# C. Taxation

# ARBITRABILITY AND TAX*



"Taxes are what we pay for civilized society."

Oliver Wendell Holmes[1]

## A. Introduction

Like fire and passion, taxation can bring ruin as well as blessing. Justice Holmes rightly observed that taxes provide the wherewithal for public benefits we associate with civilized life. However, fiscal measures also have a darker side, sometimes serving as a vehicle for indirect asset confiscation. In the oft-cited paraphrase of another American Supreme Court Justice: "The power to tax is the power to destroy."[2]

* Revised and updated, from "Arbitrability and Tax" in L. Mistelis and S. Brekoulakis (eds.), *Arbitrability: International and Comparative Perspectives* 179 (2008).

[1] The line comes from a dissent by Holmes while a Justice on the U.S. Supreme Court, in the case *Compañía General de Tabaco de Filipinas v Collector of Internal Revenue*, 275 US 87, 100 (1927). The catch-phrase was later taken by President Franklin D. Roosevelt, who said that taxes were "the dues that we pay for the privileges of membership in an organized society." Address in Worcester, Massachusetts, 21 October 1936. See Samuel I. Rosenman (ed.), *Public Papers and Addresses of Franklin D. Roosevelt* Vol. 5, 522–3 (1938).

[2] *McCulloch v Maryland*, 17 US (4 Wheat) 316, 327 (1819). A federally chartered bank had established branches in various states, one of which was Maryland. When that state imposed a tax on bank operations, the cashier of the Baltimore branch (one James McCulloch) refused to pay. The opinion by Chief Justice Marshall, upholding the power of Congress to create a national bank and ruling the Maryland tax unconstitutional, contained the following language: "An unlimited power to tax involves, necessarily, a power to destroy; because there is a limit beyond which no institution and no property can bear taxation."

In light of taxation's special potential for abuse, many investment treaties contain intricate rules to assist in separating legitimate and illegitimate exercises of fiscal power. The triage remains heavily fact-intensive, depending on the circumstances of each case. Some tax measures give rise to treaty claims, whether for expropriation, discrimination or unfair treatment. Others do not.

Drawing lines among different types of taxes resists facile analysis. By its very nature, taxation constitutes an involuntary seizure of property that bears some resemblance to expropriation in even the best circumstances. Money leaves private hands and enters government coffers without any necessary *quid pro quo*.

Allowing routine tax measures to be translated into relief under an investment convention might open the door for misuse of the treaty's investor protection regime. On the other hand, when discrimination has been dressed in fiscal garb, the investor should still have some recourse other than the type of gunboat diplomacy that investment treaties were designed to reduce.

Many treaties provide their own complex rules in an attempt to balance competing interests of the foreign investor and the host state. While far from perfect, such line-drawing often represents, *faute de mieux*, the most efficient way to promote a healthy investment protection regime.

## B. The *Matryoshka*

**Rules within rules**

Contemplating the treatment of tax measures under most investment treaties brings to mind the Russian nested doll, or *matryoshka*. One carved figure opens to reveal another, which in turn unlocks to yield yet more diminutive figurines.

Likewise, investor protection schemes in trade agreements and investment treaties often contain tax-related provisions that unfold to present exceptions to the exceptions. However, interpreting investment treaties differs from opening a *matryoshka* in one significant way. While the doll releases smaller figures, treaty exceptions often reveal other exceptions that prove as capacious as the provision from which they derogate.

To illustrate, the Energy Charter Treaty (ECT)[3] establishes a general rule on fiscal measures in Article 21: "Nothing in this Treaty shall create rights or impose obligations with respect to Taxation Measures of the Contracting Parties."[4] The same Article then enumerates

[3] Energy Charter Treaty, Lisbon, 17 December 1994, 2080 U.N.T.S 95; 33 I.L.M. 360 (1995). The ECT was intended to facilitate East-West cooperation between countries of the former Soviet Union (holders of large oil and gas resources) and Western European countries with a strategic interest in diversifying their energy supplies. See generally, Thomas W. Walde, *The Energy Charter Treaty: an East-West Gateway for Investment and Trade* (1996); Julia Doré and Robert De Bauw, *The Energy Charter Treaty: Origins, Aims and Prospects* (1995); Clarisse Ribeiro (ed.), *Investment Arbitration and the Energy Charter Treaty* (2006); Mirian Kene Omalu, *NAFTA and the Energy Charter Treaty* (1999). See also, Kaj Hobér, *The Energy Charter Treaty—Awards Rendered*, 1 Dispute Res. J. (IBA, June 2007), Steivan Defilla, *Trade under the ECT and Accession to the WTO*, 21 J. Energy & Nat. Resources L. 428 (2003); Lawrence Herman, *NAFTA and the ECT: Divergent Approaches with a Core of Harmony* 15 J. Energy & Nat. Resources L. 131 (1997).

[4] Other bilateral or multilateral investment regimes have analogous provisions. See e.g. NAFTA, Art. 2103(1); 2004 US Model BIT, Art. 21; U.S.-Ecuador BIT, Art. 10; Canada-Ecuador BIT, Art. 12.

provisions that *will* apply to tax measures: prohibitions against discrimination[5] and uncompensated expropriation,[6] for which investors may seek redress through arbitration.[7] The non-discrimination rule, however, excludes from its application both income and capital taxes, as well as tax collection measures. A carve-out for collection measures that "arbitrarily" restrict treaty benefits creates another exception from the exclusion, thus allowing claims based on some (but not all) collection practices.[8]

**Three faces of tax arbitration**

Taxation directly implicates one of the most vital sovereign prerogatives: the ability to raise the money that permits the modern state to function. Consequently, doubts are sometimes expressed about whether fiscal measures, by their nature, can or should be subject to arbitration.[9]

Assertions that tax matters remain "non-arbitrable" bring to mind the story of an elderly farmer who met his pastor while walking by the village church one Sunday. The pastor asked the farmer if he believed in infant baptism. Not being much of a theologian, and hoping to avoid a debate that might delay his supper, the old man replied, "Believe in it? Reverend, I've even seen it done!"

Likewise, arbitration of tax-related disputes proves a practical reality notwithstanding objections of a doctrinal or theoretical nature.[10] Despite lively scholarly debate,[11] arbitrators routinely address problems of taxation in the context of ordinary commercial contracts as well as claims by foreign investors brought against host states.

The amenability of tax disputes to arbitration remains highly fact-intensive, however. Even if no hard-and-fast rule prohibits all tax arbitration per se, many arbitration claims related to fiscal matters will (and should) fail. In some instances, the claim may not be ripe for

[5] Article 21(3) of the ECT says that Articles 10(2) and 10(7) "shall apply to Taxation Measures of the Contracting Parties other than those on income and on capital." These two subsections of Article 10 relate to non-discrimination and most-favored-nation treatment. In turn, exceptions to the exception exist, *inter alia*, for tax collection mechanisms or provisions of economic integration organizations and income tax treaties in Article 21(7)(a)(ii). The carve-out for tax on income and on capital leave some of the most significant categories of fiscal measures, including value added tax, import and export duties, and stamp taxes. Significantly, the ECT exclusion does not refer to Article 10(1), mandating "fair and equitable treatment."

[6] Article 21(5) of the ECT says that "Article 13 shall apply to taxes." Article 13(1)(d) requires compensation to be accompanied by "the payment of prompt, adequate and effective compensation."

[7] Article 26 of the ECT permits arbitration under the rules of ICSID, UNCITRAL and the Stockholm Chamber of Commerce. For investors from countries that are not a party to the 1965 Washington Convention, the dispute may be subject to the rules of the ICSID Additional Facility.

[8] ECT, Art. 21.

