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International Arbitration Claims against Domestic Tax Measures Deemed Expropriatory or Unfair and the Inequitable

Adrian F. Rodriguez

Special Initiative on Trade and Integration

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INTERNATIONAL ARBITRATION CLAIMS AGAINST DOMESTIC TAX MEASURES DEEMED EXPROPRIATORY OR UNFAIR AND INEQUITABLE[1]

By: Adrian F. Rodriguez[2]

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July 2005

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[1] Document prepared under contract with the Integration Department of the Inter-American Development Bank (IDB), financed under the Special Initiative on Trade and Integration. The views expressed in this document do not necessarily correspond to those of the IDB.

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§1. INTRODUCTION

Contents

[1] Globalization trends and the desire to enjoy the benefits of liberalized trade and commerce have paved the way for a number of regional Free Trade Agreements ("FTAs") with the USA Mexico led participating in North American Free Trade Agreement (NAFTA), then Chile, the Central American countries and the Dominican Republic followed with Central American Free Trade Agreement (CAFTA-DR),[3] and now it is the turn for the Andean Community region where Colombia, Ecuador and Peru are in fast paced negotiations with the USA for an Andean FTA.

[2] FTAs should lead to an increase in Foreign Direct Investment ("FDI") between signatory parties, but such increase and the expected attached benefits call for an international standard of protection for investors.

[3] Trade and commerce relations with the USA and the importance of USA investments in the region are undeniable and necessary. But, protection to USA investors under an FTA could reach unsuspected dimensions via indirect expropriation arbitration claims where domestic tax matters could rise to the level of investment disputes where otherwise they would be dealt with in domestic tax courts.

[4] What does this represent for Latin American countries and their protection of national sovereignty, particularly in the area of income and Value Added Tax (VAT) taxation, areas commonly believed to be out of the scope of application of FTA agreements?

[5] It is clear that under FTAs signatory parties do not waive tax sovereignty and retain ample regulatory powers in this regard. Nevertheless, pursuant to FTA regulations, signatory parties must be very careful in designing and applying tax policies. Any erratic, discriminatory, unsound tax policy measures could rise to the level of expropriation leading to international litigation.

[6] Latin American countries party to this type of agreements must realize the importance of this issue and the economic hardship that could result from material arbitration rulings against them, where there is finding that an unfair and inequitable tax treatment to American investors amounts to an indirect expropriation of their investment.

[7] Although it could seem farfetched, this situation has already been experienced by Argentina under its Bilateral Investment Treaty ("BIT") with the USA, to the point that the Argentine authorities have publicly declared their intention to appear before local courts to dispute the effects of the arbitration rulings against Argentina in this regard (Casey [2005]).

[8] Recently, in a VAT dispute between Occidental Exploration and Production Company *v*. Ecuador, the London Court of International Arbitration recognized jurisdiction over a domestic tax dispute that was raised to the level of an investment dispute by the claimant, confirming in its

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[3] The Dominican Republic - Central America - United States Free Trade Agreement. Ratification of the treaty is pending, currently undergoing domestic Congressional approval.

judgment the right of the claimant to a VAT refund. The Ecuadorian Government has also shown its intentions of challenging this ruling before local courts.

[9] Could this trend in investment disputes under BITs spillover to the application of investment disputes under FTAs?

[10] This paper seeks to briefly articulate that although signatory parties remain autonomous to formulate and direct their tax policy, discriminatory tax measures deemed as unfair and inequitable could amount to indirect expropriation resulting in an investment dispute subject to arbitration and the corresponding right to compensation for the loss or damage caused by such measures. For this purpose we will briefly analyze CAFTA-DR's chapters 10 and 21, investment and exceptions, respectively, which should be similar to the rules to be adopted in the Andean FTA under negotiation; this analysis will be limited to those aspects directly related to indirect expropriation and its compensation.

[11] The purpose of this paper is not to deter Latin American countries from future FTAs or BITs with the USA or other countries. On the contrary it is to stress and advocate for the importance of having a *stable, fair and equitable tax system* and for Congress, Tax Authorities and Tax Courts to keep these considerations present in the adoption, interpretation and application of domestic tax rules, as any erratic, discriminatory, unsound tax policy measures could result in international litigation and material compensation awards against the breaching signatory party.

