

# The Impact of Trade and Investment Treaties on Fiscal Resources and Taxation in Developing Countries

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## Abstract

*Developing countries need fiscal revenue to build their infrastructure, achieve energy security and environmental sustainability, and provide social services necessary for human development. While trade and investment treaties have typically been assumed to be tax revenue-neutral, economic studies demonstrate that such is not, in fact, the case. The legal literature has not given much consideration to this issue, assuming instead that the tax effects of economic globalization have been addressed by bilateral tax treaties. However, constraints on developing countries' fiscal resources resulting from trade and investment treaties are complex and nuanced, and they go much beyond the jurisdictional overlaps addressed by tax treaties. Trade and investment treaties constrain how countries design their tax policy, how they enforce it, and how they may change it.*

*This study offers several findings on the impact of trade treaties on the ability to raise revenue and maps issues for policymakers to consider. It analyzes direct fiscal revenue decreases, such as those resulting from lower tariff rates, and indirect constraints on fiscal policy arising from non-discrimination obligations in trade and investment treaties, as well as other investor protection clauses. It then considers whether and to what extent exceptions and carve-out clauses preserve tax policy autonomy. Lastly, it assesses how some developing countries can carve out more policy autonomy for themselves against international regulatory encroachment in current negotiations.*

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\* Professor of Law, Northeastern University School of Law. The author is grateful for the resources provided by the GDP Center in support of this research. The author also wishes to thank Kevin Gallagher, Rachel Thrasher, Devika Dutt and all the participants of the Workshop on Trade and Investment Treaties & Fiscal Stability: Toward Sustainable Revenue Mobilization for Development held on November 15, 2019 at the GDP Center (Boston University).

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## I. INTRODUCTION

Developing countries need fiscal revenue to build their infrastructure, achieve energy security and environmental sustainability, provide social services necessary for human development, and promote political stability.<sup>1</sup> The U.N.'s Sustainable Development Goals 17.1 and 17.4 also enshrine the need to improve tax mobilization.<sup>2</sup> While trade and investment treaties have typically been assumed to be revenue-positive or revenue-neutral,<sup>3</sup> economic studies demonstrate that such is not, in fact, the case. The legal literature has not given much consideration to this issue, assuming instead that the tax effects of economic globalization have been addressed by bilateral tax treaties. However, as a practical matter, bilateral tax treaties are not meant to address, redress, or otherwise complement trade and investment treaties when it comes to fiscal impact or tax mobilization. Moreover, as a normative matter, trade and investment treaties have many more consequences on taxation than have been recognized so far, particularly for developing countries. This Article assesses the range of impacts that trade and investment treaties have on domestic tax policy and on countries' abilities to reshape their tax policies as their socioeconomic requirements evolve. It then draws out the implications for the negotiation of future trade and investment treaties, as well as for domestic tax policymaking.

Overall, trade and investment treaties have a positive fiscal impact for rich countries, a neutral impact for middle income countries, and a negative fiscal impact for poor countries.<sup>4</sup> In broad terms, until the 1990s, trade liberalization proceeded largely by decreasing tariff rates levied on traded goods. Economic theory argues that such loss can, and should, be offset by increased fiscal revenues from the increased economic activity resulting from a more liberal and global economy. This is typically done by mobilizing direct taxation on personal income, corporate profits, and tangible and intangible property, as well as by indirect taxation on consumption and use.<sup>5</sup> Decreased duty rates may also, in some cases,

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<sup>1</sup> See Reuven S. Avi-Yonah, *Globalization, Tax Competition and the Fiscal Crisis of the Welfare State*, 113 HARV. L. REV. 1573, 1640–41 (2000).

<sup>2</sup> G.A. Res. 70/1, at 26 (Oct. 21, 2015).

<sup>3</sup> Devika Dutt, Kevin P. Gallagher & Rachel D. Thrasher, *Trade Liberalization and Fiscal Stability: What the Evidence Tells Us*, 11 GLOBAL POL'Y J. (forthcoming 2020); see also Frank Ackerman & Kevin P. Gallagher, *The Shrinking Gains from Global Trade Liberalization in Computable General Equilibrium Models: A Critical Assessment*, 37 INT'L J. POL. ECON. 50, 70 (2008) (discussing the assumption of neutrality of government fiscal balances in computational general equilibrium models used to predict gains from trade liberalization).

<sup>4</sup> Dutt et al., *supra* note 3.

<sup>5</sup> See generally Liam Ebrill, Julia Stotsky & Reint Gropp, *Revenue Implications of Trade Liberalization*, 180 INT'L MONETARY FUND OCCASIONAL PAPER SERIES (1999); M. Shahe Emran & Joseph E. Stiglitz,

lead to an increase in volume of imports.<sup>6</sup> Similarly, with respect to foreign investment, the common wisdom is that developing countries should not tax foreign investors because it is more efficient to tax local factors of production such as land, labor, and domestic capital.<sup>7</sup>

However, poor countries are typically unable to offset the loss of tariff revenue with increased revenue from income and profit taxation, or even from broad-based consumption taxes. The inability to make up for lost revenue is due to the informal nature of much of these countries' economies; poor governance; limited administrative, judicial, and enforcement infrastructure; limited resources to create, administer, and enforce a tax system; and a small tax base, amongst other factors.<sup>8</sup> Overall, then, the loss of tax revenues due to a decrease in tariff barriers translates into a net loss of revenue for low-income countries. With respect to investment, there are a number of arguments in favor of taxing foreign investors by host countries and to limit the use of tax breaks to create incentives for investors in the global competition for investment.<sup>9</sup> Double taxation avoidance mechanisms help ensure that taxation by host countries does not impose an undue burden on investors potentially taxed in other jurisdictions.<sup>10</sup> Moreover, tax breaks and other fiscal incentives that might be granted to foreign investors are typically not offset by the increased investments they are intended to yield.<sup>11</sup>

Trade and investment treaties can also add constraints to developing countries' abilities to reform and enhance their tax regimes. For example, guarantees in favor of foreign investors in bilateral investment treaties (BITs) can create a presumption in favor of the status quo at the time the investment is made. As a result, foreign investors may bring monetary claims against states subsequently changing the interpretation or enforcement of their tax policy.

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*On Selective Indirect Tax Reform in Developing Countries*, 89 J. PUB. ECON. 623 (2005); Thomas Baunsgaard & Michael Keen, *Tax Revenue and (or?) Trade Liberalization*, 94 J. PUB. ECON. 563 (2010).

<sup>6</sup> Liam Ebrill et al., *supra* note 5, at 5.

<sup>7</sup> This traditional argument is explained and debunked by Avi-Yonah, *supra* note 1, at 1641–42.

<sup>8</sup> For example, Vito Tanzi & Howell Zee, *Tax Policy for Developing Countries*, in INTERNATIONAL MONETARY FUND: ECONOMIC ISSUES NO. 27 (Mar. 2001), <http://perma.cc/FZA4-6R2K>.

<sup>9</sup> Avi-Yonah, *supra* note 1, at 1643–44.

<sup>10</sup> International tax treaties aim to avoid entities and persons covered by the treaty from being taxed in two jurisdictions for the same economic activity or income (double taxation). Instead, these treaties enshrine an agreement between the signatory countries as to which one will tax the activity, revenue, or person in cases when both countries could have asserted their taxation power absent the treaty. See generally Reuven S. Avi-Yonah, *Double Tax Treaties: An Introduction*, in THE EFFECT OF TREATIES ON FOREIGN DIRECT INVESTMENT: BILATERAL INVESTMENT TREATIES, DOUBLE TAXATION TREATIES, AND INVESTMENT FLOWS 99–100 (Karl P. Sauvant & Lisa E. Sachs eds., 2009).

<sup>11</sup> *Id.* at 1646–47.

Constraints on developing countries' fiscal resources resulting from trade and investment treaties are much more complex and nuanced than the mere loss of tariff revenue. For developing countries aiming to mobilize their fiscal resources more effectively, one crucial step is to fully understand the impact of their current trade and investment commitments on tax policy. They must also be able to evaluate the fiscal impact of future trade and investment negotiations. Both aspects are essential for developing countries' ability to exercise their fiscal sovereignty in a dynamic environment, where their domestic socio-economic needs change over time and the international framework also evolves with ongoing negotiations.

The relationship between taxation, global economic liberalization, and integration is multifaceted; this Article explores a limited aspect of this complexity. Beyond trade and investment treaties, a number of other sources of law bear on the matter but are beyond the scope of this study.<sup>12</sup> Likewise, developing countries' capacities to mobilize fiscal resources are contingent on many factors other than trade and investment treaties, which are not discussed in this Article. Domestic administrative capacity, governance and corruption problems, tax evasion and tax avoidance by domestic and foreign entities, the volume of the informal economy, the degree of economic diversification, and geopolitical factors (like geographic size and population) all massively affect countries' abilities to generate fiscal resources and their calculus over how to best utilize fiscal resources. From a tax perspective, there are a number of tax instruments that have been left out of this study because they do not pertain directly to developing countries' ability to mobilize their fiscal resources. For instance, carbon tax adjustment and other forms of border tax adjustment raise complex issues in relation to trade and investment treaties, but they tend to be deployed by developed countries to counter policies or conditions in developing countries.<sup>13</sup> The work of the Organisation for Economic Co-operation and Development's (OECD) on base erosion and profit shifting is also an important piece of the broader inquiry but is beyond the scope of the present Article.<sup>14</sup>

This Article proceeds with Section II, which maps the direct impact of trade treaties on the ability to raise revenue. Section III analyzes the constraints that

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<sup>12</sup> For example, customary international law on foreign investment, private and contractual agreements between states and investors, and double taxation treaties.

<sup>13</sup> See, for example, Charles E. McLure, Jr., *The GATT-Legality of Border Adjustments for Carbon Taxes and the Cost of Emissions Permits: A Riddle, Wrapped in a Mystery, Inside an Enigma*, 11 FLA. TAX REV. 221 (2011); Paul Erik Veel, *Carbon Tariffs and the WTO: An Evaluation of Feasible Policies*, 12 J. INT'L ECON. L. 749 (2009); Nicholas DiMascio & Joost Pauwelyn, *Nondiscrimination in Trade and Investment Treaties: Worlds Apart or Two Sides of the Same Coin?*, 102 AM. J. INT'L L. 48, 84 (2008); Adele C. Morris, *Making Border Carbon Adjustments Work in Law and Practice*, TAX POL'Y CTR. (July 26, 2018), <http://perma.cc/QKX3-GE29>.

<sup>14</sup> See generally *What is BEPS?*, OECD, <http://perma.cc/PL5Q-KRMN>.

investment treaties impose on changes in domestic tax policy. Section IV assesses the effectiveness of exceptions and carve-outs in trade and investment treaties to preserve tax policy autonomy. It also offers an outlook on how trade and investment negotiations might incorporate more awareness of the tax impact of trade and investment treaties and increase developing countries' abilities to preserve their fiscal sovereignty.

## II. CONSTRAINTS ON DOMESTIC TAXATION FROM TRADE AGREEMENTS

Trade law's most direct and clear impact on countries' tax resources is the decrease in duties levied on trade in goods. Trade liberalization since World War II has involved a multilateral process of converting trade barriers to tariffs and reducing those tariffs in successive rounds of trade negotiations. This process has therefore first generated fiscal revenue for governments converting non-revenue-producing quotas and other non-tariff barriers into tariffs, followed by a decrease in tariff rates.

