UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT

UNCTAD

INTERNATIONAL INVESTMENT AGREEMENTS AND THEIR IMPLICATIONS FOR TAX MEASURES: WHAT TAX POLICYMAKERS NEED TO KNOW

A guide based on UNCTAD's Investment Policy Framework for Sustainable Development

2021

UNITED NATIONS
UNCTAD

unctad.org/diae unctad.org/iia investmentpolicy.unctad.org worldinvestmentforum.unctad.org

UNCTAD/DIAE/PCB/INF/2021/3

TABLE OF CONTENTS

Acknowledgements **2**

Preface **2**

Executive summary: What tax policymakers need to know about IIAs **3**

Introduction **6**

Selected IIA provisions and their implications for tax measures **10**

1. Definition of investment 10
2. Definition of investor 13
3. Substantive scope of the IIA 16
4. Temporal scope of the IIA 18
5. National treatment (NT) 20
6. Most-favoured-nation (MFN) treatment 22
7. Fair and equitable treatment (FET) 25
8. Full protection and security (FPS) 28
9. Expropriation 30
10. Transfer of funds 34
11. “Umbrella” clause 36
12. Public policy exceptions 38
13. Investor–State dispute settlement (ISDS): scope and conditions of access 40

Conclusions **43**

References **45**

Acknowledgements

This guide was produced by the UNCTAD Division on Investment and Enterprise in cooperation with the WU Global Tax Policy Center. As part of the UNCTAD team, Diana Rosert and Vincent Beyer contributed to the analysis, under the direction of Richard Bolwijn and the overall guidance of James Zhan. Comments and inputs were received from Yvan Rwananga. The WU Global Tax Policy Center team, led by Prof. Dr. Jeffrey Owens, consisted of Joy W. Ndubai and Siddhesh Rao. The WU Global Tax Policy Center is a part of the Vienna University of Economics and Business, Institute for Austrian and International Tax Law.

We wish to thank Julien Chaisse, Filip Debelva, Michael Lennard, Alicia Nicholls, Martha O'Brien, Alice Pirlot, Daniel Smit and Daniel Uribe for their feedback on the draft version of this guide.

A contribution from the Kingdom of the Netherlands for the production of this guide is gratefully acknowledged.

Preface

The UNCTAD Division on Investment and Enterprise is the focal point within the United Nations system for all issues related to investment and enterprise development. It conducts cutting-edge policy analysis, provides technical assistance and builds international consensus on investment and enterprise. The Division takes a lead role in advancing solutions to the development challenges faced by the international community in this area and is dedicated to support investment in sustainable development with its investment and enterprise policy toolkits.

Since the launch of the Investment Policy Framework for Sustainable Development in 2012 (updated in 2015), UNCTAD has been at the forefront of efforts to reform the international investment regime and has provided valuable backstopping to this process.

Building on UNCTAD's long-standing expertise on FDI, investment policymaking and international investment agreements (IIAs), this guide on IIAs and their implications for tax measures complements a paper on "The Interaction of Tax, Trade and Investment Agreements" issued by the Secretariat of the Committee of Experts on International Cooperation in Tax Matters (UN Tax Committee) in April 2019. The paper of the UN Tax Committee Secretariat outlined some key issues and questions surrounding the interaction of tax and non-tax treaties, including trade agreements and IIAs. The Secretariat paper was presented at the eighteenth session of the UN Tax Committee and the Committee endorsed the proposal for follow-up work on these issues.

This guide produced by UNCTAD in cooperation with the WU Global Tax Policy Center assesses the most relevant IIA provisions regarding their implications for tax measures, using the Investment Policy Framework for Sustainable Development (UNCTAD, 2015b) as a basis. To help address potential tax-related challenges arising from IIAs, it gives guidance on the questions and "possible further lines of enquiry" identified in the April 2019 paper by providing concrete policy options for each IIA clause. It also draws on UNCTAD's previous work on the coherence between international tax and investment policies, the theme of the World Investment Report 2015 (UNCTAD, 2015c) and two special issues of the Transnational Corporations Journal released in 2018 (UNCTAD, 2018a; UNCTAD, 2018b).