[9] See Thomas Carbonneau and Andrew Sheldrick, *Tax Liability and Inarbitrability in International Commercial Arbitration*, 1 J. Trans'l Law & Policy 23, 38 (1992): "the resolution of statutory claims involving tax issues is unsuitable for arbitration."

[10] Academic debate on the arbitrability of tax measures brings to mind the comment from one professor to another in a law school faculty workshop: "Perhaps your ideas do work in practice. But will they work in theory?"

[11] See generally, Bernard Hanotiau, *L'Arbitrabilité* (2003) Recueil des cours (2002), *Académie de Droit International de la Haye* at 171–180 ; Pascal Ancel, *Arbitrage et ordre public fiscal*, Rev. Arb. 269 (2001); Matthieu de Boisseson, *Le Droit français de l'arbitrage* § 33, at 37 (1990); Ibrahim Fadallah, *L'ordre public dans les sentences arbitrales*, Recueil des cours (2002), *Académie de Droit International de la Haye*, 369 (1994) paras. 54–56, at 410–411; Philippe Fouchard, Emmanuel Gaillard and Berthold Goldman, *International Commercial Arbitration* 348, 359 (English Language edn, E. Gaillard and J. Savage (eds.), 1999), at Sections 579, n. 478, & 589–1. For a survey of ICC arbitrations touching on tax matters, see Luca Melchionna, *Tax Disputes and International Commercial Arbitration*, 74 Diritto e Pratica Tributaria Internazionale 769 (2003). See also Luca Melchionna, *Arbitrability of Tax Disputes*, IBA Section on Business Law, Arbitration and ADR Committee Newsletter 21 (May 2004).

adjudication because the government has not yet ruled on the amount of tax (if any) payable. In other cases, the relevant treaty may remove entirely certain types of tax controversies from the arbitrators' adjudicatory power.[12]

Distinctions should be drawn among three broad categories of fiscal arbitration:

(1) tax controversies arising from business relationships;
(2) overlapping tax on one transactions by two or more countries; and
(3) disputes implicating tax issues between a foreign investor and the host state.

*Business relationships*

With respect to the first category (business relationships), several different scenarios arise.[13] In the wake of a corporate acquisition, there might be questions on whether the buyer or the seller should bear taxes due for previously accrued tax liabilities. Or, an allegation might be made that the seller misrepresented corporate tax liabilities, either by reason of accounting irregularities or in hiding investigations by local revenue authorities. There might be issues about which party gets the benefits and/or burdens of credits and liabilities under a "tax allocation agreement" concluded pursuant to a corporate spin-off. In some instances, disputes among joint venture partners might arise with respect to whether one partner was authorized to make payments to a foreign country on behalf of another. Last but not least, taxpayers have been known to sue their advisers when advice about a tax shelter proves unfounded and leads to liability.[14]

*Income tax treaties*

There is also country-to-country arbitration under income tax treaties, a process recently endorsed by international organizations such as the OECD (Organization for Economic Cooperation and Development) and the ICC (International Chamber of Commerce), as well as several national fiscal authorities, including those of Austria, Belgium, Canada, Germany and the United States.[15] Such tax treaty arbitration meets the needs of multinational corporate groups seeking symmetrical treatment of income inclusions and deductions in different countries.

[12] Distinctions are sometimes made between arbitral jurisdiction (*compétence*) and the "admissibility" (*recevabilité*) of a claim. When claims are barred for reasons such as ripeness, they are said to be not admissible (*recevable*). While otherwise subject to an arbitrator's jurisdiction, the pre-conditions for their proper consideration have not been met. By contrast, a treaty prohibition on arbitration of particular tax claims could constitute a bar to the legitimate authority of an arbitrator even to consider such matters.

[13] For examples of domestic and international tax arbitration, see *Ace Ltd. v. Cigna Corp.*, 2001 WL 767015; ICC Award Nos. 6515, 6516, in Jean-Jacques Arnaldez (ed.), *Collection of Arbitral Awards/Recueil des sentences arbitrales de la CCI*, Vol. IV, 241 (1996–2000). For tax arbitration within the United States, see I.R.S. Ann. 2000–4 and 2002–60.

[14] *Reddan v. KPMG*, 457 F. 3d 1054 (9th Cir. 2006) (tax shelter sponsor held bound to arbitrate on the basis of an arbitration clause in brokerage contract related to the tax shelter transaction); *Vassalluzzo v. Ernst & Young*, 2007 WL 2076471 (Mass. S. Ct. 2007); *Vassalluzzo v. Ernst & Young and Sidley Austin* (Mass. S. Ct, C.A. No. 06-4215, 2007) (malpractice action for advice on an unsuccessful tax shelter, an arbitration clause in the engagement letter was found to cover some but not all transactions).

[15] William W. Park and David R. Tillinghast, *Income Tax Treaty Arbitration* (2004); Marcus Desax and Marc Veit, *Arbitration of Tax Treaty Disputes: The OECD Proposal*, 23 Arb. Int'l 405 (2007); Organization for Economic Cooperation and Development (OECD), *Improving the Resolution of Tax Treaty Disputes* (OECD Committee on Fiscal Affairs, 30 January 2007); Mario Züger, *Arbitration under Tax Treaties* (2001); Zvi D. Altman, *Dispute Resolution under Tax Treaties* (2005); Draft Bilateral Convention Article, Doc. No. 180/455 Rev. (10 September 2001), Draft Proposal by ICC Commission on Taxation; Robert Couzin, *Arbitration in Tax Treaties*, 29 Tax Planning Int'l Rev. 12 (March 2002); Sed Crest, *A New Way to Resolve International Tax Disputes*, Int'l Tax Rev. 24 (May 2005), Interview with Tjaco van de Houte, Secretary General of Permanent Court of Arbitration. For a more doubtful view of tax treaty arbitration, see Michael J. McIntyre, *Comments on the OECD Proposal for Secret and Mandatory Arbitration of International Tax Disputes*, 9 Florida Tax Rev. 622 (2006).

The 2008 OECD Model Tax Convention on Income and on Capital, in the Mutual Agreement Procedure of Article 25(5) provides binding arbitration in relation to disputes implicating taxpayer disputes. The OECD also provides a sample memorandum of understanding to implement the arbitration process, including rules on time for submission of the case, terms of reference and qualifications of arbitrators. Article 25 has been adopted in several U.S. treaties, including those with Belgium, Canada, France and Germany

The OECD provision was intended to address situations such as the following. A royalty payment might be made by a French subsidiary to its American parent. As between the French and American tax authorities, different views might exist on the correct amount of royalty. The varying applications of national anti-avoidance measures, intended to prevent abusive "transfer pricing," might result in income to the American parent without an equal deduction to the French subsidiary.

Although not double taxation in a *juridical* sense (given the separate corporate personalities of parent and subsidiary), such situations do present *economic* double taxation. The same income is taxed twice, to the extent that an inclusion in the American company's taxable profits has not been offset by a corresponding deduction in France. The multinational's position would be that of a stakeholder, willing to pay tax to either the United States or to France, but not to both countries. Tax treaty arbitration provides one hope for fiscal symmetry, thereby reducing the fiscal barriers to cross-border trade and investment.

*Investment disputes*

Finally, arbitration of tax disputes occurs in the context of relationships between foreign investors and host states. On rare occasions, a government may agree on an *ad hoc* basis to arbitrate disputes over the quantum of a foreign investor's tax liability.[16]

Much more common, however, are treaty-based claims by investors alleging that the host state imposed tax in a discriminatory or arbitrary manner, or used tax as a vehicle for expropriation without compensation.[17] Such tax-related investment disputes remain qualitatively different from the commercial or tax treaty context. In an investment dispute, the very legitimacy of the tax is put into question.