Section II.A discusses trade law's effect on countries' abilities to raise revenue from customs duties. Trade law also regulates trade in services, which includes cross-border e-commerce. Agreements on trade in services impose qualitative regulatory restrictions, which are typically not phrased in reference to taxation but have a bearing on how countries can design their tax policy on trade in services. Section II.B maps the intersection of trade disciplines modeled after the World Trade Organization's (WTO) General Agreement on Trade in Services (GATS) and various types of domestic taxes.

### A. Decreased Revenue from Customs Duties on Goods

The WTO's General Agreement on Tariffs and Trade (GATT) and other trade agreements generally comprise commitments by participating countries to reduce their import duties. Mean applied weighted tariffs worldwide stood at 2.59 percent in 2017, down from 8.57 percent in 1994.<sup>15</sup> While high-income countries have an average rate of 2.0 percent, low-income countries have the highest rate, at 9.8 percent.<sup>16</sup> Fiscal revenue from these tariff duties on imports varies depending on the overall value and volume of the imported products. Countries

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<sup>15</sup> The World Bank, *Tariff Rate, Applied, Weighted Mean, All Products (%)*, <http://perma.cc/BJ2V-UJAG>.

<sup>16</sup> Brazil's rate is 8.6 percent, China stands at 3.8 percent, and India at 5.8 percent. *Id.* There are important variations by country and by product, which is particularly significant for undiversified economies. Tariff bindings in regional trade agreements tend to be even lower than the multilateral most-favored nation (MFN) rates generally applicable to WTO members.

could raise their tariffs up to the bound rates<sup>17</sup> and therefore increase their fiscal revenue from tariffs, assuming the volume and value of trade does not decrease in response to the higher rate.<sup>18</sup> However, bound rates are only slightly higher than applied rates on average, giving little room for low-income countries to increase applied rates up to the maximum bound level.<sup>19</sup>

The GATT is ambiguous with respect to export duties. Arguably, WTO members are not explicitly prohibited from imposing export duties, and no framework exists for schedules of concessions to export duties. Resource-rich countries, particularly in Latin America and Africa, could therefore use counter-cyclical export taxes on commodities to finance economic diversification and development.<sup>20</sup> Article XI:2 of the GATT also specifically authorizes export restrictions in several instances, including “to prevent or relieve critical shortages of foodstuffs or other products essential to the exporting contracting party” on a temporary basis.<sup>21</sup> The limited litigation on this issue has focused on China’s export restrictions on raw commodities, but China’s accession agreements provided additional commitments, namely an obligation to phase out export taxes on all but about eighty products.<sup>22</sup> Protocols of accession for a number of other countries have also largely closed to those countries the GATT loophole on export duties.<sup>23</sup> Some regional trade agreements, including NAFTA, specifically

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<sup>17</sup> Bound rates are set in WTO members’ schedules of concessions. They are the highest tariff rates that members are allowed to impose. Members are free to impose a lower rate (“applied rate”). General Agreement on Tariffs and Trade, Oct. 30, 1947, 61 Stat. A-11, 55 U.N.T.S. 194 [hereinafter GATT], as amended by Marrakesh Agreement Establishing the World Trade Organization, Apr. 15, 1994, 1867 U.N.T.S. 154 [hereinafter WTO Agreement].

<sup>18</sup> The Laffer curve predicts that, at a certain point, increases in tariffs are inefficient because they cause a decrease in imports, resulting in a loss of overall revenue. How this theory applies in practice depends on several factors, such as the effective administration of increased duties and the availability of substitute domestic goods.

<sup>19</sup> The weighted mean MFN tariff for the world was 4.17 percent as of 2017. It was 3.4 percent for high-income countries and 10.5 percent for low-income countries. The World Bank, *Tariff Rate, Most Favored Nation, Weighted Mean, All Products (%)*, <http://perma.cc/T9AL-3M2D>.

<sup>20</sup> Countries reliant on the export of raw commodities for their domestic revenue may benefit from export taxes on these commodities at times of export booms. Such policies are dubbed “counter-cyclical” because they act to dampen the upside of the economic cycle. See generally Edwin P. Reubens, *Commodity Trade, Export Taxes and Economic Development*, 71 POL. SCI. Q. 42 (1956); Jane Korinek, *Export Restrictions in Raw Materials Trade: Facts, Fallacies and Better Practices* at the U.N. Conference on Trade and Development (UNCTAD) Global Commodities Forum (Apr. 13–14, 2015), <http://perma.cc/A64P-D2SD>.

<sup>21</sup> GATT, *supra* note 17, at art. XI:2.

<sup>22</sup> Appellate Body Report, *China—Measures Related to the Exportation of Various Raw Materials*, WTO Doc. WT/DS394/ AB/R, WT/DS395/AB/R, WT/DS398/AB/R (adopted Jan. 30, 2012); Panel Report, *China—Measures Related to the Exportation of Rare Earths, Tungsten and Molybdenum*, WTO Doc. WT/DS431/R, WT/DS432/R, WT/DS433/R (adopted Mar. 26, 2014).

<sup>23</sup> Gabrielle Marceau, *WTO and Export Restrictions*, 50 J. WORLD TRADE 563, 576–81 (2016).

phase out export duties.<sup>24</sup> Developing countries wishing to avail themselves of the potential for strategic export taxes should be mindful of whether such options continue to exist in future negotiations, particularly in bilateral and regional trade agreements.

Trade in goods derived from e-commerce further erodes revenues from tariff duties. Indeed, individual online purchases of physical products from abroad are often classified as personal household goods for customs purposes, which typically means a low or zero tariff duty.<sup>25</sup> The same product imported commercially for retail resale, however, would be classified based on the actual product and subject to import tariffs applying to such product. Alternatively, individual shipments, often of low value, may be exempt from customs duties under de minimis exceptions (as it would be more costly to administer and collect duties on such transactions than the value of the duty itself).<sup>26</sup> The WTO moratorium on customs duties on electronic transactions has further eroded revenues, with estimates of nearly \$5.2 billion for developing countries (excluding Least Developed Countries) of revenue foregone. Least Developed Countries (LDCs) lost a further \$344 million. In contrast, developed countries are estimated to be losing less than \$290 million.<sup>27</sup>

Trade agreements have very successfully decreased import tariffs. With the export duties issues in the limelight, future trade agreements are also likely to limit that revenue stream. A number of exceptions and flexibility mechanisms exist, which would allow countries to raise import duties in exceptional circumstances, often on a temporary basis, and typically involving some compensation to the affected exporting countries. These options will be examined in Section III.A.

## B. Constraints on the Taxation of Trade in Services and Cross-Border E-commerce

Agreements on cross-border trade in services, which tend to mirror the GATS in structure and substance, are becoming ubiquitous. This Section outlines the implications of the GATS for the taxation of cross-border delivery of services

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<sup>24</sup> North American Free Trade Agreement art. 314, Dec. 17, 1992, 107 Stat. 2057, 32 ILM 289.

<sup>25</sup> See, for example, *Internet Purchases: Your Responsibility and Liability*, U.S. CUSTOMS AND BORDER PROTECTION (Feb. 15, 2017), <http://perma.cc/HDD3-WXRC> (explaining exemptions for personal use items and mail shipments of less than \$800 imported into the United States).

<sup>26</sup> Susanne Teltscher, U.N. Conf. on Trade & Dev., *Tariffs, Taxes and Electronic Commerce: Revenue Implications for Developing Countries*, at 9, U.N. Doc. UNCTAD/ITCD/TAB/5, U.N. Sales No. E.00.II.D.36 (2000).

<sup>27</sup> Rashmi Banga, UNCTAD RESEARCH PAPER NO. 29, *GROWING TRADE IN ELECTRONIC TRANSMISSIONS: IMPLICATIONS FOR THE SOUTH*, at 18, U.N. Doc. UNCTAD/SER.RP/2019/1 (2019). For contextual data on LDCs, see UNCTAD, *Statistical Tables on the Least Developed Countries—2018*, U.N. Doc. UNCTAD/LDC/2018/Stats, (2018), <http://perma.cc/YNG9-JYHR>.

and then considers the special framework applying to e-commerce that further constrains countries' abilities to derive tax revenue from such activities.

### 1. The GATS' General Implications on Taxation of Trade in Services

WTO members are not obligated to open delivery of service to international competition, but they may choose to do so sector-by-sector ("positive list" approach).<sup>28</sup> Two categories of obligations arise from trade rules on services that may have fiscal implications.

First, regardless of whether a particular sector has been liberalized, a basic most-favored nation (MFN) obligation applies across the board.<sup>29</sup> For instance, the U.S. is not required to allow Indian service suppliers to provide online accounting services to U.S. businesses, but *if* allowed, the U.S. could choose to apply a sales tax of five percent. However, because of the MFN clause, the U.S. would also be required to apply the same five percent sales tax rate to any other country that it allows to provide such services. Members may grandfather in some inconsistent measures by notifying WTO members at the time of their ratification or accession, subject to a periodic review by the Council on Trade in Services.<sup>30</sup> Subsequent inconsistent measures may be maintained only if the member obtains a waiver.<sup>31</sup> Since most developing members did not have a significant service industry before the entry into force of the WTO, any inconsistent measure they wish to apply to the service industries they developed after the creation of the WTO will be subject to such a waiver process. For countries that joined the WTO after 1995, most of which are also developing countries, exemptions to their MFN obligations would likely be negotiated and reflected in their protocol of accession. As previously noted, conditions of accession have become increasingly stringent. Examples of MFN exemptions involving taxes typically cover the income tax regime for shipping enterprises or non-resident persons working on ships or aircrafts in the member state (such as Canada, Costa Rica, Chile, and the U.S.) and road taxes for cross-border transportation services (such as Austria, Cyprus, Croatia, Estonia, E.U., Russia, Turkey).<sup>32</sup> Second, some specific commitments, particularly national treatment also prohibit unfavorable taxation of foreign suppliers, *mutatis mutandis*.

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<sup>28</sup> General Agreement on Trade in Services, April 15, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 1B, at Part III (Specific Commitments), 1869 U.N.T.S. 183, 33 I.L.M. 1167 (1994) [hereinafter GATS].

<sup>29</sup> *Id.* at art. II ¶ 1.

<sup>30</sup> *Id.* at art. II ¶ 2, Annex on Art. II Exemptions.

<sup>31</sup> *Id.* at Annex on Art. II Exemptions ¶ 2; WTO Agreement, *supra* note 17, at art. IX ¶ 3.

<sup>32</sup> World Trade Organization, *Schedules of Specific Commitments and Lists of Article II Exemptions*, <http://perma.cc/R4S3-8UB6>.

A major issue is the income tax treatment of foreign service providers. Most countries tax income that is generated domestically. For instance, a foreign service provider coming to a country to deliver a service (dubbed “mode 4”)<sup>33</sup> could be liable for income taxes in that country. By contrast, some countries levy taxes based on the residence of the person in that country, irrespective of where they accrued their income from the service. The GATS only addresses such jurisdictional clashes and overlaps by largely carving out direct taxes from the scope of the agreement and leaving members to deal with the issue under double taxation treaties.<sup>34</sup> Direct taxes include income taxes, real estate appreciation taxes, payroll taxes, and taxes on capital, estate, inheritance and gift taxes.<sup>35</sup> A similar approach to carving out direct taxes was also adopted in a number of regional trade agreements.<sup>36</sup> Here, the GATS led to the growth of certain economic activities (trade in services), but the legal regime to determine where potential tax revenues accrue has not been reevaluated in light of these qualitative and quantitative changes.