Executive summary: What tax policymakers need to know about IIAs

This guide primarily addresses tax policymakers by providing insights on the functioning of provisions included in the stock of old-generation IIAs with a focus on their interaction with tax measures. It also discusses available reform options and trends in IIA practice based on UNCTAD's Investment Policy Framework for Sustainable Development (UNCTAD, 2015b) and its most recent reform toolkit, the IIA Reform Accelerator (UNCTAD, 2020a). The guide is intended to encourage and facilitate an ongoing dialogue between the tax and investment communities.

Most IIAs do not exclude taxation from their scope, which means that a wide range of tax-related measures, whether of general or specific application, are covered by them. Some 2,500 old-generation IIAs are in force today, which typically feature broad provisions and include few exceptions or safeguards. The majority of these IIAs were negotiated in the 1990s or earlier, and countries' experiences with investor–State dispute settlement (ISDS) cases show that "old treaties bite". Most known ISDS cases have been filed pursuant to old-generation IIAs. Overall, investors have brought more than 1,000 ISDS cases based on IIAs against at least 120 countries. UNCTAD data suggests that in some 140 of these cases investors have challenged tax-related measures that were taken by developed countries, developing countries and countries with economies in transition. This guide is thus addressed to tax and investment policymakers worldwide.

IIAs impose obligations on States and can interact with regulatory action in the field of tax aimed to raise revenue, eliminate double taxation or limit opportunities to engage in tax avoidance or evasion. During the last decade, investment policymakers worldwide have reassessed the role of IIAs in national development plans and weighed the pros/cons of signing them. Many countries have embarked on the reform of the IIA regime to address challenges for public policymaking arising from broad and vague substantive protection standards coupled with wide access to investor–State arbitration in IIAs.

It is an appropriate time to provide this guidance since both the tax and investment communities are undergoing an in-depth review of the approaches embedded in the respective agreements. Modernizing and rebalancing the clauses contained in old-generation IIAs as part of countries' broader IIA reform strategies can reduce attendant risks. Countries can choose from a set of reform actions, including the interpretation, amendment and replacement of provisions in old-generation IIAs (UNCTAD, 2020a). The need to assess the costs and benefits of IIAs, which considers each country's specific circumstances and development priorities, has been part of the reform discussion (UNCTAD, 2015b). The objective of IIA reform is to better balance investment protection with the host State's right to regulate and make the IIA regime more conducive to sustainable development.

The IIA reform process has been facilitated by UNCTAD's policy research, intergovernmental processes, and toolkits: The Investment Policy Framework for Sustainable Development (Investment Policy Framework; UNCTAD, 2015b) and the Reform Package for the IIA Regime (UNCTAD, 2018c). UNCTAD has put forward concrete actions to modernize old-generation IIAs. Most recently, it launched the IIA Reform Accelerator (UNCTAD, 2020a) to speed up the reform of unbalanced provisions prevalent in the existing stock of IIAs.

This guide focuses on the tax-related implications of the most relevant IIA provisions: What tax policymakers need to know about the unreformed clauses prevalent in old-generation IIAs as well as options available to reform these clauses and address the respective risks.

It also aims to stimulate the interaction between tax policymakers and IIA negotiators. The joint expertise of these two policy communities could help accelerate the IIA reform process and increase the coherence between tax and investment policymaking.

Definitions of investment and investor

The definitions of investment and investor sets out the types of assets and persons covered by the IIA. Old-generation IIAs frequently rely on broad definitions, covering an open-ended list of assets held by foreign investors. A major challenge for government agencies in a host country is to know whether an investment is a foreign investment and by which (if any) IIA relationships it could be covered. Tax administrations and tax policymakers cannot necessarily ascertain whether certain actions or measures are affecting a foreign investor covered by an IIA. The ownership chains behind a local investment may be complex and designed to gain access to IIA benefits through indirect ownership stakes. Reformed IIA clauses seek to address these problems by narrowing the scope of covered investments and investors, including through denial-of-benefits clauses.