The controversy does not concern shifting normal fiscal burdens between a buyer and a seller, or the tax authorities in the parent's home state as opposed to the subsidiary's country of incorporation. Rather, an assertion might be made that the governmental payment is not really a tax at all, but rather a disguised attempt at confiscation. This last category of tax arbitration forms the focus of this chapter.

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[16] See Jean-Pierre LeGall, *Fiscalité et arbitrage*, 1994 Rev. Arb. 3, 24–5 (1994), noting at several international tax arbitrations; Emmanuel Gaillard, *Tax Disputes between States and Foreign Investors*, N.Y. L.J. 3 (April 1997).

[17] See generally, Thomas Wälde and Abba Kolo, *Investor-State Tax Disputes: The Interface Between Treaty-Based International Investment Protection and Fiscal Sovereignty*, 35 Intertax 424 (Aug.–Sept. 2007); Richard Happ, *Beilegung von Steuerstreitigkeiten zwischen Investoren und ausländischen Staaten durch Schiedsgerichte*, IStR 649–54 (2006).

## B. The Nature of Tax Measures

**Tax as taking**

No consensus exists on why tax measures should receive special attention in investment treaties. Raising revenue does constitute a core activity of all political collectivities. However, the same can be said of many other government functions (such as administration of justice or environmental protection) that regularly give rise to claims by foreign investors. For example, an effective judiciary remains vital to any concept of sovereignty.[18] Nevertheless, court proceedings have long been a fertile source of state responsibility under both customary international law[19] and modern investment treaties.[20]

Any explanation for the treaty carve-outs given to tax measures remains tentative, and unlikely to give complete satisfaction. However, one rationale may prove more right than wrong. The best account for taxation's special status probably lies in the very nature of taxation. As mentioned earlier, tax constitutes a form of confiscation, thus opening the way to investor arguments (however misconceived) that an actionable taking of property has occurred. In particular, taxes lend themselves to characterization as a form of indirect or "creeping" confiscation, which might in principle give rise to claims under investment treaty provisions related to expropriation and discrimination.[21]

Unlike charitable contributions or purchases of goods and services, wealth transfer through taxation remains involuntary. Taxpayers have no option to say, "Sorry, we'll just skip this year's contribution." The only escape lies in ceasing the activity that otherwise triggers the tax.[22]

[18] We remember that Absalom's revolt against his father King David all started with his claim that the king was unable to put in place an effective adjudicatory mechanism. The Bible recounts that Absalom would stand on the roadside and shout to those with pending litigation: "Your claims are good and right; but there is no one deputed by the king to hear you. If only I were judge in the land! Then all who had a suit or cause might come to me [for] justice." II Samuel 15:2–4. See generally Max Weber, *The Protestant Ethic and the Spirit of Capitalism* Appendix II (P. Baehr and Gordon Wells (eds. and trans.), 2002); Rosa María Cortés, *Collected Essays in the Sociology of Religion* (1920–1921) 365: "Modern rational capitalism requires . . . calculable law and administration conducted according to formal rules, without which no rational private economic business with standing capital . . . is possible.". See also Max Weber, *General Economic History* 277( trans. F. Knight (trans.), 1966).

[19] See J.L. Brierly, *The Law of Nations* 286–7 (1963), noting different views on what constitutes *déni de justice*. A narrow interpretation contends that denial of justice exists only when foreigners have been refused access to courts. The broader view includes substandard judicial acts such as corruption, dishonesty, unwarranted delay. The term is sometimes misapplied to national court disregard of international law. In his study *Denial of Justice in International Law* (2005), Jan Paulsson rightly suggests abandonment of the term "substantive" denial of justice to describe such violations of the law of nations. See also A.W. Freeman, The *International Responsibility of States for Denial of Justice* (1938); Ian Brownlie, *Principles of Public International Law* 506–8 (6th edn, 2003).

[20] See e.g. *Mondev International Ltd. v. U.S.A.*, ICSID Case No. ARB (AF)/99/2; Award of 11 October 2002 published in 42 I.L.M. 85 (2003); *Loewen Group, Inc. v. U.S.A.*, ICSID Case No. ARB (AF)/98/3, Final Award 26 June 2003, 42 I.L.M. 811 (2003).

[21] For a South American view on tax as indirect expropriation, see Marco Chavez, *La expropiacion indirecta y el Capitulo 10 del TLC suscrito por el Peru con Estados Unidos de Norteamerica*, 4 Revista Peruana de Arbitraje 367 (Ed. Magna, Lima, 2007).

[22] From the perspective of a government (democracy and dictatorship alike), taxation can be compared to payment for benefits such as roads, schools and diplomatic protection. They need not involve either discrimination or a design to damage the underlying business activity. Like any analogy, the comparison is far from perfect. Analytic problems arise when one examines the relationship between the tax and the service. Although fiscal jurisdiction assumes some taxpayer contact with the state, the benefit received is rarely calibrated to the fee paid. In towns where real estate taxes finance public education, wealthy but childless homeowners pay more toward schools than modestly housed residents with large broods.

In attempting to distinguish legitimate revenue measures from *de facto* confiscation through taxation, one is reminded of the line by U.S. Supreme Court Justice Potter Stewart reversing a movie theater's obscenity conviction. Admitting an inability to define "hard core" pornography, Stewart added, "But I know it when I see it."[23] British judges sometimes apply a similar (but less risqué) characterization test. In deciding that a floating crane was not a "ship or vessel" for purposes of insurance policy, Lord Justice Scrutton referred to the gentleman who "could not define an elephant but knew what it was when he saw one."[24]

Like elephants and obscenity, the contours of legitimate taxation leave many fuzzy edges that frustrate rigorous discussion. Although telling them apart is not always easy, differences do exist between what might be called "normal" and "abusive" taxes. The former aim to fund government. The latter are crafted to force abandonment of a business enterprise by ruining its economic value, or to provide an investor's competitors with a beneficial fiscal framework that permits more favorable competition.

As discussed later, various treaty-based limitations come into play when an investor contends that an allegedly abusive tax violates some provision of an investment convention or free trade agreement. As also discussed in the following sections, the relevant distinctions go far beyond technical matters such as depreciation methods and timing of rebates, and touch on the very notion of revenue-raising legitimacy.[25]

**The Silesian claims**

Tax-related claims have not always benefitted from investment protection regimes. In the early 20th century, an arbitral tribunal took the view that fiscal measures by their nature did not constitute expropriation. Under this now-discredited doctrine, investors had no general recourse to arbitration for relief from abusive taxation.

The origins of the case, *Kügele v. Polish State*,[26] lie in a part of Central Europe called Upper Silesia, now found in the southeast corner of Poland. [27] Following the First World War, the ethnically Polish portion had become an autonomous region, while the largely German-speaking areas remained in Germany. Following uprisings among the Polish-speakers, part

[23] See *Jacobellis v. Ohio*, 378 U.S. 184, 197 (1964) (concurring opinion), examining when erotic expression falls outside the limits of constitutionally protected speech. The object of inquiry was a Louis Malle film *Les Amants* about a woman in an unhappy marriage. See also Paul Gewirtz, *On "I Know It When I See It"*, 105 Yale L.J. 1023 (1996).

[24] See *Merchants Marine Insurance Co. Ltd. v. North of England Protecting & Indemnity Association* [1926] 26 Lloyd's Rep. 201, 203; 32 Com. Cas. 165, 172. In the Charente River near Rochefort, a steamship had collided with a crane. If the crane was a "ship or vessel" then the insurance company apparently paid three-fourths of the damages; otherwise the damage was paid by the North of England Protecting & Indemnity Association. See also *O'Callaghan v. Elliot* [1966] 1 Q.B. 601 (a Denning decision that attributes the saying to Balfour); and *Cole Brothers Ltd. v. Phillips* [1981] STC 671, 55 Tax Cases 188. The statement is attributed to Balcombe in the article *Land Contracts: An Evolving Policy*, J. Bus. L. 39, 46 (Jan. 1996).