International trade in services may also raise equity issues as compared to domestic service businesses. Local businesses are readily taxable, whereas a service provider located abroad is often beyond the jurisdictional reach of the tax authorities of the country where the service is delivered. Not only is the country’s ability to tax remote businesses operating in its territory impeded, but the tax burden falling on the local competitors puts them at a competitive disadvantage vis-à-vis the foreign operator. In response to such a tax inequity, some countries, including France and Italy, have recently moved towards a transaction-based taxation model, and others are considering similar legislation.<sup>37</sup> In this approach, transactions taking place in the territory are taxed locally, regardless of where the business is based. Logistical and legal hurdles abound. Online transactions might not be trackable, asserting taxation power over foreign entities may raise jurisdictional issues, and collecting taxes from foreign businesses may prove logistically difficult if the foreign entity refuses to pay. Some of these issues may also fall within the ambit of a double taxation treaty, if one applies. While these issues are common to developed and developing countries alike, logistical and

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<sup>33</sup> GATS, *supra* note 28, at art. I ¶ 2(d).

<sup>34</sup> *Id.* at art. XIV(d).

<sup>35</sup> *Id.* at art. XXVIII(o).

<sup>36</sup> Catherine A. Brown, *Taxation and the Cross-Border Trade in Services: Rethinking Non-Discrimination Obligations*, 21 FLA. TAX REV. 715, 722–23 (2018).

<sup>37</sup> Guliana Poloco, *Italy—In the Forefront of Digital Services Tax Introduction*, BLOOMBERG TAX INSIGHTS (Feb. 19, 2019), <http://perma.cc/3MHD-M35W>; Geert de Clercq & Elizabeth Pineau, *French Tax on Internet Giants Could Yield 500 Million Euros Per Year: Le Maire*, REUTERS (Mar. 3, 2019), <http://perma.cc/XY9N-47AE>; Marcin Szczepański, Eur. Parl. Res. Serv., *Corporate Taxation of a Significant Digital Presence*, PE 623.571 (Dec. 2018).

governance difficulties of tracking the activities of foreign service supplies and attempting to assert and enforce a taxation authority over them are exacerbated for countries with limited resources and public governance capacity.

For countries that also rely on corporate or profit taxes, the delocalization of service providers outside of their territorial jurisdiction erodes the corporate tax base—assuming a territory-based corporate tax system, which is prevalent throughout the world. The international legal framework on cross-jurisdictional taxation, whether through bilateral double taxation treaties or investment treaties, does not resolve the issue as shown by the extensive use of tax shelters and profit shifting to avoid the payment of corporate taxes.<sup>38</sup> The OECD Model Convention with Respect to Taxes on Income and on Capital (2017) relies on the permanent establishment principle to identify where an entity should be taxed.<sup>39</sup> The definition of a permanent establishment, however, contemplates only physical facilities.<sup>40</sup> The commentary addresses e-commerce to some extent, distinguishing between the place where computer equipment is stored (which might be a place of permanent establishment), and the software or data. A website is therefore not considered a place of permanent establishment for purposes of the Model Convention because it is not located anywhere. The server on which the website data is stored, may, by contrast constitute a fixed place of business.<sup>41</sup>

Other trade agreements that cover services are often modeled after the GATS in terms of the type of legal obligations.<sup>42</sup> In some cases, liberalization is done subject to a negative list instead, which presumes that all services and all modes of delivery are open to foreign competition except those listed by each trade partner. This approach may be particularly burdensome for countries with limited capacity and resources to identify precisely which sectors should be excluded, considering the present state of their economy and potential future developments.

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<sup>38</sup> Erik Sherman, *A New Report Claims Big Tech Companies Used Legal Loopholes to Avoid Over \$100 Billion in Taxes*, FORTUNE (Dec. 6, 2019), <http://fortune.com/2019/12/06/big-tech-taxes-google-facebook-amazon-apple-netflix-microsoft/>; Allan Sloane, *A Simple Tweak Could Tell Us How Much Tax America's Largest Companies Actually Pay*, WASH. POST (Jan. 24, 2020), <http://perma.cc/R38U-PLFQ>.

<sup>39</sup> OECD, MODEL TAX CONVENTION ON INCOME AND ON CAPITAL: CONDENSED VERSION 2017, art. 5 (2017), <http://perma.cc/B8YR-VSCA>.

<sup>40</sup> *Id.*

<sup>41</sup> *Id.* at Commentary on Article 5 ¶¶ 122–31.

<sup>42</sup> A database of service commitments under the GATS and about a hundred other trade agreements is available at: WORLD TRADE ORGANIZATION, *Welcome to Services*, <http://perma.cc/9V6R-42U3>.

## 2. Taxing Cross-Border E-commerce

Taxation of the digital economy is of growing interest to policymakers and scholars alike, but there are sharp divides in how issues are framed and what policies are prescribed. This Section outlines the existing fiscal treatment of e-commerce within the WTO framework; Section III outlines some of the debates at play in current negotiations.

The WTO defines e-commerce as “the production, distribution, marketing, sale or delivery of goods and services by electronic means.”<sup>43</sup> This includes not only trade in digital versions of traditional tangible products (CDs, DVDs, books) and online purchase of physical products, but also electronic transmissions accounting for a vast number of financial transactions. Trade in data information is another quickly growing segment of e-commerce. E-commerce is a cross-cutting topic that involves trade in services, intellectual property, and, at times, trade in goods. This raises classification issues. Because digital transactions do not fit neatly in any of the current WTO agreements and have implications that are difficult to address through the existing framework, WTO members have launched negotiations for a possible separate agreement on e-commerce.

The GATS might cover a variety of e-commerce transactions that are classified as traded services. This is the case for financial services and marketing services, for instance. E-commerce would most likely involve two “modes” of service delivery.<sup>44</sup> First, service providers located in one country provide services into the territory of another country (mode 1). For example, online training courses may be offered from a U.K. institution to students elsewhere in the world; data collected by an operator based in one country may be sold to other businesses elsewhere. The country where the students are located could wish to tax the purchase of such an education service. The country where the data collection business is operating may wish to tax its business, but the country where the data is collected may also wish to tax the activity, alongside the country where the data is sold. Second, service providers setting up a commercial presence, such as a subsidiary, in another country may provide an online service to local consumers (mode 3). For example, Yahoo!, Inc., a California company, has set up subsidiaries in a number of countries to own the local Yahoo! websites and operate them (such as Yahoo.fr in France). Here again, the country where the services are delivered (France in this example), may wish to tax the local Yahoo! subsidiary. In all cases, the home country of the service provider (the U.K. in the first example and the U.S. in the second example) may also wish to tax these service providers on profits they are making from the overseas activities of their companies, but the providers might be nominally incorporated in a third country with low or no taxes. Because

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<sup>43</sup> *Work Programme on Electronic Commerce*, ¶ 1.3, WTO Doc. WT/L/274 (adopted Sept. 25, 1998).

<sup>44</sup> Modes of service delivery are defined in GATS, *supra* note 28, at art. I ¶ 2.

the computer servers from where the transactions originate may be located in yet another country (or several), it may be difficult to relate the transaction to any particular tax jurisdiction. Inasmuch as the transaction may be characterized as a trade in services, and the GATS applies, the analysis developed in Section II.B.1 above applies. However, the more disembodied the transaction, the greater the practical obstacles to tracing economic activities, attributing them to specific tax jurisdiction, and enforcing tax law against actual operators.

Developing countries are now increasing their reliance on consumption tax for fiscal revenues, largely following the advice of the World Bank and International Monetary Fund.<sup>45</sup> If they are net importers of e-commerce transactions, they would have an interest in cross-border e-commerce transactions being taxed at the point of consumption, assuming they can deploy the technological and logistical tools to identify the transactions and collect taxes.

Moreover, WTO members agreed early on not to impose duties on electronic transmissions.<sup>46</sup> This standstill agreement has been reiterated at Ministerial Conferences since 1998, with no consensus in sight as to how to address the growing digital economy. Some developing countries wish to derive tax benefits from the exploitation of their consumer markets. Others are embracing a more “open access” philosophy, hoping that unencumbered e-commerce will help bridge the digital divide between advanced and emerging economies, and ultimately generate new economic opportunities for the latter.

### C. Constraints on Tax Policy from Trade Treaties

In addition to the direct constraints on fiscal revenue resulting from decreased bound and applied tariffs, international trade law imposes a number of restrictions regarding countries’ tax policies. This Section reviews typical provisions in trade treaties that constrain the design of domestic tax policy.

#### 1. Nullification and Impairment of Trade Benefits

The GATT provides a remedy when a benefit accruing under the agreements to another party is “nullified or impaired” by “the application by another

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<sup>45</sup> See Reuven S. Avi-Yonah & Yoram Margalioth, *Taxation in Developing Countries: Some Recent Support and Challenges to the Conventional View*, 27 VA. TAX REV. 1 (2007); Esteban Ortiz-Ospina & Max Roser, *Taxation*, OUR WORLD IN DATA (2020), <http://perma.cc/9UA8-8GE6>.

<sup>46</sup> The Declaration on Electronic Commerce at the Geneva Ministerial Meeting of 2013 states “we also declare that Members will continue their current practice of not imposing customs duties on electronic transmissions.” World Trade Organization, *Declaration on Electronic Commerce*, WTO Doc. WT/MIN(98)/DEC/2 (adopted May 20, 1998). This language is reiterated in all subsequent Ministerial Declarations (issued every two years). It originated from the United States. World Trade Organization, *Global Electronic Commerce, Proposal by the United States*, WTO Doc. WT/GC/W/78 (adopted Feb. 9, 1998).

contracting party of any measure, whether or not it conflicts with the provisions” of the agreement.<sup>47</sup> For instance, a member seeking to roll back a tariff concession by imposing some other form of internal tax would be prevented from doing so, even if the new tax was not directly in violation of another GATT obligation, such as national treatment or MFN. Even if the country did not have the intent to impair another member’s trade benefit but changed its tax legislation in a way that adversely affected another member, the measure would be challengeable. This provision has been seldom used, and never with respect to a tax measure as of yet.

## 2. Non-Discriminatory Tax Treatment Requirements Within the Border

Aside from tariffs, most domestic tax policy comes under the purview of trade treaties as a result of non-discrimination obligations undertaken by states. These obligations fall broadly into two categories: MFN and national treatment.

The GATT’s MFN clause requires that WTO members extend no less favorable treatment to all other WTO members than they extend to any other country, including with respect to domestic taxes and other such charges.<sup>48</sup> This obligation came into play with respect to taxation most recently in the case brought against Brazil’s industrial policy program for the automobile sector, INOVAR-AUTO. The panel confirmed that tax reductions available under the INOVAR-AUTO program fell within the scope of GATT article I:1 and that since some of these tax advantages were granted only to Mexico and MERCOSUR members, they were inconsistent with the MFN clause.<sup>49</sup>

National treatment involves a significantly higher volume of litigation, particularly under the GATT. Non-conformity with national treatment also makes up the bulk of notifications under the GATS. National treatment obligations are particularly germane to indirect taxes, such as consumption taxes, sales taxes, use taxes, and value-added taxes.

A GATT-era case tackled the issue of taxes that were facially neutral, but in practice fell disproportionately on foreign products. In *U.S.—Automobiles*, the E.U.

<sup>47</sup> GATT, *supra* note 17, at art. XXIII ¶ 1(b).

<sup>48</sup> *Id.* at art. I ¶ 1 (extending MFN treatment to “all matters referred to in paragraphs 2 and 4 of Article III”); *id.* at art. III ¶ 2 (addressing foreign products subjected “directly or indirectly, to internal taxes or other internal charges of any kind” and to “internal taxes or other internal charges [applied] . . . in a manner contrary to the principles set forth in paragraph 1.”); *id.* at art. III ¶ 1 (enshrining WTO members’ recognition that taxes “should not be applied to imported or domestic products so as to afford protection to domestic production”).

