any other charges of a fiscal nature" levied on their "person and property, rights and interests, including their commerce, industry and occupation."[34] This arguably shaped the national treatment provisions in the successfully adopted post-war General Agreement on Tariffs and Trade in 1947 (GATT 1947).

4.1.3 Post-War Multilateral Agreement Efforts

National treatment was contained at Article III of the GATT 1947 and as discussed in Chapter 2 the GATT has been adopted into the World Trade Organisation's (WTO's) GATT 1994 (the GATT). The national treatment provisions are still used by members of the WTO via the Dispute Settlement Body (DSB) to this day to challenge the laws and regulations of other member states which are potentially in

[29] Newcombe and Paradell (n. 4) 153.
[30] Newcombe and Paradell (n. 4) 17.
[31] Article 1, Draft Convention on the Treatment of Foreigners 1929 (1929 Draft Convention).
[32] Newcombe and Paradell (n. 4) 153.
[33] Ibid, quoting Article 7, 1929 Draft Convention.
[34] Article 12, 1929 Draft Convention.

breach of Article III.[35] The GATT contains two national treatment provisions; one applies to taxation and other fiscal measures[36] and the other applies to all other forms of regulation.[37] Article III:2 of the GATT is an agreement by WTO members to refrain from taxing or applying other internal charges to products imported into their territories from other member states at levels greater than those taxes applied to *like* domestic products. Article III:4 is an agreement by WTO members, from a legal, regulatory and other requirements[38] perspective, to treat products imported from other member states in manners no less favourable than those applied to *like* domestic products. A breach of those GATT articles would be found if the measures "afford protection to domestic production."[39] The national treatment by taxation of non-domestic products can find its roots in agreements which existed before the GATT, such as Article 7 of the Estonia-Lithuania Commercial Convention of 1934.[40]

The International Chamber of Commerce's 1949 *International Code of Fair Treatment for Foreign Investment*[41] (ICC Code) included national treatment provisions, whereby foreign investments would be given treatment no less favourable than treatment of a state's own nationals,[42] including no administrative or legal discrimination on grounds of nationality which therefore extended national treatment to entry and establishment;[43] national treatment in legal and judicial protection of the person, property, rights and interests, including land and fiscal acquisitions,

[35] WTO, *Japan – Taxes on Alcoholic Beverages*, adopted on 1 November 1996; WTO, *Korea – Taxes on Alcoholic Beverages*, adopted on 17 February 1999; and WTO Panel Report, *Chile – Taxes on Alcoholic Beverages*, adopted on 12 January 2000; WTO, *Indonesia – Certain Measures Affecting the Automotive Industry*, adopted on 23 July 1998; WTO, United States – *Tax Treatment for "Foreign Sales Corporations"*, adopted on 20 March 2000.
[36] Article III:2, GATT.
[37] Article III:4, GATT.
[38] Other requirements can include a requirement to purchase machinery for production from the country to which importation is sought in order to qualify for production subsidies – GATT 1947 Dispute Settlement, 'Italian Discrimination Against Imported Agricultural Machinery', Dispute No. L/833 – 7S/60, adopted on 23 October 1958.
[39] Article III:1, GATT.
[40] Estonia and Lithuania Commercial Convention, with Annexes and Protocol, signed 13 January 1934.
[41] International Chamber of Commerce, *International Code of Fair Treatment for Foreign Investment*, ICC Pub. No. 129 (Lecraw Press, Paris 1948), reprinted in UNCTAD, 'International Investment Instruments: A Compendium – Volume III: Regional Integration, Bilateral and Non-governmental Instruments' (1996), Doc. No. UNCTAD/DTCI/30(Vol.III), 275-278 <http://unctad.org/en/Docs/dtci30vol3_en.pdf> accessed 12 March 2012.
[42] *ibid*, Article 3.
[43] *ibid*, Article 4.

purchases and sales;[44] no nationality discrimination in the composition of shareholders or in the employment hierarchy of Directors, Officers and staff in general,[45] unless an enterprise is directly concerned with national defence;[46] and like the GATT, national treatment in respect of *taxation*,[47] except that the GATT national treatment applies to 'products', whereas the ICC Code focuses on "no less favourable treatment in respect of taxation to the *nationals*" of other state parties[48] (emphasis mine). The ICC Code was not adopted but was significant in shifting the language of international investment agreements from "state responsibility for injuries to aliens and their property… [to]… the protection of foreign investment with the object of promoting economic development."[49]

National treatment was also a guiding principle in the OECD's *Code of Liberalization of Current Invisible Operations*[50] and the *Code of Liberalization of Capital Movements*,[51] both of 18 October 1961, the year in which the OECD was established, and it remains in the revised 2010[52] and 2012[53] versions of those texts.

The OECD's 1967 *Draft Convention on the Protection of Foreign Property*[54] (OECD 1967 Draft Convention), drafted as a model for future international investment agreements,[55] insisted on the constant protection and security of property of foreign nationals, and non-impairment in "the management, maintenance, use, enjoyment or disposal of such property by unreasonable or discriminatory measures."[56] Article 1(a) of the OECD 1967 Draft Convention read with the accompanying commentary gives Article 1(a) a broad meaning, extending to national treatment,[57] MFN treatment[58] and

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[44] *ibid*, Article 5.
[45] *ibid*, Article 6.
[46] *ibid*.
[47] *ibid*, Article 7.
[48] *ibid*.
[49] Newcombe and Paradell (n. 4) 21.
[50] OECD, *Code of Liberalization of Current Invisible Operations*, 28 October 1961 and 2010.
[51] OECD, *Code of Liberalization of Capital Movements*, 28 October 1961 and 2012.
[52] OECD, *Code of Liberalization of Current Invisible Operations*, 2010.
[53] OECD, *Code of Liberalization of Capital Movements*, 2012.
[54] OECD *Draft Convention on the Protection of Foreign Property*, adopted by the OECD Council on 12 October 1967.
[55] Newcombe and Paradell (n. 4) 154.
[56] OECD 1967 Draft Convention, Article 1(a).
[57] *ibid*, Notes and Comments to Article 1, 8(e)(iv): forms of discrimination would be evident from differentiation in the treatment of property of "(iv) nationals of another Party and of its own nationals."

discrimination between different nationals of the same foreign state.[59] The Article 1(a) rights to non-discrimination would only have applied to post-establishment rights,[60] whereas pre-establishment discrimination to prevent an investment from being made would have been permitted under Article 1(b).

4.2 National Treatment Provisions in Modern Investment Treaties

4.2.1 National Treatment and Most-Favoured Nation Combined

National treatment is a relative standard. This means that to assess a claim by an investor against a host state for alleged breach of a national treatment provision contained in an investment treaty, a comparison will need to be made between the manner in which the host state treated the claimant investor or his investment and a national of the host state or an investment of a national of the host state. Likewise, to assess a breach of MFN, the same methodology applies except that the national (or investment of a national) of the host state is replaced by a national (or investment of a national) of a third state. For that reason, most investment treaties that contain national treatment and MFN combine the two into one article by adding a few words instead of adding an extra paragraph or two to the treaty (and most treaties do contain them and most treaties do combine them).[61]

The Iceland-Mexico BIT[62] is a typical example of a treaty that contains a national treatment and MFN combination clause.[63] Article 3 of that BIT, titled 'Treatment of Investments', contains two national treatment and MFN clauses, one pertaining to *investors* and the other to *investments*:[64]

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[58] *ibid*, Notes and Comments to Article 1, 8(e)(ii) and 8(e)(iii): forms of discrimination would be evident by differentiation in the treatment of property of "(ii) nationals of different parties; (iii) nationals of a Party and those of a third State."
[59] *ibid*, Notes and Comments to Article 1, 8(e)(i): forms of discrimination would be evident by differentiation in the treatment of property of "(i) Nationals of the same (foreign) Party to the Convention."
[60] *ibid*, Article 1(b).
[61] Newcombe and Paradell (n. 4) 156.
[62] Agreement between the Government of the United Mexican States and the Government of the Republic of Iceland on the Promotion and Reciprocal Protection of Investments, signed 24 June 2005, entered into force 6 June 2006 (Mexico-Iceland BIT).
[63] Article 3, Mexico-Iceland BIT.
[64] The distinction between national treatment provisions that focus on investors or investments is discussed at 4.2.2 below.

(2) Each Contracting Party shall in its territory accord investments of investors of the other Contracting Party treatment not less favourable than that which it accords, in like circumstances, to investments of its *own investors* or to investments of investors of *any third State*, whichever is more favourable to the investor concerned. (emphasis mine).

(3) Each Contracting Party shall in its territory accord investors of the other Contracting Party, as regards the management, maintenance, use, enjoyment or disposal of their investments, treatment not less favourable than that which it accords, in like circumstances, to its *own investors* or to investors of *any third State*, whichever is more favourable to the investor concerned. (emphasis mine).

The reason that national treatment and MFN have been combined is MFN would apply in the same manner as national treatment would, so to add the words "or to investors of any third State" to each sub-article makes drafting sense. The only reasons not to have combination articles would be if the treaty will not have an MFN clause or will have an MFN clause but not a national treatment clause, or if the drafters wanted MFN to apply differently to national treatment, for example, in sub-article (3), to not apply to 'disposal' of the investments.[65] Other such treaties include most UK BITs (see for example the UK-Albania BIT[66], the UK-Venezuela BIT[67] and the UK-Malaysia BIT[68]), early US BITs (see for example the US-Ecuador BIT[69] and

[65] Even if this is the case, a treaty could contain a combination clause and then include 'MFN for disposals' as part of an exclusions clause.

[66] Article 3, Agreement between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the Republic of Albania for the Promotion and Protection of Investments, signed 30 March 1994, entered into force 30 August 1995 (UK-Albania BIT).

[67] Article 3, Agreement between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the Republic of Venezuela for the Promotion and Protection of Investments, signed 15 March 1995, entered into force 1 August 1996 (UK-Venezuela BIT).

[68] Article 3, Agreement between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of Malaysia for the Promotion and Protection of Investments, signed 21 May 1981, entered into force 21 October 1988 (UK-Malaysia BIT).

[69] Article II, Treaty between the United States of America and the Republic of Ecuador concerning the Reciprocal Encouragement and Protection of Investment, signed 27 August 1993, entered into force 11 May 1997 (US-Ecuador BIT).

the US-Argentina BIT[70]), and other bilaterals such as the Netherlands-Costa Rica BIT.[71]

National treatment and MFN combination clauses will not be addressed further in this chapter.

4.2.2 Investors, Investments, and Investments of Investors

Investment treaties contain national treatment provisions that either apply to both investors and investments[72] or to one of those, with investments of investors usually prevailing where a choice has been made.[73]

National treatment provisions that apply to treatment accorded to investors instead of investments include those contained in the Iceland-Mexico BIT above and Article 1102(1) of NAFTA. Article 1102(1) of NAFTA reads as:

> Each Party shall accord to *investors* of another Party treatment no less favorable than that it accords, in *like* circumstances, to its own investors with respect to the *establishment*, acquisition, *expansion*, management, *conduct*, operation, and sale or other disposition of investments[74] (emphasis mine).

Measures that will affect an investor rather than his investment include requiring a minimum share capital which is greater than that required for nationals of the host

[70] Article II, Treaty between the United States of America and the Argentine Republic concerning the Reciprocal Encouragement and Protection of Investment, signed 14 November 1991, entered into force 20 October 1994 (US-Argentina BIT).
[71] Article 3(2), Agreement on Encouragement and Reciprocal Protection of Investments between the Republic of Costa Rica and the Kingdom of the Netherlands, signed 21 May 1999, entered into force 1 July 2001.
[72] UK-Venezuela BIT; UK-Malaysia BIT; UK-Albania BIT; Article 3, United States Model BIT 2012; Article 1102, NAFTA; and Article 10(1) and 10(3), Energy Charter Treaty (ECT).
[73] Article II(1) US-Argentina BIT; Article 4(2), Agreement Between the Government of the Republic of Chile and the Government of the Republic of Croatia on the Reciprocal Promotion and Protection of Investments, signed on 28 November 1994, entered into force on 15 June 1996 (Chile-Croatia BIT); Article IV, Agreement between the Government of Canada and the Government of the Republic of Ecuador for the Promotion and Reciprocal Protection of Investments, signed 29 April 1996, entered into force 6 June 1997 (Canada-Ecuador BIT).
[74] Article 1102(1), NAFTA.

state[75] (*establishment* rights), or subjecting the profits of an investor's investment to a higher rate of tax than that applied to nationals of the host state (impairment of *conduct* and impairment of *expansion* of the investment).[76]

National treatment articles that apply to measures which affect investments of investors instead of the investors directly, include provisions like Article 3(2) of the Iceland-Mexico BIT and Article 1102(2) of NAFTA. Article 1102(2) of NAFTA in exactly the same as Article 1102(1), except that it applies to investments of investors instead of investors, i.e. "Each Party shall accord to *investments* of investors of another Party treatment no less favorable than that it accords…" Some other treaties which separate the application of national treatment between investors and investments do not have the two provisions mirroring each other as they do in Article 1102 of NAFTA, so it is common to find a NAFTA-type article that applies to investors as above (Article 1102(1), but to find the provision that applies to investors of investments reading as:

> "Neither Contracting Party shall in its territory subject *investments* or *returns* of nationals or companies of the other Contracting Party to treatment less favourable than that that which it accords to *investments* or *returns* of its own nationals…"[77] (emphasis mine).