§2. OVERVIEW OF CAFTA-DR'S FRAMEWORK ON INDIRECT EXPROPRIATION

[12] **§2.1. Investment.** CAFTA-DR's chapter 10 on investments regulates rights and obligations of the signatory parties and their investors with regard to their investments in another signatory party.[4] It also establishes the rules that will apply to Investor-State dispute settlements arising from expropriation claims, among others.[5]

[13] CAFTA-DR's investment framework applies to all covered investments in the territory of the signatory party performed by all investors of another signatory party.[6]

[14] The definition of investment, and the resulting scope of the term investor, is broad and intends to mean every asset that an investor owns or controls, directly or indirectly, that has the characteristics of an investment, including such characteristics as the commitment of capital or other resources, the expectation of gain or profit, or the assumption of risk.[7]

[15] According to CAFTA-DR's definition of the term investment, it may include, among others:

(a) an enterprise;

(b) shares, stock, and other forms of equity participation in an enterprise;

(c) bonds, debentures, other debt instruments, and loans;

(d) futures, options, and other derivatives;

(e) turnkey, construction, management, production, concession, revenue-sharing, and other similar contracts;

(f) intellectual property rights;

(g) licenses, authorizations, permits, and similar rights conferred pursuant to domestic law; and

(h) other tangible or intangible, movable or immovable property, and related property rights, such as leases, mortgages, liens, and pledges.

[16] **§2.2. Indirect Expropriation.** Pursuant to CAFTA-DR's investment framework, a signatory party is prevented from expropriating or nationalizing a covered investment either directly or indirectly through measures equivalent to expropriation or nationalization, except for a public purpose, in a non-discriminatory manner, paying prompt, adequate and effective compensation, and in accordance with due process of law pursuant to the agreed minimum standard of treatment, i.e., treatment in accordance to international law, including fair and equitable treatment and full protection and security.[8]

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4 See CAFTA-DR, Chapter 10, Section A.

5 Id. Section B.

6 See CAFTA-DR, §10.1.

7 Id. §10.28.

8 Id. §10.7 and 10.5.

[17] An action or a series of actions by a signatory party that has an effect equivalent to direct expropriation but without formal transfer of title or outright seizure, constitutes indirect expropriation.

[18] Determining whether an action or series of actions by a signatory party in a specific fact situation, constitutes an indirect expropriation, requires a case-by-case, fact-based inquiry that should consider among others:

- the adverse economic impact of the government action on the economic value of the investment (which standing alone does not establish that an indirect expropriation has occurred);

- the extent to which the government action interferes with distinct, reasonable investment-backed expectations; and

- the character of the government action.[9]

[19] Except in rare circumstances, regulatory actions designed and applied to protect legitimate public welfare objectives (such as public health, safety, and environment) do not constitute indirect expropriations, provided that such measures are nondiscriminatory.[10]

[20] **§2.3. Dispute Resolution.** CAFTA-DR's chapter 11 further sets forth the rules that should be followed in the event that an investment dispute should arise from a supposed breach by one of the signatory parties of an obligation under Section A of chapter 11.

[21] First, the claimant and the respondent should initially seek to resolve the dispute through consultation and negotiation, which may include the use of non-binding third party procedures such as conciliation and mediation.[11] If upon consideration by either party the dispute cannot be settled by consultation and negotiation, then the claimant, on its own behalf or on behalf of an enterprise (that is a juridical person) owned or controlled directly or indirectly by the claimant, may submit the dispute to arbitration claiming that the respondent has breached an obligation[12] under Section A of Chapter 11, and that such breach has resulted in loss or damage to the claimant or the enterprise or the value of its investment.[13]

[22] The claimant has three alternatives under CAFTA-DR. The International Centre for the Settlement of Investment Disputes "ICSID," if both signatory parties are parties to the ICSID Convention. The ICSID under the Additional Facility Rules provided that either signatory party is a party to the ICSID Convention. And the United Nations Commission on International Trade Law "UNCITRAL" and its arbitration rules.[14]

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9 Id., Annex 10-C, §4.