<sup>49</sup> Panel Report, *Brazil—Certain Measures Concerning Taxation and Charges*, ¶¶ 7.1012–48, WTO Doc. WT/DS472/R (adopted Aug. 30, 2017). In another program promoting the automotive sector, Indonesia’s higher tariff and tax measures applied to imports of certain members were struck down. Panel Report, *Indonesia—Certain Measures Affecting the Automobile Industry*, ¶¶ 14.123–48, WTO Doc. WT/DS54/R (adopted July 2, 1998).

complained that U.S. taxes on luxury vehicles and “gas guzzler” taxes on low fuel economy cars were a violation of the national treatment obligation of the GATT.<sup>50</sup> The Panel sided with the U.S. on the luxury car tax, finding that the price threshold of \$30,000 defining luxury cars was not set so as to afford protection to the domestic industry and that such luxury cars were not like products to vehicles below the threshold. As a result, the U.S. could treat cars above \$30,000 differently than other cars for taxation purposes. With respect to the gas guzzler tax, the Panel found that the fuel economy threshold was not “aimed at affording protection to domestic production,”<sup>51</sup> nor did it have the effect of protecting domestic production in terms of conditions of competition.<sup>52</sup>

More recently, WTO members have challenged other countries’ domestic consumption taxes favoring domestic alcoholic beverages over imported counterparts.<sup>53</sup> Similar to the *U.S.-Automobile* case, the crux of the issue was whether the competing products were “like” products, such that the less favorable treatment would not be allowed, whether they were “directly competitive or substitutable products,” or whether the products were not “like,” and could therefore be treated differently with respect to taxation. In most cases, the Panel found that the differential tax between domestic and imported beverages afforded protection to the domestic products, and the tax systems were applied in a protectionist fashion. The legal test used by the Appellate Body requires determining whether:

1. The imported products and the domestic products are “directly competitive or substitutable products” which are in competition with each other;
2. The directly competitive or substitutable imported and domestic products are “not similarly taxed”; and

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<sup>50</sup> Panel Report (unadopted), *United States—Taxes on Automobiles*, ¶¶ 5.2, 5.19, WTO Doc. DS31/R (Oct. 11, 1994).

<sup>51</sup> *Id.* at ¶ 5.24.

<sup>52</sup> *Id.* at ¶¶ 5.25-5.26. Likewise, the Panel found no breach of national treatment in the different ways in which fuel economy was calculated on domestic and imported cars.

<sup>53</sup> Appellate Body Report, *Korea—Taxes on Alcoholic Beverages*, WTO Doc. WT/DS75/AB/R (Jan. 18, 1999); Appellate Body Report, *Philippines—Taxes on Distilled Spirits*, WTO Doc. WT/DS403/AB/R (Dec. 21, 2011); Appellate Body Report, *Japan—Taxes on Alcoholic Beverages*, WTO Doc. WT/DS8/AB/R (Oct. 4, 1996); Appellate Body Report, *Chile—Taxes on Alcoholic Beverages*, WTO Doc. WT/DS87/AB/R (Dec. 13, 1999). Similar issues arose with respect to cigarettes. See Appellate Body Report, *Thailand—Customs and Fiscal Measures on Cigarettes from the Philippines*, WTO Doc. WT/DS371/AB/R (adopted July 15, 2011); Appellate Body Report, *Dominican Republic—Measures Affecting the Importation and Internal Sale of Cigarettes*, WTO Doc. WT/DS302/AB/R (adopted Apr. 25, 2005).

3. The dissimilar taxation of the directly competitive or substitutable imported and domestic products is “applied . . . so as to afford protection to domestic production.”<sup>54</sup>

In many of these cases, the respondent country unsuccessfully made a tax equity argument: wealthier consumers of more expensive imported liquor should bear a higher tax burden than consumers of the cheaper domestic equivalent beverages. The Panels’ and Appellate Body’s analyses were unaffected by such arguments.

A few industrial support programs in developing countries also raised issues under national treatment obligations.<sup>55</sup> In all these cases, the objective was not so much for the country to increase its tax revenue, as it was to promote local industrial production or the consumption of local products with lower taxes on the domestic products, compared to the imported product.

Direct taxes—such as income taxes, profit taxes, and corporate taxes—are generally understood to be excluded from the GATT’s national treatment obligation because Article III refers to taxes “affecting the internal sale, offering for sale, purchase, transportation, distribution or use of *products*.”<sup>56</sup>

Overall, then, MFN and national treatment obligations in trade agreements leave countries free to set the level of direct and indirect taxes as they see fit, so long as the policy does not discriminate against some foreign operators vis-à-vis other foreign operators or vis-à-vis their domestic competitors. Most cases tend to involve tax revenue foregone for protectionist purposes or for industrial policy purposes. Those policies will typically involve MFN and/or national treatment obligations, as well as disciplines on subsidies. These constraints not only affect countries’ current tax policy but also their ability to change their tax policy in the future to support particular sectors of their economy or population.

### III. TAX POLICY CONSTRAINTS FROM INTERNATIONAL INVESTMENT AGREEMENTS

The impact of international investment agreements on countries’ ability to mobilize fiscal resources falls into two broad categories: (1) immediate restrictions on tax policy deriving mostly from non-discriminatory rules in the treaties; and (2)

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<sup>54</sup> Appellate Body Report, *Chile—Taxes on Alcoholic Beverages*, *supra* note 53, at ¶ 47 (citing Appellate Body Report, *Japan—Taxes on Alcoholic Beverages*, *supra* note 53, at 24).

<sup>55</sup> Appellate Body Report, *China—Measures Affecting Imports of Automobile Parts*, WTO Doc. WT/DS342/AB (Dec. 15, 2008); Appellate Body Report, *Brazil—Certain Measures Concerning Taxation and Charges*, WTO Doc. WT/DS472/AB/R (Dec. 13, 2018); Panel Report, *Indonesia—Certain Measures Affecting the Automobile Industry*, *supra* note 49.

<sup>56</sup> GATT, *supra* note 17, at art. III ¶ 1 (emphasis added); *see also* Joel Slemrod & Reuven Avi-Yonah, *(How) Should Trade Agreements Deal with Income Tax Issues?*, 55 TAX L. REV. 533, 536–37 (2002).

restrictions on future changes to tax policy due to general treaty protections that are designed to create a stable and predictable regulatory environment for foreign investors.

#### A. Constraining Present Tax Policy: Non-Discriminatory Treatment of Foreign Investments and Investors

Like trade treaties, BITs typically include MFN and national treatment clauses.<sup>57</sup> Such clauses may immunize foreign investors against new taxation schemes if a BIT applies. For instance, a tax that is more onerous for foreign investors than for their domestic counterparts could breach the national treatment obligation. Similarly, a tax that is more burdensome for an investor covered by a BIT than for another foreign investor also operating in that country could run afoul of the MFN clause.<sup>58</sup> Tax measures that are facially neutral but that, by impact or by design, result in a less favorable treatment of foreign investors may also amount to a breach of MFN or national treatment guarantees. A discriminatory intent by the state is not always necessary for a measure to be found in breach of MFN or national treatment obligations.<sup>59</sup>

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<sup>57</sup> Because most BITs only grant post-establishment rights and benefits to investors, these clauses only apply once the investment has been made, not with respect to the conditions for making the investment in the first place. However, a recent trend in international investment agreements is to also address pre-establishment rights, whereby states would bind themselves to allowing foreign investors to operate domestically, rather than retain the discretionary exercise of their sovereignty on that matter. Foreign investment into a country guaranteeing pre-establishment rights would therefore become a treaty-protected right, rather than a privilege governed by domestic law.

<sup>58</sup> See Matthew Davie, *Taxation-Based Investment Treaty Claims*, 6 J. INT'L DISPUTE SETTLEMENT 202, 208–09 (2015).

<sup>59</sup> See generally S.D. Myers, Inc. and Government of Canada, UNCITRAL Arbitration, First Partial Award ¶¶ 252–54 (Nov. 13, 2000):

[I]n assessing whether a measure is contrary to a national treatment norm, the following factors should be taken into account:

whether the practical effect of the measure is to create a disproportionate benefit for nationals over non-nationals;

whether the measure, on its face, appears to favour its nationals over non-nationals who are protected by the relevant treaty.

253. Each of these factors must be explored in the context of all the facts to determine whether there actually has been a denial of national treatment.

254. Intent is important, but protectionist intent is not necessarily decisive on its own. The existence of an intent to favour nationals over non-nationals would not give rise to a breach of Chapter 1102 of the NAFTA if the measure in question were to produced [sic] no adverse effect on the non-national complainant. The word “treatment” suggests that practical impact is required to produce a breach of Article 1102, not merely a motive or intent that is in violation of Chapter 11.

Foreign investors have brought a number of cases alleging discriminatory tax treatment against the host state in arbitration proceedings available under BITs and other treaties with an investment chapter. Investors won several national treatment cases under Chapter 11 of NAFTA<sup>60</sup> and under BITs.<sup>61</sup> On the other hand, some MFN and national treatment cases were decided in favor of the State.<sup>62</sup> A number of cases involving allegations of discriminatory taxation of a foreign investor by the host State are pending<sup>63</sup> or have been settled confidentially or discontinued.<sup>64</sup> Even when the claims are ultimately unsuccessful, host States suffer. They must allocate resources to their defense and may reserve future regulatory action in the face of uncertain substantive outcomes.

Investment treaties may also provide protection against discrimination in the enforcement of a country's tax policy. For example, a foreign investor may bring a claim for being disproportionately targeted for auditing or prosecution more so than domestic entities or other foreign investors.

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<sup>60</sup> Marvin Roy Feldman Karpa v. United Mexican States, ICSID Case No ARB(AF)/99/1, Award (Dec. 16, 2002) (the investor was denied certain tax rebates on exported tobacco products, but the rebates were granted to Mexican businesses in breach of the national treatment clause); Archer Daniels Midland Co. v. United Mexican States, ICSID Case No ARB(AF)/04/5, Award (Nov. 21, 2007) (Soft drinks made with high fructose corn syrup were subject to a 20 percent tax by the Mexican government, while soft drinks sweetened with sugar cane, which were typically made in Mexico were not taxed. The tribunal found a breach of the national treatment obligation.); Corn Products International, Inc. v. United Mexican States, ICSID Case No. ARB(AF)/04/1, Award (Aug. 18, 2009) (finding also a national treatment violation regarding taxes on soft drinks); Cargill, Inc. v. United Mexican States, ICSID Case no. ARB(AF)/05/2, Award (Sept. 18, 2009) (finding also a national treatment violation regarding taxes on soft drinks).

<sup>61</sup> Occidental Exploration and Production Co. v. Republic of Ecuador, LCIA Case No. UN3467, Award (July 1, 2004) (VAT credits and tax refunds on oil exports denied to the foreign investor but granted to domestic exporters).

<sup>62</sup> Sergei Paushok v. Government of Mongolia, UNCITRAL, Award on Jurisdiction and Liability (Apr. 28, 2011) (the investor was subject to a windfall profit tax that was not imposed on Canadian investors operating in the same sector, but the tribunal said that the special deal that the Canadian company had negotiated was with two investors in a dissimilar position, such that the MFN clause did not apply); Ahmonseto, Inc. v. Arab Republic of Egypt, ICSID Case No. ARB/02/15, Award (June 18, 2007).

<sup>63</sup> Sergei Paushok v. Government of Mongolia, *supra* note 62 (imposition of windfall taxes on the sale of gold).