The UK-Malaysia BIT's national treatment provision on investments is typically wide to encompass anything which can show discrimination between a host state national's investment or his returns and those of a foreign investor. A foreigner's investments might by law be subjected to environmental regulation which applies more stringently on the foreign investment that it does on host state investments (*de jure* discrimination) or is applied more stringently on foreign investments (*de facto* discrimination). Similarly, taxes may be levied on a foreign national which are not

[75] Article 1102(4)(a), NAFTA, "… no Party may … impose on an investor of another Party a requirement that a minimum level of equity in an enterprise in the territory of the Party be held by its nationals, other than nominal qualifying shares for directors or incorporators of corporations".
[76] *Archer Daniels Midland Company and Tate & Lyle Ingredients Americas Inc. v United Mexican States* (ICSID Case No ARB(AF)/05/05), Final Award (Redacted Version) of 21 November 2007, at para 188.
[77] Article 3(1), UK-Malaysia BIT

levied on host state nationals, or the foreign investor might be declined tax rebates on exports.[78]

Whether treaty articles on national treatment focus on investors and investments or only investments is unlikely to be a decisive factor for finding liability. For example, in *Occidental,* the claimant was successful in convincing the arbitral tribunal that Ecuador had breached Article II(1) of the US-Ecuador BIT which contains a provision requiring national treatment of *investments*.[79] In *Feldman*,[80] the tribunal found Mexico liable for breaching Article 1102 of NAFTA by giving Mexican exporters of cigarettes tax rebates on exports but not providing the same to the claimant/his Mexican company.[81] Although the *Feldman* tribunal did not specify whether Article 1102(1) (national treatment of foreign nationals) or 1102(2) (national treatment of foreign nationals' investments) was breached, referring to the breach being of Article 1102 generally (or maybe entirely), the tribunal did focus on the *investor* rather than the *investment*,[82] namely because that was what the claimant based his claim on.[83] Evidently, breach of national treatment on the same issue (in this example, tax refunds on exports) can be argued on an investor basis or an investment basis.

It has been suggested that the IITs that apply national treatment to "enterprises or activities of enterprises"[84] exclude investors "from national treatment in such matters as, for example, taxation."[85] I do not see how that would be the case. If a foreign investor establishes a company in a host state and the company does not receive

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[78] *Occidental Exploration and Production Company v The Republic of Ecuador*, LCIA Case No. UN 3467, Award of 1 July 2004, at para 179.
[79] *ibid*.
[80] *Marvin Roy Feldman Karpa v United Mexican States*, ICSID Case No. ARB(AF)/99/1, Award of 16 December 2002 (*Feldman* or *Feldman* Award).
[81] *ibid*, at para 187.
[82] *ibid* at para 166: "(a) which domestic investors, if any, are in "like circumstances" with the foreign investor; (b) whether there has been discrimination against foreign investors, either *de jure* or *de facto*; (c) the extent to which differential treatment must be demonstrated to be *a result of* the foreign investor's nationality; and (d) whether a foreign investor must receive the most favorable treatment given to *any* domestic investor or to just some of them."
[83] *Feldman* Award at para 157: "The Claimant… argues that… the Claimant is being treated less favorably than a domestic investor in like circumstances."
[84] Article 3, Denmark and Indonesia Agreement Concerning the Encouragement and the Reciprocal Protection of Investments (with Protocol), signed 30 January 1968, not entered into force as of 1 June 2013 (Denmark-Indonesia BIT).
[85] UNCTAD National Treatment 1999 (n. 6) 18.

national treatment for taxation purposes in comparison to companies owned by host state nationals, that investor will likely be able to bring a claim in his own name, as was the case in *EnCana*.[86] This is possible subject to the relevant investment treaty, for example, the treaty applicable in *EnCana* was the Canada-Ecuador BIT. Article XIII(12) of the Canada-Ecuador BIT permits the foreign investor to bring a claim against the host state if an enterprise "is a juridical person incorporated or duly constituted in accordance with applicable laws of that" host state, and that company has allegedly incurred damage due to a breach of the BIT and the investor directly or indirectly owns or controls that enterprise.[87] Some tribunals can see an even wider scope in BITs to allow a foreign national to claim under a BIT. In *EnCana*, the claimant brought proceedings on behalf of its subsidiaries who were operating in Ecuador but were actually companies incorporated in third states, i.e. not Canadian or Ecuadorian. That was permitted by the tribunal[88] under Articles XIII(1) and (2) of the Canada-Ecuador BIT which permits an investor to bring a claim for loss or damage incurred by the investor for a measure taken or not taken by the host state in breach of the BIT. This is akin to the concept of piercing the corporate veil to allow the person who has suffered harm to bring a claim or who has allegedly caused harm to respond to a claim. Therefore, EnCana, the claimant, was able to bring a claim against Ecuador itself because although Ecuador's alleged BIT violations affected EnCana's third state incorporated subsidiaries, it was EnCana who would have suffered harm for any treaty violations. There are also some treaties which permit the host state-incorporated company which is owned or controlled by the foreign investor to bring a claim in its own name.[89]

[86] *EnCana Corporation v Republic of Ecuador,* LCIA Case No. UN3481, Award of 3 February 2006, at para 118 (*EnCana* or *EnCana* Award).
[87] Article XIII(12)(a), Canada-Ecuador BIT.
[88] *EnCana* Award at para 118.
[89] Article 7(2), Agreement between the Arab Republic of Egypt and the Government of Malaysia for the Promotion and Protection of Investments, signed 14 April 1997, entered into force 3 February 2000.

4.2.3 Pre-Entry and Post-Entry Application

Most IITs do not give investors the right of entry to or investments establishment rights in a host state.[90] Accordingly, in the majority of treaties national treatment applies post-entry/establishment (post-entry). The argument for granting national treatment post-entry only is demonstrated by the 1961 Draft Convention on the International Responsibility of States for Injuries to Aliens (1961 Harvard Draft), which was drafted to codify customary international law (i.e. codifying an international minimum standard of treatment). The 1961 Harvard Draft was drafted to make a host state internationally accountable to a foreign investor if there had been a clear and discriminatory violation of host state law.[91] Therefore, if host state law does not give a foreign investor establishment rights on an equal basis to its own nationals, then the foreign investor would not have a course of action because host state responsibility would only arise if the foreign investor is deprived of rights already granted to him under the host state's domestic law.

A good example of a BIT which clearly states that national treatment will apply post-establishment is the Turkey-Ethiopia BIT[92] which states at Article III(2):

> "Once the investment is accepted, each Party shall accord to this investment, treatment no less favorable than that accorded in similar situations to investments of its investors or to investments of investors of any third country, whichever is the most favorable."

On the other hand, some IITs do require host states to allow the entry and establishment of investors and investments in their territories, for example United States BITs[93] Canadian BITs[94] and regional investment agreements such as NAFTA[95] and DR-CAFTA.[96]

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[90] Newcombe and Paradell (n. 4) 158.

[91] Louis B. Sohn and R. R. Baxter, 'Responsibility of States for Injuries to the Economic Interests of Aliens' (1961) 55 *A.M.J.L.* 545, 547.

[92] Agreement between the Republic of Turkey and the Federal Democratic Republic of Ethiopia concerning the Reciprocal Promotion and Protection of Investments, signed 16 November 2000, entered into force 10 March 2005 (Turkey-Ethiopia BIT).

[93] Article 3(1) and (2) of the most recent United States of America Model BIT 2012 (US Model BIT 2012) includes "establishment" in its national treatment articles; Article II(1), US-Ecuador BIT

From a tax perspective, the inclusion of national treatment regarding establishment rights might only be relevant if charges are levied on a foreign investor or his investment pre-entry into the host state and these charges might be construed as being taxes.[97] This scenario is an unlikely one and no such tax arbitrations have been reported. Therefore, the tax arbitrations which are discussed in this chapter and throughout the thesis relate to post-entry of the investor and/or investment into the host state.

4.2.4 The Comparator

It was established at 4.2.1 above that national treatment, as a relative standard, requires assessing the manner in which the foreign investor or investment has been treated and comparing it with a host state national or investment (the comparator). Many treaties[98] guide the question by requiring foreign investors or investments to be compared to host state investors or investments in 'like,', or 'similar' *situations* or *circumstances*, meanwhile the majority of investment treaties stay silent as regards a comparator,[99] for example:

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requires each party to "permit… investment.."); Article 3(1) and (2) of the most recent United States BIT (Treaty between the Government of the United States of America and the Government of the Republic of Rwanda concerning the Encouragement and Reciprocal Protection of Investment, signed 19 February 2008, entered into force 1 January 2012 (US-Rwanda BIT)) also includes "establishment" in its national treatment articles).

[94] Article 3(1) and (2), Canada Model BIT 2004 ("establishment"); Article II(3), Agreement between the Government of Canada and the Government of the Republic of Armenia for the Promotion and Protection of Investments, signed 8 May 1997, entered into force 29 March 1999 (Canada-Armenia BIT) contains a national treatment article specifically for the parties to allow the establishment of investments; the Canada-Ecuador BIT contains the same establishment article as the Canada-Armenia BIT, and both BITs specifically exclude pre-entry rights through national treatment by titling the national treatment Article IV as "National Treatment after Establishment and Exceptions to National Treatment" (because there is no need to have establishment rights invoked twice in the same treaty.

[95] Article 1102(1) and (2), NAFTA, ("establishment").

[96] Article 10.3(1) and (2), DR-CAFTA, ("establishment").

[97] A tax which is described by a host state as a charge which is not a tax will not prevent an arbitral tribunal from seeing through the disguise (*Hellenic Electric Railways Ltd v Government of Greece*, Ad Hoc Arbitration, Geneva, Award of 18 March 1930), in which the arbitral tribunal rejected the distinction between social security contributions and taxes).

[98] The United States, Canada, Mexico and Turkey are commonly use a comparator in their BITs and MITs.

[99] Newcombe and Paradell (n. 4) 159; the Chile, China, Denmark, France, Germany, Netherlands, Switzerland and United Kingdom do not commonly use a comparator in their BITs.

> "A Contracting Party shall accord investments of the investors of one Contracting Party in its territory a treatment which is no less favourable than that accorded to investments made by its own investors…"[100]

Another example of a provision which is silent on a comparator and applies national treatment to investors with different drafting to the example above is the UK-Mozambique BIT,[101] which reads:

> "Neither Contracting Party shall in its Territory subject Nationals or Companies of the other Contracting Party, as regards their management, maintenance, use, enjoyment or disposal of their Investments, to treatment less favourable than that which it accords to its own Nationals…"[102]

The two examples above together demonstrate the majority of national treatment provisions contained in investment agreements which are silent on comparators, with the former exemplifying provisions that apply to investments and the latter exemplifying provisions that apply to investors. It is also possible for treaties to put the two together, for example:

> "Each Contracting Party shall accord to investors of another Contracting Party and to their investments, treatment no less favourable…"[103]

Treaties which do provide a comparator do not differ much in their wording to those articles copied above, they simply add to the national treatment provisions words such as "in like circumstances". The recent UK-Mexico BIT[104] is such an example, whereby the national treatment article is almost exactly the same as the UK-Mozambique and most other UK BITs, with the addition of "in like circumstances":

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[100] Article 4(2), Chile-Croatia BIT.

[101] Agreement between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the Republic of Mozambique for the Promotion and Protection of Investments, signed 18 March 2004, entered into force 12 May 2004 (UK-Mozambique BIT).

[102] Article 3(2), UK-Mozambique BIT.

[103] Article III, OECD Draft Multilateral Agreement on Investment (Draft MAI).

[104] Agreement between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the United Mexican States for the Promotion and Reciprocal Protection of Investments, signed 12 May 2006, entered into force 25 July 2007 (UK-Mexico BIT).

> "Neither Contracting Party shall in its territory subject investors of the other Contracting Party, as regards the management, maintenance, use, enjoyment or disposal of their investments, to treatment less favourable than that which it accords, in like circumstances, to its own investors…"[105]

The most common comparator in IITs is "like circumstances", however variations have been used, including "like situations",[106] "similar situations"[107] and "same circumstances".[108] The choice of words used by the drafters of treaties is not a defining factor. "Like" and "similar" are synonyms of each other,[109] "situation" and "circumstances" are synonyms of each other,[110] and although even "same" can be a synonym of "like" and "similar".[111] Although the primary definition of "same" is "identical",[112] the characterisation by arbitral tribunals of the subjects to be compared to determine whether nationality-based discrimination and anti-competitive practices have occurred is what is most important, whereby the apparent wider or narrower comparator clauses ("like" or "similar" versus "same") will not be determinative of the issue[113] for the same reason it is not an issue when the IIT does not refer to a comparator. The nature of national treatment requires a comparison to be made between a host state investor or investment and a foreign investor or investment to determine whether the foreign investor or investment has been discriminated against.

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105 Article 4(2), UK-Mexico BIT.

106 Article II(1) and (2), Treaty between the United States of America and the Republic of Senegal concerning the Reciprocal Encouragement and Protection of Investment, with Protocol, signed 6 December 1983, entered into force 25 October 1990 (US-Senegal BIT).

107 Article III(1) and (2), Turkey-Ethiopia BIT.

108 Article 3(1) and (2), Agreement between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of Belize for the Promotion and Protection of Investments, signed and entered into force 30 April 1982 (UK-Belize BIT).

109 The online Oxford English Dictionary (OED) defines "like" as "similar to"; the OED says word "similar" originates from the Latin word *similis* which means "like"; the online Collins English Thesaurus (CET) puts "similar" as a top synonym of "like" and vice versa.

110 The OED defines "situation" as "a set of circumstances in which one finds oneself"; the CET gives puts "circumstance" as a top synonym of "situation" and vice versa.

111 The OED, using geometry as an example, defines "similar" as "having the same shape, with the same angles and proportions, though of different sizes"; and the OED provides "similar" as an adverb to "same".

112 The OED's primary definition of "same" is "identical; not different".

113 Newcombe and Paradell (n. 4) 162; it will also depend on the arbitral tribunal and the circumstances of the case. For example, in *Corn Products International Inc. v United Mexican States*, ICSID Case No. ARB(AF)/04/01, Decision on Responsibility (Redacted Version) of 15 January 2008 (*Corn Products* or *Corn Products Award*), the tribunal said that "Article 1102 [of NAFTA] requires that the investors (or investments) which are being compared are in *like* not *identical* circumstances" (emphasis original) (*Corn Products* Award at para 129), indicating that had Article 1102 required comparators to be in identical circumstances then it may have been applied by that tribunal in its strict meaning.