10 Id., Annex 10-C, §4.b.

11 Id. §10.15.

12 Or an investment authorization or agreement.

13 See CAFTA-DR, §10.16.

14 Id.

§3. TAX MEASURES EQUATING TO INDIRECT EXPROPRIATION

[23] **§3.1. The Obligation not to Expropriate an Investment.** CAFTA-DR imposes obligations on its signatory parties that upon ratification of the treaty they have assumed with respect to the investors and investments of another party.

[24] As indicated above, one of the obligations assumed by the signatory parties is to prevent an investment from being expropriated or nationalized directly or indirectly, or from being subjected to measures equivalent to an indirect expropriation, except for a public purpose; in a non-discriminatory manner; upon payment of prompt, adequate and effective compensation; in accordance with due process of law pursuant to the agreed minimum standard of treatment, i.e., treatment in accordance to international law, including fair and equitable treatment and full protection and security.[15]

[25] As pointed out before, except in rare circumstances regulatory actions designed and applied to protect legitimate public welfare objectives (such as public health, safety, and environment) do not constitute indirect expropriations, provided that such measures are nondiscriminatory.[16]

[26] **§3.2. The Role of International Law.** In concluding CAFTA-DR its signatory parties adopted a special regime in all matters dealt within the treaty, including investments and their indirect expropriation. As a special regime for investment disputes by nationals or enterprises of the USA in Central America countries and the Dominican Republic, in Chile, and in Colombia, Ecuador and Peru under the upcoming Andean FTA, the FTA provides the applicable law in these matters, expressly incorporating customary international law standards for the treatment of investments.[17]

[27] In this sense, customary international law should serve as a useful tool to construe CAFTA-DR's rules with respect to the scope of important terms such as investment, measures and tax measures, indirect expropriation and fair and equitable treatment, and when a measure is discriminatory or when it protects a legitimate public welfare objective.

[28] These provisions expressly require the signatory parties to afford investors of another signatory party treatment no less favorable than that required by international law, both with respect to investments and to expropriations or measures tantamount to expropriation of an investment. These rules also serve to incorporate international law by reference into an FTA, converting all violations of international law affecting investment into FTA violations and enabling investors to enforce customary international law using the investor-to-state disputes resolution mechanisms established therein (Vandevelde [1992]).

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[15] Id. §10.7 and 10.5.

[16] Id., Annex 10-C, §4.b.

[17] Id.

[29] Although an FTA affords foreign investments a higher degree of protection than customary international law, it should be clear that in no event should foreign investments receive treatment less favorable than that required by customary international law.[18]

[30] **§3.3. Indirect Expropriation.** CAFTA-DR's §§10.7 and 21.3(6) refer to direct expropriations and to indirect expropriations, *i.e*., an action or series of actions equivalent to expropriation or nationalization. Therefore, an expropriation may occur without formal transfer of title or outright seizure of the investment.[19]

[31] CAFTA-DR is vague as to the term measures, it defines them as any law, regulation, procedure, requirement or practice. A measure alone can tantamount, *i.e*., be equivalent, to expropriation or may not, and also a number of measures over time can tantamount to what international law knows as creeping expropriation, characterized by the United Nations Conference on Trade and Development ("UNCTAD") as an expropriation carried out by a series of acts over a period of time.[20]

[32] The terms indirect expropriation or measures equivalent to direct expropriation are not defined by CAFTA-DR. Even though case law does not use uniform language when referring to these terms, international law has reached a definition of an indirect or creeping expropriation.

[33] Actions by one of the signatory parties that have the effect of substantially impairing the value of an investment of an investor of another party, may constitute indirect expropriation under CAFTA-DR. Provisions on expropriation typically apply to actions by a country that substantially impair the value of an investment, regardless of whether they amount to an isolated event or whether they are part of a major structural change in the economy.[21] In this case CAFTA-DR makes this clear by expressly stating that indirect expropriation includes actions or a series of actions equivalent to direct expropriation.

