Some Notes on the International Protection of Foreign Investors under Bilateral Investment Treaties in matters of Taxation and Tax Administration

E. A. van der bruggen

I. Introduction

Tax and foreign investment

The tax treatment by the host state of an investment (the state in which the investment is made) and of the profits generated by an investment are an important factor for every international business enterprise. Obviously, a foreign investor will want to get a clear picture of all taxes that will apply and that may weigh on the net return of his investment in another country.

Usually states have many different taxes that will concern the investor. Import duties or tariff will for example increase the cost of raw materials and equipment that are used in the manufacture of products, or will increase the cost price of goods that are meant to be resold in the host state. Value added taxes will have to be passed on to the customers of the investor and thus increase the sales price of products, or in case the investor is not entitled to offset input VAT with output VAT may present a real cost for the operation[1]. Corporate income tax will typically be levied on the net profit of the company and a withholding tax on dividend distributions will further reduce the actual profit repatriation to the foreign investor. Attracting loans, intellectual property or services from abroad will also trigger withholding taxes that will normally be considered by the investor as economical costs. Depending on the type of the investment other taxes may also play an important role such as transfer tax on immovable property, excise duty, and so-called mineral royalties.

On the other hand the host state may offer tax holidays or special tax reductions that may have an impact on investment decisions. In that case, the investor will seek advice on the conditions, the reductions and the period he is expected to benefit from this tax incentive.

The investment decision will normally take into account all important elements of the taxes of the host state, mainly their taxable basis, rates and exemptions or reductions. It is of no use just to compare tax rates when countries can have important differences in the calculation of the amount subject to tax. From the economical perspective taxes and duties are costs and as such they weigh on the net return of the investment.

Changes to the tax laws of the host state

Although taxation (or tax incentives) will rarely be the decisive factor for the investment decision, it is certain that consequent changes in tax policy or practice may have an important impact on the value of or the return on an investment. Careful investors will allow for a certain flexibility in their calculations. After all, everybody knows that tax laws and tax rates will evolve over time.

So, usually changes in host state tax regimes will not result in catastrophic consequences for (a particular) foreign investor. Moreover, states will normally be careful not to deter foreign investors with their tax policies. But on occasion a new tax regime may have a severe impact on foreign

[1] Under the tax laws of many countries that have a VAT system, certain types of business operation are not treated as VAT-taxpayers but as end-consumers, such as real estate development, banks and insurance, hospitals and universities.

investment anyway, intended or not. The canceling of a duty free zone in a host state, for example, may make the business of a chemical processing company prohibitively expensive because import tariff will now be levied on the materials that customers send to be processed. The raising of excise duty on cigarettes may make the products to expensive for a producer's existing foreign markets if a rebate for export is not provided. The sudden increase of corporate income tax rates may present severe difficulties for enterprises that have fully reinvested their profits and now cannot raise the cash to pay the additional taxes. Some new taxes may weigh relatively higher on foreign owned companies thus reducing their capacity to compete with nationally owned companies.

Measures of tax administration

New taxes or tax increases are a major concern to every business, but surprising administrative measures and decisions of the tax authorities concerning the existing ones may also present severe difficulties for foreign investors. Tax audits and investigations may lead to a re-assessment by authorities of (1) the taxable basis (amount) or (2) the characterization (nature) of the transaction or event. An example of the first kind would be when the taxable profit of the foreign investor is re-assessed either by disallowing costs or increasing revenue for the purposes of corporate income tax. In most of these cases, high penalties and interests apply. Also when the value of imported goods is increased by customs for the purpose of calculating tariff, or when the tax authorities increase the basis for excise duty calculation foreign investors may be subject to higher taxes and penalties. Examples of the second kind are re-classification of imported goods for tariff purposes or re-characterization of the type of income for the purpose of withholding taxes. Furthermore, authorities may decide to revoke tax privileges attached to an investment incentive program, cancel or delay the refund of taxes, refuse to apply tax exemptions, etc.

The manner in which the administrative measures and decisions which lead to increased tax costs for the foreign investor are carried out, are particularly of note here. The investors may feel –justified or not- that the process was arbitrary or not transparent, discriminatory or unfair.

Administrative collection measures applied by tax authorities may also severely affect the operation of foreign owned businesses. Bank accounts may be seized or frozen, goods impounded or property foreclosed.

In this article

It is now widespread practice for countries to conclude bilateral as well as regional and multilateral treaties that contain provisions that offer a certain protection for foreign investment. On a bilateral basis such treaties are often called "bilateral investment treaties ("BIT")" or "investment promotion and protection agreements". They contain provisions against unfair or discriminatory treatment and expropriation. Typically, these treaties also contain provisions on the transfer of returns from the investment, the promotion of investments and the settlement of disputes. A more recent tendency is to include investment protection measures in larger agreements that also cover free trade matters[2].

In addition, contracts between investors and states (or agencies or enterprises over which the state has authority) are also a source of protection under international law for foreign investors. With respect to taxation, "stabilization clauses" are not uncommon in concessions, exploration contracts and construction and installation contracts between foreign private investors and state entities. In such a clause, the host state promises not to change or increase the tax burden on the investor's activity or assets.

The purpose of this article is to explore the subject matter of the protection of foreign investors under such treaties in tax matters, identifying the legal issues and remaining uncertainties.

[2] US-Singapore Free Trade Agreement, section B "Investment"

II. Do Investment Treaties Apply as a General Matter to Taxation?

General remarks

One could ask the question if investment treaties in a general manner überhaupt apply to tax matters. The impression may exist that they do not, in a sense that "investment" is not the same as "tax". After all, states also conclude Double Taxation Agreements with each other, often referred to as "tax treaties", to especially deal with taxation on income and capital[3]. So perhaps, no investment treaty has any application in tax matters. More importantly, most investment treaties have clauses that exclude tax matters from the investment treaty to some extent or another[4].

Do investment treaties as a principle apply to taxation?

The purpose and object of investment treaties is to grant protection to foreign investors by means of imposing standards of treatment and other obligations upon the host state. It is indeed not to impose tax reductions or exemptions for those investors in the host state, or to impose measures to reduce double taxation. In that sense, investment treaties do not apply to taxation in the way DTA's do. But it is not difficult to prove that investment treaties do apply to tax-related matters in the absence of specific exclusions. For one thing, many treaties mention such explicitly. And with reference to investment treaties that include some specific exception for tax matters one could argue that no such exception would be necessary unless otherwise taxation would indeed fall under the scope of the investment treaty.

The view that the tax treatment of a foreign investor as a principle may fall under the scope of the protection provided under investment treaties has repeatedly been confirmed by the decisions of international arbitration tribunals. Although both issues should not be confused, the jurisdiction of an arbitration tribunal under an investment treaty can certainly be associated with the characterization of the nature of disputes between foreign investors and their host state[5].

The ICSID Convention, for example, states that the Centre shall have the jurisdiction to settle "legal disputes that arise directly out of the investment"[6]. Typically, for tax-related disputes the defending host state will invoke that the Tribunal has no jurisdiction because the issue is one of taxation and not a "legal dispute". The early jurisprudence of ICSID already indicated strongly that tax disputes related to the investment are also "legal disputes that arise directly out of the investment" for which the ICSID Tribunal may have jurisdiction. In *AMCO v Indonesia*, the Tribunal observed that tax matters may well be covered by ICSID's jurisdiction[7]. In *Kaiser Bauxite v Jamaica*, the government had agreed to a tax-stabilization clause, and the Tribunal asserted that a dispute over increased taxes would fall under the scope of art. 25 par. 1 of the ICSID Convention: "the dispute concerned the alleged rights and obligations stemming from the particular provisions in the agreements between Kaiser and Jamaica and was therefore a legal dispute"[8]. A similar situation and decision is found in *Alcoa Minerals v. Jamaica*[9]. In the more recent *Goetz v. Burundi* (the investor claimed that the

[3] Hereafter referred to as "DTA"; See Model Tax Convention on Income and on Capital, OECD, Paris, 2002.
[4] UNCTAD Series on Issues in International Investment Agreements, "Taxation", Geneva, 2000, p. 77
[5] In most cases, the jurisdiction of the arbitration tribunal will extend to all the obligations of the host state related to the foreign investment that are provided in the investment treaty, but not always. The BIT between Hungary and Norway that was at issue in the Telenor Award, for example, only allowed jurisdiction over losses, repatriation of returns and expropriation.
[6] Under art. 25 of the the ICSID-Convention, the jurisdiction of the Centre shall extend to "any legal dispute arising directly out of an investment".
[7] As quoted by Schreuer, C., *The ICSID Convention: A Commentary*, Cambridge University Press, 2001. p. 119, par. 76.
[8] *Kaiser Bauxite v. Jamaica*, 1 *ICSID Reports*, p. 303; It should be noted that in that case, taxation was explicitly mentioned in the investment contract between the parties.
[9] See Schmidt, J.T., "Arbitration under the auspices of ICSID: Implications of the decision on jurisdiction in *Alcoa Minerals v. Jamaica*", *Harv. Int.'l Law Journ*., vol. 17, p. 98 (1976).

canceling of a duty free zone resulted in the expropriation of his mining operation) the issue was settled in clear terms. The Tribunal approached the issue from the perspective that questions on reparation for harm to foreign investment are certainly legal disputes, regardless what is the type of the allegedly harmful government measure[10]. In *Feldman v. Mexico*, the issue was the failure of the tax authorities to refund excise tax for exported cigarettes, which was by the international arbitration tribunal a violation of the national treatment-provision of the investment treaty[11]. In *Occidental v. Ecuador*, the dispute sprung from the refusal of the Ecuadorian tax authorities to refund input VAT to a foreign investor, a case which the foreign investor won[12].

But one must be careful to correctly define the legal issue at hand when it comes to deciding whether an investment treaty covers a tax related matter or not. What is exactly the nature and the source of the legal rule that the investor sees as having been violated by the host state? Is it only a provision of the host state tax code or is it also a rule found in the investment treaty or in customary international law?

An example can illustrate this difference. Let us assume that the profit of a foreign investor is re-assessed by the host state's tax officials for the purposes of corporate income tax, in accordance with the host state's tax laws. The investor will want to verify if the re-assessment is carried out in accordance with the host state's income tax law, for example if the tax authorities' refusal to take certain expenses into account for tax deduction for lack of business purpose is legitimate. This is an issue of interpretation or application of the host state's tax law. Such an issue falls primarily under the jurisdiction of the domestic courts in the host state. The same measure by tax authorities may however evoke other legal issues as well. For one, the foreign investor may claim that the audits carried out by tax authorities were only directed at foreign owned enterprises, allowing nationally owned enterprises to continue paying less taxes simply because they are not selected for an audit. This legal issue is not one of the host state's *tax* law (although perhaps the host state's constitutional or administrative law may be concerned), but of international investment law, namely the question whether the provision on national treatment as provided in an applicable investment treaty has been broken. Or the foreign investor may claim that he was unable to defend himself against the re-assessment because the process applied was arbitrary and he was denied access to a proper and independent court. This is also an issue of international investment law, namely the question whether the host state has violated the obligation to extend fair and equitable treatment to foreign investors.