To make that comparison, it is logical to "compare like with like",[114] and that is the position whether an IIT is silent on a comparator, expressly uses the word "like" as a comparator (whereby most IITs that have a comparator use "like"), and even if "same" is used. Article 31(1) of the 1969 Vienna Convention on the Law of Treaties (Vienna Convention) says:

> A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose.[115]

National treatment provisions would be almost useless in an investment treaty context if the treaty drafters or the arbitral tribunal required an identical comparator because it is almost impossible for investments to be exactly the same.[116] For that reason, the *RFCC Consortium* tribunal's requirement that a comparator be identical (*identique*)[117] when the investment treaty has not given a comparator is regarded as inappropriate.[118] The national treatment articles in the Draft MAI contain "in like circumstances" in square brackets because some delegations felt that an implicit addition of a comparator was unnecessary and open to abuse in investment treaty arbitration, but for those delegations that did want a comparator included, that comparator to be included was "in like circumstances",[119] with "same" and "comparable" being rejected by most delegations as unacceptably weakening the standard of treatment.[120]

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[114]Newcombe and Paradell (n. 4) 161; the *Occidental* tribunal paras 174-176 discussed the different between "like" investors or investments in an investment treaty context and "like products" from the GATT perspective. The tribunal (referring to the WTO Appellate Body Report for *Korea – Taxes on Alcoholic Beverages*, AB-1998-7 (18 January 1999) para 118) recognised that "like products" in a GATT perspective is interpreted narrowly to include directly competitive or substitutable products, whereas "like" investors can relate to investors who share a condition (e.g. they are exporters of goods originating in the host state) - .

[115] Article 31(1), Vienna Convention.

[116] Newcombe and Paradell (n. 4) 162 note 77; for example, location in the host state, size of office, size of factory, number of employees and countries to which exports are made will most likely differ in many respects.

[117] *Consortium RFCC v Kingdom of Morocco*, ICSID Case No. ARB/00/6, Award of 22 December 2003, at para 53.

[118] Newcombe and Paradell (n. 4) 161.

[119] OECD, 'The Multilateral Agreement on Investment: Commentary to the Consolidated Text', (22 April 1998) Doc. No. DAFFE/MAI(98)8/REV1, 10 <http://www1.oecd.org/daf/mai/pdf/ng/ng988r1e.pdf> accessed 12 April 2012.

[120] *ibid,* Draft Commentary.

In practice, therefore, the comparator will be the one in like circumstances, but then the choice of which (if any) host state investors or investments are determined as being in like circumstances as the foreign investor or investment is where decisions by arbitral tribunals plays the key role. How likeness has been determined in tax-related investment arbitrations is discussed at section 4.3.1 below.

4.2.5 Tax-Specific National Treatment Provisions

Although most IITs exclude tax related issues from their national treatment and MFN provisions,[121] some IITs differ completely and actually include tax-specific national treatment articles.[122]

Article 12(1) of the 1929 Draft Convention (see 4.1.2 above) was a tax-specific national treatment provision which would have obliged signatories to accord national treatment to investors of other states with respect to: (i) taxes and any other kinds of duties; and (ii) any other charges of a fiscal nature.

ICC Code, which was created as part of the International Chamber of Commerce's drive to promote foreign direct investment,[123] and is therefore does not have

[121] See 4.2.6 below.
[122] Article 4, Agreement on Encouragement and Reciprocal Protection of Investments between the Republic of Honduras and the Kingdom of the Netherlands, signed 15 January 2001, entered into force 1 September 2002 (Netherlands-Honduras BIT); Article 4, Agreement on Encouragement and Reciprocal Protection of Investments between the Republic of South Africa and the Kingdom of the Netherlands, signed 9 May 1995, entered into force 1 May 1999 (Netherlands-South Africa BIT); Article 4, Agreement on Encouragement and Reciprocal Protection of Investments between the Republic of Nicaragua and the Kingdom of the Netherlands, signed 28 August 2000, entered into force 1 January 2003 (Netherlands-Nicaragua BIT); Article 4, Agreement on the Encouragement and Reciprocal Protection of Investments between the Republic of Ecuador and the Kingdom of the Netherlands, signed 27 June 1999, entered into force 1 July 2001 (Netherlands-Ecuador BIT); Article 4, Agreement on Encouragement and Reciprocal Protection of Investments between the Republic of Costa Rica and the Kingdom of the Netherlands, signed 21 May 1999, entered into force 1 July 2001 (Netherlands-Costa Rica BIT); Article 4, Agreement on Encouragement and Reciprocal Protection of Investments between the Kingdom of the Netherlands and the Republic of Cuba, signed 2 November 1999, entered into force 1 November 2001 (Netherlands-Cuba BIT); Article 5, Agreement on Encouragement and Reciprocal Protection of Investments between the Kingdom of the Netherlands and the Argentine Republic, signed 20 October 1992, entered into force 1 October 1994 (Netherlands-Argentina BIT).
[123] International Chamber of Commerce, 'ICC Guidelines for International Investment' (2012), 3 <http://www.iccwbo.org/Data/Policies/2012/2012-ICC-Guidelines-for-International-Investment/> accessed 27 October 2013.

signatories and is not a binding international instrument, also contains a tax-specific national treatment article, plainly stating:

> "The High Contracting Parties shall not give less favourable treatment in respect of taxation to the nationals of the other High Contracting Parties than to their own nationals."[124]

The Netherlands Model BIT 2004[125] contains two national treatment articles, one general provision on the national treatment of investments at Article 3(2)[126] and a provision for the national treatment of nationals of the other contracting state in fiscal matters at Article 4. The full Article 4 reads:

> With respect to *taxes*, fees, charges and to *fiscal deductions and exemptions*, each Contracting Party shall accord to nationals of the other Contracting Party who are engaged in any *economic activity* in its territory, treatment not less favourable than that accorded to its own nationals or to those of any third State who are in the *same circumstances*, whichever is more favourable to the nationals concerned. For this purpose, however, any special fiscal advantages accorded by that Party, shall not be taken into account:
>
> a) under an agreement for the avoidance of *double taxation*; or
> b) by virtue of its participation in a customs union, economic union or similar institution; or
> c) on the basis of reciprocity with a third State (emphasis mine).[127]

There are three matters to address with this article: (i) what it applies to; (ii) who it applies to and in relation to which matters; and (iii) what the exceptions to its application are. I will address these in turn below.

[124] Article 7, ICC Code.
[125] Kingdom of Netherlands Model Bilateral Investment Treaty – Standard Text (March 2004) (Netherlands Model BIT 2004).
[126] Article 3(2), Netherlands Model BIT 2004.
[127] Article 4, Netherlands Model BIT 2004.

(i) It applies to "taxes" (the levying of tax – i.e. tax rates); fiscal "deductions" (this will include tax concessions); and fiscal "exemptions" (this will include tax rebates and zero-rate taxes).

(ii) The standard of treatment applies to the nationals of the other state-party who are engaged in economic activities in the host state and are in the *same circumstances* as the host state nationals or nationals of a third state (MFN obligation). "Nationals" is defined as natural persons of a party, legal persons constituted under the law of a party, and legal persons not constituted under a law of a party but directly or indirectly controlled by a natural or legal person of a party.[128] "Economic activities" is not defined in the Model BIT but can be taken on its *prima facie* meaning as activities of a commercial nature which will include investments.

(iii) The exceptions to its application are: firstly, favourable treatment accorded to host state nationals or nationals of a third state under double taxation treaties (DTTs) which are used to avoid individuals and companies from paying tax on the same income in two different jurisdictions; secondly, favourable treatment accorded on the basis of membership to customs unions (such as the East African Customs Union), economic unions (such as the European Union which in itself contains a customs union) and other unions (a catch all, such as membership of organisations such as the OECD); and thirdly, the reciprocity with a third state provision captures the incidence of a bilateral tax treaty (BTT) in which each state grants investors of the other state tax advantages in order to attract foreign direct investment (FDI).

There are two aspects of the Dutch provision which are of interest. Firstly, why is there a national treatment and MFN provision specifically for tax? And secondly, what is the meaning behind "same circumstances" in Article 4? The first question was recently answered by the tribunal in *ConocoPhillips*,[129] brought under the now

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[128] Article 1(b), Netherlands Model BIT 2004.

[129] *ConocoPhillips Petrozuata B.V., ConocoPhillips Hamaca B.V., ConocoPhillips Gulf of Paria B.V. and ConocoPhillips Company v Bolivarian Republic of Venezuela*, ICSID Case No. ARB/07/30, Decision on Jurisdiction and the Merits of 3 September 2013 (*ConocoPhillips or ConocoPhillips* Award).

terminated Netherlands-Venezuela BIT[130] which contained the Dutch model provision copied above in essentially the same form.[131] The tribunal concluded that matters of taxation "are subject only to the obligations stated in Article 4 and not to the more generally worded fair and equitable treatment obligation included in Article 3."[132] It is therefore used as a tax-exclusion clause to except the application of fair and equitable treatment (contained in Article 3 of the Netherlands Model BIT but not contained in Article 4) to tax matters. Article 4 therefore allows states to limit their obligations under the "broad and absolute obligation of fair and equitable treatment"[133] on account of the "*special character* of the power of a State to impose taxation"[134] (emphasis mine).

As to the second question, the most debatable aspect of Article 4 is that it applies to foreign nationals who are in the *same circumstances* as host state nationals and nationals of third states. How this would be interpreted by an arbitral tribunal is questionable because as yet it has not been arbitrated[135] despite being prevalent in a number of the Netherlands' BITs.[136] I concluded at 4.2.4 above that whether a treaty contains a comparator or not is not fundamental to disputes because the tribunals are likely to use investors or investments in *like circumstances* in any event. Whether or not that is the case with this Dutch provision is not as clear cut because the general national treatment provision at Article 3(2) of the Netherlands Model BIT does not contain a comparator at all, whereas Article 4 contains a very stringent comparator which is marginally short of being "identical". The Netherlands Model BIT therefore contains two national treatment provisions with each one on a different end of the comparator spectrum,[137] and that is the reason why the Dutch intentions in using the words "same circumstances" may be perceived more stringently by an arbitral

[130] Agreement on Encouragement and Reciprocal Protection of Investments between the Kingdom of the Netherlands and the Republic of Venezuela, signed 22 October 1991, entered into force 1 November 1993 and terminated effective 1 November 2008 (Netherlands-Venezuela BIT).
[131] Article 4, Netherlands-Venezuela BIT.
[132] *ConocoPhillips* Award at para 315.
[133] *ibid*.
[134] *ibid* at para 316.
[135] "Same circumstances" was not examined in *ConocoPhillips* because the claimants agreed there was no claim under that provision (*ConocoPhillips* Award at para 332).
[136] The provision exists in the same or almost identical form in all the Dutch BITs referenced at (n. 122) above.
[137] The reader is reminded that in the absence of a comparator being written in the IIT provision, the comparator will almost always be that in "like circumstances", except for inappropriate decisions like that in *RFCC* (n. 117) above.

tribunal if and when called upon to examine the provision in any future arbitrations. That said, the hypothesis at 4.2.4 above that no two investors or investments are ever likely to be the same (the same being identical), and that an arbitral tribunal would not require that kind of comparator because it would neutralise the essence of the national treatment provision, still stands. Therefore, it is the author's opinion that a comparator for the sake of Article 4 would not be determined in such a stringent manner because that could render it pointless under Article 31 of the Vienna Convention, however it would likely have to be viewed narrowly, with a comparator being very similar to the subject of the claim against the host state, and so the wide interpretation of *like circumstances* in *Occidental* (see section 4.3.1 below) is unlikely to be adopted and a tribunal may instead require that rather than a subject being compared to exporters of any goods, the subject would have to be compared to exporters of the same category of goods.

4.2.6 National Treatment Tax Exclusions

As already mentioned at 4.2.4 above, most IITs exclude matters of taxation from their national treatment provisions. There are two primary reasons that national treatment and MFN provisions are excluded from matters of taxation:

(i) so that states retain maximum fiscal sovereignty;[138] and

(ii) following on from (i), so that states can grant favourable tax treatment to their nationals or nationals of a third state (would breach national treatment and MFN respectively but for the tax exclusions).[139]

Maximum fiscal sovereignty includes avoiding investor-state arbitration and regulatory chill.

[138] *ibid*, 36.

[139] Ibid; there is a third reason for the exclusion of national treatment and MFN provisions which I believe is too weak to include as a primary reason, that is "the complexity of tax matters may render such matters unsuitable for inclusion in the kind of standardized provisions that are typical of BITs" (ibid). The reason I feel it is weak is if tax matters are not too complex to apply to the standard expropriation and other IIT protections, then the same matters cannot be too complex to apply to the standard national treatment and MFN provisions.

Typical examples of tax exclusions include Article 4 of the France-Venezuela BIT;[140] Article 4(4) of the Croatia-Spain BIT; Article 3(4) of the Germany-Saint Lucia BIT (which also contains a protocol that clearly states the national treatment provisions "do not oblige a Contracting Party to extend to persons resident in the territory of the other Contracting Party tax privileges, tax exemptions and tax reductions which according to its tax laws are granted only to nationals and companies resident in its territory");[141] Article 5(b) of the Denmark-Ghana BIT;[142] Article III(4)(b) of the Turkey-Ethiopia BIT; and Article 5 of the UK-Hungary BIT.[143] Article 5 of the UK-Hungary BIT is a good example of a BIT article which rules out national treatment for matters relating to taxation, and it states:

> "The provisions in this Agreement relative to the grant of treatment no less favourable than that accorded to the investors of either Contracting Party or of any third State shall not be construed so as to oblige one Contracting Party to extend to the investors of the other the benefit of any treatment, preference or privilege resulting from:
>
> (a) ….
>
> (b) any international agreement or arrangement relating *wholly* or *mainly* to taxation or any *domestic legislation* relating wholly or mainly to taxation"[144] (emphasis mine).

The reference in the above article to international agreements or arrangements is aimed primarily at double taxation treaties (DTTs) signed with third states. DTTs[145]

[140] France-Venezuela BIT, signed 2 July 2001, entered into force 30 April 2004 (France-Venezuela BIT); see also Article 3(5), France Saudi Arabia , signed 26 June 2002, entered into force 18 March 2004 (France-Saudi BIT).
[141] Protocol para. 3(c), Germany-Saint Lucia BIT; see also Protocol para. 3(b), Germany-Mexico BIT.
[142] Agreement between the Government of the Kingdom of Denmark and the Government of the Republic of Ghana concerning the Promotion and Protection of Investments, signed 13 January 1992, entered into force 6 January 1995 (Denmark-Ghana BIT).
[143] Agreement between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the Hungarian People's Republic for the Promotion and Reciprocal Protection of Investments, signed 9 March 1987, entered into force 28 August 1987 (UK-Hungary BIT).
[144] Article 5(b), UK-Hungary BIT.

are designed to prevent the double taxation of nationals who operate in the two jurisdictions of the signatories to a DTT and are likely to be taxed for the same income under both jurisdictions (therefore being taxed twice). DTTs will thus result in one jurisdiction not taxing an investor operating in its territory at all or at the full rate. There are therefore sound reasons for this exception to national treatment.