Substantive scope of IIAs

Most old-generation IIAs do not contain exclusions from their substantive scope for taxation, which means that tax-related measures, whether of general or specific application, are covered by IIAs. This includes tax measures that fall within the scope of a double taxation treaty (DTT) between the two countries. Even where exclusions exist, ISDS tribunals adopt their own interpretation or definition of "taxes" and do not necessarily rely on domestic law guidance. Policy options for reform include carve-outs for tax measures from all or certain IIA provisions as well as procedural mechanisms for joint determinations involving decision-making by the competent domestic authorities.

Temporal scope of IIAs

Old-generation IIAs frequently extend treaty protection to investments made before the entry into force of the agreement. A measure that was taken prior to entry into force of the IIA but with "lasting effects" on such investments could under certain circumstances give rise to ISDS proceedings, creating uncertainties for tax policymakers. Reform options generally seek to clarify and limit the IIA's temporal scope.

National treatment

The national treatment (NT) provision protects foreign investors/investments against discrimination vis-à-vis domestic investors. Although a similar clause can be found in DTTs, the content is different as the NT provisions of IIAs cover *de facto* and *de jure* discriminatory treatment, and distinctions based on residence are not *per se* accepted under IIAs. Preferential treatment exclusively granted to national investors such as tax exemptions may be challenged under IIAs even where this treatment is in accordance with the host State's legislation. Reform options for this IIA clause seek to clarify the circumstances that are relevant for foreign and domestic investors to be in "like circumstances" and explicitly allow derogations on the basis of legitimate regulatory objectives such as the equitable and effective collection of taxes.

Most-favoured-nation treatment

The most-favoured-nation treatment (MFN) provision protects foreign investors/investments against discrimination vis-à-vis other foreign investors. Investors have rarely invoked the MFN provision to challenge the actual level of material treatment given to foreign investors from third States. More frequently, investors invoked the MFN clause to import more investor-friendly provisions from the host State's IIAs with third States, thereby "cherry-picking" advantageous IIA standards. For example, investors can attempt to circumvent tax exceptions in the IIA under which the ISDS case is brought, on the basis that another IIA signed by the host country does not contain them. Reform options among others seek to explicitly limit this practice.

Fair and equitable treatment

Fair and equitable treatment (FET) is the clause most frequently invoked by investors in ISDS cases. Old-generation IIAs typically include an FET provision drafted in a minimalist, open-ended way. ISDS tribunals' interpretations of FET have grown over time and covered, among others, expectations of regulatory stability and compliance with the legitimate expectations of investors, expectations of transparency and participation in governmental decision-making, and proportionality tests for State measures. For tax administrations and tax policymakers working in an environment of evolving tax regulations, these FET concepts can expose tax authorities to ISDS claims. New-generation IIAs often provide more guidance as to what the standard covers, for example through the inclusion of exhaustive lists of types of treatment that are prohibited by the FET clause. Some recent IIAs entirely omit the FET clause.

Full protection and security

Many old-generation IIAs contain a full protection and security (FPS) clause without clarifications. ISDS tribunals have in some cases extended the scope of FPS to legal security, economic/commercial or other security. Notions and concepts such as the stability of the tax framework, stability of the commercial environment and protection against economic impairment of the investment can be relevant under this provision. New-generation IIAs often clarify that FPS exclusively relates to physical or police protection.

Expropriation

The expropriation provision protects foreign investors in case of dispossession of their investments by the host country. Most old-generation IIAs equally include protection in case of indirect expropriation, without explicit safeguards for non-discriminatory regulatory actions in the public interest. Tax measures with the effect of (substantially) depriving the investor of the value of their investment are vulnerable to challenge. Expropriation clauses constitute a source of uncertainty for States and tax authorities as there is no bright line separating permissible tax measures from tax measures that amount to confiscation or expropriation of an investment and require compensation. Reform options such as the inclusion of specific criteria that seek to guide a tribunal's assessment are frequently encountered in new-generation IIAs.

Transfer of funds obligation

The transfer-of-funds provision grants the right to free movement of investment-related financial flows into and out of the host country. Many old-generation IIAs contain a transfer-of-funds provision without exceptions. In most IIAs no explicit guidance is provided on the types of restrictive measures that may be permitted or conditions for their application. While the good faith application of tax measures is unlikely to violate this standard, including clear guidance in IIA texts can provide certainty to tax policymakers and investors, and will limit arbitral tribunals' discretion in ISDS cases.