[25] See later discussion in Section E.

[26] *Kügele v. Polish State*, 5 February 1932. English language summary as Case No. 34, *Annual Digest of Public International Law Cases* (Hersch Lauterpacht (ed.), 1931/1932). The terms of the relevant treaty are reproduced in Case No. 33 of that volume of the *Annual Digest*.

[27] The adjective "Upper" remains somewhat of an irony, since the region appears in the lower right corner (the southeast) of most maps of Poland, near its borders with the Czech Republic and Slovakia. Apparently labeled for its location between the "upper" parts of two rivers (the Oder and the Vistula) flowing down from the Silesian highlands, the region was alternatively under the control of Poland, Bohemia, Austria, Prussia, and Germany. Rich in agriculture and coal, the area included towns such as Chorzów, Katowice and Bytom (Beutem).

of Upper Silesia was awarded to Poland pursuant to a Geneva Convention brokered by the League of Nations.[28]

To address claims by Germans for expropriation, the treaty established what seems to be the first modern European investment protection regime, giving investors a direct cause of action against the host country.[29] The Arbitral Tribunal of Upper Silesia (officially "*Tribunal Arbitral de la Haute Silésie*") provided an avenue for vindication of investor rights independent of either local courts or the diplomatic protection of the investor's home state.

Under the label "license fees" (which today might be called excise taxes), Poland had imposed an allegedly confiscatory levy on a brewery owned by an ethnic German, which according to the owner was forced to cease business because of the tax. Claiming that the tax was tantamount to expropriation, the German proprietor filed a claim for compensation.

In a 1932 decision, the Arbitral Tribunal rejected the claim on the basis that taxation by definition cannot give rise to expropriation. According to the Tribunal, the imposition of a tax implies the existence of a business, which in turn presupposes that the enterprise has not been confiscated. An arbitral tribunal chaired by the eminent Belgian Professor, Georges Kaeckenbeeck, reasoned as follows:

> The increase of the tax cannot be regarded as a taking away or impairment of the right to engage in a trade, for such taxation presupposes the engaging in the trade. . . . The trader may feel compelled to close his business because of the new tax. But this does not mean that he has lost the right to engage in the trade. For had he paid the tax, he would be entitled to go on with his business.[30]

Today, such reasoning would be difficult to imagine. As discussed in the following section, barriers to tax arbitration still exist. However, none of them rest on the view that fiscal measures somehow must be deemed non-arbitrable.

## D. The Architecture of Investment Protection

**Treaty hierarchies**

The current network of investment and free trade agreements was adopted to enhance economic cooperation and cross-border capital flows through a two-part regime: (i) substantive investor protections against discrimination, confiscation and other unfair governmental measures, and (ii) a relatively neutral dispute resolution mechanism in the event of disagreement

[28] Geneva Convention of 15 May 1922, Poland and Germany.

[29] The 1922 treaty (apparently concluded only in French) can be found as an Annex in Georges Kaeckenbeeck, *The International Experiment of Upper Silesia: A Study in the Working of the Upper Silesia Settlement 1922–1937* (OUP, 1942). Kaeckenbeeck served as President of the Arbitral Tribunal from 1922 through 1937. See also Georges S. Kaeckenbeeck, *Essential Human Rights*, 243 Annals of the American Academy of Political and Social Science 129–33 (Jan. 1946). North America had experimented with a prototype of investment arbitration in 1794, when the so-called "Jay Treaty" (named for its American negotiator John Jay) gave British creditors the right to arbitrate claims of alleged despoliation by American citizens and residents. See Treaty of Amity, Commerce and Navigation, London, 19 November 1794, U.S.-U.K., 8 Stat. 116. Under Article 6, damages for British creditors were to be determined by five Commissioners, two appointed by the British and two by the United States. The fifth was to be chosen unanimously by the others, in default of which selection would be by lot from between candidates proposed by each side. See generally Barton Legum, *Federalism, NAFTA Chapter Eleven and the Jay Treaty of 1794*, 18 ICSID News (Spring 2001).

[30] Case No. 34, *Annual Digest* (n. 26) 69, summarizing with excerpts from *Schiedsgericht für Oberschlesian*, Volume III(1), 24 (1932).

on how those protections should operate.[31] The cornerstone of most investment treaties lies in a prohibition of uncompensated expropriation of foreign-owned property, whether such expropriation be direct or indirect.[32]

In their interaction with tax measures, investment treaties often contain a level of complexity that tends to defy normal discourse. Multiple qualifiers and exceptions for exceptions apply with respect to even simple propositions. Other than insurance policies and revenue codes, few public documents present as many exegetical challenges.

For example, Article 21 of the ECT says that the treaty does not create rights or impose obligations with respect to taxation measures.[33] Then it goes on to make an exception for the part of Article 10 related to non-discrimination and most-favored-nation provisions, which *do* apply to tax measures.[34] But the exception applies only to measures other than income and capital taxes, which would seem to leave all other government imposts, such as value added tax, excise tax, stamp duties, import and export taxes.

But that is not all. The rule that non-discrimination provisions apply to tax measures contains several exceptions. These include, *inter alia*, tax collection mechanisms.[35] This exception to an exception contains its own additional exception, with respect to measures that "arbitrarily" discriminate against investors from the other contracting party. There are also exceptions for advantages accorded under regional economic integration organizations[36] and income tax treaties.[37] As to these items, one is sent back into the general Article 21 rule that no rights are created or obligations imposed.

Just when light was beginning to dawn, we note that the ECT definition of "taxes" explicitly excludes customs duties.[38] What does this mean? If customs duties are *not* taxes, then the initial exclusion of Article 21 (creating no rights and imposing no duties with respect to tax

[31] See generally William W. Park and Guillermo Aguilar Alvarez, *The New Face of Investment Arbitration*, 28 Yale J. Int'l L. 365 (2003). Not all would agree with this positive assessment of investment protection regimes, as witnessed by the recent denunciation of Bolivia's denunciation of its obligations under the ICSID Convention (effective in late 2007), followed by Nicaragua's threat to withdraw from that Convention, Venezuela's decision to withdraw from the World Bank and Ecuador's declaration of intent to abrogate its bilateral investment treaty with the United States and remove ICSID jurisdiction related to oil and mining. See Emmanuel Gaillard, *The Denunciation of the ICSID Convention*, N.Y. L.J. (26 June 2007). For a historical view of investment protection, see William W. Park, *Legal Issues in the Third World's Economic Development*, 61 B.U. L. Rev. 1321 (1981). For an intriguing perspective on the origins of the debate, see Eugene Staley, *War and the Private Investor* (1935).

[32] On indirect expropriation, see Michael Reisman and Robert Sloane, *Indirect Expropriation and Its Valuation in the BIT Generation*, 2003 Brit. Y.B. Int'l L.115 (2004); Rachell Edsall, *Indirect Expropriation under NAFTA and DR-CAFTA: Potential Inconsistencies in the Treatment of State Public Welfare Regulations*, 86 B.U. L. Rev. 931 (2006); Burns H. Weston, *"Constructive Takings" under International Law: A Modest Foray into the Problem of "Creeping Expropriation"*, 16 Virg. J. Int'l L. 103 (1975). For an illustration of indirect expopriation, see *Case Concerning the Barcelona Traction, Light and Power Co, Ltd (Belgium v Spain) (2d Phase)*, 1970 ICJ 3, 9 I.L.M. 227 (1970), where a Canadian company's profitable Spanish assets were taken through a bankruptcy proceeding allegedly orchestrated to reward a supporter of then-dictator General Francisco Franco. The bankruptcy resulted when Spanish authorities refused to permit transfer of foreign currency necessary to service sterling bonds.