The national treatment exception in the above article to domestic legislation relating wholly or mainly to taxation means the host state will not be liable under the investment treaty for granting preferential treatment, preferences and privileges under its domestic legislation to its nationals and those of a third state (no breach of MFN), and this type of legislation can be more discriminatory towards the national of the other party.[146]

The China-Netherlands BIT[147] also does not apply national treatment to international agreements and arrangements relating wholly or mainly to taxation.[148] It does not, however, contain the exception to domestic legislation, meaning a discriminatory domestic legislation will be caught by the national treatment provision. The protocol to the China-Netherlands BIT does prevent a Netherlands investor from bringing a claim against China for breach of national treatment for any existing (at the time of signature) non-conforming measures (this applies to any measures including taxation), but it is endeavoured to progressively remove such measures.[149]

The non-exclusion to the application of national treatment for matters relating taxation can be crucial to a claimant's success under an investment treaty claim. In *EnCana*, the tribunal ruled against their jurisdiction for the claimant's (EnCana's) claim for breach of national treatment under Article IV of the Canada-Ecuador

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[145] DTTs also typically exclude NT and MFN from tax matters (UNCTAD, 'Taxation' (2000), Series on Issues in International Investment Agreements, Doc. No. UNCTAD/ITE/IIT/16, 2 <http://unctad.org/en/docs/iteiit16_en.pdf> accessed 15 August 2011).

[146] Any discrimination could however be caught under the fair and equitable treatment provisions of such treaties, with these taxation exception to national treatment or MFN not applying to fair and equitable treatment provisions.

[147] Article 3(3), Agreement on Encouragement and Reciprocal Protection of Investments between the Government of the People's Republic of China and the Government of the Kingdom of the Netherlands, signed 26 November 2001, entered into force 1 August 2004 (China-Netherlands BIT).

[148] Article 3(6)(b), China-Netherlands BIT.

[149] Protocol, Ad Article 3, China-Netherlands BIT.

BIT[150] as well as its claims under Article II of that treaty,[151] because Article XII(1) of the BIT excludes their application to taxation measures. Article XII(1) states, “except as set out in this Article, nothing in this Agreement shall apply to taxation measures.” The remainder of the sub-articles are airtight, explicitly allowing taxation measures to apply only to an alleged breach between the “central government authorities of a Contracting Party and the investor”[152] and to expropriation,[153] both of which are subject to the tax veto discussed at section 3.2.4 of Chapter 3. The only claim that the tribunal decided the merits of was the Article VIII claim for expropriation[154] which was rejected[155] (see section 3.5.3 of Chapter 3). This is in sharp contrast with *Occidental*, brought by a United States claimant (Occidental Exploration and Production Company (OEPC)) under the US-Ecuador BIT for the alleged breaches of national treatment; fair and equitable treatment; non-impairment of the management, use and enjoyment of the investment through arbitrary or discriminatory measures; and expropriation, all based on the same type of government measures taken by Ecuador’s tax authorities against EnCana (declining of tax rebates and retrospective denial of rebates previously granted). Unlike the Canada-Ecuador BIT, the US-Ecuador BIT was held to allow claims for breach of national treatment through taxation measures.

The tax inclusions/exclusions are contained in Article X (tax policies exclusions) of the US-Ecuador BIT which reads:

> 1. With respect to its tax policies, each Party should strive to accord fairness and equity in the treatment of investment of nationals and companies of the other Party.
>
> 2. *Nevertheless*, the provisions of this Treaty, and in particular Article VI [dispute resolution between investor and state] and VII [dispute resolution

[150] *EnCana* Award at para 146.
[151] Article II(1) obligation on the host state to encourage and create favourable conditions for investors of the home state; Article II(2)(a) obligation to accord fair and equitable treatment to the investor’s investments and returns; *EnCana* Award at para 107.
[152] Article XII(3), Canada-Ecuador BIT.
[153] Article XII(4), Canada-Ecuador BIT.
[154] *EnCana* Award at para 168.
[155] *EnCana* Award at para 199.

between both state parties], shall apply to matters of taxation only with respect to the following:

(a) expropriation, pursuant to Article III;
(b) transfers, pursuant to Article IV; or
(c) the observance and enforcement of terms of an investment agreement or authorization as referred to in Article VI (1) (a) or (b), to the extent they are not subject to the dispute settlement provisions of a Convention for the avoidance of double taxation between the two Parties, or have been raised under such settlement provisions and are not resolved within a reasonable period of time (emphasis added).

The provisions of Article X(2)(a) and (b) are straightforward to understand, i.e. expropriation and transfers respectively. Article X(2)(c) refers to the enforcement of terms of an investment agreement or investment authorisation between one party and an investor of the other party which are not subject to a DTT or are subject to a DTT but are not resolved under the DTT dispute resolutions provisions within a reasonable period of time.[156] Reading Article X(2) on its own would entail national treatment exempt from taxation measures, however, the arbitral tribunal in *Occidental* decided that the obligation of a host state to "strive to accord fairness and equity" with respect to its tax policies at Article X(1) was "not devoid of legal significance,"[157] and, despite the language of Article X(1) being less mandatory than the language of the national treatment, MFN and fair and equitable treatment provisions at Article II of the treaty, Article X(1) was still as mandatory as Article II. The tribunal decided that the term "nevertheless" at Article X(2) does not derogate from the legal effect of Article X(1) because it cannot be "read to mean that in respect of tax policies the host State could pursue an unfair or inequitable treatment."[158] Like EnCana, OECD was unsuccessful in its expropriation claim for not meeting the standards required to be deemed expropriated, but unlike EnCana, OECD had the benefit of claiming for breach of national treatment by taxation and it

[156] Article X(2), US-Ecuador BIT.
[157] *Occidental* Award at para 70.
[158] *Occidental* Award at para 70.

was successful in that claim, as well as its claim for breach of fair and equitable treatment on the same merits.

In a common and recurring theme of arbitral awards, tribunals make it clear that they are not bound by the decisions of other arbitral tribunals, but they do often use the reasoning of other tribunals, quote other tribunals, and reach findings in line with those other unrelated awards; that is how customary international law standards have developed over time, with different opinions formed that eventually make a set of informal but vital precedents. The arbitration of taxation issues in international investment disputes is fairly new domain and the *Occidental* tribunal's assessment of the tax exclusions under the US-Ecuador BIT was the first assessment of a provision of that type (i.e. the not so clear cut 'grey area' exclusion of national treatment for matters of taxation). In *Nations Energy*,[159] an arbitration under the US-Panama BIT,[160] an almost identical provision as Article X of the US-Ecuador BIT was a focal issue. Article XI(1) (tax policies exclusions) of the US-Panama BIT is a verbatim copy of Article X(1) of the US-Ecuador BIT copied above, while Article XI(2) is almost the same but for a couple of redactions:

> 2. Nevertheless, this Treaty shall apply to matters of taxation only with respect to the following:
>
> (a) expropriation, pursuant to Article IV;
> (b) transfers, pursuant to Article VI; or
> (c) the observance and enforcement of terms of an investment agreement or authorization, as referred to in Article VII (1)(a) or (b).

Article XI(2) of the US-Panama BIT differs to Article X of the US-Ecuador BIT in two ways; firstly, for the purposes of enforcing the terms of an investment agreement or authorisation from a tax perspective, Article XI(2)(c) does not require the non-

[159] *Nations Energy Inc., Electric Machinery Enterprises Inc., Y Jaime Jurado v The Republic of Panama*, ICSID Case No. ARB/06/19, Award of 24 November 2010 (*Nations Energy* or *Nations Energy* Award).
[160] Treaty between the United States of America and the Republic Of Panama concerning the Treatment and Protection of Investments, with Agreed Minutes, signed 27 October 1982, entered into force 30 May 1991 (US-Panama BIT).

existence of a DTT, or where a DTT does exist, it does not require that the enforcement provisions under the DTT be invoked and to give those provisions a reasonable time to resolve the dispute; and secondly, it does not specify that the three sub-articles apply specifically to investor-state or state-state disputes. Despite these apparently minor differences, the US-Panama taxation article appears to be less restrictive than its US-Ecuador counterpart. This is partly attributed to the fact that it does not explicitly require disputes relating to investment agreements or authorisations that are subject to BTTs to first undergo dispute resolution under the BTT dispute resolution mechanisms and to give those mechanisms a reasonable time to resolve those issues and they can instead they can be brought under the BIT from the outset. The apparent less restrictive nature of the provision is, however, mainly because Article XI(2) of the US-Panama BIT does not state that matters of taxation in relation to expropriation, transfers and investment agreements or authorisations shall apply "in particular" to investor-state disputes or to state-state disputes as is seen in Article X(2) of the US-Ecuador BIT.[161]

In *Nations Energy*, the arbitral tribunal departed from the decision of the *Occidental* tribunal, deciding that by using the words "strive to accord" instead of more prescriptive language such as "grant" or "shall", the United States and Panama intended to limit from taxation measures the binding effect of the fair and equitable and national treatment rules.[162] The *Nations Energy* tribunal further added that the "*[n]evertheless*, this Treaty shall apply to matters of taxation only with respect to the following..." (emphasis mine) in Article XI(2) clearly meant that Article XI(2) was an exception to Article XI(1), which undoubtedly meant that the commitment under Article XI(1) was outside the framework of the obligations.[163] The *Nations Energy*

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[161] See below.

[162] *Nations Energy* Award at para 472 (original text at para 472 of the Award reads: *"A criterio del Tribunal Arbitral, el artículo XI del TBI es claro. Al utilizar en el artículo XI.1 los términos "procurará otorgar" en lugar de un lenguaje más prescriptivo (como "otorgará"), los Estados partes han querido limitar el efecto obligatorio de la norma, excluyendo por tanto los recursos previstos por el tratado a favor de los inversionistas en el supuesto previsto en dicho artículo"*).

[163] *Nations Energy* Award at para 473 (original text at para 473 of the Award reads: *"El empleo, en el párrafo XI.2, de los términos "sin embargo este convenio se aplicará a los asuntos de tributación únicamente con respecto a…" claramente significa que el artículo XI.2 constituye una excepción al artículo XI.1, lo que sin ninguna duda implica que el compromiso previsto en el artículo X.1 queda fuera del marco de las obligaciones previstas por el TBI a cargo del Estado, cuya ejecución puedan reclamar directamente los inversionistas"*).

tribunal therefore rejected its jurisdiction to decide on the alleged breaches by taxation of the national treatment and fair and equitable protections.[164]

The different findings of the two cases is profound, not least because, despite the US-Panama BIT tax exclusions (in *Nations Energy*) being prima facie less stringent than the tax exclusions of the US-Ecuador BIT (*Occidental*), jurisdiction was not granted under the US-Panama BIT but was granted under the US-Ecuador BIT. In addition, it interesting that the *Occidental* tribunal ignored the "in particular" wording contained in Article X(2) of the US-Ecuador BIT, i.e. that matters of taxation shall apply in particular to investor-state arbitration and state-state arbitration in relation to expropriation, transfers and investment agreements or authorisations (Article XI(2) of the US-Panama BIT does not have the "in particular" wording). The inclusion of the "in particular" wording can be construed as significant if interpreted as meaning that matters of taxation in relation to disagreements on expropriation, transfers and investment agreements or authorisations are specifically subject to the investor-state arbitration or state-state arbitration under Articles VI(3) and VII(1) respectively; i.e. they are arbitrable; whereas although the host state must strive to accord national treatment in its taxation measures, if it does not, the issue cannot be arbitrated because unlike Article X(2) which explicitly subjects, for example, matters of taxation relating to expropriation to arbitration, Article X(1) does not afford the same explicit subjection to national treatment. Therefore, although it is, as the *Occidental* tribunal said, unlikely that the United States and Ecuadorian drafters intended to allow a host state to be unfair and inequitable in its tax policies, it would appear that, on this premise, it was their intention. The adoption of this school of thought would render the *Occidental* decision wrong.

Furthermore or on the other hand, the inclusion of "in particular" in the US-Ecuador BIT could be interpreted as giving greater credence to the "nevertheless" in Article X. To better exemplify this point, I will paraphrase Article X(2):

[164] *Nations Energy* Award at para 482 (original text at para 482 of the Award reads: *"La exclusión de la materia fiscal es por lo tanto delimitada y no se aplica en los casos limitadamente enumerados por el artículo XI.2. Ahora bien, interpretar el artículo XI.1 como hacen los Demandantes llegaría a vaciar de todo sentido la admisión limitada de los asuntos tributarios, prevista en el artículo XI.2 confiriendo al Tribunal Arbitral una amplia competencia para apreciar la política tributaria del Estado"*).

Although each Party should strive to accord fairness and equity including national treatment in relation to its tax policies, the investor-state arbitration and state-state arbitration provisions of this treaty shall apply with respect to matters of taxation only to the following:

(a) expropriation, pursuant to Article III;
(b) transfers, pursuant to Article IV; or
(c) the observance and enforcement of terms of an investment agreement or authorization as referred to in Article VI (1) (a) or (b), to the extent they are not subject to the dispute settlement provisions of a Convention for the avoidance of double taxation between the two Parties, or have been raised under such settlement provisions and are not resolved within a reasonable period of time.