Reference can be made here to the arguments presented by the EC before the WTO Panel in the FSC Case against the US. The EC started a dispute settlement proceeding against the US with respect to certain special tax reductions which were available for exporters of goods under the Foreign Sales Corporation-incentive. According to the EC, for the US not to tax the income of these exporters constituted a subsidy under the relevant WTO agreement. The US argued that, based on footnote 59 to the Subsidies and Countervailing Measures Agreement[13], tax matters should not be brought before the WTO Panel but before another more appropriate forum. The EC rebutted as follows:

---

[10] *Antoine Goetz et al v Burundi*, No. ARB/95/3, par. 83 (available at www.investmentclaims.com/decisions/Goetz-Burundi-Award-10Feb1999.pdf) (hereafter: "*Goetz v. Burundi*").

[11] *Feldman v Mexico*, Case No. ARB(AF)/99/1, Award of 16 December 2002 (available at www.investmentclaims.com/decisions/Feldman-Mexico-Award-16Dec2002-Eng.pdf) (hereafter "*Feldman v Mexico*")

[12] *Occidental v Ecuador*, London Court of International Arbitration case UN 3467 Award 1 July 2004 (available at www.investmentclaims.com/decisions/Encana_Equador_Award.pdf) (hereafter "*Occidental v. Ecuador*")

[13] Footnote 59 is attached to Item (e) of the Illustrative List of Export Subsidies in Annex I to the SCM Agreement. It states in relevant part that: "The Members reaffirm the principle that prices for goods in transactions between exporting enterprises and foreign buyers under their or under the same control should for tax purposes be the prices which would be charged between independent enterprises acting at arm's length. Any Member may draw the attention of another Member to administrative or other practices which may contravene this principle and which result in a significant saving of direct taxes in export transactions. In such circumstances the Members shall normally attempt to resolve their differences using the facilities of existing bilateral tax treaties or other specific international mechanisms, without prejudice to the rights and obligations of Members under GATT 1994, including the right of consultation created in the preceding sentence."

> "[t]he European Communities is complaining about the FSC scheme because it results in export subsidies, not as an aberrant tax practice. It is not complaining that the right of European Communities Member States to tax is being impaired or that the income of European Communities persons is being doubly or unfairly taxed. It is rather complaining that the United States is *exempting* income from the export of United States goods from tax that it would normally collect. The European Communities is also complaining that the availability of special administrative pricing rules for the FSCs compounds the export subsidy and, since it is only available on the export of United States goods, can also be considered an export subsidy. However the European Communities is not complaining about availability of special administrative pricing rules *as such*, only their effect as an export subsidy. That is why the European Communities brings its complaint to this Panel and not to a tax forum. A tax forum might be more appropriate if the United States were to apply the special administrative pricing rules of the FSC scheme to all transactions between related enterprises, including domestic and import transactions, and not just to transactions involving the export of United States goods. However that is not the case. Since the European Communities is complaining about an export subsidy, the WTO is the appropriate forum."[14]

In summary it can thus be said that while investment treaties were not meant to create rights for foreign investors (and obligations upon states) in terms of taxation and tax calculation specifically, they do provide in certain rights and standards for *all kinds of treatment* by the host state of *foreign investment*. Whether this treatment is associated with business permits and licenses, environmental policy, price regulations, physical security, intellectual property protection, access to raw materials and fuel, or with taxation and tax administration, does not matter (as long as none of these subject matters is explicitly excluded from the protection of the treaty). Along the same lines as the reasoning of the EC reproduced above, an investor cannot use the investment treaty to complain about a tax measure *as such*, but only in the context of a violation of a right under the investment treaty. The investment treaty only offers protection in accordance with its own provisions. By the same token, a dispute on the interpretation and application of a provision in the tax code will be subject to the jurisdiction of the host state's courts only, unless a rule in the investment treaty was violated as well.

Investment treaties with a general exclusion for tax matters

Treaty practice shows that most investment treaties to some extent or another exclude taxation from the subject matter[15]. Some investment treaties contain an explicit exception for tax matters with regard to the *whole treaty*[16]. This is for example the case in the ASEAN Investment Treaty where it is provided that:

> "The provisions of this agreement shall not apply to matters of taxation in the territory of each Contracting Parties. Such matters shall be governed by any Avoidance of Double Taxation Treaty between the Contracting Parties and the domestic tax law of each Contracting Party"[17]

What is the exact effect of this general exclusion for the protection of investors? Does it mean that the host state is free to flaunt every obligation of the treaty, discriminate and even expropriate foreign investors as long as the method used is taxation and tax administration? Does it mean that foreign investors may be treated grossly unfair and unreasonable as long as it happens with something that is related to taxation?

---

[14] *United States – Tax Treatment for Foreign Sales Corporations*, Panel Report, 4.106

[15] UNCTAD Series on Issues in International Investment Agreements, "Taxation", Geneva, 2000, p. 77

[16] In most treaties, exceptions are included as a part of the provision on national treatment or most favored nation treatment. This is for example the case in art. 5 of the French Model BIT where it is provided that: "Les dispositions de cet Article ne s'appliquent pas aux questions fiscals". ("The provisions of this article does not apply to tax issues"). Art. 5 contains the national treatment and the most favored nation treatment of foreign investments.

[17] ASEAN Agreement for the Protection of Investments, art. V.

To discover the meaning and effect of this general exclusion, the terms "matters of taxation" must be understood. The rules on the interpretation of treaties are well established in international law and were codified in the Vienna Convention on the Law of Treaties[18]. The general rule on interpretation requires that 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. It is furthermore required to take into account "any relevant rules of international law applicable in the relations between the parties"[19].

As to the "ordinary meaning" of "taxation", most investment treaties do not offer an actual definition. Incidentally, neither do tax treaties[20]. There seems to be international consensus that in order to be a tax the sum that is due (1) must be made for something other than a particular benefit (service, right or performance) (2) to a public body (3) for the general purpose of raising revenue and (4) based on a generally defined liability in law or regulations[21]. One could thus say that a "matter of taxation" is a matter where an investor is subjected to such generally defined liability (the tax law) in order to raise revenue for the host state or for a public body for something other than a particular benefit or service.

Knowing what a "matter of taxation" is does not resolve the question. As was mentioned above, the heart of the matter is that certain issues of taxation are *also* issues of international investment law. In that context, two interpretations of the exclusion for "matters of taxation" can be put forward. The first one ("restrictive") reads "matters of taxation" as "matters that are only matters of taxation". This would refer to "*pure*" matters of taxation, where matters and disputes on the interpretation and application of the host state tax laws (and tax treaties) *as such* are excluded from the scope of the investment treaty. Then, the exclusion for "matters of taxation" has in fact a limited effect on the application of the treaty to tax-related investment matters. Without contradicting the ordinary meaning of the terms, "matters of taxation" could namely be taken to mean just that, *a purely the process of subjecting something to tax*. The exclusion means that the host state remains free in terms of tax policy, to create a new tax or to change tax rates regardless of the rights guaranteed to foreign investors under the investment treaty. When "matters of taxation" are excluded from the article on national treatment, for example, the host state is free to impose higher taxes for foreign investors than for national investors[22]. However, when another source of law *besides* the tax code of the host state enters into play, the issue is no longer considered *only* "a matter of taxation". That would for instance be the case when a foreign investor is denied an appeal against an arbitrary tax assessment. Such a treatment may very well be a "matter of taxation" because it concerns a tax assessment, but it is *also* a possible denial of justice that constitutes a breach of the minimum standard of treatment of aliens (and foreign investors)[23] and a breach of international human rights[24].

This restrictive interpretation is maybe supported by the object and purpose of investment treaties, and by the obligation to give treaties their full effect. If the general exclusion for tax matters is not explained restrictively, one could argue, some other provisions of the treaty would become meaningless, such as the provision on expropriation. The possibility of expropriation through taxation is well established in international law as will be seen in detail below, and the treaty must be interpreted in accordance with international law rather than contrary to it. If "expropriation by means of taxation" is regarded as a "matter of taxation" rather than a matter of expropriation an the investment treaty with a general exclusion for taxation would in fact *reduce* the protection of foreign investors instead of *increasing* it, which is certainly the object and purpose of any investment treaty.

[18] Art 31-33 Vienna Convention on the Law of Treaties
[19] Art. 31 (3) c) Vienna Convention on the Law of Treaties
[20] OECD Model Tax Convention on Income and Capital, Commentary on art. 2, 3
[21] Vogel, K., On Double Taxation Conventions, Kluwer, p. 147
[22] Such would probably be forbidden under the non-discrimination provision of Double Taxation Agreements as least insofar the discrimination is based on nationality rather than residence (art. 24 OECD Model DTA)
[23] On this issue, see below
[24] Namely of the "right to a fair trial" in art. 8, 10 and 11 of the Universal Declaration of Human Rights; See, on this subject, Weissberodt, D., The Right to a Fair Trial, Martinus Nijhoff Publ., 2001.

Surely, the treaty must be interpreted in a way that gives real meaning and effect to what the parties agreed[25].

Another argument in favor of the restrictive interpretation could be that investment treaties (also the ones with the exclusion for "tax matters") will often state that obligations of international law existing at the time of concluding the treaty or established (between the parties) after that, will prevail over anything in the treaty if it is more favorable for the foreign investor. This is for example provided in the German Model BIT which reads:

> "If the legislation of either Contracting State or obligations under international law existing at present or established hereafter between the Contracting States in addition to this Treaty contain a regulation, whether general or specific, entitling investments by investors of the other Contracting State to a treatment more favourable than is provided for by this Treaty, such regulation shall to the extent that it is more favourable prevail over this Treaty." [26]

This would also apply to obligations in customary international law such as the minimum standard of treatment of aliens and denial of justice. As will be seen below, the minimum standard and denial of justice are comprised in "fair and equitable treatment" and the minimum standard in customary international law does not seem to contain a general exception for tax matters. Therefore, the question could be raised if a provision in the treaty that makes an exception for "tax matters" on the "fair and equitable treatment" standard might be rendered inoperative because of the provision in the treaty that ensures that a more favorable treatment under other international obligations shall prevail.

Finally, exceptions for "tax matters" may also be rendered inoperative by the working of a most favored nation-clause in case the host state did allow "tax matters" to be covered in treaties with other states.

On the other hand, the exclusion for tax matters may be interpreted in a wider sense, a sense that extends the effect of the exclusion. One could argue that not only "pure" tax matters are excluded, but also possible violations of the investment treaty's core standards of protection when these violations consist out of subjecting an investor to tax. One argument in favor of this interpretation is that an investment treaty contains mostly obligations upon the host state to respect certain standards of treatment, and therefore an exception of "taxation" must be seen in the context of those standards of treatment. In other words, it makes no sense to provide in an exception for taxation from these standards that would not have the effect of excluding tax-related matters that would otherwise fall under the scope of the standards. Put yet another way, the tax exclusion was put there in relation to investment protection so it must be interpreted as indeed removing that protection, even for tax matters that also fall under the scope of the investment protection. What would otherwise be the purpose of the exclusion?

