

INTERNATIONAL TAX ARBITRATIONS



Tax arbitration is an evolving field, but international case law is beginning to define it, particularly in relation to Latin America. Doak Bishop, Craig Miles and Roberto Aguirre Luzi of King and Spalding LLP discuss taxes that violate international law and how companies are seeking redress

Modern taxation is a political tool with functions ranging from encouraging or discouraging certain social or personal activities to reallocating income and wealth within a country. There is no question that the power to tax is integral to the economic self-determination of a government – but despite this, a country is not exempt from complying with international law. It is the nature of taxation to take wealth from a legal entity and to transfer it to the account of the state; the question, then, turns to whether this transfer is done in accordance with international law.

Although international case law on taxation is still in a relatively early phase, there are some significant cases arising out of political risk insurance claims and mixed tribunals like the Iran–United States Claims Tribunal. More recently, there have been noteworthy cases from international arbitral tribunals interpreting bilateral investment treaties (BITs), which discuss how tax measures in certain circumstances can be expropriatory. Although there is still much uncertainty such as how to pinpoint the moment a tax measure crosses the line and becomes confiscatory, existing case law defines the contours of when a government can be held internationally responsible for its tax measures.

Crossing the line

Domestic taxation may violate international law or be tantamount to expropriation in the following examples:

- confiscatory taxes that either alone or in combination with other taxes, are excessive or destructive;
- taxes designed to force abandonment of property or its sale at a distress price;
- taxes that violate or repudiate an explicit commitment given to the investor by the host state (such as a tax stabilisation agreement);
- discriminatory taxes;
- arbitrary taxes, when it is manifestly clear that there is no taxable event according to the tax code or if the application of the tax to the facts is unfounded; and
- taxes that violate or repudiate the law of the host state upon which the foreign investor was entitled to rely under international law.

The common element in these six examples is that each recognises that what a foreign investor normally expects is critical in its decision to venture into the host state. No country is generally obliged to refrain from amending its law, except in the special circumstance in which a tax stabilisation agreement is arranged. But when a state amends its law with respect to a foreign investor, it is expected to do so in a way that meets international principles of due process and domestic principles of legality. This expectation is the base upon which an investor relies in making an investment in a foreign state.

The US Restatement of Foreign Relations Law sheds further light on when a tax measure may turn into an expropriatory act or violate international law. It reflects four basic situations: (i) confiscatory tax measures; (ii) tax measures that prevent or unreasonably interfere with the use or enjoyment of property; (iii) discriminatory tax measures; and (iv) taxes designed to force an alien to abandon property or sell it at a distress price.

Political risk insurance case law

Cases coming out of companies' political risk insurance (PRI) policies are forming a set of case law that helps to define taxation that violates international law. Among these, *Revere Copper and Brass, Inc v OPIC* is a landmark.

In 1967, a Jamaican subsidiary of Revere made an agreement with the Jamaican government regarding the construction and operation of a mining plant in Jamaica, which provided for tax stability. Seven years later, a newly elected government announced that it would not be bound by its existing aluminum contracts and issued a series of measures that stripped Revere of some of its investment guarantees. Further ignoring the tax stability agreement, the government increased taxes and royalties, citing changes in the economic environment that justified these increases. Within a year of the measures' implementation, Revere's revenues dropped substantially forcing it to shut down the plant. Revere made a claim under the expropriation provision of its PRI policy with the Overseas Private Investment Corporation (OPIC), but OPIC denied the claim and Revere filed for arbitration. In the ensuing arbitration, the 'Revere' tribunal recognised that a mere breach of contract

does not constitute expropriation, but concluded that in this case the government's repudiation of the tax stability agreement directly prevented Revere from exercising effective control over the use or disposition of its property. Thus, it found an expropriation under the terms of the policy.

Another PRI case regarding tax measures is *Reynolds-Guyana Mines*. Reynolds owned a bauxite mining facility in Guayana, and in 1970, the Guyanan government announced its intent to acquire a meaningful participation in Reynolds's investment. When Reynolds refused to accede to the government's plan, Guyana found a US\$2.7 million tax deficiency, and passed bauxite severance and production taxes, requiring a US\$7 million minimum payment: this was tantamount to a 1,630 per cent tax increase. Reynolds refused to pay the new levy. In response, the government placed a ban on shipments of chemical and calcined bauxite, which forced Reynolds to withdraw its personnel, shut down the plant and lay off the local workers. OPIC and Reynolds agreed to US\$10 million compensation for Reynolds's claim against OPIC. Later, the government of Guyana, OPIC and Reynolds signed an agreement in which the government agreed to pay US\$14.5 million for the nationalised assets and US\$10 million to offset the tax refund and levy claims between Reynolds and the government.