The *Occidental* tribunal, however, did not put any emphasis at all on the "in particular" wording of Article X of the US-Ecuador BIT[165] and the *Nations Energy* tribunal did not have the option to examine it because the wording does not exist in the tax policies article of the US-Panama BIT. The *El Paso*[166] tribunal, however, was faced with a claim under the US-Argentina BIT[167] which contains a tax exclusion

[165] The non-inclusion of the "in particular" provision in Article XI(2) of the US-Panama BIT can be interpreted as insignificant because, if the protections under the BIT for expropriation or transfers are breached or relevant investment agreements or authorisations are breached, and the BIT applies to those protections and agreements in matters of taxation, if the breaches cannot be rectified with recourse to the investor-state arbitration and state-state arbitration mechanisms in the BIT because Article XI(2) does not spell it out, then the entire article would be pointless. In fact, requiring the inclusion of the "in particular" wording to invoke dispute resolution articles contained in an IIT for matters of taxation could be said to be akin to requiring, for the sake of making them arbitrable, the "in particular" provision to be included in every IIT article that contains standards and protections irrespective of whether they relate to taxation or not. The absence of the "in particular" wording in the US-Panama BIT, therefore, is insignificant, because giving it significance would deem Article XI meaningless in its entirety because there would be no recourse to arbitration despite the treaty protections being breached through taxation. Likewise, giving the inclusion of the "in particular" wording significance in the US-Ecuador BIT would result in matters of taxation in relation to expropriation, transfers and investment agreements or authorisations being arbitrable, but arguably rendering all other standards and protections contained in the BIT non-arbitrable because they do not apply "in particular" to the dispute resolution articles of the BIT.

[166] *El Paso Energy International Company v The Argentine Republic*, ICSID Case No. ARB/03/15, Decision on Jurisdiction of 27 April 2006 and Award of 31 October 2011 (*El Paso* or *El Paso* Jurisdiction Award or *El Paso* Award).

[167] Treaty between the United States of America and the Argentine Republic concerning the Reciprocal Encouragement and Protection of Investment, with Protocol, signed 14 November 1991, entered into force 20 October 1994 (US-Argentina BIT).

article which is a verbatim copy of Article X of the US-Ecuador BIT, at Article XII. The claimant in *El Paso* (El Paso) claimed for breaches of fair and equitable treatment,[168] full protection and security[169] and failure of the host state to accord treatment which is no less than that required by international law.[170] Although El Paso did not claim for breach of national treatment, the discussion of the tribunal's jurisdiction on the above alleged breaches was on exactly the same basis as the *Occidental* tribunal.

The *El Paso* tribunal approached the subject by reading Article XII(2) as it is, including the "in particular" provision, stating:

> "According to Article IIX(2), the provisions of the BIT, in *particular those of Articles VII and VIII (dispute settlement)* [i.e. arbitration], do not apply to matters of taxation, except: (i) if the matter is connected with, or amounts to, an expropriation… (ii) if it is related to the compliance with and enforcement of an investment agreement or authorisation; or (iii) if it relates to transfers…"[171] (emphasis mine).

The *El Paso* tribunal's paraphrasing of the tax exclusion makes it plainly clear that the provisions of the BIT do not apply if they relate to taxation and they especially will not apply to the dispute settlement provisions of the BIT, except for expropriation, etc. The *El Paso* tribunal found the "strive to accord fairness and equity" provision creates "only a best-effort obligation."[172]

Most importantly, Article X of the US-Ecuador BIT was considered by the English High Court in Ecuador's challenge[173] to set aside the *Occidental* award under sections 67 and 68 of the 1996 English Arbitration Act, claiming the arbitrators exceeded their jurisdiction.[174] Although the court affirmed the tribunal's jurisdiction under Article X(2)(c), it was judged that "apart from matters of taxation that come

[168] Article II(2)(a), US-Argentina BIT; *El Paso* Jurisdiction Award at para 32.
[169] Article II(2)(a), US-Argentina BIT.
[170] *ibid*.
[171] *El Paso*, Jurisdiction Award at para 111.
[172] *El Paso* Award at para 291.
[173] *Republic of Ecuador v Occidental Exploration & Production Co* [2006] EWHC (Comm).
[174] *ibid* at para 3.

within the three identified exceptions [expropriation, transfers, investment agreements/authorisations], all matters of taxation are outside the ambit of the BIT" and "unless a particular "*matter of taxation*" comes within the ambit of Article X(2) (a) [expropriation], (b) [transfers] or (c) [investment agreements/authorisations], then the dispute resolution provisions of the BIT Article VI [investor-state arbitration] cannot apply to any dispute that arises between a State and an investor in relation to that "*matter of taxation*"."

4.3 Application of the National Treatment Standard in Tax Arbitrations

This chapter will now turn to the requirements set by international arbitral tribunals and IITs that a claimant must meet to prove a breach of national treatment by the host state, and, specifically how those standards have been applied in tax arbitrations.

4.3.1 The 'Like Circumstances' Comparator in Tax Arbitrations

There cannot be a breach of national treatment unless the treatment of the foreign investor or investment can be compared with a host state *like* investor or investment.

4.3.1.1 Economic Circumstances of a Comparator on Whom the Tax Measure Was Not Applied

The relevant cases to discuss in this section are *Archer Daniels*,[175] *Cargill*,[176] and *Corn Products*.[177] These were discussed in Chapter 3, however a quick recap of the facts is necessary. *Archer Daniels*, *Cargill* and *Corn Products* were three separate arbitrations brought under NAFTA, and for relevance in this chapter, under NAFTA Article 1102. They centred on an amendment of 31 December 2001 to Mexico's

[175] *Archer Daniels Midland Company and Tate & Lyle Ingredients Americas Inc. v United Mexican States,* ICSID Case No. ARB(AF)/05/05, Award (Redacted Version) of 21 November 2007 (*Archer Daniels* or *Archer Daniels* Award).
[176] *Cargill Incorporated v United Mexican States*, ICSID Case No. ARB(AF)/05/2, Award (Redacted Version) of 18 September 2009 (*Cargill* or *Cargill* Award).
[177] *Corn Products International Inc. v United Mexican States*, ICSID Case No. ARB(AF)/04/01, Decision on Responsibility (Redacted Version) of 15 January 2008 (*Corn Products* or *Corn Products Award*).

Impuesto Especial Sobre Producción y Servicios (IEPS) which translates to '*Special Tax on Production and Services*'. The amendment was alleged to discriminate against companies owned by investors of the United States in the soft drink sweetener industry[178] (sweetener tax). The claimants/their Mexican subsidiaries were producers and distributors of high-fructose corn syrup (HFCS), a product produced and distributed in Mexico entirely by companies owned by American investors.[179] As a cost-effective alternative to Mexican-produced cane sugar, soft drink manufacturers substituted cane sugar with HFCS or blended the two together. The sweetener tax was levied not on HFCS itself, but on beverages that contained HFCS[180] and on services used to transfer and distribute HFCS and soft drinks that contain HFCS,[181] and this caused soft drink manufacturers to revert back to using mainly cane sugar which became the cheaper option. The sweetener tax was suspended on 5 March 2002 by the President of Mexico and the suspension was lifted by the Mexican Supreme Court on 12 July 2002, who deemed the suspension as unlawful, and importantly, stated that the tax had the "non tax-related purpose" of "protecting the Mexican sugar industry."[182] In that respect, the sweetener tax was introduced by Mexico on the back of failed negotiations with the government of the United States to allow surpluses of Mexican sugar to be sold on the United States market.[183] So the tax was enacted as a countermeasure to the alleged non-compliance by the United States with their NAFTA obligations[184] and/or to help the domestic sale of Mexican cane sugar which was in surplus; what is certain is it succeeded in the latter effect.

A WTO panel was constituted at the request of the United States to determine whether the sweetener tax was in breach of the GATT.[185] The tax was found to breach: (i) the first sentence of Article III(2) of the GATT,[186] namely a product of

[178] *Cargill* Award at para 105-106.
[179] *ibid* at para 106.
[180] *ibid* at para 107.
[181] *ibid* at para 105; and *Archer Daniels* Award at para 2.
[182] *Cargill* Award at para 109.
[183] *ibid* at paras. 71 to 79; *Corn Products* Award at paras 33 and para 37; *Cargill* Award at paras 81 to 99.
[184] *Corn Products* Award at para 63.
[185] WTO, *Mexico – Tax Measures on Soft Drinks and Other Beverages*, adopted on 24 March 2006.
[186] *ibid* 161 at para 9.2(a)(iv).

one WTO contracting party being subjected, directly or indirectly, to taxes in excess of those applied to like domestic products; (ii) the second sentence of Article III(2) as read with Article III(1) of the GATT,[187] namely that the tax was applied to imported products to afford protection to domestic products; and (iii) Article III(4) of the GATT,[188] namely that the imported products were being treated less favourably in comparison to like products of Mexican origin in respect of the laws, regulations and requirements affecting their sale, purchase, transportation, distribution or use.

There was a fundamental difference between the questions before the arbitral tribunals and those before the WTO. The WTO had to determine whether the *product*, HFCS, was *like* Mexican cane sugar (it was concluded that they were directly competitive or substitutable")[189], whereas the arbitral tribunals had to decide, most importantly, whether the claimants/their Mexican investments, as producers/suppliers of HFCS, were in *like circumstances* with Mexican cane sugar *producers/suppliers* to the soft drink industry.[190]

(i) Cargill

In *Cargill,* Mexico contended that the domestic sugar cane producers were not in like circumstances with American investors in HFCS because the economic situation of the sugar cane industry was dire and the HFCS industry was healthy.[191] If the economic disparity between sugar and HFCS was the basis for the rationale and objective of the tax measure in question,[192] then Mexico may have succeeded in proving that Cargill or its Mexican subsidiaries were not in like circumstances with producers of cane sugar, therefore disproving the claim for breach of Article 1102 of NAFTA. Mexico, however, did not succeed with that argument[193] because the sweetener tax was found not to be a measure designed to advantage the sugar industry, but one designed to disadvantage the healthy HFCS industry (as retaliation

[187] *ibid* 161 at para 9.2(a)(ii).
[188] *ibid* 161 at para 9.2(a)(iii).
[189] *Cargill* Award at para 194; and WTO Panel Report (n. 185) 127 at para 8.78.
[190] *Cargill* Award at para 196; *Archer Daniels* Award at para 204.
[191] *Cargill* Award at paras 201 and 208.
[192] *ibid* at para 209.
[193] *ibid* at para 209.

against the United States government), effectively driving HFCS out of the market,[194] and the fact that sweetener tax did benefit sugar producers was irrelevant because the tax was levied to pressurise the United States government into living up to other NAFTA obligations.[195] The sweetener tax was therefore aimed at the United States investors in HFCS because those investors have the lobbying power to influence the United States government,[196] and for that reason, the difference in the economic circumstances was irrelevant on the facts, especially because the dire state of the sugar industry was not the reason that the tax was levied.[197]

In Cargill, therefore, the economic disparity between producers of competing products was not a solid enough argument to prove that said producers were not in 'like circumstances' for tax purposes.[198]

(ii) Archer Daniels

The comparator debate in *Archer Daniels* was not as drawn out as it was in *Cargill*, with Mexico claiming in *Archer Daniels* that the lack of access to the United States market for Mexican sugar producers proved that Mexican cane sugar producers and American HFCS producers and suppliers showed a difference in the circumstances.[199] That point was dismissed as irrelevant.[200]

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[194] *ibid* at para 208.
[195] *ibid.*
[196] *ibid* at para 209.
[197] *ibid.*
[198] *ibid*; Mexico also tried to distinguish between HFCS suppliers to the soft drink industry and cane sugar suppliers to the soft drink industry for two other reasons: (i) HFCS suppliers invested in more goods than only sweeteners (sugar cane suppliers invested only on the one product; and (ii) the sugar industry was highly regulated (as regards pricing) whereas the HFCS industry was not (*Cargill* Award at para 197). (i) was dismissed because like circumstances was to be construed as whether Cargill was in like circumstances "in respect of its HFCS business" with domestic sugar producers (*Cargill* Award at para 199); and (ii) was dismissed because the tribunal could not see the relevance of the difference in levels of regulation, a point which Mexico did not expand upon either, seemingly unable to justify their own argument (*Cargill* Award at para 200).
[199] *Archer Daniels* Award at para 198.
[200] *ibid*; see section 4.3.1.2 for the *Archer Daniels* discussion on no *identical* comparator.

(iii) *Corn Products*

In *Corn Products*, Mexico put forward a number of arguments to prove that cane sugar producers and HFCS producers were not in like circumstances for tax purposes on a number of economic circumstances bases: (i) the United States did not allow Mexican producers of cane sugar access to the American sweetener market whereas United States investors in HFCS had access to the Mexican sweetener market;[201] (ii) due to the financial crisis in the Mexican sugar industry, producers in a financial crisis cannot be taken to be in like circumstances with producers that are financially secure[202] – on this point, Mexico relied on the decision in *GAMI*[203] in which the *GAMI* tribunal decided that sugar producers in financial hardship were not in like circumstances with sugar producers that were not;[204] (iii) the price of sugar was subject to financial regulation but HFCS was not,[205] which in turn affects the investors in those products; and (iv) the trade association that the claimant was a member of lobbied against extending access of the United States market to Mexican sugar producers and were therefore not in like circumstances.[206]

Overall, the arbitral tribunal rejected Mexico's arguments, finding without doubt that Mexican sugar producers operated in the same business or economic sector as American HFCS producers,[207] the sector being sweetener suppliers to the soft drinks industry.[208]

More specifically: (i) whether Mexican producers of sugar had access to the United States market "was *entirely* irrelevant to the decision to impose the [sweetener] tax"[209] (emphasis mine) and it was actually imposed because of

[201] *ibid* at para 125.
[202] *ibid* at para 105.
[203] *GAMI Investments Inc. v United Mexican States*, NAFTA Arbitration, Final Award of 15 November 2004.
[204] *ibid* at para 114; *Corn Products* Award at para 107.
[205] *Corn Products* Award at para 69.
[206] *ibid* at para 125.
[207] *ibid* para 120.
[208] *ibid*.
[209] *ibid* at para 129.