Occidental v. Ecuador and *Encana v. Ecuador*

The issue of exclusions for "matters of taxation" was at the center of the deliberations of the arbitration Tribunal in *Occidental v. Ecuador*[27]. In that case, Ecuador refused to refund the investor excess VAT, claiming that the participation of the investor in the oil revenue (as agreed in the investment contract between Occidental and Ecuador) already included that refund. The article of the US-Ecuador BIT on dispute settlement did not allow "matters of taxation" besides expropriation,

[25] *EnCana v Ecuador*, (Separate Partial Dissenting Opinion), 3 February 2006, by H.A. Grigera Naon (available at www.investmentclaims.com/decisions/Encana_Equador_Partial_Dissent.pdf) (hereafter "*Encana v Ecuador Separate Opinion*")
[26] German Model BIT, art. 8 par 1. See also art. 3 par 5 of The Netherlands Model BIT
[27] *Occidental v Ecuador*, par. 64 et seq.

transfers and observance of investment contracts to be subjected to international arbitration[28]. Based on that exclusion, Ecuador argued that the arbitration Tribunal did not have jurisdiction. Both the Tribunal itself and the British court that was asked by Ecuador to annul the award afterwards needed to interpret the terms "matters of taxation" and its effect on the jurisdiction of the Tribunal. Both took the position that the issue in this case is not whether under Ecuador tax law the investor would normally have the right to the VAT refund, (there was no doubt about that), but whether the investment contract had been breached by the refusal of refunding the VAT[29].

It should be noted, however, that in a decision on a similar set of facts (but different treaty), *Encana v. Ecuador*, the Tribunal came to a different conclusion, which was explained as follows:

> "In this respect there are significant differences between the BIT applicable in the present case and that which fell to be applied by the Tribunal in Occidental. The United States Ecuador BIT, Art. X also contains a taxation exemption it is in different terms to Art. XII of the Canada Ecuador BIT; in particular, Art. X(2)(c) of the United States-Ecuador BIT allows claims relating to taxation provided they are claims with respect to "the observance and enforcement of terms of an investment Agreement". Moreover under Art. VI(1) of the US Ecuador BIT, jurisdiction is conferred on arbitral tribunals in relation to "investment disputes between a Party and a national or company of the other Party" which arise out of or relate, *inter alia*, to "an investment agreement between that Party and such national or company". In Occidental, although the claimant had not invoked any claims of breach of contract or relied on contract-based rights as such (Occidental Award, $546, 72) the Tribunal held that "because of the relationship of the dispute with the observance and enforcement of the investment Contract involved in this case, it has jurisdiction to consider the dispute in connection with the merits insofar as a tax matter covered by Article X may be concerned""[30]

It must be noted, however, that in *Encana v. Ecuador* the foreign investor had ample possibility to fight the tax authorities' refusal to refund the VAT in the Ecuadorian courts and when the investor did so and won, the tax was refunded immediately. There was thus no denial of justice in the view of the Tribunal. Moreover, the Award was decided two against one and the dissenting Arbitrator did find the Tribunal to have the necessary jurisdiction[31].

It is difficult at this stage to draw real conclusions from the *Occidental* and *Encana* cases for the interpretation of exclusions for tax matters in investment treaties. The interplay with contractual rights of the investor is one of the complicating factors in this regard. The different outcome of both cases illustrates the need for clarification of the issue.

III. Fair and Equitable Treatment in Tax Matters

1. <u>General remarks</u>

Almost every investment treaty provides that the host state must accord to foreign investment by investors from the other state "fair and equitable treatment". Often the provision reads:

> "Each Contracting State shall in its territory in any case accord investments by investors of the other Contracting State fair and equitable treatment as well as full protection under the Treaty"[32]

[28] BIT US-Ecuador 27 August 1993, Art X
[29] *Occidental v Ecuador*, par. 68 et seq.; *Republic of Ecuador v Occidental Exploration and Production Co* [2006] EWHC 345, Aikens J.
[30] *Encana v. Ecuador*, footnote 119
[31] *Encana v Ecuador* Separate Opinion par. 24
[32] Germany Model BIT art 2 par. 2.

Many differences in formulation exist in treaty practice. The fair and equitable standard is often complemented by an additional provision, although it is not certain if the addition is not already covered by "fair and equitable treatment". This addition often reads:

> "Neither contracting state shall in any way impair by arbitrary or discriminatory measures the management, maintenance, use or enjoyment of investments in its territory of nationals of the other Contracting Party"[33]

The "fair and equitable treatment" standard is adopted in virtually all investment treaties. Certain treaties also offer some specifics on the content of the standard[34]. It is also mentioned in several multilateral instruments or guidelines[35].

2. "Fair and equitable treatment" and the international minimum standard

There is much authority to associate "fair and equitable treatment" with the so-called international minimum standard for the treatment of aliens and their property, which is a dynamic set of rules formed in customary international law and which is thus binding on all nations. The "minimum standard" includes mostly rules on standards of justice ("denial of justice" and "due process")[36], treatment of aliens in detention[37] and reasonable measures of protection and security for life and property of aliens[38].

It is important to note that "fair and equitable treatment" is in any event an international standard, independent of the treatment by the host state of an investment of its own nationals or their investments. In other words, the fact that nationals are treated "just as unfairly" is no defense when the host state violates the "fair and equitable treatment" provision with respect to foreign investment.

Based on an analysis of the international case law on the subject, the OECD Working Paper includes the following elements that are encompassed in the "fair and equitable treatment" standard[39]:

- Vigilance and protection (due diligence)
- Due process and prohibition of arbitrariness;
- Prohibition of denial of justice
- Transparency
- Good faith and legitimate expectations

3. Due diligence in tax matters

Usually referred to as vigilance and protection, this obligation is an element of "fair and equitable treatment". It often applies to physical security, seizures and the acts of the state's police and security forces but in fact is extended to all powers of persons acting under the authority of the state.

---

[33] Netherlands Model BIT art. 3 par 1.
[34] US Model BIT, art. 5 par 2; US-Australia Free Trade Agreement signed on March 1, 2004; Art 909 Australia-Thailand Free Trade Agreement signed on October 19, 2003, see text of the Agreement on http://www.dfat.gov.au/trade/negotiations/aust-thai/aust-thai_fta.pdf.
[35] 1992 World Bank Guidelines on Treatment of Foreign Direct Investment stipulate for example in their article III(2) "each State will extend to investments established in its territory by nationals of any other State fair and equitable treatment according to the standards recommended in the Guidelines"; Article 12 (d) *1985 Convention establishing the Multilateral Investment Guarantee Agency (MIGA);* Article 1105 (1) of the NAFTA.
[36] US and Mexico General Claims Commission, *Janes* Claim, United Nations, Reports of International Arbitral Awards, 1926, IV, p.82.); see also below
[37] US and Mexico General Claims Commission, *Harry Roberts Claim*, United Nations, *Reports of International Arbitral Awards,* 1927, IV, 77)
[38] G.Sacerdoti, "Bilateral Treaties and Multilateral Instruments on Investment Protection", *Recueil des Cours*, Tome 269, 1997, p.347)
[39] OECD Working Papers on International Investment, Fair and Equitable Treatment Standard in International Investment Law, Paris, September 2004, p. 26

The obligation is for the state to control its functions, the measures taken by officials so that illegal treatment does not occur. The state is not liable to prevent all violations, but it must take reasonable measures to prevent and remedy violations. When agents of a state enterprise illegally seized two hotels in Egypt, for example, in the context of a dispute between that enterprise and the foreign investor who owned the hotels, the Tribunal found that Egypt had violated its duty to extend fair and equitable treatment, namely due diligence and vigilance. The government knew that the agents of the state enterprise were about to illegally seize the hotels and did nothing to prevent it. And once the seizure was a fact, Egypt did nothing to remedy the situation, the Tribunal considered[40].

In tax matters seizures and other measures of pressure or collection are often applied when taxpayers do not (timely) pay the tax debt. The question is thus raised to which extent the duty of due diligence applies in these cases. As long as the host state's tax collection measures are legal under the law of the host state *and* do not violate international law (including fair and equitable treatment, national treatment under investment treaties, etc.) it seems that they cannot lead to a violation of the duty to due diligence on the host state. But if the seizure measures applied are illegal under the host state's domestic law, or when the measures violate international law, then the host state has the duty to take reasonable measures to prevent them or, if they already were taken, to remedy the situation. It seems that this is not an absolute duty, so it must for example be shown that the host state knew about the measures and could have prevented them. A more fundamental question is exactly when the host state's collection measures may be deemed to violate international investment law. Is it possible to deduce practical rules from the various sources of international law in this respect? For the moment, this is an open question. The issue of collection or recovery measures will be revisited below with respect to expropriation.

4. <u>Denial of justice in tax matters</u>

The principle of "denial of justice" is deemed a part of customary international law and is thus binding upon all nations[41]. In its narrow sense, which is used here, "denial of justice" refers to access to courts and to wrongdoing by courts both in terms of procedure and in terms of substantive justice. Foreigners and thus also foreign investors must be given a fair judicial treatment. A fair and independent court can squash unlawful governmental measures and thus remedy a state measure that would otherwise be a violation of international law. That is why tax assessments which are unlawful under domestic law are not (yet) violations of international law. The host state's judicial infrastructure must be allowed to perform its normal function, which does by the way not necessarily mean that a foreign investor is barred from the arbitration procedure under the investment treaty until domestic legal proceedings are finalized.

The problem becomes one of "denial of justice" if the correcting function of a fair domestic legal proceeding does not occur. However, international arbitration tribunals are not appellate courts for domestic judicial decisions that foreigners do not agree with. Even an "error" by a domestic court – supposing one would later establish that the decision was indeed erroneous- does not necessarily constitute a denial of justice under international law[42]. The error must be of such a significance, or the procedures applied so unusual and unfair that it puts into question the legitimacy of the whole proceeding.

In the words of the Arbitral Tribunal of the *Azzinian v Mexico*[43], denial of justice in the strict sense would occur when:

---

[40] *Wena Hotels Ltd. (U.K.) v. Arab Republic of Egypt*, ICSID Case No ARB/98/4 (Award) (Dec. 8, 2000), [*annulment denied]* reprinted in 41 I.L.M. 896 (2002).
[41] *F.V. García-Amador et Al.*, Recent Codification of the Law of State Responsibility for Injuries to Aliens (180) 1974
[42] *Encana v Ecuador*, par. 194-196
[43] *Azzinian v Mexico*, ICSID ARB(AF) 97/2, par 102-103 (available at www.investmentclaims.com/decisions/Azinian-Mexico-Award-1Nov1999-Eng.pdf) (hereafter "*Azinian v. Mexico*")

- the relevant courts refuse to entertain a suit; or
- they subject it to undue delay; or
- they administer justice in a seriously inadequate way; or
- there was a clear and malicious misapplication of the law.

In another relevant investment case, *Mondev v USA*, denial of justice was seen as follows:

> "The test is not whether a particular result is surprising, but whether the shock or surprise occasioned to an impartial tribunal leads, on reflection, to justified concerns as to the judicial propriety of the outcome, bearing in mind on the one hand that international tribunals are not courts of appeal, and on the other hand that Chapter 11 of NAFTA (like other treaties for the protection of investments) is intended to provide a real measure of protection. In the end the question is whether, at an international level and having regard to generally accepted standards of the administration of justice, a tribunal can conclude in the light of all the available facts that the impugned decision was clearly improper and discreditable, with the result that the investment has been subjected to unfair and inequitable treatment. This is admittedly a somewhat open-ended standard, but it may be that in practice no more precise formula can be offered to cover the range of possibilities"[44]

The implications of "denial of justice" as an element of the "fair and equitable treatment" standard are important for matters involving tax disputes. The following examples can illustrate this:

Review by courts in tax matters

The absence of an administrative appeal or independent judicial review is clearly very problematic in terms of denial of justice. Even if nationals of the host state also have no access to appeal or judicial review, it seems likely that a Tribunal will find that international law is breached. In the absence of independent review, the taxpayer is always at the mercy of the authorities.