[34] A signatory party may be responsible for an indirect expropriation of property when it subjects investor's property *to taxation*, regulation, or other action that is confiscatory, or that prevents, unreasonably interferes with, or unduly delays, effective enjoyment of investor's property, or when the actions makes it impossible for the firm to operate at a profit.

[35] In Metalclad, a NAFTA Tribunal ruled that under NAFTA expropriation includes covert or incidental interference with the use of property which has the effect of depriving the owner, in whole or in significant part, of the use or reasonably-to-be-expected economic benefit of property even if not necessarily to the obvious benefit of the host State.[22]

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[18] See CAFTA-DR, §10.5.

[19] See CAFTA-DR, CHAPTER 10, ANNEX 10-C(4).

[20] UNCTAD. *Bilateral Investment Treaties in the Mid-1990s*, United Nations, 1998: "(…) creeping expropriation is comprised of a number of elements, none of which can separately constitute the international wrong. These constituent elements include non-payment, non-reimbursement, cancellation, denial of judicial access, actual practice to exclude, non-conforming treatment, inconsistent legal blocks, and so forth."

[21] Id. at 65.

[22] ICSID, in the matter of *Metalclad Corporation v. The United Mexican States*, Case N° ARB(AF)/97/1, August 30,2000.

[36] ICSID recently restated the state of international law on expropriation, stating that a deprivation or taking of property may occur under international law through interference by a state in the use of that property or with the enjoyment of its benefits, even where legal title to the property is not affected (ICSID [2000]). A measure or series of measures can still eventually amount to a taking, though the individual steps in the process do not formally purport to amount to a taking or to a transfer of title.[23] What has to be identified is the extent to which the measures taken have deprived the owner of the normal control of his property.[24] A decree which heralds a process of administrative and judicial consideration of the issue in a manner that effectively freezes or blights the possibility for the owner reasonably to exploit the economic potential of the property, can, if the process thus triggered is not carried out within a reasonable time, properly be identified as the actual act of taking.[25]

[37] **§3.4. Fair and Equitable Treatment.** As to fair and equitable treatment, this phrase is not defined, although it should include 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.

[38] UNCTAD's position paper on fair and equitable treatment states that under the fair and equitable standard the central issue remains simply whether the actions in question are under all circumstances fair and equitable or unfair and inequitable (UNCTAD [1999]).

[39] In this sense the plain and ordinary meaning of fair and equitable should prevail. Fair is generally defined as having the qualities of impartiality and honesty; free from prejudice, favoritism, and self-interest. Just; equitable; even-handed; equal as between conflicting interests. Equitable is defined as "just, conformable to the principles of justice and right."

[40] It is both reasonable and legitimate for investors to expect that a government (in a broad sense) will conform its conduct to its constitution, laws, regulations, treaties, and customary international law. In addition, if a signatory party fails to act consistently with the representations and benefits offered to attract foreign investment, and to unforeseeably change the essential rules of the game upon which investors relied when making the investment, this should also be considered as unfair and inequitable.

[41] **§3.5. Tax Measures.** CAFTA-DR provides exceptions to the application of its rules including those on investments. Among these exceptions in Chapter 21, §21.3(1) provides for no application of the treaty to taxation measures. Nevertheless, §21.3(6) provides an exception to this exception with regard to Expropriation and Compensation and Submission of these claims to Arbitration under the treaty. According to §21.3(6) §10.7 (Expropriation and Compensation) and 10.16 (Submission of a Claim to Arbitration) apply to a taxation measure alleged to be an expropriation or a breach of an investment authorization or investment agreement.

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[23] Id.

[24] Id.

[25] Id.