HFCS's share of the Mexican market;[210] (ii) the fact that the trade association that the claimant was a member of lobbied against Mexican sugar producers having greater access to the American market actually reinforced the point that HFCS and sugar producers were in like circumstances;[211] and (iii) if the financial and surplus problem in the sugar industry was price regulations, said regulations could have been softened, yet they were not, and instead a tax was levied to increase the price of HFCS.[212]

4.3.1.2 Different Products, Like Investors and Investments in Tax Treatment?

(i) Archer Daniels

In *Archer Daniels*, Mexico contended that although HFCS and cane sugar are like products for the purposes of Article III of the GATT as confirmed by the WTO Panel, that does not mean HFCS and cane sugar producers are in like circumstances.[213] The tribunal decided that, whilst HFCS and cane sugar producers were not identical comparators "even though they compete face-to-face in the same market … when no identical comparators exist, the foreign investor may be compared with less like comparators, if the overall circumstances of the case suggest that they are in like circumstances."[214] The appropriate subjects for comparison with respect to the treatment of Archer Daniels through the levy of the sweetener tax was, therefore, Mexican cane sugar producers, because they compete directly with one another to supply sweeteners to the soft drink industry.[215]

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[210] *ibid*; in addition, the tribunal said that Article 1102 of NAFTA requires investors or investments to be in "*like* not *identical* circumstances" (emphasis original) (*ibid*).
[211] *ibid* at para 135.
[212] *ibid* at para 127; the price regulation argument was also rejected on the grounds that the products at issue were interchangeable and indistinguishable from the point of view of soft drink customers (*ibid* at para 126).
[213] *Archer Daniels* Award at para 192.
[214] *ibid* at para 202.
[215] *ibid* at para 204.

(ii) Cargill

In *Cargill*, Mexico argued as they did in *Archer Daniels*, that HFCS producers and cane sugar producers were not in like circumstances because they produce different products. The tribunal referred to *GAMI*[216] and *Pope & Talbot*[217] which were two cases in which the foreign investors and domestic producers were not in "like circumstances" despite producing the same products and competing in the same market.[218] Therefore, more than a likeness of goods is required to choose with whom the tax treatment of the foreign investor must be compared with and in the circumstances, sugar (i.e. sweetener) producers and suppliers *to the soft drink industry* were in like circumstances with HFCS (i.e. sweetener) producers and suppliers to the soft drink industry.[219]

(iii) Corn Products

In *Corn Products*, Mexico put forward the same arguments as it did in *Archer Daniels* and *Cargill* above about the irrelevance of the WTO decision that cane sugar and HFCS are like products under the GATT.[220] Although the tribunal accepted that like products under the GATT does not denote like circumstances of investors in investment treaty arbitration (which the claimant did not argue),[221] it is not irrelevant.[222] The tribunal said that where investors produce like products and the measure (in this case, a tax) discriminates against one of the like products, then that indicates a violation of the national treatment protections in IITs.[223]

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[216] *GAMI* (n. 203).
[217] *Pope & Talbot, Inc. v Government of Canada*, NAFTA Arbitration, Interim Award of 26 June 2000.
[218] *Cargill* Award at para 195.
[219] *Cargill* Award at paras 211 and 214.
[220] *Corn Products* Award a para 102.
[221] *ibid* at para 121.
[222] *ibid* at para 122.
[223] *ibid.*

(iv) Occidental

One of the most fundamental decisions in national treatment jurisprudence on choosing a relevant comparator was *Occidental*. The reader will recall from Chapter 3 that the *Occidental* (and *EnCana*) dispute centred on the retrospective and prospective denial of VAT refunds to the claimant, OEPC, which was paid on locally purchased or imported goods that became part of their fixed assets, raw materials, inputs and services.[224] OEPC was granted refunds for VAT it had paid on its inputs for exported oil under Ecuador's Internal Tax Regime Law (ITRL) as it was effective prior to 30 April 1999. The ITRL was amended, effective 30 April 1999, with Article 69A granting refunds to for VAT paid on local purchases or imported goods used in the *fabricación* (manufacture) of goods to be exported. On the basis of Article 69A, Ecuador's tax authority, the Sericio de Rentas Internas (SRI), issued denying resolutions to OEPC's requests for refunds and issued retrospective denials for refunds already granted.

OEPC was granted VAT rebates for applications it made between July 1999 and 30 April 2001,[225] which were denied retrospectively on 1 April 2002,[226] as were subsequent applications for rebates between January and March 2003.[227] The SRI denied refunds based on their interpretation of *fabricación* (manufacture) in Article 69A of the ITRL, which the SRI did not extend to oil production,[228] and in case their interpretation was wrong, the SRI said the VAT refunds were covered in OEPC's participation contract with the state-owned oil company Petroecuador.[229] The participation contract did not provide for VAT refunds,[230] therefore it had to be determined whether Ecuador had a case to answer for breach of national treatment under Article II(1) of the US-Ecuador BIT.

[224] Article 65 of the Ecuadorian Tax Law (pre-April 30th 1999); Elihu Lauterpacht and Christopher Greenwood, *International Law Reports: Volume 138* (CUP 2010), 70.
[225] *Occidental* Award at paras 32 and 135.
[226] *ibid* at para 32; SRI Resolution 234 of 1 April 2002.
[227] *ibid*; SRI Resolution 406 of 31 January 2003 and SRI Resolution 026 of 6 March 2003.
[228] *ibid* at para 135.
[229] *ibid.*
[230] *ibid* at para 143.

OEPC based its national treatment argument on being compared with Ecuadorian nationals who are exporters of goods involved in activities such as mining, fishing, lumber, flowers, bananas and African palm oil,[231] for which the SRI granted VAT refunds under Article 69A of the ITRL.[232] These exporters were argued to be in like situations with OEPC, because although they were not oil producers, like situations encompasses companies engaged in exports even though they are in different sectors.[233] Ecuador disputed this on the contention that 'like situations' "can only mean that all companies in the same sector are to be treated alike,"[234] and Petroecuador, being the only Ecuadorian oil producer, was not granted VAT refunds.[235]

The arbitral tribunal agreed with the claimant's interpretation of "like circumstances", and that it cannot be interpreted in the narrow sense put forward by Ecuador because "the purpose of national treatment is to protect investors as compared to local producers, and this cannot be done by addressing exclusively the sector in which that particular activity is undertaken."[236] Therefore, to assess the treatment in taxation of OEPC as compared with Ecuadorian nationals, Ecuadorian producers who export goods, albeit other than oil, were the chosen comparator.[237]

4.3.1.3 Same Products, Like Investors and Investments in Tax Treatment?

Feldman[238] was another NAFTA Article 1102 arbitration and was also the subject of discussion in Chapter 3. Another quick recap is necessary here in light of the national treatment claim. The claimant was a United States national who was the sole owner and controller of Corporación de Exportaciones Mexicanas, S.A. de C.V. (CEMSA),

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[231] *ibid* at para 168.
[232] *ibid* at para 136.
[233] *ibid* at para 168.
[234] *ibid* at para 171.
[235] *ibid* at para 172.
[236] *ibid* at para 173.
[237] This finding is parallel to the comment by the dissenting arbitrator in *UPS v Canada* (see 4.3.2.2 below) who stated: "It is possible for two investors or enterprises to be in the same sector or to be in competition and nonetheless be quite unlike in respect of some characteristic critical to a particular treatment." (*UPS* Dissent at para 16.)
[238] *Feldman* Award (n. 80).

a company incorporated in Mexico which engaged in buying, reselling and exporting cigarettes.[239] The dispute centred on Mexico's Ministry of Finance and Public Credit (*Secretaría de Hacienda y Crédito Público*) (SHCP) declining retrospectively and prospectively refunds to CEMSA for tax paid on exported cigarettes, which between 1990 and 1997, a 'zero tax rate' applied to exported cigarettes[240] under Mexico's IEPS.

A brief overview of the facts are: (i) CEMSA bought cigarettes from volume retailers and the price paid to the retailers included tax;[241] (ii) in order to be granted tax refunds under Article 4 of the IEPS, CEMSA had to prove the tax paid on cigarettes "separately and expressly on their invoices"[242]; (iii) only producers and resellers who have purchased cigarettes from producers have the breakdown of tax paid,[243] meanwhile producers were unwilling to provide CEMSA with a breakdown of the taxes[244]; (iv) CEMSA was granted and paid refunds for exported cigarettes between June 1996 and September 1997[245]; (v) rebates to CEMSA were terminated on or before 1 December 1997, accompanied by a refusal to pay rebates for exports made in October and November 1997 in the amount of US$2.35 million[246]; (vi) on 14 July 1998, CEMSA was audited by SHCP and was ordered to repay approximately US$25 million for rebates paid from January 1996 to September 1997, with interest and penalties[247]; (vii) from 1 December 1997, companies were required to register on the Sectorial Exporters Registry to qualify for tax rebates and CEMSA was declined registration;[248] (viii) registration on the Sectorial Exporters Registry was denied on the basis of an on-going audit of CEMSA for its earlier claims for tax rebates[249]; and (ix) two Mexican companies (Mercados Regionales and Mercados Extranjeros) which were owned by Mexican nationals were also resellers and exporters of cigarettes, were unable to produce invoices stating the tax paid on cigarettes

[239] *Feldman* Award at para 10.
[240] *ibid* at para 8.
[241] *ibid* at para 15.
[242] *ibid.*
[243] *ibid.*
[244] *ibid* at para 118.
[245] *ibid* at para 19.
[246] *ibid* at para 20.
[247] *ibid* at para 22.
[248] *ibid* at para 21; in addition, absent registration on the Sectorial Exporters Registry, CEMSA could not get the required export documentation (*pedimento*) from the Mexican Customs authorities and could not export goods at all (*ibid* at para 21).
[249] *ibid.*

separately, were granted tax refunds during the same periods that refunds to CEMSA were denied, were granted registration on the Sectorial Exporters Registry as cigarette exporters,[250] and they had not been audited by SHCP for rebates paid to them.[251]

Unlike *Archer Daniels*, *Cargill* or *Occidental*, the comparator in *Feldman* was easier for the arbitral tribunal to ascertain. Mexican-owned *producers* of cigarettes who also traded in exports were not in like circumstances with CEMSA,[252] however, Mexican-owned *traders* of cigarettes who purchased Mexican cigarettes for export, namely Mercados Regionales and Mercados Extranjeros, were in like circumstances with CEMSA because they carried out the same activities[253] and were therefore the perfect comparators against whom to compare Mexico's taxation measures.

4.3.1.4 Different Services, Like Investors and Investments in Tax Treatment?

In *UPS v Canada*,[254] a United States company that provides postal services in Canada brought a claim under Chapter 11 of NAFTA for breach of national treatment at Article 1102.[255] The claim was commenced against Canada in part for the enforcement of its customs laws allegedly being unfair to the claimant.[256] UPS's investment in Canada was a Canadian subsidiary called 'UPS Canada' which was incorporated under the laws of Ontario[257] UPS believed that the Canadian state-owned Canada Post Corporation was given advantages over UPS and UPS Canada (together UPS, unless specified) under with respect to customs laws.

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[250] *ibid* at para 23.
[251] *ibid* at para 161.
[252] *ibid* at para 171.
[253] *ibid* at paras 171 and 172.
[254] *United Parcel Service of America Inc. v Government of Canada*, NAFTA Chapter 11 Arbitration, Award on the Merits and Dissent of 24 May 2007 (*UPS*, *UPS* Award or *UPS* Dissent).
[255] UPS also claimed under Article 1103 – most-favoured-nation; Article 1104 – the better of national treatment or most-favoured-nation; Article 1105 – minimum standard of treatment under international law including fair and equitable treatment and full protection and security; and Article 1502(3)(a) and 1503(2) – requirement on Canada to ensure a Canadian state-owned company (Canada Post on these facts) acts in a manner consistent with Canada's obligations under Chapter 11, Section A, of NAFTA (these include Articles 1102 to 1105). The claims against the conduct of Canada Post were dismissed (*UPS* Award at paras 63 and 78).
[256] *UPS* Award at para 11.
[257] *ibid* at para 6.

UPS contended that “UPS is in ‘like circumstances’ with … Canada Post by virtue of the fact that they compete in the same market and for the same market share. Canada Post *non-monopoly* products are generally substitutable with UPS courier products.”[258] Like most developed countries, Canada benefits from two international goods importation services: (i) goods imported via the express consignment industry (i.e. courier services); and (ii) good imported via international postal traffic received from foreign postal administrations.[259] UPS provided services in the former (the non-monopoly ‘products’), whereas Canada Post provided services in both (with international postal traffic being the monopoly held by Canada Post).

Unlike other tax-related arbitrations that have been examined in this chapter, UPS’s claim was not based on how it was treated for its own tax purposes (e.g. by being levied with a tax (directly or indirectly) or by not being granted tax refunds). Instead, the claim was based on customs laws that UPS had comply with in relation to taxing the goods being imported into Canada through its courier services.

Canada adopted different customs measures for the importation of goods by courier and by mail because the manner in which the goods arrive for importation for each method is different.[260] The tribunal was convinced this was necessary[261] and that assertion was correct because it is the norm for countries, including the United Kingdom and the United States, to adopt different customs procedures for post and courier services[262] because the operators of post and courier services “have different objects, mandates and transport and deliver goods in different ways and under different circumstances.”[263]

For customs purposes, UPS operated under Canada’s Courier Low Value Shipment Program (CLVS Programme) while Canada Post operated under the Customs International Mail Processing System (CIMP System) and through an agreement

[258] *ibid* at para 87.
[259] *ibid* at paras 7 and 96; the foreign postal administrations are those administrations belonging to countries that are members of the United Nation’s Universal Postal Union (members currently stand at 192 countries as at 22 November 2013).
[260] *ibid* at para 100.
[261] *ibid* at para 99.
[262] *ibid* at para 118.
[263] *ibid* at para 116.

between it and the Canadian Department of National Revenue (Postal Imports Agreement).[264] The Postal Imports Agreement was a secret agreement dated 25 April 1994 but was disclosed to UPS in 1999.[265] Canada Post used the CIMP System and the Postal Imports Agreement for its mail as well as its courier services.