In international law, the notions of a denial of justice and of a "fair trial" are relatively developed. The appeal or independent judicial review must be of such a nature that it can deliver justice to the investor. More precisely, the proceedings must be in accordance with the requirements of the international minimum standard in all respects. This means that fundamental rights as fairness, right to a defense, rule of law, good faith and proper rules of procedure must be respected. A "rubber-stamp" review that agrees with the authorities regardless of the merits of the case can certainly not fulfill that requirement.

The appeal or review must be timely so that the process does not become meaningless. It is difficult to prescribe exact time limits in this regard as much will have to depend on the facts and the circumstances of each case.

With respect to tax matters, various issues are raised when it comes to the international obligation to provide the taxpayer with a "fair trial". Most states have administrative phases of dispute settlement, where the taxpayer's protest is decided by a government official and not by an independent judge. Sometimes, there is only the administrative procedure for certain types of taxes. The question can be raised if that in itself constitutes a denial of justice. The same can be asked for stringent conditions and restrictions to have access to independent legal proceedings in tax cases, such as short time periods for filing a request or high expenses.

Although many states provide that an appeal or a review does not suspend the obligation to pay the tax that is in dispute, such a measure may easily lead to situations where the taxpayer has no real chance to defend himself, so that there could be a denial of justice. This could be the case with an

[44] *Mondev International LTD v. United States of America*, ICSID Case No. ARB(AF)/99/2, par 64 65.

arbitrary and extremely high tax assessment that is vigorously disputed by the taxpayer. But, since the tax in dispute must be paid even in case of appeal or review, for a high tax claim the taxpayer may go bankrupt even before winning the appeal or the review.

Practical and economical circumstances can also raise questions of denial of justice in tax cases. When disputing import duties, for example, in case an investor does not have the right to import goods and pay duties while reserving his right to protest the assessment after customs clearance, one could argue that the investor does not really has access to a fair and independent legal proceeding. Commercial and financial considerations will prevent most investors from leaving the goods in the customs depot to await the outcome of a lengthy court battle.

Grossly unjust decisions by tax courts

When tax courts find in favor of the tax authorities in domestic tax disputes, there may be a denial of justice under international law if the decision was “shocking to the sense of legal property” or “clearly improper” against the backdrop of the administration of justice.

As was said above, it does not suffice that the domestic tax court came to the wrong conclusion. That is not a claim which can be entertained before an international tribunal, which does not sit in the capacity of appellate court to the host state’s tax courts. In other words, the tax courts in the host state may come to the wrong decision without this in itself being a denial of justice under international law[45]. For international law to be breached in this respect, the host state tax court must have willfully ignored the law, applied rules of procedure which are clearly dishonest to the investor or administer justice so slow that the process becomes meaningless to the investor. “Dishonest rules of procedure” could include review by a judge that is not impartial and independent and unequal rules on evidence. An undue influence by the government on the decision by the court would probably also amount to a denial of justice.

5. Due process and arbitrariness in tax matters

General remarks

The “fair and equitable treatment” standard is often interpreted to include respect for due process and to prohibit arbitrariness. Moreover, many investment treaties include an obligation on the host state forbidding certain unreasonable, discriminatory of arbitrary measures[46].

In its wider sense, “denial of justice” applies to actions by all the branches of the state and the executive, including the tax authorities and customs[47]. It has often been applied by international courts and tribunals, sometimes in relation to “arbitrariness” which is mentioned in provisions of many investment treaties[48].

The decision of the International Court of Justice in the ELSI case is in this regard of particular note. In that decision, the Chamber offered a definition of what is arbitrary:

[45] *Encana v Ecuador*, par. 194-196
[46] See for example Netherlands Model BIT art. 3.1
[47] *H. Accioly in Recueil des Cours (1959)* p. 379; Hackworth, Digest of International Law ; A. Freeman shares the same view in « The International Responsibility of States for Denial of Justice » (1938)
[48] *Alex Genin, Eastern Credit Limited, Inc. and A.S. Baltoil Genin v. Republic of Estonia,* ICSID Case no ARB/99/2 , 25 June 2001

> "Arbitrariness is not so much something opposed to a rule of law, as something opposed to the rule of law…It is a willful disregard of due process of law, an act which shocks, or at least surprises, a sense of judicial propriety"[49].

The *Waste Management v. Mexico* case also offers an interesting analysis of the content of "fair and equitable treatment" with respect to due process:

> "Taken together, the S.D. Myers, Mondev, ADF and Loewen cases suggest that the minimum standard of treatment of fair and equitable treatment is infringed by conduct attributable to the State and harmful to the claimant if the conduct is arbitrary, grossly unfair, unjust or indiosyncratic, is discriminatory and exposes the claimant to sectional or racial prejudice, or involves a lack of due process leading to an outcome which offends judicial propriety –as might be the case with a manifest failure of natural justice in judicial proceedings or a complete lack of transparency and candour in an administrative process. In applying the standard it is relevant that the treatment is in breach of representations made by the host State which were reasonably relied on by the claimant"[50]

The Tribunal in the *Occidental v. Ecuador* case also offers interesting considerations in this regard[51]:

> "Although fair and equitable treatment is not defined in the treaty, the Preamble clearly records the agreement of the Parties that "such treatment is desirable in order to maintain a stable framework for investment and maximum effective utilization of economic resources". The stability of the legal and business framework is thus an essential element of fair and equitable treatment. The Tribunal must note in this context that the framework under which the investment was made and operates has been changed in an important manner by the actions adopted by the [tax authorities]. … The tax law was changed without providing any clarity about its meaning and extent and the practice and regulations were also inconsistent with such changes. Various Arbitral Tribunals have recently insisted on the need for this stability. The Tribunal in Metalclad held that the Respondent 'failed to ensure a transparent and predictable framework for Metalclad's planning an investment. The totality of these circumstances demonstrate a lack of orderly process and timely disposition in relation to an investor of a Party acting that it would be treated fairly and justly'."

A denial of justice, arbitrariness and infraction on due process are not the same as unlawfulness under domestic law. A regulation that is unlawful under the domestic law of the host state of an investment is not necessarily "arbitrary" or "a denial of justice"[52].

Due process in tax administration

The domestic legal systems of many states have developed notions of "due process" or "principes de bonne administration" which have been applied to tax matters. Those domestic laws or doctrines may in some ways actually have the same operational contents as the international concept of due process.

In tax matters, the issue of due process and arbitrariness will mostly be raised in cases where the tax authorities have an explicit or implicit discretion under the tax laws and regulations. This discretion can relate to the granting (or refusing) of privileges such as tax holidays, reductions and credit and delay of payment. It can also relate to investigation and enforcement such as audits, tax recovery measures and measures to obtain information. As opposed to the domestic laws and doctrines, due process of tax administration matters has not been much examined in international law. Some further

---

[49] *Elettronica Sicula S.p.A. (ELSI) (United States of America v. Italy)*, ICJ Reports, 1989, p. 15, par. 128
[50] *Waste Management, Inc. v. The United Mexican States*, ICSID Case No. ARB(AF)/00/3
[51] *Occidental v. Ecuador* par. 184 et seq.
[52] *ELSI USA v Italy*, loc cit, par. 128

study of international[53] and national[54] sources may result in a clearer understanding of the obligations of states on tax proceedings.

Due process of a tax re-assessment

How does the requirement of due process affect the tax reassessment process? Errors may happen and in every state and a tax re-assessment always involves some degree of discretion for the tax officials that carry out the audit. The question can be raised if the requirement of due process means that a re-assessment measure must be justified with objective arguments in law and in fact. Given that a taxpayer must be able to defend his case, a re-assessment that is completely unmotivated will be difficult to maintain in view of the requirement of due process and the prohibition of arbitrariness.

When tax authorities carry out re-assessments based on factual data such as prices, values or margins, ideally the relevance (the reasonable relationship with the taxpayer's case) of that data should be clearly demonstrated. In many states, the data should also be made available to the taxpayer for review. The question remains how this would be regarded from the perspective of international law. Tax re-assessments based on "secret comparables" in transfer pricing cases, for example, is troublesome from the perspective of the standard of "fair and equitable treatment"[55], because it is for the taxpayer simply impossible to argue against evidence he is not aware of.

Also, it seems likely that the taxpayer must be given proper notice in writing of the re-assessment procedure and of the points of view of the tax authorities so he can offer alternative explanations or arguments to the contrary. A re-assessment that is completed without hearing some way or another the taxpayer may easily be seen as contrary to due process.

The finality of the process is also an issue. Once an audit is completed and the re-assessment is issued, are tax authorities prevented from revisiting the same tax years of the same taxpayer to find new issues or grounds for re-assessments, unless newly acquired information (for example from cross-checking with other taxpayers) has come up? Or may audits be done and redone without limitation from the perspective of international law?

None of these failures in terms of due process or arbitrariness necessarily leads to a violation by the host state of the "fair and equitable treatment" provision in an investment treaty. The host state may have domestic measures in place to remedy the situation, such as an administrative appeal or a judicial review. Unless those appeals or reviews are carried out in a way that denies justice, the host state is not internationally liable under an investment treaty.

Answers by tax authorities on questions about the interpretation or application of the tax law

Many countries provide in the possibility for rulings on the interpretation of the tax law, and in "advance pricing agreements" on transfer pricing cases. In some national legal systems, there are some uncertainties as to the legal status and binding effect of such rulings and arrangements. It would be interesting to explore this question from the perspective of international investment law. It seems likely that the principle of due process and the prohibition of arbitrariness implies that when tax authorities answer a request from a foreign investor about the tax treatment of their investment, the given answer should bind the tax authorities. This should be the case even when it turns out that the answer was in fact incorrect.

[53] For example the International Covenant on Civil and Political Rights, art. 14 (due process).
[54] It would be instructive to verify which rights have been recognized by most states in the administration of justice in tax cases. OECD on Taxpayer's rights
[55] Transfer Pricing Guidelines for Tax Administrations and Multinational Enterprises, OECD Paris

In the *Occidental v. Ecuador* case, the Tribunal emphasized that the ruling the foreign investor had requested from the tax authorities was answered “wholly unsatisfactory and thoroughly vague” and this was one of the elements the Tribunal based itself on to find in favor of the foreign investor[56].

Refusal or undue delay by tax authorities to register a taxpayer

Tax systems usually operate by means of identifying and registering those who are subject to its operation. Often, registration does not only create liabilities but also benefits for taxpayers such as entitlement to refunds of tax that was paid or withheld at source in excess of what will be finally due by the taxpayer. In such a case, tax authorities may delay the refund of excess taxes by refusing or delaying the registration of taxpayers.

This may constitute a violation of the ”fair and equitable treatment” standard which requires due process and good faith on the part of entities of the host state, or the “national treatment” standard in case national investors are in fact being registered less cumbersome[57].

6. Transparency in tax matters

There is reference to “transparency” in instruments of international trade law[58] and many investment treaties impose an obligation upon the host state to publish or make otherwise available the laws and regulations that relate to foreign investment[59]. The US Model BIT provides for example that:

> “Each Party shall ensure that its:
>
> (a) laws, regulations, procedures, and administrative rulings of general application; and
>
> (b) adjudicatory decisions
>
> respecting any matter covered by this Treaty are promptly published or otherwise made publicly available”[60].