<sup>64</sup> J.M. Longyear, LLC v. Government of Canada, Claim (2014), <http://perma.cc/2VVP-BFZD> (ineligibility for tax reductions); Bidzina Ivanishvili v. Georgia, Claim, ICSID Case No. ARB/12/27 (2012) <http://perma.cc/4B9M-KMMM> (legislative amendments purportedly giving tax authorities priority over the secured claims of banks); Lao Holdings N.V. v. Lao People's Democratic Republic (I), ICSID Case No. ARB(AF)/12/6, Award ¶¶ 69–70 (Aug. 6, 2019) (Eighty percent tax on casino revenues and allegedly unfair and oppressive audits).

## B. Constraining Future Tax Policy: Indirect Expropriation; Fair and Equitable Treatment of Investors

Numerous investor-state disputes deal with domestic changes in tax policy that adversely affect foreign investors. Indirect expropriation<sup>65</sup> and fair and equitable treatment (FET)<sup>66</sup> provisions in investment treaties offer a vehicle for such claims. With respect to indirect expropriation, investors typically claim that a change in tax law, resulting in a higher tax burden for themselves or their investment, so decreases the value of the investment that it is tantamount to a taking by the state in breach of the treaty.<sup>67</sup> FET claims typically involve investors complaining that a change in tax policy so dramatically changes the conditions for their investment that it unfairly surprises them and is disallowed under the treaty.<sup>68</sup> Some examples of changes in tax policies that have or could be challenged include termination of rebates or exemptions, taxation on capital transfer, profit repatriation, and taxation of passive income (particularly on intellectual property).<sup>69</sup>

Most claims of indirect expropriation through taxation are not successful. States are presumed to be within their right in exercising their taxation power. To succeed, an investor must show a substantial deprivation of the investment's

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<sup>65</sup> See, for example, 2012 U.S. Model Bilateral Investment Treaty art. 6 (2012), <http://perma.cc/Y2J8-EF7B> [hereinafter 2012 U.S. Model BIT]: “Neither Party may expropriate or nationalize a covered investment either directly or indirectly through measures equivalent to expropriation or nationalization (“expropriation”), except: (a) for a public purpose; (b) in a non-discriminatory manner; (c) on payment of prompt, adequate, and effective compensation; and (d) in accordance with due process of law and Article 5 [Minimum Standard of Treatment](1) through (3).” Annex B ¶ 4 further specifies that “[t]he second situation addressed by Article 6 [Expropriation and Compensation] (1) is indirect expropriation, where an action or series of actions by a Party has an effect equivalent to direct expropriation without formal transfer of title or outright seizure.”

<sup>66</sup> See, for example, *id.* at art. 5:

1. Each Party shall accord to covered investments treatment in accordance with customary international law, including fair and equitable treatment and full protection and security.

2. . . . (a) “fair and equitable treatment” includes the obligation not to deny justice in criminal, civil, or administrative adjudicatory proceedings in accordance with the principle of due process embodied in the principal legal systems of the world.

<sup>67</sup> U.N., *Expropriation: UNCTAD Series on Issues in International Investment Agreements II*, U.N. CONFERENCE ON TRADE AND DEVELOPMENT, 15 (2012) <http://perma.cc/H664-SBNP> [hereinafter UNCTAD, Investment Agreements].

<sup>68</sup> UNCTAD, IIA ISSUES NOTE, NO. 2, FACT SHEET ON INVESTOR-STATE DISPUTE SETTLEMENT CASES, 4 (2019) (“In the decisions holding the State liable, tribunals most frequently found breaches of the fair and equitable treatment provision.”).

<sup>69</sup> Davie, *supra* note 58, at 204–08.

value, which is a high bar.<sup>70</sup> When Mexico imposed a twenty percent tax on sales of soft drinks made with high fructose corn syrup, some investors made indirect expropriation claims in addition to the national treatment claims mentioned above. Unlike the national treatment claims, these were not successful.<sup>71</sup> With respect to indirect expropriation, even when a tax measure makes the business unprofitable, arbitrators have not necessarily found that the measure was expropriatory.<sup>72</sup>

In addition to a substantial deprivation of value, the tax measure must have an exceptional or arbitrary character that takes it outside the realm of normal government activity for it to be considered expropriatory.<sup>73</sup> Perhaps the most notorious of such cases involved the treatment of Yukos and affiliated companies by Russia in the 2000s. The claim was mostly one of expropriation, but it also involved the discriminatory targeting of Yukos and affiliate companies for tax audits. After subjecting Yukos to numerous tax audits and imposing large tax assessments for alleged tax liabilities, Russia prevented Yukos from paying the proffered tax bills by immediately freezing its assets. When Yukos was unable to pay due to the freeze, Russia seized the assets and sold them below market value to Rosneft, a competing Russian state-owned enterprise. The CEO of Yukos at the time was a political critic of Russia's President Vladimir Putin, and the entire scheme was widely understood as a political maneuver to dispossess him of the company and deliver the lucrative assets to Putin's control.<sup>74</sup> A series of investor-

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<sup>70</sup> UNCTAD, *Investment Agreements*, *supra* note 67, at 104.

<sup>71</sup> Archer Daniels Midland Company, *supra* note 60, at ¶ 251.

<sup>72</sup> *Marvin Feldman v. Mex.*, ICSID Case No. ARB(AF)/99/1, Award, ¶ 112 (Dec. 16, 2002); *see also* *Occidental Exploration and Production Co. v. Ecuador*, *supra* note 61, at ¶ 89; *Sergei Paushok v. Mong.*, UNCITRAL, Award on Jurisdiction and Liability, *supra* note 62 at ¶¶ 330–36 (April 28, 2011); *EnCana Corp. v. Ecuador*, UNCITRAL, Award, ¶¶ 174–77 (Feb. 3, 2006) (stating a loss of tax breaks amounting to 10 percent of the transaction value was not an expropriation); *Burlington Res. Inc. v. Ecuador*, ICSID Case No. ARB/06/08/5, Decision on Liability, ¶ 450 (Dec. 14, 2012) (stating that the windfall tax “99% considerably diminished Burlington's profits, but [did] not prove that Burlington's investment became unprofitable or worthless”); *Perenco Ecuador Ltd. v. Ecuador*, ICSID Case No. ARB/08/6, Decision on Remaining Issues of Jurisdiction and on Liability, ¶¶ 672–84 (Sept. 12, 2014) (The Panel drew a distinction between “a partial deprivation of value, which is not an expropriation, and a ‘complete or near complete deprivation of value’, which can constitute an expropriation.” A windfall tax of ninety-nine percent of profits above a certain benchmark was not found to be an expropriation.)

<sup>73</sup> UNCTAD *Investment Agreements*, *supra* note 67, at 36.

<sup>74</sup> Jake Rudnitsky & Ellen Proper, *Russia Faces \$50 Billion Payout From Seizure of Oligarch Oil Assets*, BLOOMBERG (Feb. 18, 2020), <http://perma.cc/JU7B-SV52>; *see also* RICHARD SAKWA, PUTIN AND THE OLIGARCH: THE KHODORKOVSKY-YUKOS AFFAIR (2014).

state disputes brought by Yukos shareholders against Russia ensued, with arbitration awards in favor of the investors.<sup>75</sup>

FET claims are more likely to succeed than expropriation claims. In the words of one landmark arbitration, FET claims require a showing of state conduct that is “arbitrary, grossly unfair, unjust or idiosyncratic, is discriminatory . . . or involves a lack of due process leading to an outcome which offends judicial propriety.”<sup>76</sup> Although the standard seems high, it is easier to reach than the standard for expropriation.<sup>77</sup> It has been likened to a standard of good faith and respect for the investor’s legitimate expectations.<sup>78</sup> As such, it is fairly fluid in its interpretation and potentially most problematic for states wishing to change their tax policies. The issue is whether investors have a legitimate expectation that the tax treatment they enjoyed when they invested should remain the same or whether they should expect the state to evolve its policies, particularly in developing countries that may be in the process of building their tax apparatus. In *Occidental Exploration v. Ecuador*, the Tribunal found that FET obligations were breached because “[t]he tax law was changed without providing any clarity about its meaning and extent and the practice and regulations were also inconsistent with such changes.”<sup>79</sup> The Tribunal noted: “[Occidental] undertook its investments, including its participation in the pipeline arrangements, in a legal and business environment that was certain and predictable. This environment was changed as a matter of policy and legal interpretation, thus resulting in the breach of fair and equitable treatment.”<sup>80</sup>

Allowing FET claims to go forward in cases of a change in tax regime is particularly problematic because investors could, instead, take contractual steps to protect themselves against such changes. For instance, investors could seek a tax stabilization agreement from the host state.<sup>81</sup> Although they are private contracts

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<sup>75</sup> See generally *RosInvestCo U.K. Ltd. v. The Russ. Fed’n*, SCC Case No. V079/2005, Final Award (Sept. 12, 2010); *Renta 4 SVSA et al. v. The Russ. Fed’n*, SCC No. 24/2007, Award (July 20, 2012); *Yukos Universal Ltd. (Isle of Man) v. The Russ. Fed’n*, PCA Case No. AA 227, Final Award (July 18, 2014).

<sup>76</sup> *Waste Management Ltd. v. Mex.*, ICSID Case No. ARB(AF)/00/3, Award, ¶ 98 (Apr. 30, 2004).

<sup>77</sup> See, for example, *Occidental Exploration and Production Co. v. Republic of Ecuador*, LCIA Case No. UN3467, Award, ¶¶ 89, 186–87 (July 1, 2004) (holding the investor was unsuccessful on the expropriation claim but succeeded on the FET claim on the same facts).

<sup>78</sup> See generally Emily Sipiorski, *Introducing Good Faith in International Investment Law*, in OXFORD INTERNATIONAL ARBITRATION SERIES (2019).

<sup>79</sup> *Occidental Exploration and Production Co.*, LCIA Case No. UN3467, at ¶ 184.

<sup>80</sup> *Id.* at ¶ 196. Occidental was awarded approximately USD 71 million of VAT reimbursement and USD 3.5 million in interest. *Occidental Exploration and Production Co.*, at ¶¶ 207, 211.

<sup>81</sup> Davie, *supra* note 58, at 208, 219. The Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP) also contemplates elevating the legal status of a stabilization agreement offered by a state to that of a multilateral obligation. For instance, Peru stipulated that

between an investor and the state, such agreements may benefit from some protections offered by an applicable BIT, including its dispute settlement provisions, through the operation of “umbrella clauses.”<sup>82</sup> FET should therefore not be used as a back door to protect investors who failed to bargain privately for a particular tax treatment and hence assumed the risk of regulatory changes.

Even where there is no applicable BIT, guarantees of good faith and fair treatment may arise under international law. Such was the case in *Duke Energy v. Peru*.<sup>83</sup> The investor benefited from tax stabilization guarantees, which were authorized under domestic Peruvian law on the protection of investment. Peru then modified the interpretation and application of its tax stabilization regime. The Tribunal examined whether Peruvian courts and Peruvian authorities had been unreasonable in changing their tax stabilization regime such as to breach stability guarantees under international law and it found that they had not.<sup>84</sup> However, the Tribunal did find a breach of a guarantee of tax stabilization with respect to the interpretation and application of one law at stake.<sup>85</sup> It seems that this finding was based on the Tribunal’s interpretation of Peruvian law, even though the Tribunal posits elsewhere that it does not sit as a court of appeals for Peruvian law.<sup>86</sup> It also examined whether the investor had reasonably relied on stabilization interpretations such that Peru could be estopped from changing the

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[a] stability agreement . . . may constitute one of multiple written instruments that make up an ‘investment agreement,’ as defined in Article 9.1 (Definitions). If that is the case, a breach of such a stability agreement by Peru may constitute a breach of the investment agreement of which it is a part.