[33] At some places the ECT refers to "Taxation Measures" (Art. 21(1)–(4)), while at other places the treaty uses the term "taxes" (see Art. 21(5) concerning expropriation rules under Art. 13), without any explicit indication of why the different phraseology was chosen.

[34] ECT Art. 10(2) and (7).

[35] ECT, Art. 21(3)(b).

[36] ECT, Art. 21(3)(a).

[37] See ECT, Art. 21(3)(a), with its cross reference to Art. 21(7)(a)(ii), which includes any international agreement "for the avoidance of double taxation."

[38] ECT, Art. 21(7)(d).

measures) would not apply in the first place. So the otherwise applicable investor protections (including fair and equitable treatment) remain in force, notwithstanding that they were initially excluded with regard to tax measures.[39]

As a general matter, most (but not all) conventions contain few provisions that permit tax claims to be brought with respect to denial of "fair and equitable" treatment. Taxes that seem unfair and inequitable remain subject to general exclusions for tax measures, and thus non-arbitrable. The fear seems to be that notions of fairness and equity remain too malleable and chameleon-like to be useful, and could lend themselves to mischief, at least from the host state's perspective.

The exceptions make more sense when viewed in the light of specific national tax measures. To illustrate, Article 2103(4) of NAFTA allows the non-discrimination provisions to apply to taxes "other than those on income or capital gains."[40] Why the carve-out? What is it about income taxes that might pose problems?

The answer is not hard to find when one looks at common features of income tax codes. Most national tax systems are full of provisions which on their face apply in a discriminatory fashion. Understandably, such discrimination often exists for reasons of administrative convenience, given the difficulty of overseas auditing and enforcement.

To illustrate, Section 884 of the United States Internal Revenue Code imposes tax on the "dividend equivalent amount" of profits earned by foreign (but not domestic) corporations. Sound reasons may exist for this tax, which tends to equalize the burden imposed on foreign entities operating through branches and those using corporate subsidiaries. Nevertheless, the measure is clearly discriminatory. Foreign companies are subjected to a tax not imposed on their domestic counterparts. Indeed, the American tax authorities have recognized that in appropriate instances relief may be available through the non-discrimination provisions of double tax conventions.[41]

Or to take another case in point, most developed countries tax non-resident aliens and foreign corporations on their passive income (such as dividends and interest) based on "gross receipts" although citizens and residents, by contrast, pay tax on net income.[42] For example, the default rule in the United States remains a thirty percent (30 percent) tax on gross amounts of dividends received by foreigners, and ten percent (10 percent) on the gross realized by them on real estate dispositions.[43] By contrast, residents and citizens are taxed only on net gain, whether from securities or real estate.

[39] Article 21(3) states explicitly that the non-discrimination and most-favored-nation provisions of Article 10(2) and (7) will apply to taxation measures, but makes no mention of Article 10(1), the provision mandating "fair and equitable treatment" with a goal to "encourage and create stable, equitable, favourable and transparent conditions for investors."

[40] The provision goes on to include "the taxable capital of corporations, taxes on estates, inheritances, gifts and generation skipping transfers and those taxes listed in paragraph 1 of Annex 2103(4), which designates certain excise taxes on insurance premiums."

[41] See Treasury Regulations, § 1.884-1(g). See also United States Model Income Tax Convention, Art. 24 ("Non-Discrimination"), 16 November 2006.

[42] See e.g. Reuven Avi-Yonah, *Globalization, Tax Competition and the Fiscal Crisis of the Welfare State*, 113 Harv. L. Rev. 1573 (2000); Michael J. Graetz, *Foundations of International Income Taxation* ch. 7 (2003).

[43] See e.g. I.R.C. §§ 871 and 881 on dividends and other passive income. When applicable, most treaties reduce this gross amount to more reasonable proportions. See OECD Model Income Tax Convention, Arts. 10 (dividends), 11 (interest) and 12 (royalties). With respect to real estate dispositions I.R.C § 1445 imposes a tax on gross amouts realized, which can in some instances be adjusted if the taxpayer reaches an agreement with the government. Unlike passive income, however, real estate dispositions do not benefit from treaty-based tax benefits. See FIRPTA "Treaty Override" in P.L. 96-499 (1980) § 1125.

**The competent authority filter**

To distinguish normal and abusive taxes, many investment treaties require that claims of tax-related expropriation may be sent to arbitration only after the matter is first referred to the two competent fiscal authorities of the host and investor states.[44] For example, under NAFTA the authorities are given six months to try to work things out, and together may veto any arbitration implicating tax measures. The veto (sometimes called a "filter") must be exercised *jointly* by both countries, which means that the investor loses the right to file an expropriation claim only if its own home state authorities have not been convinced to endorse the view that the tax is confiscatory.[45]

The analogous ECT provision says only that the competent authorities shall "strive to resolve" the issues.[46] That treaty adds, however, that "under no circumstances" will arbitration be delayed because of involvement by the tax authorities beyond a six-month period following referral by the investor or host state. Thus the governmental "meet and confer" process takes on the nature of a conciliation stage of sorts, followed by binding arbitration under the dispute resolution provisions of Article 26. The competent authorities (at least those of the investor's state) can be expected to balk at arbitration only if the relevant measures are intended to operate *de facto* as takings rather than legitimate revenue gathering.

## E. A Tale of Two Cases: *Occidental* and *Encana*

In his intricate novel *A Tale of Two Cities*, Charles Dickens addresses themes related to love, justice and sacrifice during the French Revolution. A dissolute and habitually drunk English barrister voluntarily mounts the guillotine in Paris to save his romantic rival, a French aristocrat wrongly condemned for crimes committed by his cruel uncle. In so doing, the drunkard finds redemption through a noble act far better than he had imagined himself capable.

Tax arbitration has none of the passion of the Dickens novel. However, it does present stark contrasts of a different kind. Slight drafting differences from one treaty to another yield dramatically different levels of investor protection.

Perhaps the most striking illustration can be found in the different treatment of Ecuador's refusal to refund value added tax for purchases made by two foreign oil companies, one American and the other Canadian. The *Occidental*[47] and *Encana*[48] decisions were rendered slightly more than eighteen (18) months apart, in July 2004 and February 2006, respectively. Each addressed an oil company's entitlement to value added tax (VAT) refunds on goods and

[44] ECT, Art. 21(5) provides: "The Investor or the Contracting Party alleging expropriation shall refer the issue of whether the tax is an expropriation or whether the tax is discriminatory to the relevant Competent Tax Authority." NAFTA, Art. 2103(6) contains a slight variant in its language: "The investor shall refer the issue of whether the measure is not an expropriation for a determination to the appropriate competent authorities set out in Annex 2103.6 at the time that it gives notice under Article 1119 (Notice of Intent to Submit a Claim to Arbitration)."

[45] See generally, William W. Park, *Arbitration and the Fisc: NAFTA's Tax Veto*, 2 Chicago J. Int'l L. 231 (2001); reprinted in 16 Int'l Arb. Rep. 33 (May 2001).

[46] ECT, Art. 21(5)(b)(ii).

[47] *Occidental Exploration and Production Co. v. Ecuador*, 1 July 2004. Charles Brower, Francisco Orrego Vicuńa, Patrick Barrera Sweeney. UNCITRAL arbitration, with LCIA serving as Registrar. Susan Franck, *Note*, 99 Am. J. Int'l L. 675 (2005).