There are a few recent international decisions that associate “fair and equitable treatment” with transparency of the host state’s legislation and regulation. In other words, the host state is held to be in violation of the requirement of “fair and equitable treatment” in case the regulations or procedures that cause injury to the foreign investor were not transparent.

In *Metalclad Corporation v. United Mexican States* (see paragraphs 66-69), the Tribunal found that the absence of a clear rule concerning construction permits requirements in Mexico, had “*failed to ensure a transparent and predictable framework for Metalclad’s planning an investment”*[61]. It decided that this failure of the part of Mexico to ensure the transparency required by NAFTA –in its Article 1802 on transparency—was a breach of fair and equitable treatment under Article 1105.

A similar mention is reported by the OECD Working Paper outside of the scope of NAFTA. In the *Maffezini case*, the Tribunal held that:

> “….because the acts of SODIGA (public company) relating to the loan cannot be considered commercial in nature and involve its public functions, responsibility for them should be

[56] *Occidental v Ecuador*, par. 184

[57] *Feldman v Mexico* par. 175 “The evidence also shows that CEMSA was denied registration as an export trading company, apparently in part because this action was filed, and in part as a result of the ongoing audit of the rebates for exports during 1996 and 1997, even though, as Mr. Diaz Guzman indicated, three other cigarette export trading companies had been granted registration”

[58] See for example art 63 of TRIPS and art. III of GATS

[59] NAFTA art. 1802; See for an overview UNCTAD IIA Series Transparency

[60] US Model BIT, art. 10 par. 1

[61] *Metalclad Corporation v. United Mexican States,* par 101

attributed to the Kingdom of Spain. In particular, these acts amounted to a breach by Spain of its obligation to protect the investment as provided for in Article 3(1) of the Argentine- Spain Bilateral Investment Treaty. Moreover, the lack of transparency with which this loan transaction was conducted is incompatible with Spain's commitment to ensure the investor a fair and equitable treatment in accordance with Article 4(1) of the same treaty. Accordingly, the Tribunal finds that, with regard to this contention, the Claimant has substantiated his claim and is entitled to compensation…".

It is however difficult to deduce hard and fast rules from these decisions with respect to all investment disputes, especially with respect to tax matters, which are often seen as inherently complicated and difficult to understand. Many uncertainties remain. What is the consequence when a state failed to meet its general obligation to publish laws and regulations? Is this (always) a violation of the "fair and equitable treatment" standard? Or (only) a violation of the provision on the publication of laws and regulations itself? In the latter case, how is the state liable towards investors? What if the state – a least developed country for example- lacks the resources to fulfill its obligations? Although strictly speaking the dispute settlement mechanism of the investment treaty may very well apply to each and every obligation in the treaty, including the one on transparency, it is difficult to imagine a violation of such obligation on transparency that is not also a violation of "fair and equitable treatment" as well. How can foreign investors defend themselves in disputes with the host state if relevant regulations are not made known? So, perhaps an explicit requirement on transparency will mostly serve to emphasize that it is the duty of the host state to provide clarity (publicly and on a case by case basis) on the interpretation and application of tax laws, regulations and procedures.

An obligation to publish investment-related laws, regulations etc. will most likely apply to taxation as well as "pure" investment laws and regulations if one takes the position that taxation is included in "the treatment of investment". Taxation may certainly "affect the investments of investors" in the sense of that provision and thus tax laws, regulations, procedures as well as rulings and decisions must be made known.

7. Good faith and legitimate expectations of investors

The fair and equitable treatment standard is taken to include the obligation of good faith on the host state[62]. One can scarcely find a principle more fundamental to the law of treaties than the requirement of observing treaty obligations in good faith. Not only is "good faith" mentioned five times in the Vienna Convention on the Law of Treaties[63], and enshrined in the UN Charter[64], it has repeatedly been invoked and acknowledged by international courts[65] to say nothing of the international literature dedicated to this topic[66]. The principle of good faith has been associated with the respect for

[62] OECD Working Papers on International Investment, Fair and Equitable Treatment Standard in International Investment Law, Paris, September 2004, p. 26

[63] Preamble, art. 26 (*pacta sunt servanda*), art. 31 (general rules of interpretation), art. 41 (provisions of internal law) and art. 69 (consequences of invalidity).

[64] Art. 2 par 2 Charter of the United Nations

[65] Including in *Treatment of Polish Nationals case*, PCIJ 1932 A/B, n. 44, p. 28.; *Minority Schools in Albania case*, PCIJ, 1935 A/B, n. 64, p. 19-20.; *Rights of Foreign Nationals in Morocco case*, *ICJ Reports* 1952, p. 212.; *North Sea Continental Shelf cases*, 1969 ICJ Reports 3 p. 47 par. 85.; *Nuclear Tests cases*, 1974 *ICJ Reports* 253, p. 268 par. 46.; *WHO/Egypt Agreement Advisory Opinion*, 1980 *ICJ Reports* 73, p. 95-8 (par. 48-51).; *Military and Paramilitary Activities in and against Nicaragua case* (jurisdiction and admissibility) 1984 *ICJ Reports* 392, p. 418 par. 60.; *Border and Transborder Armed Actions Nicaragua-Honduras* (jurisdiction and admissibility) 1988 *ICJ Reports* 396, p. 69 par. 105

[66] Kolb R., La Bonne Foi en Droit International Public, PU France, 2000.; O'Connor Good Faith in International Law, Darmouth, 1991.; Rosenne, S., Developments in the Law of Treaties 1945-1986 (Chapter 3- Good faith in the codified law of treaties), Cambridge UP, p. 135-179.; Mani V.S. Basic Principles of Modern International Law, Lancers Books, 1993, p. 200-220.; Stuyt A.M., "Good faith and bad faith", *N.I.L.J.*, vol. 28, 1981.; Zoller, E., La Bonne Foi en Droit International Public, ed. A. Pedone, Paris, 1977.; Virally M., "Review Essay: Good faith in public international law", *AJIL*, 1983, p. 130-134

legitimate expectations of treaty partners[67]. This means in essence that there may be circumstances where one party may reasonably expect the other party will conduct itself in a certain manner.

In some investment law cases, international tribunals have referred to the legitimate expectations of foreign investors with respect to the policy of the host state[68]. Tribunals accept that investment decisions are made on certain basic expectations and assumptions. As a principle states remain free and sovereign to issue regulations which are not what investors may have hoped for. But there may be circumstances where it would be unreasonable for the host state not to respect the legitimate expectations of foreign investors.

This issue may play an important part when it comes to drastic changes in the tax policy of the host state, but it remains largely unexplored. Although the general rule remains that states are free to change the tax regime of foreign investors, it is clear that the principle of good faith protects the legitimate expectations of investors in specific circumstances. When a tax exemption for investments in a certain sector is installed by the government of the host state only to be cancelled just after a major investment has been completed, for example, the principle of legitimate expectations may come into play. More study is however needed on this issue.

---

[67] Tammes (Netherlands), GAOR, 20th session, 6th Cmtee, 974th mtg, p. 199 (referring to good faith and the expectations that parties make while drafting an instrument, as noted by Mani, V.S. Basic Principles of Modern International Law, Lancers Books, 1993, p. 205; *Fisheries Jurisdiction*, Judgment, *ICJ Reports*, 1973, p. 57-58, par. 22-23

[68] See for example *TECMED v Mexico* ICSID case No ARB(AF)/00/2 (Award) (May 29, 2003) par. 102; *Azurix v Argentina*, ICSID No. ARB/01/12, par 316

IV. National Treatment and Most Favored Nation Treatment in Tax Matters

1. Content of the obligations

General remarks

The standards of national treatment and most favored nation treatment are adopted in most investment treaties in one form or another. Its general purpose is to ensure that foreign investors are not treated less favorably than national investors or investors from other states. Specifications may be provided as to what type the subject matter the obligation applies to, or which sectors of business activity.

National treatment and most favored nation treatment are also central principles for agreements on the free trade in goods. The general most favored nation-obligation is a cornerstone of the WTO system[69]. GATT provides also in an obligation entitled "national treatment" not to subject imported goods to an "internal taxation" that is more burdensome than that for like domestic goods[70]. The origin and thus the working of "national treatment" in trade treaties is however different from the "national treatment" in investment treaties.

In essence, national treatment forbids (negative) discrimination. In that regard it is noteworthy that DTA's have their own rule on the subject entitled "non-discrimination" which reads as follows:

> "Nationals of a Contracting State shall not be subjected in the other Contracting State to any taxation or any requirement connected therewith, which is other or more burdensome than the taxation and connected requirements to which nationals of that other State in the same circumstances, in particular with respect to residence, are or may be subjected."[71]

Less favorable than who?

To verify whether the obligation on national treatment has been broken, a comparison must be made. The treatment of foreign investors must be compared with the treatment of national investors. In case of "most favored nation treatment", the comparison is made with the investments of nationals of third states. This is different from the "fair and equitable" standard which contains rules which are valid internationally and the host state must respect them, regardless of how the host state treats investments of its own nationals or those owned by nationals of third states.

The scope of protection that is available under "national treatment" and "most favored nation treatment" in an investment treaty depends on how the comparison is carried out. Who must the foreign investor be compared with? The narrower the scope of the comparison, the less likely one can prove discrimination. The scope can be quite wide if the contracting parties did not state who to compare with in the text of the treaty. Tax treaties usually state that the comparison must be made with a taxpayer "in the same circumstance", while investment treaties can contain various qualifications of the principle[72].

It may be that the investment treaties of the host state do not state such limitations. In this case the foreign investor must be compared with national or third state-investors in general. It extends to every matter that is relevant for the investment. All unequal treatment by reason of the nationality of the investor is forbidden under the treaty, as long as the treatment has a bearing on the investment.

---

[69] Art. I General Agreement on Tariffs and Trade
[70] Art. III General Agreement on Tariffs and Trade
[71] Art 24 (1) OECD Model DTA; The phrase "in particular with respect to residence" was added to make clear that a differential treatment based on residence is not prohibited under the provision.
[72] UNCTAD Issues on International Investment Agreements, National Treatment, 1999, New York and Geneva, p. 12

Examples in the treaty

Some investment treaties offer a few examples of matters that fall under the scope of this provision. The Protocol to the German Model BIT, for example, provides that

> "The following shall, in particular, be deemed "treatment less favourable within the meaning of Article 3; unequal treatment in the case of restrictions on the purchase of raw or auxiliary materials, of energy or fuel or of means of production or operation of any kind, unequal treatment in the case of impeding the marketing of products inside or outside the country, as well as any other measures having similar effects, Measures that have to be taken for reasons of public security and order, public health or morality shall not be deemed "treatment less favourable" within the meaning of Article 3."[73]

De facto discrimination

It is particularly noteworthy that "national treatment" and "most favored nation treatment" must be granted in fact as well as in law. It does not suffice to extend the same treatment to foreign investors in the written laws and regulations when in fact those laws and regulations are selectively applied or applied in such a manner that in fact only foreign investors (or the foreign investors of one state) are treated less favorably. International obligations are more a matter of actual effect than of theoretical compliance.