The customs laws that benefitted Canada Post directly in a financial manner which UPS claimed was a breach of Article 1102 of NAFTA were: (i) an exemption for Canada Post to pay interest and penalties for the late payment or non-payment of duties or taxes[266]; (ii) the ability of Canada Post to levy and retain a handling fee of CA$5 for the collection of duties and taxes from recipients of packages imported through the postal system[267]; (iii) an exemption on Canada Post from charging recipients of packages imported through the postal system a 7% goods and services tax on the CA$5 handling fee[268]; and in summary of the foregoing (iv) the failure or neglect by Canada to accord to UPS national treatment by "failing or neglecting to ensure that Canada Post charges duties and taxes to Canadian importers on packages imported by Canada Post through the postal system for which duties and taxes are payable and has allowed large volumes of packages to be imported into Canada without the collection of such duties and taxes. Where packages are imported by UPS Canada, duties and taxes are appropriately collected. As a result of the differential treatment, Canada Post receives a competitive advantage over UPS Canada, to the detriment of UPS Canada."[269]

Despite the above being a wide array of measures, they can be summarised in three points: (i) UPS Canada performed services for Canada's Border Services Agency (Canada Customs) without compensation, whereas Canada Post was remunerated for performing the same[270]; (ii) UPS Canada had to pay cost recovery fees for services that Canada Customs officers perform in connection with UPS Canada's imports, whereas similar charges for not imposed on Canada Post for its imports[271]; and (iii)

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[264] *ibid* at para 88.
[265] *ibid* at para 80.
[266] *ibid* at para 80(a)(iv).
[267] *ibid* at para 80(b).
[268] *ibid* at para 80(c).
[269] *ibid* at para 80(e).
[270] *UPS* Dissent at para 29.
[271] *ibid.*

Canada Customs did not levy the same fines and penalties against Canada Post as it did on UPS Canada and Canada Customs did not collect duties and taxes prescribed by law from Canada Post in the same manner or extent as it did with UPS Canada.[272]

The arbitral tribunal, by a majority, dismissed UPS's national treatment claim because the treatment accorded to postal traffic is different to the treatment accorded to courier operators "for the simple reason that circumstances are not like."[273] The tribunal reiterated that is the case in the United Kingdom and the United States, and that the customs procedures are fully compliant with international conventions.[274] Therefore, since postal services and courier services are not 'like', the majority tribunal held that Canada Post and UPS were not in 'like circumstances' "in respect of the customs treatment of goods imported as mail and goods imported by courier."[275] This is a fair decision with respect to the differential treatment for customs purposes between post and courier services. A different decision on that issue could have opened Pandora's Box in all countries that adopt different customs procedures for the importation of goods by post and courier. The majority tribunal did, however, fail to focus narrowly on Canada Post's courier services. For example in *Cargill*, Mexico contended that Mexican sugar producers were not in like circumstances with Cargill because the Mexican sugar producers only invested in the one product, whereas Cargill invested in more than only HFCS.[276] That argument was dismissed by the tribunal who said that the determination as to whether sugar producers and Cargill are in like circumstances must be decided "in respect of its [Cargill's] HFCS business" only.[277] Arguably, similar application was plausible in *UPS* as well and that is what formed part of the separate opinion of the dissenting arbitrator. Canada Post's courier business had at least three close substitutes for UPS Canada products,[278] Canada Post explicitly compared their products with UPS Canada's products in internal documents[279] and Canada Post routinely determined the prices of its own courier service products with reference to UPS's and UPS

[272] *ibid* at para 31.
[273] *ibid* at para 118.
[274] *ibid*; the conventions are the United Nation's Universal Postal Convention and the World Customs Organisation's Kyoto Convention.
[275] *UPS* Award at para 119.
[276] *Cargill* Award at para 199.
[277] *ibid*.
[278] *UPS* Dissent at para 21.
[279] *ibid* at para 24.

Canada's competing products.[280] The dissenting arbitrator stated in his opinion the facts as they were with respect to Canada Post's courier business, that being Canada Post "sees UPS and UPS Canada as its competitors, sees the class of products at issue in this dispute as one in which parallel Canada Post and UPS products directly compete, and takes actions in response to that competition between parallel products of Canada Post and UPS."[281] This was therefore persuasive evidence that Canada Post and UPS were in like circumstances with respect to customs actions concerning the courier business.[282] UPS, having more than met the like circumstances test by establishing that it was in like circumstances with Canada Post regarding the courier business,[283] should have been alleviated from proving it was in like circumstances regarding postal services, because it clearly was not, and the burden should have then been shifted on Canada to of disprove that Canada Post and UPS were in like circumstances with respect to the courier business.[284]

4.3.2 Less Favourable Treatment and Nationality-Based Discrimination in *De Jure* or *De Facto* Application of Tax Measures

4.3.2.1 Less Favourable Taxation Treatment and De Jure and De Facto Tax Discrimination with Intent

In *Archer Daniels*, the arbitral tribunal found that the sweetener tax reduced ALMEX's (the claimants' investment) profits on the sale of HFCS and thus impaired ALMEX's ability to "conduct or expand operations to satisfy the domestic demand for HFCS in Mexico."[285] Article 1102 of requires foreign investors and investments to be treated no less favourably than home state investors and investments with respect to "… expansion … [and] conduct …"[286] The effect of the tax was determined to result in United States producers and distributors of HFCS receiving less favourable treatment than that accorded to Mexican sugar producers[287] since soft

[280] *ibid*.
[281] *ibid.*
[282] *ibid* at para 25.
[283] *ibid* at para 26.
[284] *ibid.*
[285] *Archer Daniels* Award at para 188.
[286] Article 1102(1) and (2), NAFTA.
[287] *Archer Daniels* Award at para 211.

drinks containing cane sugar were exempted from the tax.[288] The imposition of the tax thus targeted the HFCS industry, composed of United States investors including the claimants in *Archer Daniels*, while the domestic cane sugar industry was protected.[289] In addition, the tribunal found the sweetener tax imposed dissimilar taxation on directly competitive products (HFCS and cane sugar) which was "discriminatory and contrary to the national treatment principle in under Article 1102"[290] and that was the underlying intent of the enactment of the tax.[291] The sweetener tax clearly discriminated *de jure* and *de facto* between Mexican investors and United States investors, with the written letter of the law affecting investors in HFCS (and therefore United States investors) and the application affecting the same investors, whereas it did not affect Mexican investors in cane sugar (*de jure* or *de facto*) even though they competed with United States investors in supplying sweeteners to the soft drink industry. The result of the discrimination was less favourable treatment being accorded to the claimants. Together with the determination that the claimants and Mexican cane sugar suppliers to the soft drink industry were in 'like circumstances',[292] the arbitral tribunal in *Archer Daniels* concluded that the sweetener tax denied national treatment to the claimants and their investment (ALMEX) in violation of Article 1102 of NAFTA.[293]

In *Cargill*, the arbitral tribunal also concluded that the sweetener tax was a violation of national treatment,[294] with the treatment received by suppliers of HFCS to the Mexican soft drinks industry being less favourable than the treatment received by cane sugar suppliers to the same industry[295] and that as a result of the sweetener tax the competitiveness of HFCS suppliers diminished.[296] In addition, as regards discrimination, the *Cargill* tribunal forthrightly stated that the sweetener tax was discriminatory both in intent and effect[297] (*de jure* and *de facto*) because it was

[288] *ibid.*
[289] *ibid* at para 212.
[290] *ibid.*
[291] *ibid* at para 210; this was in addition to the tax being introduced to coerce HFCS producers into lobbying the United States government to comply with its own NAFTA obligations (*Cargill* Award at para 209).
[292] *Archer Daniels* Award at para 204.
[293] *ibid* at para 213.
[294] *Cargill* Award at para 223.
[295] *ibid* at para 219.
[296] *ibid.*
[297] *ibid* at para 220.

directed at United States producers and suppliers of HFCS to make them put pressure on the United States government,[298] with Mexican cane sugar suppliers obviously exempted from the taxation measures.

In *Corn Products*, Mexico maintained that the sweetener tax was enacted as a response to the financial crisis of the domestic sugar industry in Mexico and not to target HFCS investors, that the HFCS industry was a central feature of the financial crisis.[299] This argument was rejected because it confused the *nature* of the measure with the *motive* for which it was taken.[300] Whilst the motive behind the imposition of the sweetener tax was to address the crisis in the Mexican sugar industry,[301] the nature of the tax treated producers of HFCS less favourably than sugar producers, and a laudable goal that the state believes is necessary does not take from its discriminatory nature that results in less favourable treatment of foreign investors.[302]

4.3.2.2 Less Favourable Taxation Treatment and De Facto Tax Discrimination

(i) Occidental

In *Occidental*, the SRI (tax authority), as explained above, retracted granting resolutions for VAT refunds and issued denying resolutions because of its face-value interpretation of the relevant Ecuadorian tax law which stated that VAT refunds were to be granted for goods used in the 'manufacture' of exported goods. The SRI cannot be faulted for that interpretation since even the Ecuadorian Tax Courts ruled the same in one case between a company called

[298] *ibid.*
[299] *Corn Products* Award at para 104; HFCS was a central feature to the Mexican sugar industry crisis because the reason that Mexican sugar producers were not given access to the American market (where Mexican sugar producers could have sold their surpluses) was because the United States refused to take into account Mexican produced HFCS in calculating whether Mexico had a sugar surplus (*Corn Products* Award at para 104) – and Mexican produced HFCS was actually produced by American investors.
[300] *ibid* at para 142.
[301] This includes a 'retaliatory' measure against the United States' alleged violations of its NAFTA obligations because the Mexican sugar industry was said to be suffering by not having access to the American sugar market. The sweetener tax was therefore designed not only to push soft drinks producers into buying sugar instead of HFCS, but to get the HFCS producers to lobby the American government into allowing Mexican sugar access to the United States market.
[302] *Corn Products* Award at para 142.

Repsol YPF Ecuador SA and the SRI,[303] however, the Special Taxation Chamber of Ecuador's Supreme Court provided a final ruling in that case, deciding that Article 69A of the ITRL did grant refunds to all exporters, including oil exploration and production companies, with 'manufacturing' encompassing every type of production activity.[304] The tribunal made a determination on the matter itself by examining Article 169 of the Ecuadorian Tax Law Regulations which included the requirements for filing for a tax refund and "ratified the general purport of the Tax Law in respect of the rights of exporters, manufacturers and "producers to a refund of VAT paid on the purchase of goods and services."[305] The *Occidental* tribunal decided that OEPC did have a right to tax refunds under Ecuadorian tax legislation[306] and that reimbursement was due also under Andean Community Law[307] and Andean Community Law was binding on Ecuador.[308] Accordingly, there was no *de jure* discrimination by Ecuador. However, since the foreign investor (OEPC) was not granted refunds that it was due while Ecuadorian exporters of other products were granted refunds, the interpretation of the non-discriminatory law followed by the SRI resulted in OEPC receiving less favourable treatment than that accorded to Ecuadorian companies[309]and that had a *de facto* discriminatory effect. The SRI's interpretation of the law came from confusion and a lack of clarity in the law and practices relating to it and that confusion and lack of clarity resulted in some form of arbitrariness,[310] however the arbitrariness was deemed to be unintended by the SRI[311] and there was no discrimination against foreign-owned companies with intent.[312] A violation of national treatment does not rest on a finding of intended discrimination (and if it did then the entire principle would be weakened).

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303 *Occidental* Award at para 140.
304 *ibid* at para 141.
305 *ibid* at para 130.
306 *ibid* at para 143.
307 *ibid* at para 146; under Andean Community Law, OEPC would have been entitled to reimbursement in forms other than refunds (*ibid* at para 152).
308 *ibid* at para 152.
309 *ibid* at para 177.
310 *ibid* at para 163.
311 *ibid.*
312 *ibid* at para 177.

Together with the finding that OEPC were in like circumstances with Ecuadorian exporters of other products (see 4.3.1.2 above), the tribunal concluded that Ecuador had violated the national treatment obligations under Article II(1) of the US-Ecuador BIT.[313]

(ii) *Feldman*

In *Feldman*, the claimant contended that the law in question was not "discriminatory on its face",[314] i.e. there was no question of *de jure* discrimination in the Mexican tax law, but it was applied in a discriminatory manner, i.e. there was *de facto* discrimination in the application of the tax law. The claimant argued that Mexico's SHCP *de facto* discriminated against his company (CEMSA) in the years 1996 to 2000.[315] In evidence of the discrimination carried out between 1996 and 1997, the claimant pointed to the admittance of Mexico of paying money to three cigarette reseller/exporter companies in September 1996, a period in which the claimant and his company were denied tax rebates or when efforts were being made by the SHCP to recoup rebates already paid.[316] For the period 1998 to 2000, the claimant contended that the SHCP permitted at least Mercados From the years 1998 to 2000, Mexico's SHCP permitted at least three Mexican-owned cigarette resellers/exporters (including Mercados Regionales and Mercados Extranjeros) to export cigarettes and receive tax rebates.[317] Additionally, the Mexican-owned 'like' companies were not retrospectively audited for tax rebates paid to them by the SHCP.[318] Mexico argued that the claimant argued only on the basis of *de facto* discrimination and because the claimant could not prove *de jure* discrimination in Mexico's tax law, it would be inappropriate for the arbitral tribunal to find a violation of national treatment the failure of SHCP to provide a benefit that they did not have the authority to provide in law,[319] and, with regard to the audits,

[313] *ibid* at para 179.
[314] *Feldman* Award at para 157.
[315] *ibid* at para 155.
[316] *ibid*; the amount paid to the three cigarette exporters was NP$91 million (Nuevos Pesos).
[317] *ibid.*
[318] *ibid* at para 161.
[319] *ibid* at para 160.

Mexico contended that when there are companies in like circumstances, the fact that one has been audited sooner than the others does not indicate discrimination.

The *Feldman* tribunal decided that, where there is *de facto* discrimination in the application of the tax law, it is irrelevant whether the law is *de jure* discriminatory.[320] What was imperative on the facts in *Feldman* was that rebates were in fact given to Mexican investors in like circumstances whereas the foreign investor was not and the *de facto* difference in treatment was sufficient to establish a denial of national treatment.[321] The tribunal also held that the claimant need not prove the discrimination was based on his nationality because that would "tend to excuse discrimination that is not facially directed at foreign owned investments."[322] This decision corresponds to the *Occidental* decision in which there was also no *de jure* discrimination in Ecuador's tax laws, and this is wise because an otherwise determination would give all legislators and their actors free reign to discriminate and get away with it because the written letter of the law is *de jure* non-discriminatory.