[42] Any investor seeking to submit a claim to arbitration pursuant to CAFTA-DR's §§10.7 and 21.3(6), at the time that it gives written notice of its intent to submit a claim to arbitration,[26] must first refer to the competent authorities of both signatory parties (*i.e.*, claimant's and respondent) the issue of whether that taxation measure involves an expropriation. If the competent authorities of both signatory parties do not agree to consider the issue or, having agreed to consider it, fail to agree that the measure is not an expropriation within a certain period of time, the investor may proceed to submit its claim to arbitration.[27]

[43] Unexpected, non-transparent tax measures (in a broad sense) adopted by a signatory party can result in an indirect expropriation. Should the tax measure substantially impair the value of the investments and provided that the claimant can evidence that the respondent has violated the fair and equitable treatment standard because the measures interfere with distinct and reasonable investment-backed expectations, among other factors.

[44] As indicated, a tax measure can be any law, regulation, procedure, requirement, or practice, but is not limited to the listed items by the definition in CAFTA-DR's §2.1. The only limitation to a tax measure is set by §21.6 in CAFTA-DR's exceptions chapter, pursuant to which a tax or taxation measure does not include customs duties, a countervailing or antidumping duty, or fees or other charges in connection to importation; other than that, the term tax measure should be construed as a catchall term. The scope of the term tax measure remains to be detailed by case law.

[45] This issue was reviewed in Marvin Feldman *v.* México (ICSID [2002]), a case under NAFTA concerning a dispute regarding the application of certain tax laws by the United Mexican States to the export of tobacco products by Corporación de Exportaciones Mexicanas, S.A. de C.V. ("CEMSA"), a company organized under the laws of Mexico and owned and controlled by Mr. Marvin Roy Feldman Karpa, an USA citizen.

[46] In this case the claimant argued that Mexico's refusal to rebate excise taxes applied to cigarettes exported by CEMSA and Mexico's continuing refusal to recognize CEMSA's right to a rebate of such taxes regarding prospective cigarette exports constituted a breach of Mexico's obligations under NAFTA's Chapter 11, Section A, in particular §1110 (Expropriation and Indemnification), among others.

[47] Although the decision in this case was not reached on the basis of expropriation, the Tribunal considered whether Mexico's actions effectively drove CEMSA out of the cigarette export business, constituting indirect or creeping expropriation.

[48] The Tribunal considered that by their very nature, tax measures, even if they are designed to and have the effect of an expropriation, would be indirect, with an effect that may be tantamount to expropriation. If the measures are implemented over a period of time, they could also be characterized as creeping. For the Tribunal creeping expropriation is not distinct in nature from, and is subsumed by, the terms indirect expropriation or tantamount to expropriation.

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[26] See CAFTA-DR, §10.16(2).

[27] Id. §21.3(6).

[49] The Tribunal also noted that the ways in which governmental authorities may force a company out of business, or significantly reduce the economic benefits of its business, are many, including confiscatory tax measures that may be considered to be expropriatory actions, stressing that non-discriminatory, bona fide general taxation does not establish liability.

[50] **§3.6. Right to Compensation.** As in outright expropriation, in the case of expropriatory tax measures the investor has the right to payment of prompt, adequate and effective compensation. Compensation shall be equivalent to the fair market value of the expropriated investment immediately before the expropriatory action was effected; be paid without delay; be fully realizable; and be freely transferable at the prevailing rate of exchange on the date of expropriation; include interest at a commercially reasonable rate from the date of expropriation.

[51] According to international law compensation arising from an expropriation claim is measured by the fair market value of the loss to the investor.

[52] Should the tax measures adopted by the signatory party impair substantially the value of the investment, the consequent loss or damage should give the investor a right to be compensated in the above outlined terms.

[53] **§3.7. The Public Policy Exception.** It is important to stress that entering into an FTA does not equate to a waiver of tax sovereignty. Signatory parties retain their regulatory powers in this regard and can still autonomously design and adopt a bona fide general and nondiscriminatory tax policy.

[54] CAFTA-DR provides for an additional exception that should be deemed as setting out a bottom line when it comes to tax measures deemed as expropriatory. CAFTA-DR in its Annex 10-C, §4.b., states that except in rare circumstances, regulatory actions designed and applied to protect legitimate public welfare objectives (such as public health, safety, and environment) do not constitute indirect expropriations, provided that such measures are nondiscriminatory.