The "national treatment" and "most favored nation treatment" standards suggest that only discrimination which is based on the nationality of the foreign investor is forbidden. Therefore, it is normally required that the foreign investor proves that he is discriminated based on his *nationality*. On the other hand, when the discrimination is *de facto* discrimination in the application of laws that on the face of it appear to be non-discriminatory, international courts and tribunals will primarily examine if the actual effect is detrimental mostly or only to foreign investors or foreign investors of one state. In such cases, it may namely be impossible for a foreign investor to prove that a host state measure is motivated by the will to differentiate on the basis of nationality rather than on some seemingly objective criterion. It seems that Tribunals will often not expect the investor to prove the what is impossible to do[74].

Transparency

National treatment also has a bearing on transparency. If it is not clear how a host state treats foreign investors under its laws, regulations and administrative practices or decisions, how can be verified if the treatment extended to nationals is more favorable or not? This point is made in the UNCTAD publication on National Treatment as follows:

> "**Transparency.** A vital aspect of national treatment is to ensure that foreign investors are fully informed of the laws, regulations and administrative practices that apply to their operations. Such matters may be better known to domestic investors. It is implicit in the national treatment standard that such information imbalances be eliminated. Equally, transparency may require that exceptions to national treatment are clearly reported so that foreign investors are aware of them. This practice is followed, for example, under the OECD National Treatment instrument (OECD, 1993) and in the TRIMs Agreement (Article 6, UNCTAD, 1996, vol. I, p. 281)"[75].

2. **Content of the obligation of national treatment and most favored nation treatment in tax matters**

[73] German Model BIT Protocol ad art. 3 par a)
[74] *Feldman v Mexico*, excerpts from par 181-183
[75] UNCTAD Issues on International Investment Agreements, National Treatment, 1999, New York and Geneva, p. 60

Many investment treaties have exceptions for "national treatment" or for "most favored nation treatment" relating to taxation, which are discussed further below. For those instances where taxation is not excluded, or where the exclusion itself is not applicable, the question is raised how the national treatment and most favored nation treatment affect tax measures of the host state.

Discriminatory tax laws and regulations

Under general international law, it is debatable whether there is a prohibition for a state to tax foreigners more burdensome than nationals. One position is that as long as a sufficient lien exists in terms of jurisdiction, the state is based on its sovereignty allowed under international law to tax however it likes, including taxing foreigners less advantageous than nationals or taxing some foreign nationals heavier than other foreign nationals[76]. By concluding an investment treaty that offers national treatment to investors of the other state, the host state limits that freedom.

For such an obligation to have any real meaning, it must be construed as covering all elements of the host state taxation This means that the calculation of the taxable basis, the tax rate, the collection measures of the tax, possible tax exemptions, access and procedures for appeal or protest, may all be compared between foreign investors and national investors or investors of third states. If for any of those elements the foreign investor is treated less favorable because he is not a national of the host state or of a third state, the standard is breached.

But there are many uncertainties when it comes to applying "national treatment" to the tax treatment of investors, among other things because *de jure* discrimination is rare in matters of taxation. It is in other words rare for tax laws to provide in the language of laws and regulations that some taxpayers will be treated differently because they are not nationals (although some states have or had one income tax system for nationals and another one for foreign-owned enterprises) and even rarer to discriminate among foreign nationalities[77]. In income tax law, the residence of a taxpayer is usually a major criterion for overt differential tax treatment. It is for example widespread for states to subject non-residents to a final withholding tax on their gross income from a loan, a license or a share participation while the same income earned by residents will be taxed on a net basis. This differential treatment is of course well known to foreign investors. Nevertheless, it raises the question if discriminating foreign *residents* can amount to *de facto* discrimination because most foreign residents are also foreign nationals, a question that has already been addressed in the context of EU law[78]. One could in my view successfully argue that resident- and non-resident investors are not "in like circumstances" from the point of view of the application of the tax law[79], but not all investment treaties state that "national treatment" must be measured in relation to national investors "in like circumstances". Also, "nationality" is probably defined differently in investment treaties than in domestic tax laws. The Model BIT of The Netherlands, for example, includes as "nationals" the legal persons constituted anywhere in the world or in the host state, but controlled, directly or indirectly by natural persons or legal persons of the state of the investor[80].

Moreover, will a defense of "residents are not nationals" be accepted by an international arbitration tribunal when it is clear that a (new) tax treatment only hurts foreign investors and favors national investors? Imagine that a host state greatly increases the tax-free reserves to be applied by banks, but

[76] Marthaa, R., The Jurisdiction to Tax in International Law, p. 17; Quereshi, A.H., "The freedom of a state to legislate in fiscal matters under general international law", BIFD, 1987, p. 14; *Cook v. Mexico* 4R, Int. Arb. Awards, 1926, p. 593
[77] It is common in customs duties. States will often provide in special tariffs for goods originating from certain other states based on bilateral or regional free trade agreements, which are usually also excluded from the MFN-article of investment treaties. Furthermore, an exporter is not an investor and "nationality" and "origin" are different matters as well.
[78] Art. 52 and 58 EC Treaty; See for example Royal Bank of Scotland, ECJ, C-311/97, 29 April 1999.
[79] Typically, non-residents are subject to tax only on the income derived from the country while residents are subject to tax on their worldwide income.
[80] Agreement on Encouragement and Reciprocal Protection of Investments between ... and the Kingdom of The Netherlands, art. 1 b).

the new regulation only applies to banks that are nationals of the host state and not to branches in the host state of foreign banks, even though they are identical in all other respects. Because of this measure, which applies to residents of all nationalities, foreign banks that have branches in the host state are put at e serious disadvantage. If that host state under an investment treaty has obligated itself to national treatment for the investors of the other state, such a discrimination of foreign residents might strike an international arbitration tribunal as a breach of that obligation.

In conclusion, it can be said that tax discrimination based on residence remains an unsettled issue from the perspective of national treatment in investment treaties. In some treaties these difficulties are recognized and a special mention is made of tax discrimination based on residence. The German Model BIT states for example that

> "the provision of [national treatment and MFN] do not oblige a Contracting Party to extend to natural persons or companies 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 natural persons and companies in its territory"[81].

Discriminatory administration of tax laws and regulations

As was mentioned above, international law also recognizes discrimination that happens in fact rather than in law. A selective application of tax laws or regulations designed to disfavor foreign investors (or foreign investors of a certain state) or with the unintended effect of disfavoring certain foreign investors may constitute a breach of the "national treatment" standard in investment treaties.

This was illustrated in *Feldman v Mexico*, where a foreign investor was refused excise tax refunds for exported cigarettes. The tax authorities claimed that the refund was refused because the foreign investor did not respect the regulations on required information to be included on invoices that entitle to the refund. These regulations were the same for national investors. The Tribunal considered as follows:

> "Also, given that this is a case of likely *de facto* discrimination, it does not matter for purposes of Article 1102 [national treatment under NAFTA] whether in fact Mexican law authorizes [the tax authorities] to provide [excise tax] rebates to persons who are not formally [excise tax] taxpayers and do not have invoices setting out the tax amounts separately, as has been required by the [excise tax] law consistently since at least 1987 and perhaps earlier. The question, rather, is whether rebates have *in fact* been provided for domestically owned cigarette exporters while denied to a foreign re-seller, CEMSA. Mexico is of course entitled to strictly enforce its laws, but it must do so in a non-discriminatory manner, as between foreign investors and domestic investors. Thus, if the [excise tax law] Article 4 invoice requirement is ignored or waived for domestic cigarette reseller/exporters, but not for foreign owned cigarette reseller/exporters, that *de facto* difference in treatment is sufficient to establish a denial of national treatment under Article 1102 [national treatment NAFTA]"[82].

In cases of de facto discrimination, it may be impossible for a foreign investor to prove that he is being discriminated *because of his nationality*, which is in fact a requirement for national treatment to have been breached. This situation was considered by the Tribunal in the Feldman case as well, and it considered that:

> "It is clear that the concept of national treatment as embodied in NAFTA and similar agreements is designed to prevent discrimination on the basis of nationality, or "by reason of nationality." (U.S. Statement of Administrative Action, Article 1102.) However, it is not self-

[81] Treaty between the Federal Republic of Germany and .... Concerning the Encouragement and Reciprocal Investment of Investments, Protocol ad art. 3 b)
[82] *Feldman v Mexico*, par 169

evident, as the Respondent argues, that any departure from national treatment must be *explicitly* shown to be a result of the investor's nationality. There is no such language in Article 1102. Rather, Article 1102 by its terms suggests that it is sufficient to show less favorable treatment for the foreign investor than for domestic investors in like circumstances. In this instance, the evidence on the record demonstrates that there is only one U.S. citizen/investor, the Claimant, that alleges a violation of national treatment under NAFTA Article 1102 (transcript, July 13, 2001, p. 178), and at least one domestic investor (Mr. Poblano) who has been treated more favorably. For practical as well as legal reasons, the Tribunal is prepared to assume that the differential treatment is a result of the Claimant's nationality, at least in the absence of any evidence to the contrary […]

> More generally, requiring a foreign investor to prove that discrimination is based on his nationality could be an insurmountable burden to the Claimant, as that information may only be available to the government. It would be virtually impossible for any claimant to meet the burden of demonstrating that a government's motivation for discrimination is nationality rather than some other reason".[83]

The question of *de facto* discrimination in the administration of taxation may in theory arise in every matter where the tax authorities have discretion in the application of tax laws and regulations. The case of *Feldman* concerned the selection of taxpayers for audit, but other examples may spring to mind including the choice of audit procedures (standard of proof, required evidence, time to complete the audit,..), assigning of less burdensome tax regimes, granting of tax exemptions, the granting of delays for the payment of tax and granting reductions in penalties and interests. Delaying tax appeals or tax court proceedings involving foreign investors whereas those involving nationals are settled swiftly may also constitute a breach of "national treatment"[84].

In many of these instances, the discrimination of the foreign investor as compared to national investors may also be a violation of the "fair and equitable treatment" standard or the prohibition on "arbitrary" or "unreasonable" treatment.

3. Exceptions to "national treatment" or "most favored nation treatment" for tax matters

Internationally, most investment treaties provide in an exception for "tax matters" to the provision on "national treatment" or to "most favored nation treatment" or to both. The scope of the exception shall depend on the exact wording of the provision, but in any case the aim of the states is to make it possible to discriminate foreign investors or among foreign investors in terms of tax treatment.

"national treatment or most favored nation treatment does not apply in tax matters"

In treaties where the provision on "national treatment" or "most favored nation treatment contains an exclusion for tax matters in general terms it may be phrased as follows:

> "The provisions of this Article do not apply to tax matters"[85]

[83] *Feldman v Mexico*, excerpts from par 181-183
[84] *ELSI USA v Italy*, loc. cit., par 112. The state of the foreign investor claimed that administrative appeals by foreign investors were delayed more than those of nationals. The ICJ did not deny hat such could be a breach of national treatment but found the claim unproven.
[85] See for example France Model BIT art. 5; US Model BIT art. 21 par. 1 ("Except as provided in this Article, nothing in Section A shall impose obligations with respect to taxation measures")

In case the treaty contains a clause which excludes tax matters from the provisions on "national treatment" or "most favored nation treatment", the host state is free to legislate in tax matters so that foreign investors will be taxed less favorably than nationals or nationals of other states. Other provisions of the treaty will however remain applicable to "tax matters" and a treatment that violates both the provision on national treatment (for which an exception on "tax matters" exists) and another provision (for which no exception on "tax matters" exists), there is still a breach of the investment treaty.