Comprehensive and Progressive Agreement for Trans-Pacific Partnership, Ch. 9, Annex 9L, Section B.3 (May 8, 2018), <http://perma.cc/94UN-ZC6B> [hereinafter CPTPP].

<sup>82</sup> Umbrella clauses appear in numerous BITs, but their scope and applicability to fiscal issues is uncertain. They typically state: “Either Contracting Party shall constantly guarantee the observance of the commitments it has entered into with respect to the investments of the investors of the other Contracting Party.” Agreement on the Promotion and Reciprocal Protection of Investments, Switz.-Para. art. 11, Jan. 31, 1992, <http://perma.cc/L69V-7GVJ>. For a discussion of umbrella clauses, see, for example, Jarrod Wong, *Umbrella Clauses in Bilateral Investment Treaties: Of Breaches of Contract, Treaty Violations, and the Divide Between Developing and Developed Countries in Foreign Investment Disputes*, 14 GEO. MASON L. REV. 137 (2006). Some authors argue that umbrella clauses have a chilling effect on developing countries’ taxation of foreign investors, particularly in the oil and gas sector, where investors typically secure stabilization agreements. See generally Cristina Bodea et al., *Global Treaties and Domestic Politics: Do BITs Constrain Fiscal Policy in Developing Countries?* 11–13 (2018) (unpublished manuscript) (on file with author).

<sup>83</sup> *Duke Energy International Peru Inv. No. 1 Ltd. v. Peru*, ICSID Case No. ARB/03/28, Award (Aug. 18, 2008).

<sup>84</sup> *Id.* at ¶ 307.

<sup>85</sup> *Id.* at ¶¶ 345, 365–66.

<sup>86</sup> *Id.* at ¶ 226.

regime. The Tribunal found that the claimant had failed to meet its burden of proof.<sup>87</sup>

In conclusion, domestic tax policies have been challenged under BITs via different types of claims. Although many of these claims have been unsuccessful, states have been forced to devote resources to defend the autonomy of their tax policies.<sup>88</sup> These challenges also create an uncertain environment for states considering tax legislation, potentially chilling the development of their fiscal regime. The Dutch BITs, in particular, have been a favored vector for investors for making the types of claims described above. However, the Netherlands recently adopted a new model BIT that would limit the ability of investors to gain benefits through simple shell incorporation as Dutch companies.<sup>89</sup> Preventing companies from accessing Dutch BITs in that way will help support the emerging diversification of BITs drafted by other countries, where the latter have often restricted the scope and nature of claims that can be made under their new BITs. However, it will take some length of time for the new Dutch model BIT to supersede the older Dutch BITs, should the Netherlands pursue this course of action.

#### IV. PRESERVING DOMESTIC TAX AUTONOMY: CARVE-OUTS, EXCEPTIONS, AND FUTURE NEGOTIATIONS

Trade and investment treaties typically include some provisions to preserve the autonomy of states' policies regarding tax law and policy. This Section assesses what these provisions are and how they operate to maintain a state's ability to raise tax revenue. It also highlights their limitations and offers some perspective on strengthening tax policy autonomy in future trade and investment agreements.

##### A. Maintaining the Ability to Raise Tax Revenue: Safeguards, Carve-Outs and Exceptions

Trade and investment treaties offer a number of avenues for states to assert and protect their taxing powers. Most of these provisions are not directly aimed at tax policy but may be used for fiscal mobilization. Other provisions are explicitly aimed at avoiding conflicts between trade and investment obligations,

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<sup>87</sup> *Id.* at ¶¶ 322–23.

<sup>88</sup> For a list of investor-state tax disputes, see, for example, Claire Provost, *Taxes on Trial – How Trade Deals Threaten Tax Justice*, TRANSNATIONAL INSTITUTE RESEARCH PAPER 10–12 (Feb. 2016), <http://perma.cc/66SX-32Z3>.

<sup>89</sup> Netherlands Model Investment Agreement (Oct. 19, 2018) arts. 1(b)(ii) and 1(c), <http://perma.cc/D422-NU7E> (requiring companies to conduct “substantial business activities” in their home state in order to qualify as an investor under the treaty).

on the one hand, and domestic and international tax rules, on the other hand, but their scope and interpretation are uncertain.

### 1. Tariff and Services Liberalization Renegotiations

Trade treaties allow states to renegotiate their market liberalization commitments. With respect to tariffs on trade in goods, the GATT allows a party to increase its tariffs above the bound rate, subject to negotiation with affected parties and possible compensation to any party suffering a loss as a result of the modified tariff.<sup>90</sup> With respect to trade in services, the GATS also allows modification or withdrawal of a scheduled commitment, subject to negotiations with affected members and possible compensation.<sup>91</sup> If compensation is not forthcoming, affected parties may seek arbitration and possibly retaliate in an equivalent amount of trade benefits vis-à-vis the party that modified its schedule.<sup>92</sup>

Such provisions therefore make it possible, albeit costly, for a state to raise its tariffs or otherwise reduce its market access to foreign competition. In theory, the goal is to maintain an equivalent level of trade liberalization, such that if a party wishes to change its policy in one sector, it will be required to offset it in another sector. The net fiscal impact of such rearrangements may be correspondingly marginal. These provisions are really intended for a party to protect the domestic producers of a sector, or the balance of trade in a sector, rather than to roll back on trade liberalization for purposes of increasing fiscal resources. In practice, such renegotiations seldom, if ever, occur.<sup>93</sup> For fiscal mobilization purposes, tariffs and services liberalization renegotiations are of minimal use.

### 2. Temporary Increases in Tariffs

Instead of outright tariff or market access renegotiations, states more commonly use a range of other provisions that provide more flexibility with their

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<sup>90</sup> GATT, *supra* note 17, at art. XXVIII:4 (allowing a party to enter into negotiations to modify its tariff schedule “in special circumstances”).

<sup>91</sup> GATS, *supra* note 28, at art. XXI.

<sup>92</sup> *Id.*

<sup>93</sup> A few months after the Uruguay Agreements came into force, Brazil notified an increase of import tariffs on 109 products for a maximum period of one year, specifying that “the measure, of a temporary character, has as its objective the preservation of the results already achieved by the economic stabilization plan ‘Plano Real’ and does not affect the process of liberalization of the Brazilian economy and its integration to the international economy.” Notification in pursuance of Paragraph 3 of the Understanding Regarding Notification, consultation, dispute settlement and surveillance and the Decision on notification procedures annexed to the Final Act embodying the results of the Uruguay Round of multilateral trade negotiations – Communication from Brazil, WT/L/66 (May 10, 1995). It is unclear whether the increase in tariff was made pursuant to GATT art. XXVIII (which provided some additional flexibilities during the first few months of the WTO).

trade commitments. For example, safeguards and anti-dumping duties are aimed at protecting domestic producers against surges in competing imports and certain foreign trade practices deemed unfair, respectively.<sup>94</sup> In practice, both consist of imposing higher tariffs on some products on a temporary basis. Such tariffs may generate additional fiscal resources at the border if imports of targeted products do not decline so much as to offset the potential additional revenues from the increased tariffs. Safeguards, countervailing duties, and anti-dumping duties may also indirectly stymie a decline in tax revenue if they help tax-paying domestic producers stay in business in the face of foreign competition. Maintaining such businesses may have positive direct and indirect tax benefits domestically.

### 3. Tax Carve-Outs in Trade in Services Agreements

The GATS contains two significant features to protect members' tax policies. First, a general exception allows members to take measures that would otherwise breach their national treatment obligation "provided that the difference in treatment is aimed at ensuring the equitable or effective imposition or collection of direct taxes in respect to services or service suppliers of other Members."<sup>95</sup> The agreement further specifies that such measures may include taxation on non-resident service suppliers when they supply services domestically, taxation of local consumers of services provided from abroad, and a range of other measures.<sup>96</sup> Second, the GATS carves out measures that are inconsistent with the MFN obligation due to double taxation treaties or other international tax agreements.<sup>97</sup> Nonetheless, the measure must be applied in a way that is not a disguised restriction on trade or an arbitrary or unjustifiable discrimination between countries where similar conditions prevail. The provision, often called a "tax carve-out," is a relatively common feature of agreements on trade in services, including NAFTA and the Trans-Pacific Partnership (TPP).<sup>98</sup> The TPP added a broader catch-all clause for any conflict between the national treatment obligation and tax measures.<sup>99</sup>

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<sup>94</sup> GATT, *supra* note 17, at arts. VI (anti-dumping and countervailing duties), XIX (safeguards); *see also* Agreement on Implementation of Article VI of the General Agreement on Tariffs and Trade 1994 (Anti-Dumping Agreement), 1868 U.T.S. 201; Agreement on Safeguards, 1869 U.N.T.S. 154; GATS, *supra* note 28, at art. X (emergency safeguard measures).

<sup>95</sup> GATS, *supra* note 28, at art. XIV(d), n.6.

<sup>96</sup> *Id.*

<sup>97</sup> *Id.* at art. XIV(e).

<sup>98</sup> Brown, *supra* note 36, at 722–23.

<sup>99</sup> TPP art. 29.4(2), <http://perma.cc/33VJ-6YMT> ("Except as provided in this Article, nothing in this Agreement shall apply to taxation measures."). For an examination of the scope of tax carve-outs, see generally Brown, *supra* note 36, at 722–40. For an examination of tax carve-outs in Australian trade in services agreements, see Tania Voon, *Balancing Regulatory Autonomy with Liberalisation of Trade*

Notably, these provisions are limited in their application, as they constitute exceptions to the national treatment and MFN obligations. They are also subject to interpretation. In the case of the national treatment exception, the issue is whether the measure is “aimed at ensuring . . . equitable or effective” taxation or tax enforcement.<sup>100</sup> No case has interpreted this provision so far. Based on WTO jurisprudence, “aimed at” suggests an objective standard based on the actual design and operation of the measure, rather than an examination of the political motivation behind the measure.<sup>101</sup> The GATT standard of a measure “relating” to a listed objective is probably the closest to an “aimed at” requirement.<sup>102</sup> There is no guidance in existing cases as to how the term “equitable” might be interpreted or how much deference might be given to the state imposing the measure. Future trade agreements with similar provisions should clarify that the state imposing the measure must be afforded maximum deference in the determination of equitability of taxation, and that the effectiveness requirement must take into account the specific constraints and limitations of the taxing authorities, with, again, significant deference to the imposing state. Moreover, the chapeau of the General Exceptions article requires that a measure “not [be] applied in a manner which would constitute a means of arbitrary or unjustifiable discrimination between countries where like conditions prevail, or a disguised restriction on trade.”<sup>103</sup> This applies to both the national treatment exception for “equitable or effective” taxation and

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*in Services: An Analytical Assessment of Australia’s Obligations Under Preferential Trade Agreements*, 18 MELBOURNE J. INT’L L. 373, 401–02 (2017).

<sup>100</sup> GATS, *supra* note 28, at art. XIV(d).

<sup>101</sup> For example, in a case involving GATT Article XX, the Appellate Body found that the Panel should have examined whether the measure itself was related to the conservation of clean air. It ultimately decided that there was a “substantial relationship” between the measure and the clean air objective, and that the measure was “primarily aimed at” the conservation of clean air within the meaning of Article XX(g). Appellate Body Report, United States — Standards for Reformulated and Conventional Gasoline, WT/DS2/AB/R, DSR 1996:I, 3, 13-22 (Apr. 29, 1996). In a case involving the Agreement on Trade-Related Investment Measures, the panel assessed whether the measures were aimed at promoting investment and had an impact on trade. Brazil — Certain Measures Concerning Taxation and Charges, WT/DS472,497/R, ¶¶ 7.793-7.806.