[48] *Encana v. Republic of Ecuador*, 6 February 2006. James Crawford and Christopher Thomas in the majority, with Horacio Grigera Naón issuing a Partial Dissenting Opinion on expropriation, reprinted 45 I.L.M. 895 (2006) with comment by Devashish Krishan. UNCITRAL arbitration, with LCIA serving as Registrar.

services in Ecuador.[49] Each related to a "participation contract" for oil and gas exploration, whereby the foreign company bore all risk and expenses in return for a share in the production at the contract area. Each contract calculated the amount due the company as percentages of the oil extracted based on similar factors.

Here the similarities end. In *Occidental* (which arose under Ecuador's BIT with the United States) the investor won a refund. In *Encana* (brought under Ecuador's BIT with Canada) the investor lost. The cases underscore the significance of subtle treaty wording, as we shall see in the following discussion.[50]

### *Occidental*

#### *The award*

The dispute between Occidental and Ecuador arose under the 1993 Bilateral Investment Treaty between the United States and Ecuador, with respect to whether Occidental was entitled to obtain VAT refunds on payments made for goods and services purchased in connection with the production and export of oil under the parties' Participation Contract. Initially, Ecuador had refunded the VAT, but later changed position. Occidental alleged that the actions of the Ecuadorian revenue service amounted to breaches of Article II of the BIT which prohibits discrimination and mandates "fair and equitable" treatment.

The contractual aspect of the *Occidental* dispute implicated the question of whether or not the formula for determining the oil company's participation (referred to as "Factor X"[51]) implicitly took into account VAT reimbursement. In other words, did the contract fix the oil company's revenue (calculated according to Factor X) at a level higher than it would have been otherwise, so that the company would make enough money to offset the payment of VAT? Was the revenue participation a "back door" form of VAT reimbursement?

The arbitral tribunal answered that question in the negative, and found that Ecuador's denial of VAT refunds breached the treaty's non-discrimination provision and its duty of "fair and equitable" treatment. Consequently, Ecuador was ordered to reimburse the VAT in an amount of $71 million plus interest.

To get to this point, however, the tribunal had to decide a preliminary jurisdictional matter related to Article 10(2) of the U.S.-Ecuador BIT, which applies the treaty to tax matters but

[49] Taxes were imposed on local purchases and services, as well as imports of goods.

[50] *Occidental* and *Encana* are only two among a number of investment cases that implicate tax measures. See e.g. *Marvin Roy Feldman Karpa v.United Mexican States*, ICSID Case No. ARB(AF)/99/1; Award and Dissenting Opinion of 16 December 2002, published in 42 I.L.M. 625 (2003), finding Mexico liable for discriminatory tax under NAFTA, which in Section 2803(4) says that non-discrimination provisions of Article 1102 shall apply to tax measures. It is reported that the tax filter was in fact applied in this case, allowing two of the three expropriation claims to pass through. See also *Enron Corp. and Ponderosa Assets, L.P. v. Argentine Republic*, ICSID Case No. ARB/01/3; Decision on Jurisdiction of 14 January 2004. See also *El Paso Energy International Co. v. Argentine Republic*, ICSID Case No. ARB/03/15; Decision on Jurisdiction of 27 April 2006; and *Duke Energy International Peru Investments No. 1, Ltd. v. Peru*, ICSID Case No. ARB/03/28; Decision on Jurisdiction of 1 February 2006. One of the most well-known cases brought under the ECT to date (*Yukos/Menatap*) involves taxation. See *Hulley Enterprises Limited* (Cyprus) v. *Russian Federation* (PCA Case No. AA 226), *Yukos Universal Ltd (Isle of Man) v. Russian Federation* (PCA Case No. AA 227); *Veteran Petroleum Ltd* (Cyprus) v. *Russian Federation* (PCA Case No. AA 228).

[51] The terms of "Factor X" contained in Participation Contract, Art. 8.1 (whose subheading was titled "Calculating Contractor Participation") apparently include no references to cost elements or value added taxes, but simply allocate production volumes between Ecuador and Occidental, with the state participation in subheading 8.5 calculated simply as the difference between the number 100 and Occidental's participation percentage.

only with respect to several limited provisions. One was expropriation.[52] However, the tribunal found no evidence of direct or indirect expropriation, and held that claim inadmissible.[53]

Another portion of Article 10(2) said that the treaty would apply to tax matters with respect to "the observance and enforcement of terms of an investment agreement or authorization."[54] The arbitrators found that the Participation Contract between the host state and the investor was just such an investment agreement, and the Factor X dispute related to that agreement. Consequently, the tribunal confirmed its jurisdiction.[55]

An additional consideration was found in the introductory provision in Article 10(1) which stated that with respect to its tax policies, each country should "strive to accord fairness and equity" in the treatment of investments by the other's nationals. Finding that this provision was "not devoid of legal significance" the arbitrators determined that its obligations were not dissimilar to the duties of "fair and equitable" treatment in treaty Article II.[56] The tribunal read this language as imposing an obligation of fairness and equity with respect to the three categories of matters contained in Article 10, including observance of an investment agreement.

Ultimately, the arbitrators found that the failure to refund the VAT was due not to any deliberate action, but from the arbitrariness of what they called "an overall rather incoherent tax structure."[57] Consequently, Ecuador was held to have breached its obligations to guarantee both national treatment and "fair and equitable" treatment under Article II of the treaty.

This did not end the story, however. Ecuador challenged the award in London (the arbitral seat) under the English Arbitration Act, alleging that the arbitrators exceeded their powers by considering the VAT matter. As will be discussed, the English courts supported both the arbitrators' power in the particular case to consider tax matters and the judiciary's general exercise of supervisory jurisdiction over investment arbitration.

*The English court action*

The 1996 English Arbitration Act contains at least two provisions permitting courts to address what might be called excess of authority (*excès de pouvoir*) in the broad sense. The first permits challenge as to the "substantive jurisdiction" of the award.[58] The second allows challenge for "serious irregularity," which is defined to include a tribunal "exceeding its powers" in some way not covered by the provision on substantive jurisdiction, but which causes "substantial injustice."[59]

Ecuador attacked the award in favor of Occidental on both grounds. Each was rejected.[60] Following some of the same lines of argument as the arbitral tribunal, the Court determined

[52] U.S.-Ecuador BIT, Art. 10(2)(a).

[53] Occidental Award of 1 July 2004, para. 92.

[54] U.S.-Ecuador BIT, Art. 10(2)(c). This provision contained its own exception for claims subject to dispute settlement procedures in a double tax treaty, or when such settlement provisions do not resolve the matter in a reasonable time. A third prong of that article (Art. 10(2)(b)) applied the BIT to tax matters with respect to "transfers."

[55] Occidental Award of 1 July 2004, para. 7.

[56] Ibid. para. 70.

[57] Ibid. para. 200.

[58] Arbitration Act 1996, § 67(1).

[59] Ibid. § 68(2)(b).

[60] *Republic of Ecuador v. Occidental Exploration and Production Co. (OEPC)*, [2006] 1 Lloyd's Rep. 773, [2006] EWHC 345, 2006 WL 690585 (QBD (Comm Ct), decided 2 March 2006).

that the dispute indeed fell within the terms of Article 10(2)(c) of the treaty as it related to observance and enforcement of an investment agreement. The Participation Agreement was such an agreement, and the dispute over the meaning of "Factor X" clearly related to that agreement.