The exclusion of matters of taxation itself presents its own interpretation problems, which were discussed above. The discussion applies mutatis mutandis to tax exceptions to the national treatment or most favored nation treatment.

"no obligation to grant benefits"

In many investment treaties, there is an exception for tax matters which is more specific in its formulation. It is worded as follows:

> "The provisions of paragraphs (l) and (2) above 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) any existing or future customs unions or similar international agreement to which it is or may become a party, or (b) any matter pertaining wholly or mainly to taxation"[86].

Under this exception, the emphasis is more on tax advantages which may be granted to investors. The host state is allowed to give preferential treatment to nationals in its domestic tax laws without having to extend to foreign investors the same benefit. A more favorable tax regime for nationals is thus admissible, such as lower tax rates, special tax reductions and exemptions, and different calculation of the taxable base (tax on turnover instead of profit for example).

With respect to "most favored nation treatment" the exception allows the host state to grant benefits to foreign investors of other states under its own tax legislation and, which will be more common, under provisions of international treaties. It seems not required that the treaty itself relates wholly or exclusively to taxation such as double taxation agreements. An agreement concerning transport by air, for example, or another investment protection agreement, may contain provisions giving benefits to investors from third states.

V. Expropriation in Tax Matters

1. <u>Direct and indirect expropriation</u>

As a principle, expropriation is not necessarily illegal under international law, or (in other words) a breach of international law. Put another way, international law distinguishes between legal and illegal expropriation. In order to be legal under international law, the expropriation must satisfy certain conditions. These conditions are found in customary international law as well as in bilateral investment treaties. In general terms, the conditions stipulate that the expropriation must be made in the public interest, may not be discriminatory or without due process, and must be compensated[87].

---

[86] India Model BIT art. 4 par 3; See also the Thailand Model BIT, art. 4 par 3 ("*or any domestic legislation relating wholly or mainly to taxation*").

[87] On the standard used to determine the amount of compensation, see below.

States may relieve some of the remaining uncertainty by concluding an investment treaty with conventional conditions related to expropriation[88].

The provision on expropriation of The Netherlands Model BIT is taken here as an example. It reads as follows:

> "Neither Contracting Party shall take any measures depriving, directly or indirectly, nationals of the other Contracting Party of their investments unless the following conditions are complied with:
>
> a) the measures are taken in the public interest and under due process of law;
>
> b) the measures are not discriminatory or contrary to any undertaking which the Contracting Party which takes such measures may have given;
>
> c) the measures are taken against just compensation. Such compensation shall represent the genuine value of the investments affected, shall include interest at a normal commercial rate until the date of payment and shall, in order to be effective for the claimants, be paid and made transferable, without delay, to the country designated by the claimants concerned and in the currency of the country of which the claimants are nationals or in any freely convertible currency accepted by the claimants"[89].

Not only formal expropriations or nationalizations can give rise to a breach of international law. There is ample evidence that by indirect expropriation, by the taking of property in fact, or by rendering the possession or the operation of the investment impossible, a state may also be breaching the international law on expropriation. Measures taken by a state without the intent to expropriate a property directly or indirectly may still amount to an expropriation under international law[90]. The Convention on the International Responsibility of States for Injuries to Aliens of 1961 states for example that:

> "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"[91].

This finds a sound basis in the decisions of the international courts[92], the US-Iran Claims Tribunal[93] and ICSID-awards[94].

2. When does taxation become confiscatory?

It is obvious that international rules to safeguard the property of aliens against expropriation would become meaningless if taxation would be *ipso facto* excluded from scrutiny in this respect. On the other hand, customary international law also recognizes the right of the host state to levy taxation[95],

---

[88] UN Centre on Transnational Corporations, Bilateral Investment Treaties, 1988, p. 53-54.

[89] The Netherlands Model BIT, art. 6

[90] *Starett Housing Case*, 23 ILM 1990, p. 1115 (1984).; Christie, G.C., "What constitutes a taking of property under international law?", 38 *BYIL* 1962, p. 339.

[91] Art. 10, par. 3 (a) of that Convention, reprinted in 55 *AJIL*, 1961, p. 545.

[92] *German Interests in Polish Upper Silesia case*, PCIJ 1926, Ser. A, No. 7 at 14-45; *Chorzow Factory case*, PCIJ, Ser. A, no. 17, 29-; ELSI case, *ICJ Reports*, 1989, 15, par. 114 .

[93] *Harza Engineering Co vs. Iran*, Award No. 19-98-2 of 30 December 1982; *ITT Industries Inc vs. Iran*, Award No. 47-156-2 of 26 May 1983.

[94] Particularly the AMCO award, *ICSID Reports* 1, p. 431- (further discussed below).

[95] Albrecht, A.R., "The taxation of aliens under international law", 29 *BYiL* (1952), p. 172; 1961 Harvard Draft Convention on International Responsibility art. 10 par. 5; Christie, G.C., loc. cit., p. 332.; Hackworth, G. H., Digest of International Law, vol. III, p. 575.

and thus also the right to increase an existing tax, to introduce a new one, or to revoke an exemption. The difficulty is thus to make the difference between legal taxation and illegal expropriation.

The following rules must in that regard be followed.

Investment becomes useless

The first rule is that, in order to speak of an expropriation, the negative impact of the taxation must be such that it becomes inevitably useless to own the investment[96]. A decrease in the profitability or possibility to sell the investment in itself does not suffice[97], and neither does a high tax rate[98]. This rule can be inferred from the concept of expropriation in international law, which requires that the property is taken away by the host-state, either directly or indirectly[99].

This confirms that when the levied taxation adversely affects the investment to such a degree that the investment loses its economical value immediately or in the foreseeable future it may be deemed an expropriation. It should be noted, however, that the tax assessment imposed by the host-state need not be so high that it exceeds the market value of the alien property or company straight away. Of course, if such should happen, there would clearly be a tax that is so excessive that it has the same effect as an expropriation. Otherwise, the investor must only establish that with this amount of taxation, the usefulness of the investment is eliminated, for example because the investment will not generate a net-profit anymore due to the increased taxation. The investor may also suffice by demonstrating that the net-profit generated after tax will be so low that the project or company can no longer be sold on an open market at all[100], or sold for a reasonable price[101]. In both instances it will be important to verify if the investor can “pass on” the tax increase to his customers by increasing the price of his products or services. This issue was mentioned in an interesting arbitration award on tax increase and expropriation in Jamaica[102]. If the investor cannot increase the prices of his products or services, because it would price them out of the market, the investor may very well have no other choice but to discontinue the project.

The normal, regular levy of taxation will not often have such an effect that it renders the entire investment useless. States are careful not to discourage foreign investors with such a tax system. Income taxes, for one thing, by definition only reduce the net-profit of the investment with a percentage. Excise taxes, import duty and turnover taxes are different in this respect but the rates of these taxes are usually not very high and the cost can if all goes well be passed on to the customers of the taxpayer. This is reflected in many investment claims related to tax-expropriation, where the tribunals finally decide that there was no expropriation because the investment has not been rendered

---

[96] Whiteman, M., loc. cit, p. 1016.; Wortley, B., Expropriation in Public International Law, Cambridge University Press, 1959, p. 50-51.; “General limitations on the use of property will not, usually, amount to expropriation, though they may give rise to retorsion. Whatever may be the remedy of foreigners caught by general changes in the law, if those changes do not in fact dispossess them but merely lessen the value of their holdings or expectations, in the general interest, then bona fide changes in the public interest will not be confiscations, since the owners are left in possession of their property; they may be assimilated to loss by taxation”; Christie, G.C., loc. cit., p. 311.

[97] *Starrett Housing v. Iran* (Iran-US Claims Tribunal) , 23 *ILM* 1090, p. 1117 (1984)

[98] In the Gilis Arbitration (Entscheidungen, V, p. 196) a tax “absorbing 50% of the property of the taxpayer” was held not to be confiscatory in the light of the terms of payment.

[99] Wortley, B., loc. cit., p. 53.

[100] Impossibility of alienation has repeatedly been accepted by international tribunals as proof of expropriation; See Christie, G.C., loc. cit., p. 316-318.

[101] This would exclude a “distressed price” or a “price which is only a fraction of its value”; Comments by Sohn and Baxter on the Harvard Draft Convention on the International Responsibility of States for Injuries to Aliens, 55 *AJIL* 1961, p. 558-559.

[102] *Revere Copper v OPIC, ILR,* vol. 56, p. 319. This case is an arbitration between the investor and the Overseas Private Investments Corporation, which insured against loss resulting from “expropriatory action”. The majority of the arbitration panel found that the tax increase in itself did not constitute “the loss of effective control” but together with the repudiation of the mining license by the government of Jamaica, it did. The “passing on” of the tax to the consumer is mentioned in the minority opinion on p. 318.

useless because of the tax. The companies of the foreign investors remained in operation and under the control of the foreign investor[103].

The situation is different for tax claims as a consequence of re-assessments and disputes with the tax authorities. These claims may be retroactive over all non-prescribed years and will include interests and penalties, so the amounts may for example exceed the equity of a company.

Causality

Another rule that can be deduced is the requirement of a causality between the tax measures by the host state and the discontinuity of the investment. If an investor discontinues or is forced to discontinue his investment for reasons that are not a direct consequence of the taxation, but rather due to the insufficient capital of the company, the general worsening economic climate, mismanagement or any other reason that is unrelated to an act by the host-state, there is no expropriation. In the *Oscar Chinn case*, for example, the Permanent Court of International Justice considered that the failure of the Chinn enterprise was due to general economic conditions and not to the Belgian increase of measures on tariffs[104]. A similar consideration was made more recently in the *ELSI case* by the International Court of Justice, which at the same time emphasizes the importance of establishing the causal link between the act of the host-state (in *Goetz v. Burundi* the taxation) and the end of the investment activities:

> "…it is simply not possible to say that the ultimate result was the consequence of the acts and omissions of the Italian authorities, yet at the same time to ignore the most important factor, namely ELSI's financial situation, and the consequent decision of its shareholders to close the plant and put an end to the company's activities"[105]

Another example where not the host-state taxation but the investor himself is the true cause of the discontinuity of the investment, occurs when the taxes imposed and the collection measures in connection therewith are simply the consequence of the investors negligence or fraud. An example of this is found in the jurisprudence of the Iran-US Claims Tribunal. Iranian national Emanuel Too blamed the US Internal Revenue Service that the impounding of his liquor license had in fact expropriated him of his restaurant. The investor claimed but did not prove that the taxes were only levied because he was an Iranian national. The Tribunal decided that:

> "the IRS's action was the result of the Claimant's failure to pay taxes withheld by him on his employees' salaries. […] This claim is dismissed because the Claimant has failed to show that the IRS's action was anything other than a lawful levy for overdue taxes, for which there is no state responsibility"[106]

Penalties and conservancy-measures for non-payment of tax debts are not beyond scrutiny, though. Allegations of tax fraud can easily be made by a host-state that is determined to harass and expulse an investor. In this regard, another condition for an expropriation to be lawful under international law (at least under most expropriation-clauses in bilateral investment treaties), namely the condition of due process comes into play. Tax penalties and recovery measures that indirectly lead to the expropriation of a foreign investment and that are not established in accordance with due process, must be held illegal under international law.

