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Bilateral Investment Treaties and Bilateral Tax Treaties

by

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Introduction

Media reports of meetings of heads of governments or of ministers of finance often consist of a report of signature of agreements for avoidance of double taxation and for investment protection.[1] These bilateral investment treaties (BITs) and double taxation agreements (DTAs) are significant parts of the regulatory framework that support cross border investment; however, the interaction between the two is largely unexamined.

The reliance by Vodafone International Holdings BV on the India-Netherlands bilateral investment treaty (BIT),[2] to solve one of the most significant international tax disputes during present times, is an important example of the interaction between DTAs and BITs. Vodafone chose to seek formal redress by way of service of a notice of dispute against the Indian government, initiating the dispute settlement process under the BIT. It is significant that Vodafone chose the formal route in the BIT rather than the mutual agreement procedures in the DTA. It is important to note that a big difference between DTAs and BITs is that whereas in the latter the taxpayer can initiate proceedings, this is not the case in the former.

A related question is to ask whether these treaties actually impact international investment flows. With respect to BITs, their stated purpose is to protect and promote foreign investments; from an investment perspective, DTAs are intended to reduce the administrative complexities of foreign investments as well as confront double taxation problems. A growing debate, especially in the development community, is to ask if the reduced tax take for developing countries due to DTAs are being matched by increases in foreign investment. ITIC has conducted a detailed study on the impact of DTAs on FDI, which has shown that DTAs do have a positive impact on FDI. However, development campaigners often argue that both types of international investment agreements can be detrimental to developing countries and may not be effective legal instruments to attract foreign investors.

Recent announcements by Indonesia and South Africa regarding the cancellation of some of their BITs,[3] and the move by countries like to Cambodia to avoid signing DTAs indicate a growing trend. Another important development in this regard is the experience in Mongolia, which has withdrawn from specific treaties as a result of disagreements on their impact in relation to a large investment project. With thousands of bilateral investment treaties (BITs) and double taxation agreements (DTAs) now in existence, it is worthwhile to examine in greater detail the interaction between BITs and DTAs.

Preliminary Comparative Analysis

BITs and DTAs share some common objectives:

- To facilitate foreign investment;
- To prevent discriminatory treatment of foreign investors and provide a level playing field;

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- To provide more certainty to taxpayers as to the consequences of an investment decision;
- To provide a dispute resolution mechanism (see reference to Vodafone issue); and
- To promote economic growth and investment in both contracting states.

However, BITs have some other stated aims:

- Ensure equal treatment of domestic and foreign investors and investments.
- Limit possibility of expropriation/nationalization of investments and provide for adequate compensation for any expropriation.
- To ensure funds can be transferred out of the host country without delay.
- Provide for dispute resolution where differences arise.
- In some cases investment treaties restrict the imposition of performance requirements, such as local content targets or export quotas, as a condition for the establishment, acquisition, expansion or management of an investment.
- Sometimes provide for investors to have the right to engage the top managerial personnel of their choice, regardless of nationality.

On the other hand, DTA's have some tax specific goals:

- Allocation of taxing rights between the contracting states.
- Establish methods for relief from double taxation and double non taxation;
- Neutrality of treatment of taxpayers;
- A dispute resolution mechanism;
- Exchange of tax information and in some cases assistance in collection of taxes.
- Other issues, including the treatment of certain categories of taxpayer or income.

It is useful to note that the different institutional frameworks within which BITs and DTAs are negotiated are an important factor in their differing approach and application. In the case of the former it tends to be national investment agencies (such as Board of Investment) or Ministries of Trade and Industry/ Foreign Affairs that lead ,whereas with DTAs, the Ministry of Finance would be the leader, with some expertise being drawn from a tax administration. Further DTAs tend to be based on a formal model such as the UN or OECD models, whereas with BITs, there is no universal model. Finally, it is safe to say that due to the immediacy of some of the subject matter of DTAs, they have been more frequently litigated in national courts, and accordingly more comparative experience and guidance on their interpretation is available worldwide.

One neglected aspect of the role played by BITS is that they indirectly contribute to countering corruption since the knowledge that an investor has resort to independent arbitration is a powerful disincentive to ensure that government plays by the rules.