<sup>102</sup> In *China — Rare Earths*, the Panel stated:

the rational connection test endorsed by the Appellate Body in *U.S. — Shrimp* is potentially less strict than the previously employed ‘primarily aimed at’ standard. However, it is important to note that the Appellate Body in *U.S. — Shrimp* appeared to retain the ‘substantial relationship’ test developed in *U.S. — Gasoline*. This suggests that, while measures need not be primarily aimed at conservation, they must still bear a substantial, close, and real relationship to the conservation objective; as the Appellate Body said in *U.S. — Gasoline*, a merely incidental or inadvertent connection will not suffice.

Reports of the Panel, *China — Measures Related to the Exportation of Rare Earths, Tungsten, and Molybdenum*, ¶ 7.283, WT/DS431/R (Mar. 26, 2014) [hereinafter *China Panel Report*].

<sup>103</sup> GATS, *supra* note 29, at art. XIV; *see also* interpretation of similar language in GATT, *supra* note 17, at art. XX.

the MFN exception when the discrimination is due to compliance with a bilateral tax treaty or other similar agreement. The Panels and the Appellate Body have interpreted this requirement to mean that states' measures must also be the least trade restrictive alternatives that will achieve the purpose allowed in the general exception.<sup>104</sup>

Overall, tax carve-outs in trade agreements are somewhat vague and generally untested. While the language is fairly open-ended, interpretative practice at the WTO suggests that a number of tools could and likely would be utilized to constrain states' policy autonomy if a challenge were to arise.

#### 4. Tax Carve-Outs and Non-Conforming Measures in Investment Treaties

Taxation is explicitly addressed in two ways in investment treaties. First, a compliance provision might reassert investors' obligations to comply with local law, including tax law. Second, through the operation of carve-out clauses similar to those included in trade treaties, treaty protections might not extend to taxation measures. With respect to tax carve-outs, negotiators should be aware of three main sets of issues: the definition of tax measures; the scope of any carve-out; and the judicial or arbitral review of both the definition of tax measures and their possible inclusion in the scope of dispute settlement clauses of the treaty.

Investment agreements offer a range of tax carve-outs. Some exclusionary clauses address the applicability of specific provisions to taxation matters while others broadly exclude taxation measures from the treaty and from the adjudicative power of arbitrators under the treaty.<sup>105</sup> For example, the U.S.-

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<sup>104</sup> China Panel Report, *supra* note 102, at ¶ 7.202; *see also id.* at ¶ 7.354 (“[T]he chapeau of Article XX allows for a degree of discrimination provided it is justified and not arbitrary and where the complainants are unable to demonstrate the availability of a WTO-consistent alternative measure.”).

<sup>105</sup> For the history and varying scope of tax carve-out clauses in investment agreements, *see generally* Davie, *supra* note 58, at 210–16. The 2012 U.S. Model BIT article, *supra* note 65, at art. 21 (citations omitted) provides:

1. Except as provided in this Article, nothing in Section A shall impose obligations with respect to taxation measures.
2. Article 6 [Expropriation] shall apply to all taxation measures, except that a claimant that asserts that a taxation measure involves an expropriation may submit a claim to arbitration under Section B only if: (a) the claimant has first referred to the competent tax authorities of both Parties in writing the issue of whether that taxation measure involves an expropriation; and (b) within 180 days after the date of such referral, the competent tax authorities of both Parties fail to agree that the taxation measure is not an expropriation.
3. Subject to paragraph 4, Article 8 [Performance Requirements] (2) through (4) shall apply to all taxation measures.
4. Nothing in this Treaty shall affect the rights and obligations of either Party under any tax convention. In the event of any inconsistency between this Treaty and any such convention, that convention shall prevail to the extent of the

Argentina BIT implies only a best-efforts intent to apply the ethos of the treaty to taxation matters, but specifically extends the coverage of the treaty, in particular its dispute settlement provisions, to taxation issues in relation to expropriation and monetary transfers (such as repatriation of capital or profits):

1. With respect to its tax policies, each Party should strive to accord fairness and equity in the treatment of investment of nationals and companies of the other Party.
2. Nevertheless, the provisions of this Treaty, and in particular Article VII and VIII [dispute settlement], shall apply to matters of taxation only with respect to the following:
  - a. expropriation, pursuant to Article, IV;
  - b. transfers, pursuant to Article V; or
  - c. the observance and enforcement of terms of an investment agreement or authorization as referred to in Article VII(1)(a) or (b),

to the extent they are not subject to the dispute settlement provisions of a Convention for the avoidance of double taxation between the two Parties, or have been raised under such settlement provisions and are not resolved within a reasonable period of time.<sup>106</sup>

Such language would restrict investor complaints relating to taxation to indirect expropriation claims, which, as previously discussed, are the most difficult to win, and to claims relating to transfers.

The Hong Kong-Netherlands BIT provides an alternative approach:

Without prejudice to Article 3(1) [fair and equitable treatment], the provisions in this Agreement relative to the grant of treatment not less favourable than that accorded to the investors of either Contracting Party or to investors of any other State shall not be construed so as to oblige one Contracting Party to extend to the investors of the other the benefit of any treatment, preference or privilege resulting from:

1. any international agreement or arrangement relating wholly or mainly to taxation or any domestic legislation relating wholly or mainly to taxation . . . or
3. reciprocal arrangements with any other State.<sup>107</sup>

Unlike the U.S.-Argentina BIT, this language would seem to disallow tax-related indirect expropriation claims, but leave the door open to the easier-to-win claims under FET.

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inconsistency. In the case of a tax convention between the Parties, the competent authorities under that convention shall have sole responsibility for determining whether any inconsistency exists between this Treaty and that convention.

<sup>106</sup> Treaty Concerning the Reciprocal Encouragement and Protection of Investment, U.S.-Arg., Nov. 14, 1991, 31 I.L.M. 124, art. XII.

<sup>107</sup> Agreement on the Encouragement and Protection of Investments, H.K.-Neth., Nov. 19, 1992, 1745 U.N.T.S. 5, art. 7.

By contrast, the investment chapter of the Comprehensive and Progressive Trans-Pacific Partnership (CPTPP) does not include a tax carve-out. Instead, the CPTPP provides a complex set of tax carve-outs in the General Exceptions Chapter that apply to some or all trade, investment, e-commerce, and specific other CPTPP commitments.<sup>108</sup> The investment chapter of the CPTPP merely specifies that, absent some legal guarantee to the contrary, the loss of a subsidy or government grant, does not, in itself, amount to an expropriation.<sup>109</sup> This is perhaps a response to some of the tax-related indirect expropriation claims made under BITs, as mentioned in Section II.B above.

Additionally, general exceptions or escape clauses may be available in investment treaties for states facing situations of fiscal crisis. Traditionally, provisions on non-precluded measures would have been the only such recourse. Invoking such exceptions has been very limited in practice and largely unsuccessful in arbitrations.<sup>110</sup> The CPTPP recently took a different tack, allowing parties to notify “non-conforming” measures in place at the time of the signature of the treaty.<sup>111</sup> This is essentially a way for states to customize their obligations by stipulating their own exceptions to the treaty’s provisions. However, such an approach is static, in that it only covers rules and policies in place at the time of the treaty, but not future policies that might run afoul of treaty obligations. Here again, a state’s ability to effectuate future changes in tax policy may be subject to investment treaty claims and disputes.

In conclusion, a number of legal avenues exist to exclude fiscal matters from trade and investment treaties. In practice, exclusionary provisions are somewhat limited in coverage and their effectiveness to protect states’ tax policy autonomy in dispute settlement is largely untested. Perhaps most importantly, they are aimed at avoiding conflicts of law, rather than at creating a reasoned, comprehensive effort to separate tax policy from trade and investment regulation. More recent model investment agreements from emerging countries, such as the new Indian Model BIT, demonstrate some attempt to reverse this trend and to exclude taxation matters from trade and investment law.<sup>112</sup> The choice by some developing countries, including South Africa, India, and Indonesia, to withdraw from or let

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<sup>108</sup> CPTPP, *supra* note 81, at art. 29.4.

<sup>109</sup> *Id.* at art. 9.8.6.

<sup>110</sup> See generally William W. Burke-White & Andreas Von Staden, *Investment Protection in Extraordinary Times: The Interpretation and Application of Non-Precluded Measures Provisions in Bilateral Investment Treaties*, 48 VA. J. INT’L L. 307 (2007).

<sup>111</sup> CPTPP, *supra* note 81, at art. 9.12.

<sup>112</sup> Model Text for the Indian Bilateral Investment Treaty, art. 11(iii) (Gov. of India, Ministry of Fin. Dep’t of Econ. Aff. (Inv. Division), F. No. 26/St20t3-IC proposed Dec. 28, 2015), <http://perma.cc/4HEM-G9ZB> [hereinafter India Model BIT].

lapse their BITs is another way to ensure that balancing the intersection of taxation and investment law remains the sole province of domestic authorities.<sup>113</sup>

## B. Protecting Tax Autonomy in Current Trade and Investment Negotiations

### 1. Factors Affecting the Fiscal Impact of Trade in Goods Liberalization

Negotiations on tariffs may take several forms, which can affect fiscal revenues to varying degrees depending on the form of liberalization and on the economic make-up of individual countries. As a starting point, negotiators should consider the following issues:

- Negotiation modalities: formula-based negotiations for tariff cuts across the board result in less control over the fiscal impact of the cuts depending on the structure of imports. Line-by-line negotiations may preserve higher tariffs on key imports.
- Laffer Curve considerations: would a decrease in tariff rate increase the volume of imports, ultimately generating the same net amount of duties? If not, how will the state make up for the lost revenue? This also depends on the efficiency of duties collection overall and in particular sectors.
- Production and consumption elasticity: what is the production and consumption elasticity between the imported and the domestic competing product and how will it be affected by a decreased tariff?
- Weighting the present and future effects of a trade negotiation: what are the economic projections regarding the relative growth or contraction of imports by sector or product? This affects the country's future ability to raise revenue through tariffs.
- Tariff cuts exemptions: can the country benefit from an exemption from tariff cuts? For example, LDCs are typically not obligated to make reciprocal concessions.<sup>114</sup>

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<sup>113</sup> For a status of BITs, see generally UNCTAD Investment Policy Database; for South Africa: <http://perma.cc/KT7V-6PN5>; for Indonesia: <http://perma.cc/G8JW-CVCZ>; for India: <http://perma.cc/YM2Y-AKT9>. See also Xavier Carim, *International Investment Agreements and Africa's Structural Transformation: A Perspective from South Africa*, South Centre Investment Policy Brief No. 4, 3–6 (Aug. 2015); Kavaljit Singh and Burghard Ilge, *India Overhauls its Investment Treaty Regime*, <http://www.ft.com/content/53bd355c-8203-34af-9c27-7bf990a447dc> (July 15, 2016); Antony Crockett, *The Termination of Indonesia's BITs: Changing the Bathwater, But Keeping the Baby?*, 18 J. WORLD INV. & TRADE 836 (2017).

<sup>114</sup> Comm. for Dev. Pol'y and U.N. Dept. of Econ. and Soc. Aff., *Handbook on the Least Developed Country Category: Inclusion, Graduation and Special Support Measures*, U.N., 28–31 (2018).

## 2. Debates on the Fiscal Implications of Data Transactions and E-Commerce

Trade negotiations on e-commerce, and particularly debates about the treatment of cross-border data flows, show that no consensus exists among WTO members, or even categories of members, with developing countries divided on the preferred approach to a number of contentious issues. The shift to other fora, such as the TPP, has raised the stakes: regional trade agreements, by definition, include only limited subsets of countries, but the standards they set might have spill-over effects on non-participating countries.<sup>115</sup> Developing countries engaged in negotiations on e-commerce should be cognizant of a number of fiscal issues outlined below.