[55] This exception points out objectives such as protection of public health, safety and the environment. Nevertheless, this provision is ample and can be construed to include within its scope other public policy objectives such as sound public financing (tax policies), essential for the functioning of the government.

[56] As stressed by the Tribunal in Marvin Feldman *v*. México (ICSID [2002]), non-discriminatory, bona fide general taxation does not establish liability. An FTA does not bar a signatory party from adopting a nondiscriminatory, fair and equitable tax measure, which under the public policy exception should not equate to an expropriatory measure.

[57] Nevertheless and while taxation is preserved, policymakers of the signatory parties must be very careful in designing and applying tax policies, since any discriminatory, unsound tax policy measures could rise to the level of expropriation leading to international litigation and awards against the signatory country that adopts a discriminatory, unfair or inequitable impairing the value of an investment.

§4. DOMESTIC TAX DISPUTES RISING TO THE LEVEL OF INVESTMENT ARBITRATION DISPUTES

[58] A question remains for arbitration case law to resolve and that is whether pursuant to CAFTA-DR and the future Andean FTA with the USA domestic tax disputes could eventually rise to the level of investment disputes where otherwise they would be dealt with in domestic tax courts.

[59] CAFTA-DR does not define the term tax measure. It can be construed to include a variety of situations, including laws, regulations, procedures, requirements or practices by any body or authority of a signatory party.[28]

[60] In this sense, governmental domestic tax disputes between an investor or an enterprise of the investor and the tax authorities resulting in a proved substantial impairment of the corresponding investment could eventually and under certain circumstances, be deemed as an expropriatory or an unfair and inequitable tax measure.

[61] Provided that the rules therein are similar to those in CAFTA-DR, this unsuspected scope of the investment and expropriation rules of the future Andean FTA could make a career with arbitration tribunals.

[62] The London Court of International Arbitration recently reviewed a similar issue in the matter of an UNCITRAL arbitration pursuant to an investment claim filed under the Ecuador–USA BIT by Occidental Exploration and Production Company *v*. The Republic of Ecuador.[29]

[63] In this case Occidental (USA company) had entered into a participation contract with Petroecuador, the State-owned oil exploration and production company of Ecuador. Occidental applied regularly to the Ecuadorian Tax Service[30] for the refund of VAT paid in the purchases required for its exploration and exploitation activities and the Ecuadorian Tax Service made such refund regularly.

[64] Beginning in 2001 the Service issued "Resolutions" annulling previous resolutions granting the refunds, denying all further refunds requested by Occidental under the participation contract and demanding from the company the reimbursement with interest of the previously refunded amounts, on the grounds that the VAT refunds were already accounted in the participation formula under the contract and that therefore, Occidental did not have a right to such VAT refunds and that previous refund resolutions were based on a mistaken interpretation of the VAT law in force at that time.

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[28] Id. §§ 2.1 and 21.6.

[29] London Court of International Arbitration, in the matter of *Occidental Exploration and Production Company v. The Republic of Ecuador*, Case N° UN 3467, July 1, 2004.

[30] "Servicio de Rentas Internas - SRI."

[65] Although decisions by the domestic tax courts on this matter were still pending, Occidental filed an arbitration claim against Ecuador under the Ecuador-U.S. BIT, arguing a breach of treaty guarantees protecting Occidental's investment in that Country.

[66] Among others, Occidental argued in its arbitration claim that Ecuador had breached its obligations under the BIT, particularly its obligations to afford the investor with a fair and equitable treatment and not to expropriate the investor's investment. Ecuador opposed these argument on the merits and in addition objected to jurisdiction and admissibility of the claims.

[67] In this case the respondent objected to jurisdiction and admissibility of the claim arguing that the claimant's lawsuits before Ecuadorian tax courts showed an irrevocable choice to submit the disputes to domestic jurisdiction precluding submission of the dispute to international arbitration under the BIT. Claimant's response to this objection was that although contract-based and tax-based claims where filed with the domestic tax courts, it had not submitted an investment dispute to the Ecuadorian courts. Therefore, submission of a treaty-based claim was not precluded.