"Umbrella" clause

The "umbrella" clause establishes a commitment on the part of the host State to respect its obligations regarding specific investments, for example those arising from contractual arrangements. Revising or withdrawing bilateral (and potentially unilateral) commitments the host State entered into with respect to a foreign investor such as tax stabilization clauses in investment contracts or tax rulings can come within the ambit of the IIA. Through the umbrella clause, contractual obligations or unilateral commitments could, thus, be elevated to IIA obligations and lead to ISDS proceedings. The majority of new IIAs do not include umbrella clauses.

Public policy exceptions

Largely absent from old-generation IIAs, public policy exceptions permit measures otherwise inconsistent with the IIA to be taken under specified circumstances. They can provide a higher degree of flexibility in implementing tax measures when these are justified with respect to specific policy objectives (e.g. for the protection of the environment or public health), and can have implications for the outcomes of tax-related ISDS cases. Tax-specific exceptions that aim at, for example, the effective and equitable collection of taxes can be included.

Access to investor–State arbitration

About 95 per cent of IIAs provide for States' advance consent to international arbitration proceedings between an investor claimant and the respondent State. Investors can directly challenge State measures before an ISDS tribunal. Recourse to domestic courts or the exhaustion of local remedies is not required under most IIAs. Tax matters are generally not excluded from ISDS. The types of tax-related claims that have arisen under IIAs were diverse (e.g. withdrawal of incentives, increases in windfall profit taxes) and were often intertwined with non-tax measures (e.g. forced liquidation, interference with or termination of contracts). Such claims can, but do not necessarily overlap, with the subject matter covered by DTTs and mutual agreement procedures (MAPs). Policy options for new-generation IIAs include limitations to ISDS access for tax-related cases or joint determinations by the competent domestic authorities allowing them to declare that certain tax measures do not breach substantive IIA obligations.

Introduction

This guide primarily addresses tax policymakers by providing insights into the functioning of provisions included in the stock of old-generation international investment agreements (IIAs),[1] with a focus on their interaction with tax measures. It also discusses available reform options for IIAs and trends based on UNCTAD's Investment Policy Framework (UNCTAD, 2015b), the Reform Package for the IIA Regime (UNCTAD, 2018c) and its most recent reform toolkit, the IIA Reform Accelerator (UNCTAD, 2020a). This guide is intended to encourage and facilitate an ongoing dialogue between the tax and investment communities.

Most IIAs do not exclude taxation from their scope, which means that a wide range of tax-related measures, whether of general or specific application, are covered by them. The actions of tax authorities, as organs of the State, and tax policymaking more generally can potentially engage the international responsibility of a State under an IIA when adversely affecting foreign investors and investments. This can involve costly arbitration proceedings, known as investor–State dispute settlement (ISDS). UNCTAD data suggests that some 140 ISDS cases have challenged tax-related measures based on IIAs. The respondent States in these cases were developed countries, developing countries and countries with economies in transition. This guide is thus addressed to tax and investment policymakers worldwide.

Some 2,500 old-generation IIAs are in force today, which typically feature broad provisions and include few exceptions or safeguards (table 1). The majority of these IIAs were negotiated in the 1990s or earlier. Countries' experiences with investor–State dispute settlement (ISDS) cases show that "old treaties bite". Most known ISDS cases have been filed pursuant to old-generation IIAs. Recent IIAs tend to include more reform-oriented features.

Table 1. Reform-oriented elements in IIAs – comparison of "old" and "new" BITs

Treaty provisions Options for IIA Reform	UNCTAD Policy Framework Option	Earlier BITs (1959–2010) (2,432)	Recent BITs (2011–2016) (110)
Preamble Refer to the protection of health and safety, labour rights, the environment or sustainable development	1.1.2	8%	56%
Definition of covered investment Expressly exclude portfolio investment, sovereign debt obligations or claims to money arising solely from commercial contracts	2.1.1	4%	39%
Definition of covered investor Include a "denial of benefits" clause	2.2.2	5%	58%
Most-favoured-nation treatment Specify that such treatment is not applicable to other IIAs' ISDS provisions	4.2.2	2%	45%