The *Feldman* tribunal thus concluded that the claimant made a prima facie case for differential and less favourable treatment by Mexico's SHCP as compared with the Mexican-owned cigarette resellers/exporters, Mercados Regionales and Mercados Extranjeros,[323] also ruling that Mexico's promise of conducting audits of those Mexican-owned companies being weak and unpersuasive.[324] The tribunal also decided that the Mexican tax law (Article 4(3) of the IEPS) which was used to discriminate against and provide less favourable taxation treatment to the claimant was effectively waived for Mexican-owned companies.[325] The tribunal concluded that the factual pattern of the taxation treatment accorded to the claimant was more than a "minor error or two" and instead was a pattern of official action/inaction over a number of years which resulted in *de facto*

[320] *ibid at* para 169.
[321] *ibid.*
[322] *ibid* at para 184, quoting the arbitral tribunal in *Pope & Talbot* (n. 217) at para 79.
[323] *Feldman* Award at para 187.
[324] *ibid.*
[325] *ibid.*

discrimination which violated the national treatment principles at Article 1102 of NAFTA.[326]

(iii) UPS

As discussed at 4.3.1.4 above, UPS Canada were not found to be in 'like circumstances' with Canada Post by the majority of the arbitral tribunal, however, it will be beneficial to briefly examine the view of the dissenting arbitrator who did find the UPS Canada to be in 'like circumstances' with Canada Post in respect of the courier business.

Dean Ronald A. Cass, the dissenting arbitrator, had to decide whether: (i) UPS Canada having to pay Canada Customs for services similar to those received by Canada Post from Canada Customs for free was a violation of the national treatment principle at Article 1102 of NAFTA; (ii) Canada Customs paying Canada Post for materials handling for undertaking customs handling services but not compensating UPS Canada for the same was a violation of Article 1102; and (iii) the fines and penalties levied by Canada Customs on UPS Canada which were not levied on Canada Post the practice of collecting taxes and duties from UPS Canada being more stringent than the practice to Canada Post was a violation of Article 1102. The arbitrator found the differences to be substantial.[327] The arbitrator rejected Canada's attempt at justifying less favourable treatment by necessity due to the differences between postal imports and courier imports,[328] differences which Canada Post's courier services had the benefit of enjoying.[329] Canada's necessity defence for the difference in treatment between mail imports and courier imports which resulted in less favourable treatment being accorded to courier imports, in the arbitrator's opinion, actually should have resulted in less favourable treatment being accorded to mail imports by necessity. On the facts, greater customs compliance and therefore greater Canada Customs resources

[326] *ibid* at para 188.
[327] *UPS* Dissent at para 32.
[328] *ibid* at para 46.
[329] *ibid* at para 45 ("the differences between the postal stream and the courier stream addressed by Canada in … generally do not distinguish the UPS products at issue here from competing Canada Post products").

were necessary for the requirements of Canada Post's mail products and services, therefore, charging UPS Canada and being more stringent on UPS Canada for tax compliance for fewer resources used by UPS Canada and greater tax compliance by UPS Canada should have resulted in UPS Canada being treated more favourably than Canada Post and certainly not less favourably.[330] Canada Post's courier products and services were therefore accorded more favourable treatment than the treatment accorded to UPS Canada and the "manifest inconsistency" between the customs treatment of Canada Post as compared with UPS Canada for similar products which were handled on similar bases for similarly situated customers was concluded by the dissenting arbitrator to be a violation of Article 1102 of NAFTA. [332]

4.4 Conclusion

In this chapter, the superfluous characteristics of national treatment have been analysed and discussed, building up to the analysis of the treatment of tax in investor-state arbitration of alleged national treatment violations. We have learned that the equal tax treatment of foreign investors and investments with like host state investors and investments is rooted in the history of the national treatment principle, whereby the very development of the national treatment standard in a general sense stemmed in part from the equal tax treatment of like domestic and foreign products.

The study of national treatment in tax arbitration has entailed an analysis of arbitral awards dealing with jurisdictional issues and merits of claims. The jurisdictional issues have centred on exclusions to the application of tax measures to national treatment protection in IITs. Tax exclusions are generally very clear cut, such the exclusion contained at Article 5(b) of the Denmark-Ghana BIT which states that the national treatment and MFN protections do not apply to "…any international agreement or arrangement relating wholly or mainly to taxation or any domestic legislation relating wholly or mainly to taxation."[333] The arbitral awards that contained discussions on tax exclusions under national treatment claims were

[330] *ibid* at paras 46, 47 and 48.
[332] *ibid* at para 63.
[333] Article 5(b), Denmark-Ghana BIT.

brought under the US-Ecuador BIT (*Occidental*), the US-Panama BIT (*Nations Energy*) and the US-Argentina BIT (*El Paso*). Those treaties, whilst excluding tax from national treatment protection, obliged the host state to act fairly and equitably with its application of tax policies. The *Occidental* tribunal found the obligation meant that tax was included in national treatment protection, whereas the *El Paso* and *Nations Energy* tribunals refused jurisdiction because it was "only a best-effort obligation."[334] The English High Court confirmed that the fairness and equity obligation did not except national treatment protection from the tax exclusion in the US-Ecuador BIT[335] and the *Occidental* tribunal therefore overreached its jurisdiction by deciding the national treatment claim.[336] The *Occidental* tribunal, by giving themselves jurisdiction to entertain the national treatment claim, shows that arbitral tribunals are willing to be more flexible in their approach that to alleged national treatment tax violations than they are tax expropriation. This is especially so in respect of the *Occidental* tribunal's decision on the merits of the national treatment claim.

Once a comparator in like circumstances to the claimant or claimant's investment is identified, the question before the arbitral tribunal is *"has the foreign investor/investment been treated less favourably in comparison with the host state national investor/investment?"* In taxation, a foreign investor is treated less favourably than a like circumstances host state investor if any tax advantages given to the host state investor are not reciprocated, and this includes anything in relation to the levying and collection of taxes, such as: a tax is levied on the foreigner but not the host state national; the foreigner pays a higher rate of the same tax; tax laws are applied more stringently on the foreign investor; or the foreigner does not benefit from tax advantages given to the host state national such as tax refunds on exports. The same applies to the differential tax treatment of foreign investments as compared with host state investments.

In *Feldman*, finding Mexico liable for violating the national treatment protection by enforcing its tax laws (including the invoice requirement) against the claimant's

[334] *El Paso* Award at para 291.
[335] *Republic of Ecuador v Occidental Exploration & Production Co* [2006] EWHC (Comm).
[336] This does not take away from the addition to the jurisprudence of the national treatment principle by *Occidental*.

investment was a *de facto* violation and relatively easy for the tribunal to recognise the differential tax treatment. Similarly, the *de jure* and *de facto* discrimination and less favourable treatment accorded the claimants and their investments in *Archer Daniels*, *Cargill*, and *Corn Products* was also very recognisable – a tax was levied and enforced that affected producers and suppliers of HFCS (an industry owned in Mexico by United States investors) to the soft drink industry whereas the comparable and competitive producers and suppliers of cane sugar to the soft drink industry were not affected by the tax. It is clear, therefore, that arbitral tribunals apply the principles of national treatment to taxation in the same manner as they do with any other regulatory measures of the state. In fact, in *Occidental*, the arbitral tribunal went as far as adding to the jurisprudence of national treatment in order to find Ecuador in violation of national treatment through tax. To that end, whilst national treatment of like investors and investments under IITs is not the same as national treatment of like products under the GATT, previous jurisprudence on the IIT national treatment principle narrowly defined the domestic comparators by requiring a strong correlation between the domestic investors/investments and the foreign investors/investments,[337] namely that they trade in the same sector and are competitors of one another, as they were in *Feldman*, *Archer Daniels*, *Cargill* and *Corn Products*. The *Occidental* tribunal expanded the principle by deciding that investments in different sectors of the economy that are not competitors but *export* their products are in like situations, thereby putting exporters of oil (OEPC's sector), bananas, flowers and seafood in the same boat and finding that the claimant was treated less favourably by not being granted tax refunds.

Overall, in investor-state arbitration, tax is treated the same as any other state measures that can and have allegedly violated the national treatment protection. If a comparator is established and that comparator has been treated favourably in the *de jure* and most importantly the *de facto* application of tax, arbitral tribunals will not stop short of finding a state liable for breaching international law through its sovereign power to tax.

[337] Newcombe and Paradell (n. 4) 165.

Chapter 5 Final Comments

In this thesis, the treatment of tax in investor-state arbitrations in which expropriation and national treatment violations were claimed have been studied. We have learned that: tax is capable of being expropriatory; the characterisation of allegedly expropriatory measures as taxes will not prevent arbitral tribunals from examining the merits of a claim – i.e. the *impact* of the state measure defines whether it is an expropriation, not the *form*; finding a state liable for tax expropriation requires the state to have violated the conduct requirements and this also denotes an intention by the state to expropriate through tax; and of course the investor must prove that the tax measures had the effect of expropriation. With regards to the latter point, the customary international law standard of deprivation for finding liability of expropriation is a substantial deprivation. There have been cases (non-tax) in which arbitral tribunals have lowered the threshold of deprivation to find states liable for partial or temporary deprivations. As we learned in Chapter 3, arbitral tribunals presiding over tax expropriation claims are highly unlikely to lower the threshold to finding state liability for expropriation and are in fact likely to view the substantial deprivation standard very strictly and in a manner that might require a total deprivation of property. This hypothesis stems from the fact that only two cases resulted in a finding of tax expropriation and they involved a total deprivation of investment,[1] whereas another case that had a seemingly substantial deprivation[2] failed on the merits. In addition, another case that involved a total deprivation of a claim to money was not an expropriation because it did not violate the conduct requirements,[3] which is not the role of the conduct requirements. The analysis of the treatment of tax as expropriation also demonstrated that arbitrators do not consider tax expropriation claims lightly and will not find a state liable for tax expropriation (thus benefitting investors' profits) unless the expropriation is arbitrary and wipes out all benefits of an investment. The research undertaken has therefore concluded that tax does have a *lex*

[1] *RosInvest Co. UK Limited v The Russian Federation*, SCC Case No. V 079/2005, Final Award of 12 September 2010; and *Quasar de Valores SICA V S.A., 0RGOR DE V AWRES SICA V S.A., GBI 9000 SICA V S.A., ALOS 34 S.L. v The Russian Federation*, SCC Case No. 24/2007, Award of 20 July 2012.
[2] *Burlington Resources Inc. v Republic of Ecuador*, ICSID Case No. ARB/08/5, Decision on Liability of 14 December 2012.
[3] *EnCana Corporation v Republic of Ecuador*, LCIA Case No. UN3481, Award and Partial Dissent of 3 February 2006 (*EnCana*, *EnCana* Award or *EnCana* Dissent).

specialis character under the customary international law of expropriation because arbitrators apply stricter rules to finding a state liable for tax expropriation by requiring a total deprivation of investment and a violation of the conduct requirements.

The analysis of the treatment of tax in alleged national treatment violations has established that arbitral tribunals generally apply the normal principles of national treatment jurisprudence to tax arbitrations of that treaty protection. We have seen that it is relatively easy for investors to prove a violation of national treatment protection once a comparator is established who has been treated more favourably in the *de jure* and most crucially the *de facto* application of the host state's tax laws. It is clear, therefore, especially compared with the treatment of tax in expropriation claims, that tax has a *lex specialis* character in the application of expropriation rules but not in the application of the national treatment standard. Tax does, however, benefit from special treatment under IITs by exclusively being excluded from applying to national treatment protection.

The stark contrast between the difficulty in proving a tax expropriation claim and the simplicity in proving a national treatment claim demonstrates why national treatment is generally excluded from applying to tax measures in most IITs, whereas a state need not shy away from allowing the application of expropriation to tax measures because arbitral tribunals will seldom find them liable under that investment treaty and customary international law principle.

This brings us to the assessment of whether states have done the right thing for their tax sovereignty by excluding the application of national treatment to tax measures. As discussed in Chapter 2, the deliberation of the state's sovereign power to tax, as with any disputes on the legitimacy of the state's sovereign actions, would ordinarily be entertained by the courts of the host state by reason of the parties' residence, *lis pendens*, or other. By signing and ratifying IITs, host states relinquish sovereignty not only to arbitral tribunals made up of foreign private individuals, but to foreign investors, especially powerful multinational corporations, through regulatory chill.

It is clear from the evidence in Chapter 4 that there is high turnout of arbitral awards in favour of the investor for national treatment tax violations in comparison to how many claims there have been. This is especially so because all that is required to prove a violation of national treatment is the differential treatment between the like investors or investments, whereas tax expropriation requires a substantial or total deprivation of investment. Seeing as states change their tax laws periodically, including tax rates, tax exceptions, tax exemptions, and all sorts of tax advantages that might apply to some but not all investors or investments, they run a high risk of being in violation of international law under national treatment protection if it applies. This demonstrates that, in lieu of the exclusions contained in most IITs to the application of national treatment to taxation measures, states would be at risk of being respondents to an abundant and unprecedented number of tax arbitrations, as well as possibly succumbing to regulatory chill and relinquishing their tax sovereignty to some extent to foreign investors. Tax expropriation claims, on the other hand, will be few and far between because it is a very rare occurrence where a state's tax laws will be alleged to be expropriatory, and tax expropriation claims are seldom likely to result in a finding of state liability. States have, therefore, definitely managed to curtail the impact on their tax sovereignty by including exclusions in IITs on the application of national treatment to taxation measures. Moving forward, I would therefore recommend that states, both capital importers and exporters, draft tax exclusions in their IITs in relation to national treatment and most-favoured-nation treatment principles. I also recommend that the tax vetoes for expropriation claims, which exist in only a handful of IITs are included, are included more uniformly in states' IITs. This will help countries to avoid frivolous tax expropriation claims as the tax authorities from the home and host state can agree than a tax expropriation has not taken place. These are simple safeguards that will help to preserve the tax sovereignty of states and preserve expenditure on possible litigations, which, ironically, are likely to be funded by tax revenues. On the other hand, I would recommend that businesses with international investments and strong lobbying power lobby their governments to make tax more arbitrable under IITs by removing tax exclusions to national treatment protection in existing IITs and not including the same in future IITs. Business should also lobby the same in relation to tax vetoes for expropriation claims.

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