With respect to tax issues, the U.S. Trade Representative's "Digital 2 Dozen" principles for negotiations supported by the tech industry include prohibiting digital customs duties and securing market access on investment and cross-border digital services.<sup>116</sup> Some commentators have warned that current strategies in the CPTPP and at the WTO are likely to lead to a consolidation of market dominance by the biggest U.S. digital technology and services firms, foreclosing opportunities for "digital development" in emerging countries.<sup>117</sup> Such concerns are echoed in particular by the African Group (a WTO coalition of sub-Saharan African members)<sup>118</sup> and LDCs, which generally oppose negotiations on e-commerce in the current framework.<sup>119</sup> On the other hand, the Friends of E-Commerce for Development group—comprised of Argentina, Chile, China, Colombia, Costa Rica, Kazakhstan, Kenya, Mexico, Moldova, Montenegro, Nigeria, Pakistan, Sri Lanka, and Uruguay<sup>120</sup>—are seeking to move ahead in negotiations in a way that protects the interests of developing members. Participants in this group also have their own varying negotiation priorities.

Significant points of contention include classification of services under the GATS; the application of the modes of services to digital transactions, which often

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<sup>115</sup> On the mapping of trade regulation of data flows, see generally Susan Ariel Aaronson & Patrick Leblond, *Another Digital Divide: The Rise of Data Realms and its Implications for the WTO*, 21 J. INT'L ECON. L. 245 (2018).

<sup>116</sup> U.S. Trade Rep., *The Digital 2 Dozen* (Apr. 13, 2016).

<sup>117</sup> Jane Kelsey, *How a TPP-Style E-commerce Outcome in the WTO would Endanger the Development Dimension of the GATS Acquis (and Potentially the WTO)*, 21 J. INT'L ECON. L. 273, 275–77 (2018).

<sup>118</sup> Comm. from India and S. Afr., Work Programme on Electronic Commerce. Moratorium on Customs Duties on Electronic Transmissions: Need for a Re-Think, <http://perma.cc/KQ5H-B5E8>.

<sup>119</sup> See U.N. Conf. on Trade and Dev., *World's Poorest Economies Eye Digital Economy Engagement* (Apr. 3, 2019), <http://perma.cc/DDS4-WWBS>.

<sup>120</sup> MC11 In Brief, Electronic Commerce, WTO (Mar. 2, 2020), <http://perma.cc/7MFJ-FP84>.

involve elements of modes 1, 2 and 3; and the interpretation and appropriateness of a technological-neutral approach.<sup>121</sup> How each of these terms is construed may have specific and different fiscal implications in terms of who is taxed (for example, consumer, some service provider along the chain), where taxes are levied (for example, place where the digital transaction is consumed, place of origin of the transaction, place where the data is stored), and which kind of tax might be imposed (for example, sales tax, value added tax, income tax, corporate tax, profit tax, transaction tax). Developing countries' evolving positions as recipients and creators of e-commerce further add to the complexity of identifying their interests and the desirable corresponding policies. At present, they are largely a source country of e-commerce, rather than a resident country of international e-commerce businesses, with the exception of China. Since most domestic taxation systems are resident-based, developing countries tend to have a limited ability to mobilize the tax base for activities sourced in their territory by non-resident businesses.<sup>122</sup>

Even if e-commerce ends up being largely tariff-free, as advocated by a number of countries, it is generally agreed that it should not be tax-free.<sup>123</sup> Instead, it should be "tax neutral" as compared to brick and mortar equivalent transactions, particularly for consumer tax and corporate tax.<sup>124</sup> The OECD offered some framework principles in 1998, including that trade resulting from e-commerce should be taxed in the jurisdiction of consumption.<sup>125</sup> Some developing countries follow the OECD framework. For instance, South Africa requires foreign service suppliers to register for value-added taxation.<sup>126</sup> To date, however, no clear and consistent framework has emerged to support this position, and profit shifting by multinational corporations continues on a massive scale.<sup>127</sup> E-commerce appears to have resulted in an erosion of the corporate and consumer tax base, which governments are now trying to address domestically.<sup>128</sup>

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<sup>121</sup> See generally Kelsey, *supra* note 117, at 284–95.

<sup>122</sup> For an early examination of this issue, see Barrett Schaefer, *International Taxation of Electronic Commerce Income: A Proposal to Utilize Software Agents for Source-Based Taxation*, 16 SANTA CLARA HIGH TECH. L. J. 111, 135–36 (2000).

<sup>123</sup> Teltscher, *supra* note 26, at 8.

<sup>124</sup> *Id.*

<sup>125</sup> OECD, *Electronic Commerce: Taxation Framework Conditions*, DAF/CFA(98) 50 (1998).

<sup>126</sup> Amy Wilson et al., *The Effect of Electronic Commerce on the Erosion of Tax Bases – Developing Appropriate Taxation Laws in South Africa*, Southern Afr. Acct. Ass'n 2016 Western Cape Regional Conf., Conference Paper, 18 (2016).

<sup>127</sup> See generally Thomas R. Tørsløv et al., *The Missing Profits of Nations* (Nat'l Bureau of Econ. Research, Working Paper No. 24701, 2018).

<sup>128</sup> UNCTAD, *Trade and Development Report 2018* at 87, UNCTAD/TDR/2018, Sales No: E.18.II.D.7. As early as the 1990s, the U.S. and the E.U. identified the downward pressure on tax

### 3. Trends in Investment Treaty Negotiations

The volume of investor-state litigation involving tax measures, as described in Section II above, has clearly made states more attuned to what had hitherto likely been unforeseen or unintended consequences of their treaty commitments. A range of drafting options are available to protect states' taxation power in future treaties.

Provisions requiring compliance with local law (including tax law) are becoming more expansive in recent investment agreements or models, likely as part of the trend to protect host state autonomy more robustly. For instance, the new Indian model BIT states: "The parties reaffirm and recognize that: . . . (iii) Investors and their investments shall comply with the provisions of law of the Parties concerning taxation, including timely payment of their tax liabilities."<sup>129</sup> Notably, this broad drafting would appear to elevate to an international obligation compliance both with the domestic law of the host state as well as compliance with the law of the home state of the investor. The symmetry in obligations is interesting in light of corporate tax relocation tactics that aim to decrease the company's tax liability in all jurisdictions.

Tax carve-out clauses in investment treaties are also seeing more scrutiny from negotiators. The new Dutch model BIT (2018) illustrates a limited carve-out approach, mostly aimed at avoiding conflicts with double taxation treaties.<sup>130</sup> It explicitly provides that MFN and national treatment obligations apply to taxation measures but seeks to exclude any issue covered by a double taxation treaty or other international fiscal agreement.<sup>131</sup> The draft Pan-African Investment Code also takes a very limited approach merely to avoid conflicts with double taxation treaties and to ensure the latter's prevalence over the Code.<sup>132</sup> The U.S. Model BIT takes a middle ground by mostly excluding taxation measures from the ambit of its model BIT, except that the treaty obligations on expropriation and performance requirements (such as the prohibition on local content requirements)

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base from e-commerce. *See generally* *Disappearing Taxes; The Tap Runs Dry*, THE ECONOMIST (May 29, 1997), <http://perma.cc/Q9RH-4DP7>; Max Cash, *Electronic Commerce and Tax Base Erosion* (Eur. Parl. Directorate-general for Research, Working Paper, ECON 108/EN, 1999); Donald Bruce & William F. Fox, *E-Commerce in the Context of Declining State Sales Tax Bases*, 53 NAT. TAX J. 1373 (2000). Some authors also predicted early on that tax base erosion due to e-commerce would be even more acute in developing countries. *See generally* Richard Jones & Subhjit Basu, *Taxation of Electronic Commerce: A Developing Problem*, 16 REV. L. COMPUTERS & TECH. 35, 41–44 (2002); Banga, *supra* note 27, at 17–25.

<sup>129</sup> India Model BIT, *supra* note 112, at art. 11(iii).

<sup>130</sup> Netherlands Model Investment Agreement, *supra* note 89, at art. 10.

<sup>131</sup> *Id.*

<sup>132</sup> Econ. Aff. Dep't., Draft Pan-African Investment Code, African Union Commission art. 39 (2016).

still apply to taxation measures.<sup>133</sup> In all these variants, the carve-outs are designed as conflict of law tools, rather than as an exclusion of a regulatory topic from the treaty, in order to protect full domestic autonomy.

By contrast, the new Indian model BIT carves out “any law or measure regarding taxation, including measures taken to enforce taxation obligations.”<sup>134</sup> Moreover, it specifies that the host state has jurisdiction to decide whether an alleged breach is a matter of taxation and such a decision is not reviewable by arbitral tribunals. This language is no doubt a response to the number of investor-state arbitrations arising on tax issues and recent adverse decisions on other subject matters that essentially overturned Indian judicial decisions. Its inclusion is clearly intended to protect tax policy autonomy, rather than merely to avoid conflicts between international investment and international tax commitments.

States wishing to preserve maximum tax policy autonomy should consider a multiple-pronged approach. First, they should seek a robust domestic law compliance requirement, which elevates obligations already existing under domestic law to an international law obligation enforceable against investors, if only as a defense to an investor claim or to mitigate potential damages. Second, they could draft a broad carve-out that explicitly excludes tax matters from the scope of the protections granted to investors under the treaty, particularly national treatment, expropriation, fair and equitable treatment and umbrella clauses. Third, they could preclude taxation issues from falling within the scope of treaty dispute settlement procedures. This would ensure that tax policy and enforcement remain solely within domestic jurisdiction. Lastly, a conflict-type clause or carve-out clause that addresses potential overlap with bilateral or multilateral taxation treaties should protect states from potential clashes with other international obligations.

## V. CONCLUSION

Trade and investment treaties affect fiscal mobilization in a number of ways. In some cases, the drafters’ intention to include or exclude certain tax matters is clear, but in other cases, the fiscal impact of the treaties seems to have been somewhat unforeseen. There is no consistent or coherent treatment of fiscal matters in trade and investment treaties. Yet, the volume of litigation both under trade agreements and investment agreements belies the assumption that taxation issues are dealt with by double taxation treaties and that a simple conflicts clause will serve to exclude tax matters from trade and investment treaties. Moreover, tax treaties are limited in their scope. They are proving insufficient to address

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<sup>133</sup> 2012 U.S. Model BIT, *supra* note 65, at art. 21 (stating expropriation claims based on taxation measures must first be referred to tax authorities for a determination whether the measure indeed amounts to an expropriation).

<sup>134</sup> India Model BIT, *supra* note 112, at art. 2.4.

transfer pricing, profit shifting, base erosion, and the challenges of the digital economy, especially amidst the myriad new forms of transactions generated by a globalized economy. As a result, countries may face both regulatory gaps, resulting in uncertainty in interpretation, implementation, and adjudication of the law, and regulatory overlap, allowing forum shopping and other maneuvering by investors and traders.

Furthermore, the interplay between trade and investment treaties, which is largely unaddressed from a legal perspective, allows benefits secured in the trade regime to be undermined by loopholes in the investment regime, thereby allowing companies to evade tax policies secured in the trade arena. Preserving tax policy autonomy is therefore also a matter of coordination between trade and investment regimes.

This field of inquiry is in its infancy, but the issues for policymakers, lawyers, and economists are pervasive. This Article offers an initial mapping of the theoretical and practical problems that must be explored by scholars and policymakers alike.