Protective treaties

Customary international law and investment treaties, such as BITs, do not make taxation of an investment per se a form of expropriation. Unless a government has agreed to waive the taxation of an investor, for example in some sort of 'tax holiday', taxation of foreign investors' activities is ordinarily a lawful activity and a foreign investor must be deemed to have invested expecting to pay the proper tax of the host state, unless a provision is made to the contrary. But there are limits on the host state's power to tax.

BITs provide certain standards of protection against tax measures. Some, like the United States–Argentina BIT, adopt a regime in which taxation may be tantamount to expropriation. So, if a tax violates an explicit commitment given to the investor by the host state, or if it is accomplished in ways that violate the

constitutional, substantive or procedural law of the host state, an arbitral tribunal may find the tax measure to be expropriatory. Furthermore, under the US BITs, taxation may violate other standards of protection, such as 'fair and equitable treatment', 'national treatment', and 'full protection and security', etc.

In *Occidental v Ecuador*, Occidental had made a contract with Petroecuador, the Ecuadorian state-owned oil company, for the exploration and exploitation of oil in Ecuador. Before 2001, Occidental was being reimbursed for the VAT paid on purchases required for its oil operations. In 2001, however, the Ecuadorian tax authorities interpreted the law to mean that VAT refunds were due only for manufactured exports and that oil, as a production export, did not qualify. Occidental filed a claim against Ecuador for violation of the US-Ecuador BIT and the arbitral tribunal found that: (i) the Ecuadorian tax authorities wrongly interpreted the contract; (ii) Occidental's requests for clarification were met with vague and unsatisfactory answers; and (iii) the tax law changes were inconsistent with the practice and regulations.

The tribunal rejected Occidental's claim that Ecuador impaired its management and other rights, but did find Ecuador internationally liable for violating its BIT obligation to treat

Occidental's investment "on a basis no less favourable than that accorded in like situations to investment or associated activities of its own nationals or companies, or of nationals or companies of any third country, whichever is the most favourable." Essentially, the tribunal found that a number of companies engaged in the export of other goods such as flowers and seafood were being reimbursed by Ecuador for VAT, and it held that those companies were in "like situations" to Occidental, which exports oil.

The tribunal also found Ecuador liable for violation of the fair and equitable treatment standard in the BIT. The arbitrators noted the 'soft law' obligation in the BIT to strive to treat investors fairly in tax policy, as well as the reference in the tax section to the expropriation provision of the BIT, which in turn required that the fair and equitable treatment provision be complied with by the state, and found that "[t]he stability of the legal and business framework is [...] an essential element of fair and equitable treatment". Therefore, Ecuador's changes to the legal framework and refusal of Occidental's application for a VAT refund violated the BIT's obligation to ensure fair and equitable treatment.

Some BITs, however, may carve out tax measures from their standards of protection or limit them only to claims for expropriation. In

EnCana v Ecuador, the tribunal dismissed the claimant's claim under the Canada-Ecuador BIT. Like Occidental, EnCana owned a participation contract for the exploration and exploitation of oil in Ecuador, and the Ecuadorian tax authorities had rejected EnCana's applications for VAT refunds. In contrast to the Occidental case, the 'EnCana' tribunal found that under the Canada-Ecuador BIT, it had no jurisdiction over tax claims unless they constituted an expropriation.

The majority of the 'EnCana' tribunal failed to find an expropriation and rejected EnCana's claim. It found that there was no commitment from Ecuador in relation to future VAT credits and that, in any event, the denial of a VAT refund did not have a substantial impact on the investment. The majority stated that "[o]nly if a tax law is extraordinary, punitive in amount or arbitrary in its incidence would issues of indirect expropriation be raised."

This article has noted some of the more relevant issues and arguments that are being discussed by tribunals in deciding whether tax measures can be arbitrated. Although there are still several issues that need to be clarified, especially in the investment arbitration field, it is likely that tax measures will continue to be the object of scrutiny by arbitral tribunals and international standards will be further elaborated.