Tax recovery measures

---

[103] *Occidental v Ecuador,* par. 68; *Feldman v Mexico,* par 112 et seq.
[104] *Oscar Chinn case*, PCIJ, series A/B, No. 63.
[105] *ELSI USA v Italy*, par. 119.
[106] Award No. 460-880-2 of 29 December 1989, reprinted in 23 *Iran-US C.T.R*., 378-8.

The recovery measures a state takes to collect tax debts deserve some particular attention. Such measures may easily have an expropriatory effect, even when the amount of tax that is recovered is in itself not confiscatory[107]. A tax debt that is not enormous but disputed and hence not finally determined may be collected by the state with the use of measures that are so drastic and disproportional that they result in the discontinuity of the investment. A temporary closure of the business facilities, the seizure of business assets and bank accounts or even the temporary imprisonment of executives of the local company on allegations of tax fraud may all result in the investment losing all value and prospects. In this case, the amount of the tax due takes second seat to the effect of the recovery measures themselves.

Timing and unforeseeable character of the measure

It can be submitted that *a foreseeable* tax increase in the host state cannot be deemed an expropriation, even if it has the effect of rendering the investment useless[108]. A taxation that is increased to a level that could or should reasonably have been expected or at least kept for possible, cannot constitute a disguised expropriation. As Wortley wrote in his classic treatise on expropriation in international law, the budgetary needs of states vary from time to time, and the amount of taxes may be expected by the investor to fluctuate to some extent[109]. If an investor organizes and finances his project in such a manner that any minor increase in taxes or duties may mean the end of the investment, the taxation cannot reasonably be seen as the true cause for the demise of the foreign property. The question to which extent tax increases may be deemed foreseeable depends on all the circumstances of the case. The past track record of the host-state, the tax due on similar investments in similar countries and the prevailing international practice on the matter may in my view be taken into account in this regard.

3. Conditions for a legal expropriation under investment treaties

As was pointed out above, not all expropriations are illegal under international law. Similarly, a taxation that constitutes an indirect expropriation is under many bilateral investment treaties not contrary to international law if it was carried out (1) in the public interest, (2) in accordance with due process, (3) is not discriminatory and (4) does not violate any provisions of an individual investment contract. The most important condition is however that compensation is paid for the expropriated property. This condition will be discussed below. In the case of excessive taxation leading to expropriation this requirement will, by definition, not be fulfilled. For this reason alone, therefore, taxation that indeed constitutes an indirect expropriation will nearly always be contrary to international law[110]. It is nonetheless useful to briefly verify the other conditions mentioned as well, because failing to meet them may have an effect on the awarded compensation by an international tribunal.

Public purpose

Under the international law on expropriation it is required that any expropriatory measure is taken for public purposes. This condition is also found in the ECHR[111].

A court (both international, domestic and European) will be reluctant to dismiss an expropriation for lack of public purpose[112]. It is generally assumed that the government is the more appropriate body to

[107] Gilis Arbitration, Entscheidungen, V, p. 197.
[108] The foreseeable character of an (unpublished) tax measure (that was claimed to breach art. 1 of Prot No. 1 ECHR) was considered by the European Court of Human Rights in *Spacek v. Czech Republic*, application 26449/95 as quoted by Baker, PH., "Taxation and the European Convention on Human Rights", *BTR*, 2000, p. 224.
[109] Wortley, B., loc. cit., p. 46.
[110] The only qualifications of this statement that I see at present is in case the host state decides to grant compensatory benefits (payment delays, reduction of other taxes or duties, etc.) to taxpayers that were, perhaps unintentionally, exceptionally hard hit by the tax increases
[111] Art. 1, par. 1 Protocol No. 1 to the European Convention of Human Rights.

decide what is in the public interest, and if expropriations are in that regard warranted[113]. There is no universally agreed definition of "public interest", and courts and tribunals have applied a wide margin of this concept[114]. As a principle, taxation should always be in the public interest because the funds collected end up in the public treasury[115].

Discrimination

A further stipulation in many investment treaties is that the host state may not discriminate when carrying out expropriation measures. A taxation that may be deemed an indirect expropriation and which discriminates for example on the basis of nationality is for example illegal under international law. It is noteworthy that discriminatory tax measures which do *not* lead to the discontinuity of the alien property may be a breach of the investment treaty anyway under the requirement of national-, fair and equitable-, or most favored nation treatment[116].

Due process

Nearly all investment treaties, Dolzer and Stevens point out, require that expropriations be effectuated under due process of law[117]. The same authors note that this would include a right to advance notification[118] and a fair legal proceeding before the expropriation takes place[119]. A tax assessment (which results in the discontinuity of the investment) that cannot be appealed or challenged in a fair legal proceeding would on this ground be deemed illegal under the international law of expropriations. Reference can be made to the discussion above with respect to fair and equitable treatment.

In most countries assessments may be challenged by the taxpayer on their legal merits. If such a procedure exists, and if it is fair[120], and if it is not so slow that it loses all effectiveness[121], the assessments must be deemed to be in accordance with due process.

VI. Some Concluding Remarks

Investment treaties are not specifically aimed at taxation in cross border relations such as double taxation agreements but they nevertheless have a significant impact on the protection of foreign investors in matters of taxation, particularly with respect to the administration of taxation and the settlement of tax disputes.

Investment treaties will normally not shield a foreign investor from the financial impact of new taxes or a general change in the tax laws of the host state as long as those taxes are introduced as a matter of normal fiscal and economic policy. Double taxation agreements do not provide such protection

---

[112] Friedman, Expropriation in International Law, Stevens & Sons, 1953, p. 141.; American Law Institute, Restatement of the Law, second, (sec. 185 (a) (b)), pt. IV, p. 553-554

[113] Decisions by the European Commission of Human Rights No. 11089/84 DR 49, page 202

[114] *Amoco v. Iran*, Iran-US Claims Tribunal, *ILR* vol. 83, p. 552

[115] Wortley, B., loc. cit., p. 106.; Albrecht, A.R., loc. cit., p. 173-174

[116] Van Raad, K., Non-Discrimination in International Tax Law, p. 214-244.; *Jeney Claim*, US Foreign Claims Settlement Commission, *ILR*, vol. 26, p. 312-313 (on taxes in Hungary during world war II having a discriminatory nature –not held).

[117] Dolzer, R. and Stevens, M., Bilateral Investment Treaties, Martinus Nijhoff Publ., 1995, p. 106.; Vandevelde, K., US Investment treaties policy and practice, Kluwer, 1992, 121.

[118] See also above on timing and unforeseeable character of the tax measure.

[119] Dolzer, R. and Stevens, M., loc cit, p. 106; Vandevelde, K., US Investment treaties policy and practice, Kluwer, 1992, p. 121.

[120] Weissberodt, D., The Right to a Fair Trial, Martinus Nijhoff Publ., 2001.

[121] See the (rejected) complaints of the plaintiff in *Bareiss v. Federal Republic of Germany*, (Arbitral Commission on Property, Rights and Interest in Germany, *ILR*, vol. 28, p. 580-583) who deemed the procedures under German tax law so slow that he submitted his case to the arbitral tribunal known as the Settlement Commission.

either, by the way. Only a tax-stabilization clause in a contract between an investor and the host state explicitly has such an effect.

The “national treatment” or “most favored nation treatment” obligations will prohibit discriminatory taxes but overt discrimination in matters of taxation is quite rare. De facto discrimination in tax matters may be more common and offers prospects for investors, but the interpretation of the exclusion for tax matters must in most cases be considered here.

In exceptional circumstances a drastic change in the tax policy of the host state could perhaps be seen as a violation of the treaty (indirect expropriation, if other conditions are also met or “fair and equitable treatment”) if the investor legitimately expected that this feature of the tax treatment would be maintained. This would be the case, for example, if the host state especially created a favorable tax regime to attract investors. There is some authority for this view but much will depend on the circumstances of each case.

For the interpretation and application of tax laws the host state’s courts as a principle keep the sole jurisdiction. If the host state’s courts are “wrong” the international arbitration tribunal cannot be used as an appellate court. But that does not mean that the international tribunal is not of any use for “pure” tax matters. The “fair and equitable treatment” standard, as it incorporates “denial of justice” can have important implications for the taxpayers’ rights in the host state. The host state, when settling domestic tax disputes, must provide access to fair and impartial courts that do not grossly misapply the law and that treat cases without unreasonable delay. The actual circumstances when tax proceedings amount to a denial of justice are yet to be outlined, though. More importantly, perhaps, international tribunals will safeguard international rights of the investor even if the national court does not. Just because a domestic court does not see a violation of domestic law by a state measure this does not mean that an international tribunal can no longer see a violation of international law by the same state measure. In other words, even if a tax assessment or another tax measure is in accordance with domestic law it may yet be in violation of international law. The rule of international law concerned will however be more basic, more fundamental than provisions found in domestic tax codes such as rules on due process, denial of justice or discrimination.

Along the same lines, investment treaties impose states to administer taxation in a reasonable manner without discrimination. Will probably mean that when tax authorities have discretion when applying tax laws and regulations, or when they make decisions and assessments they have to take into account certain rights for the taxpayer. The actual content of these rights should be further explored but it is likely to relate to the right to be fully informed, to offer a defense, to be given a chance to be heard, and to be dealt with in a straightforward manner. To be in accordance with the requirement of due process, decisions and administrative measures must be in accordance with administrative rules subject to tax law and general administrative law, and be based on objective facts and documents. One could argue that a taxpayer is to be given written explanations as to the reasons of a tax administration measure or an assessment. When it becomes clear from factual evidence that tax authorities for some reason are less strict in the application of tax laws and regulations for nationals than for foreign investors, or when national investors are being given preferential treatment in tax collection and disputes, the “national treatment” obligation of the investment treaty is probably breached. Mutatis mutandis the same can be said for preferential treatment of investors from a certain third state.

The obligation of transparency has a bearing on various other obligations in the investment treaty. At least, one could say, tax authorities should make a serious effort to inform foreign investors on laws, regulations and administrative guidelines and decisions with respect to the taxation of their investment, especially because they are in this respect already at a disadvantage compared to national investors. The actual consequences in terms of liability when the obligation of transparency is breached, is however not entirely clear.

With respect to expropriation, one of the fundamental issues is which “investment” can be the object of an expropriation, particularly with respect to claims by taxpayers to refund of taxes. The question is also raised under which circumstances investment treaties offer investors protection from a policy of extreme tax increases that renders the investment useless and for which the investor could legitimately expect that they would not occur. Regular, recurring taxes are not likely to lead to the degree of loss necessary to claim an expropriation but it is by no means impossible. However, in case of taxation directly on property or income of the foreign investor (as opposed to taxes on the property or income of his subsidiary) or on contractual rights that belong to the investor, a case for expropriation is probably less complicated.

Exceptional tax re-assessments can because of their retroactive effect and the interests and penalties lead to the loss of the entire or a substantial part of the investment. In such cases, the role of investment treaties is to guarantee due process and to exclude denial of justice and discrimination.

The fact that many investment treaties have excluded “tax matters” to some degree obviously has an important impact on the application of investment protection in tax-related matters. But the exclusion must be properly understood and it is not clear if there is consensus on the matter.