Although the investor's claim was based on the treaty rather than a particular investment agreement, this did not prevent the tribunal from possessing jurisdiction by virtue of the treaty provisions related to observance of investment agreements.[61] The decision was upheld by the Court of Appeal in a carefully reasoned opinion that looked to the Vienna Convention on the Law of Treaties to provide guidance in the construction of the bilateral investment treaty between Ecuador and the United States.[62]

Prior to addressing the jurisdictional challenge, the High Court also had to examine whether the challenge was "non-justiciable" because it pertained to a treaty between two sovereigns.[63] Although acknowledging that the treaty obligations derived from public international law, the Court noted that the performance of treaty-derived rights (i.e. the arbitration itself) had been made subject to the municipal law of England, permitting English courts to hear challenge to an award.[64]

It is important to keep in mind that the decision on "justiciability" does not affect arbitrability either way. The award addressing the VAT questions would have remained valid even if the court had found that the BIT questions were *not* justiciable. What would have changed was not the result of the arbitration, but simply the judicial power to look at claims of excess of arbitral jurisdiction under the English Arbitration Act.

### *Encana*

#### *The majority award*

The relevant jurisdictional limits relevant to *Encana* can be found in Article 12 of the Canada-Ecuador BIT, which diverges from the analogous provisions of the U.S.-Ecuador BIT in both form and substance.[65] The opening subsection of Article 12 of the Canadian treaty states that: "Except as set out in this Article, nothing in this Agreement shall apply to taxation measures." The treaty begins with a negative but quickly proceeds to exceptions (including rules for expropriation[66] and breach of specific contracts with the central government[67]) as to which claims may be brought with respect to tax measures.

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[61] Ibid. para. 113.

[62] *Republic of Ecuador v. Occidental Exploration & Production Co.*, [2007] EWCA Civ 656 (4 July 2007). Article 31 of the Vienna Convention takes into account factors such as the object and purpose of the treaty, while Article 32 refers to "supplementary means of interpretation" such as preparatory work and circumstances of conclusion.

[63] Apparently the challenge to justiciability was brought with respect to the challenge under Section 67 of the 1996 Arbitration Act, but not the challenge under Section 68.

[64] See decision of Justice Aikens in *Republic of Ecuador v. Occidental Exploration and Production Co. (OEPC)* [2005] 2 Lloyd's Rep 240, [2005] EWHC 774 (Comm. Ct.), 2005 WL 1104120 (29 April 2005), upheld by the Court of Appeal on 9 September 2005, [2005] EWCA Civ 111.

[65] In addition, Article 13(3)(c) of the Canada-Ecuador BIT provides that an investor may submit a matter to arbitration only "if the matter involves taxation, the conditions specified in paragraph 5 of Article 12 have been fulfilled." Article 12(5) states that the tax authorities of the contracting states will be given six months to reach a joint determination that a fiscal measure does not contravene an investment agreement with the central government or does not constitute an expropriation.

[66] Canada-Ecuador BIT, Art. 8.

[67] Canada-Ecuador BIT, Art.13(3).

By contrast, the American convention begins with an affirmation that "the treaty shall apply to matters of taxation" but only with respect to certain delineated measures that establish protective hedges around the general rule.

Most significant, however, was the absence of any Canadian equivalent to Article 10(1) in the United States treaty, which states that the host state will "strive to accord fairness and equity in the treatment of investment of nationals and companies of the other Party." The Canada treaty did contain a provision stating that the expropriation provisions (requiring prompt, adequate and effective compensation pursuant to Article 8) would apply to taxation measures.[68] Otherwise, the only tax-related right given the investor derived from fiscal measures that resulted in the breach of an agreement with the host state "central government authorities," in which event the measures would be considered a claim for treaty violation.

Under the facts of the case, the majority of the tribunal found that failure to provide a VAT refund did not constitute a breach of any agreement between the oil company and the government of Ecuador. Moreover, no evidence persuaded the tribunal majority that the failure to give a rebate constituted a *de facto* expropriation.[69] Unlike the arbitrators in *Occidental*, the *Encana* tribunal was not able to rely on any provision concerning fair and equitable treatment in fiscal matters.[70]

*The dissent: expropriating investment returns*

A partial dissent in *Encana* disagreed with the majority's view of the benefits accorded under the investment treaty. According to the highly fact-specific dissent, the Ecuadorian Tax Court and the Ecuadorian Congress interpreted the relevant portions of the national tax statute in a fashion that discriminated against the oil and gas sectors of the economy and resulted in deprivation of property in violation of Article 8 of the investment treaty.

The dissent raised an interesting distinction between investment returns as contrasted with the investment itself, looking to the fruit rather than the tree. While admitting that Ecuador's behavior did not give rise to indirect expropriation of the investment itself, the dissent noted that the revenue seemed to have been "negatively affected" and in essence expropriated.

## F. Abusive Taxes

**Treating like taxpayers in like manner**

Given the ubiquity and the diversity of modern tax systems, the passage of time can be expected to generate a rich tapestry of cases that address the interaction of investment treaties and fiscal measures. Any laundry list of issues to watch would likely be led by the *quaere*: "What makes tax abusive?"

The lion's share of *bona fide* investor claims can be expected to rely on some element of abuse or arbitrariness by the fiscal authorities. A particular tax measure will be said to violate host

[68] The "tax filter" is applicable to expropriation claims, giving the two fiscal authorities a six-month window to impose a joint veto by determining that a tax measure does not constitute an expropriation. See Canada-Ecuador BIT, Art.12(4).

[69] As noted later, the dissent found that an expropriation had in fact occurred "to the extent that [investment] returns have been negatively affected as a consequence of the denial of VAT refunds."

[70] Article 10(1) of the US-Ecuador treaty had required the host state to "strive to accord fairness and equity in the treatment of investment of nationals and companies of the other Party."

state duties to the investor (whether phrased as expropriation, discrimination or unfair treatment) in function of how other similarly situated taxpayers were treated.

In today's world, few fiscal measures reveal themselves as confiscatory on their face. Tax laws do not normally aim at only one taxpayer, or impose rates of 90 percent on profits or asset value.[71]

As a general rule, modern tax measures can be expected to show some sophistication in connection with measures that might be seen as making business operation futile or property ownership untenable. Gross revenue might be taxed without adequate deduction for cost of goods sold or reasonable business expenses. Or, long-term capitalization might be required for items whose useful life spanned much shorter accounting periods.[72]

In this context, one might return to the quotation of Justice Holmes that served as epigraph to this chapter: taxes are what we pay for civilized society.[73] The statement appeared in a case decided at a time when the Philippine islands were an American colony. A local tax had been levied on fire insurance premiums paid by a Spanish tobacco company to English and French insurers.

The majority opinion by Chief Justice Taft held the taxes to be invalid. "[A]s a state may not deprive a person of his liberty without due process of law," reasoned Taft, "it may not compel any one within its jurisdiction to pay tribute to it for contracts or money paid to secure the benefit of contracts made and to be performed outside of the state."[74]

Justice Holmes disagreed in a dissent that bears closer scrutiny. "It is true," wrote Holmes, "that every exaction of money for an act is a discouragement to the extent of the payment required."[75] He continued, however, by noting that "there may be a difficulty in deciding whether an imposition is a tax or a penalty." While noting that the intent to prohibit activity may be plainly expressed, Holmes concluded that sometimes a tax may be "shown to be a penalty by its excess in amount over the tax in similar cases."[76]

This last expression, the "excess in amount over the tax in similar cases," lies at the heart of distinctions between normal and abusive taxes. The test looks not only to the way the fiscal legislation is drafted, but also to the fashion in which the measures are implemented, comparing how taxpayers are treated when in similar circumstances. While not likely to address

[71] In connection, of course, some might suggest abnormality in the 2009 proposal to punish certain American financial services executives after the financial crisis of the prior year, after disclosure that the American International Group would pay more than $200 million in bonuses to employees of its financial services division after having received $170 billion in bailouts. In March 2009 the House of Representatives approved a tax of 90% on bonuses awarded by corporations receiving more than $5 billion in aid from Troubled Asset Relief Program, a measure which some speculated might pose problems under Article 1, Section 9, paragraph 3 of the U.S. Constitution, which prohibits *ex post facto* laws and bills of attainder. See *Would an AIG-Bonus Tax Pass Constitutional Muster?*, Wall Street J., 18 March 2009.