[68] The Tribunal held that it had jurisdiction to consider the dispute and dismissed the respondent's objection to jurisdiction and admissibility of the claim. Analyzing the broad scope definition of investment under the BIT, the Panel found that claimant's rights under the contract with Petroecuador constituted a covered investment under the BIT. Further on, the Panel construed the BIT provisions to allow claimant to file a treaty-based claim even if the claimant has resorted to domestic courts. For the Panel, to the extent that the nature of the dispute submitted to arbitration is principally, albeit not exclusively, treaty-based, the jurisdiction of the Tribunal was considered as correctly invoked.[31]

[69] This case shows how under certain circumstances and even though the claimant had previously filed domestic lawsuits to safeguard its rights under domestic tax law, an investor can recur to characterize its claim under the BIT as an investment dispute and seek treaty-based review of the Government's tax measures. In this regard the Panel cited Societé Genérale de Surveillance (SGS *v)*. Pakistan (ICSID [2003]) where the Tribunal also concluded that it is for the claimant to characterize the claims as it sees fit.

[70] With respect to the claim of indirect expropriation of the investment, claimant argued that unlawfully, arbitrarily, discriminatorily and retroactively taking its right to VAT refunds Ecuador had expropriated all or part of claimant's investment. The respondent contended that the actions by the Service did not constituted expropriation.

[71] In this regard the Tribunal acknowledged citing Feldman *v*. Mexico[32] *that taxes can result in expropriation*, as can other types of regulatory measures. Nevertheless, in this particular case the Tribunal did not find the standards required by indirect expropriation under Metalclad, *i.e*., the existence of a deprivation, that this deprivation must affect at least a significant part of the investment, and that all of it relates to the use of the property or a reasonably expected

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[31] Supra, footnote 31.

[32] Supra, footnote 29.

economic benefit.[33] For the Panel in this case, the respondent's tax measures did not amount to direct or indirect expropriation since there were no findings of a substantial deprivation of the use or reasonably expected economic benefit of the investment, or of these measures affecting a significant part of the investment.

[72] Although in this case the Tribunal did not find a substantial deprivation deriving from the tax measures adopted by the Service, this does not mean that in other cases and under different circumstances an arbitration panel could not conclude otherwise.

[73] In this case, claimant also argued a breach of the BIT by Ecuador when failing to provide the investment fair and equitable treatment, by revoking preexistent decisions that were legitimately relied upon by investor to assume its commitments and plan its commercial and business activities, frustrating claimant's legitimate expectations on the basis of which the investment was made. The respondent objected arguing that there was no expectation of a VAT refund at the time the investment was made.

[74] The Tribunal pointed out from the BIT's protocol the desirability of fair and equitable treatment in order to maintain a stable framework for investment and maximum effective utilization of economic resources, concluding that such stability of the legal and business framework is thus an essential element of fair and equitable treatment.

[75] The Tribunal found that the framework under which the claimant's investment was made had changed by the actions adopted by the Ecuadorian Tax Service breaching the respondent's obligation not to alter the legal and business environment in which the investment was made; therefore, triggering an unfair and inequitable treatment.

[76] As a consequence of the Tribunal's finding that the respondent failed to afford fair and equitable treatment to the investor, among others, the Tribunal declared that the claimant was entitled to retain the amounts initially refunded by the Service and that the Service's denying resolutions requiring the reimbursement of those amounts were without legal effect, further holding that the claimant was entitled to the VAT refunds requested. The Tribunal's award held that, in order to avoid a double recovery should the local outstanding lawsuits be successful, the claimant was not entitled to additional recovery and directed the claimant to cease and desist from any local court actions in this matter.

[77] This case shows how a domestic tax dispute can potentially be characterized as an investment dispute allowing the investor to assert treaty-based jurisdiction with an international arbitration tribunal. In addition and pursuant to international law, it entertained the possibility of domestic tax measures being considered expropriatory and unfair and inequitable, depending on the facts and circumstances of each case. If we take into account the similarity of the investment framework in USA's BITs and FTAs, it should be reasonable to entertain the possibility that this situation could potentially spillover to the interpretation and application of CAFTA-DR's investment rules and those of the upcoming Andean FTA, which should also be similar.