[72] In theory, any expense can be capitalized if the accounting interval is short enough. A lunch could be capitalized if one hour were taken as the relevant period. In most tax administration today, an annual cycle would be considered normal.

[73] *Compañía General de Tabaco de Filipinas v Collector of Internal Revenue*, 275 US 87, 100 (1927).

[74] 275 US 87, 95.

[75] It was in this context that Holmes characterized taxes as "what we pay for civilized society, including the chance to insure."

[76] Ibid. 100–1. With respect to the specific tax at issue Holmes continues: "But here an act was done in the Islands that was intended by the plaintiff to be and was an essential step towards the insurance, and, if that is not enough, the government of the Islands was protecting the property at the very moment in respect of which it levied the tax."

all situations of abusive taxation, the "similar cases" test serves as a useful starting point for identifying taxes intended to expropriate assets rather than raise revenue.

For example, taxes imposed only on people of a particular religion or race would normally be suspect, even if levied at very low rates. However, the same tax (or one at a much higher rate) would pass muster if all creeds and colors were required to pay equally.[77]

Not every discriminatory tax will lack legitimacy, however. For administrative convenience most countries impose special fiscal burdens on non-resident aliens and foreign corporations. As mentioned earlier, these include tax on gross receipts (rather than net income) for investment returns such as dividends, interest and royalties received by non-resident aliens, as well as taxes on the gross amount received from real property gains and taxes on branches of foreign corporations that are not imposed on domestic entities.[78]

**Analogies from non-fiscal contexts**

Determining when tax constitutes expropriation for treaty purposes may in some instances be furthered by reference to the intellectual and legal tools that address related questions in other contexts. For example, governmental measures that impair an investor's enjoyment of property have given rise to host state liability under the Energy Charter Treaty.[79]

In the United States "takings" have been found to occur when government regulations have substantial negative economic effect on private interests.[80] Although the taxing power is commonly understood to lie outside the scope of the Fifth Amendment taking clause,[81] the law of regulatory takings might nevertheless provide elements of an analytic framework to explore what makes fiscal measures abusive.

When American courts address the matter of regulatory takings, they ask what governmental actions might be the functional equivalent of traditional government ouster of owners from their property.[82] A taking occurs if governmental regulation goes too far. The tricky part of the exercise is to determine how far is "too far."

Few "bright line" rules exist in this connection. However, the U.S. Supreme Court has identified several factors of particular significance, including the economic impact of a regulation on the owner, the extent to which a regulation interferes with investment related

[77] See generally, Richard Epstein, *Takings* 283–305 (1985). Professor Epstein distinguishes various forms of taxation (such as special assessments, progressive income taxes and estate/gift taxation), with particular attention to proposals for the so-called "flat tax" discussed in the United States from time to time.

[78] On the branch profits tax, see U.S. International Revenue Code § 884, which is so patently aimed at foreigners that it can trigger application of anti-discrimination prohibitions of income tax treaties.

[79] For a non-tax analogy under the ECT Treaty, see *Nykomb Synergetics Technology Holding AB v. Latvia* (Stockholm Chamber of Commerce, 16 December 2003), discussed in Kaj Hobér, *Energy Investment Arbitration in Eastern Europe* ch. 5 (2007). With the alleged complicity of the central government, the Latvian national electricity grid had refused to pay a Swedish company the tariff provided in a contract for construction of co-generation facilities producing electric power from natural gas. Finding discrimination (based on higher multipliers applied to another company) the tribunal also raised the prospect that the investor suffered "impairment" in its use and enjoyment of the property through unreasonable or discriminatory measures contrary to treaty Article 10.

[80] For example, United States Constitution, Art. V provides that "private property [shall not] be taken for public use without just compensation."

[81] In *Penn Central Transportation Co. v. City of New York*, 438 U.S. 104, the U.S. Supreme Court observed "that government may execute laws or programs that adversely affect recognized economic values. Exercises of the taxing power are one obvious example" ibid. 124. See also Abraham Bell and Gideon Parchomovsky, *Taking Reassessed*, 87 Virg. L. Rev. 277, 284 (2001), suggesting that "when the government 'takes' through taxes, or reduces value by exercise of its police powers, it need not compensate."

[82] *Lingle v. Chevron U.S.A., Inc*. 544 U.S. 528 (2005).

expectations; and the character of the government action.[83] Moreover, legitimate takings must be for public use, a notion now defined (rightly or wrongly) so broadly as to include almost any taking that is "rationally related to a conceivable public purpose."[84]

## G. Conclusion: The Art of Taxation

In explaining the core of his fiscal policy, a finance minister to Louis XIV remarked: "The art of taxation consists in so plucking the goose as to obtain the largest amount of feathers with the smallest amount of hissing."[85] In 17th century France, of course, taxation implicated a tangle of *ad hoc* mechanisms to finance royal lifestyle, rather than a systematic instrument of economic or social policy.[86] Nevertheless, many aspects of taxation continue from one century to another.[87]

Among these constant elements in taxation through the ages, few have been more persistent or problematic than the delicate line-drawing between legitimate and illegitimate taxes. The former pursue normal revenue-raising goals or serve to shape social and economic behavior.[88] The latter include imposts and levies aimed at depriving owners of their property.

In distinguishing normal taxes from abusive fiscal measures, both sides of the investment have an interest in seeing things as did Oliver Wendell Holmes rather than Jean-Baptiste Colbert. Not all discriminatory measures lack legitimacy. However, one element common to much abusive taxation lies in the arbitrary and unequal treatment of similarly situated taxpayers. Some sort of "similar cases test" remains a touchstone in identifying the type of taxation acceptable to host states and foreign investors alike.

[83] *Penn Central Transportation Co. v. City of New York* 438 U.S. 104 (1978). Pursuant to New York City's Landmarks Preservation Law the Grand Central Terminal (owned by the Penn Central) was designated as a landmark, thus interfering with Penn Central's plan to have a lessee construct a multistory office building over the Terminal. Penn Central argued that its property had been taken without just compensation. The court held that a taking did not occur in this case. Even though the owner had been denied the right to exploit the airspace, the law did not prevent him from realizing a reasonable rate of return on the investment.

[84] *Kelo v. City of New London*, 545 U.S. 469 (2005), where a Connecticut municipality approved a development plan intended to revitalize an economically distressed portion of the city. Some of the property needed for the project was to be acquired through the use of eminent domain. Part of the expropriated property was to be transferred to the pharmaceutical company Pfizer to build a research facility. A split court held that "economic development takings" remain constitutional.

[85] The original attributed to Jean-Baptiste Colbert (1619–83) reads: "*L'imposition est l'art de plumer une oie pour obtenir le maximum de plumes avec le minimum de cris.*"

[86] See André Meurrisse, *Histoire de l'impôt* 83–90 (1978), recounting more than a century of tax escapades ultimately contributing to the French revolution of 1789.

[87] One fiscal perennial seems to be taxation's enhanced role in wartime. Shortly after Colbert's death in 1683, French aggression in the German Palatine created a need for new and even more creative revenue-raising measures. The attacks triggered a half century of armed conflict against the so-called Grand Alliance, a prototype European Union of sorts (minus France, of course) that included Austria, Bavaria, Brandenburg, Britain, the Netherlands, Portugal, Saxony, Spain and Sweden.

[88] On conduct-shaping taxes, see Xavier Oberson, *Les Taxes d'Orientation* (1991).