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[33] Supra, footnote 21.

Contents

§5. CONCLUSIONS

[78] CAFTA-DR and the upcoming Andean FTA will allow signatory parties to enjoy the benefits of liberalized trade and commerce. But, awareness should be created about the consequences and responsibility that comes along with this type of treaties, since the increase of FDI between signatory countries and the attached benefits may not come cost-free.

[79] Protection to USA investors under an FTA and international law standards could reach unsuspected dimensions via indirect expropriation and fair and equitable treatment arbitration claims where domestic tax matters could rise to the level of investment disputes where otherwise they would be dealt with in domestic tax courts.

[80] CAFTA-DR's definition of investment, and the resulting scope of the term investor, is broad. Therefore, care and attention is demanded from domestic authorities to the potential reach of their tax measures with respect to assets and rights having the characteristics of an investment, as defined by the treaty.

[81] In concluding CAFTA-DR its signatory parties adopted a special regime in all matters dealt within the treaty, imposing obligations on its signatory parties that include preventing an investment from being expropriated or nationalized directly or indirectly, or from being subjected to measures equivalent to an indirect expropriation. In this regard, CAFTA-DR expressly incorporated customary international law standards for the treatment of investments, which should serve as a useful tool to construe CAFTA-DR's rules with respect to the scope of important terms such as investment, measures and tax measures, indirect expropriation and fair and equitable treatment.

[82] CAFTA-DR's §§10.7 and 21.3(6) refer to direct expropriations and to indirect expropriations, i.e., an action or series of actions equivalent to expropriation or nationalization. CAFTA-DR is vague as to the term measures, defining them as any law, regulation, procedure, requirement or practice. Therefore, actions by one of the signatory parties that have the effect of substantially impairing the value of an investment of an investor of another signatory party may constitute indirect expropriation pursuant to CAFTA-DR.

[83] Although, CAFTA-DR provides exceptions to the application of its investment rules to taxation measures, with regard to the obligations not to expropriate an investment and to afford investors with fair and equitable treatment, CAFTA-DR should be applicable. Therefore, *unexpected, non-transparent tax measures adopted by a signatory party can result in an indirect expropriation or can be deemed as a breach of the obligation to afford investors fair and equitable treatment,* entitling them to payment of prompt, adequate and effective compensation.

[84] A tax measure can be any law, regulation, procedure, requirement, or practice, unless expressly excluded by CAFTA-DR. In this sense and pursuant to CAFTA-DR and the future Andean FTA with the USA, *domestic tax disputes could eventually rise to the level of investment disputes where otherwise they would be dealt with in domestic tax courts.*

[85] As illustrated by the Occidental *v*. Ecuador[34] case previously reviewed, under certain circumstances and even though the claimant had previously filed domestic lawsuits to safeguard its rights under domestic tax law, an investor could recur to characterize its claim as an investment dispute seeking treaty-based relief from an arbitration tribunal.

[86] FTAs do not prevent signatory countries from autonomously designing and implementing bona fide general tax policies, as long as they are: nondiscriminatory, fair and equitable. Nevertheless, policymakers must be careful in such design and implementation.

[87] Providing investors with a *stable, fair and equitable tax system should be now more important than ever*, considering the economic hardship that could result from the proliferation of this type of claims.

[88] The possibility of breaching treaty obligations not to expropriate an investment and to afford the investor fair and equitable treatment should always be considered by Congress, Tax Authorities and Tax Courts when adopting, interpreting and applying domestic tax rules that could qualify as tax measures under the treaty.

[89] Although the reaction to this type of awards under BIT is a negative one, signatory countries of both BITs and FTAs must realize that their only purpose is to make the rule of international law prevail by eradicating arbitrary measures affecting FDI negatively.

[90] The considerations made for CAFTA-DR in this paper should be considered also applicable in the case of the Andean FTA currently under negotiation between USA, Colombia, Ecuador and Peru, provided that the investment framework adopted in the Andean FTA is similar to that in CAFTA-DR.

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[34] Supra, footnote 31.

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