Difference in Approach and Application

There are of course some key differences between investment treaties and tax treaties. They have different objectives, and crucially a different relationship to national law. The two types of treaties are overseen by different international bodies (e.g. ICSID, UNCITRAL, OECD). However, the most significant difference is that dispute resolution procedures involve different bodies and processes. It is generally considered, e.g., that Vodafone chose the BIT route due to the availability of clear dispute resolution process rather than rely on the treaty partners to resolve issues at the national government level.

In particular, the availability of the International Centre for the Settlement of Investment Disputes (ICSID), which oversees the Convention of the Settlement of Investment Disputes between States and Nationals of Other States[4] is an important difference between the two. The Convention enables a non-state party to take action against the government of another State to seek redress where it feels to have been unfairly treated under national investment laws and policies. Organized under the World Bank system, the ICSID has as its objective the facilitating of conciliation and arbitration procedures, which are different depending on the countries involved.

Tax and Investment Treaties – Tole in Development

In the context of increasing challenges to the utility of DTAs and BIT, is necessary to fully examine, and restate the case for BITs and DTAs for developing countries. ITIC has conducted some important research with regard to the latter,[5] and it would be appropriate the utility of such agreements in promoting investment and spreading prosperity in the developing world. Such countries and international investors both benefit from these agreements, and some in depth research into their actual impact will demonstrate these benefits. At a preliminary level, it is possible to state that these treaties bring the following benefits:

Investment treaties:

- Provide additional certainty to foreign investors.
- Aim to facilitate the inflows of capital and technology into the host country.
- Some treaties promote information exchange about investment opportunities or encourage the use of investment incentives to increase foreign investment.
- Some treaties contain provisions relating to public policy concerns about development, e.g. exceptions related to health, environmental issues or security.

Tax treaties:

- Attracting foreign investment requires a tax regime that helps create an environment where investment and innovation are encouraged.
- Foreign investors require certainty and predictability in the tax system and a system for tax dispute resolution.
- Academic studies looking at the effect of tax treaties on investment flows have not reached a consensus on the impact of tax treaties.
- The impact of tax treaties on investment and growth depends also on the economic structure of the country, the relationship between treaties and domestic law and the view taken by the administration and courts in applying tax treaties.
- Academic studies have looked at the possibility of tax treaties being used as a new form of development assistance.

Current Trends in Bilateral Investment Treaties

There are some noticeable trends in the current direction of BITs, which should also be part of the study:

- A tendency to include provisions in respect of sustainable development (such as health, safety and environment provisions).
- More investment treaties are being concluded between developing countries.
- Developing countries are increasingly concerned with both encouraging inward investment and protecting the investments of their residents abroad.
- Various types of investment agreement are being signed on regional and international as well as bilateral levels.
- Increasingly investment treaties contain provisions relating to intellectual property, the environment and labor rights.
- Investment treaties are addressing public policy concerns such as health and safety, security or protection of the environment.
- There are more differences in the detailed provisions of investment treaties.
- There is increasing incidence of investor–State arbitration.

A parallel development worldwide has been growth of regional free trade agreements and the way they are increasingly dealing with tax issues. Examples of such developments can be seen in the Asia Pacific region, and in the interaction between the US and the EU, which were brought into sharp focus during the formal dispute settlement proceedings related to the US FSC/ETI rules. It is very likely that the WTO will take an increasing role in tax issues, as the interplay of tax and trade rules bring these issues into sharper focus. A related concept paper addresses the issue, and proposes research on the subject.

Future Developments and Critical Examination of Trends

There is currently significant discussion that DTAs are affected by the following trends:

- Adaptations required for the modern business environment, especially to take into account globalization, new technology, digital commerce, increasing use of intangible assets and environmental concerns.
- Former capital importing countries are increasingly becoming capital exporters as well and this may require adaptations to treaties;
- Changes to treaties are likely to result from the OECD/G20 action plan on base erosion and profit shifting (BEPS).

On the other hand it is considered that there is a need for improvement in the dispute resolution process in BITs to introduce more transparency and consistency in decisions. There may also be a need for reform of the way in which arbitrators are appointed. According to UNCTAD the following reforms should be considered:

- Increasing possibilities for alternative dispute resolution;
- Reforming the current dispute resolution system;
- Reviewing the access by investors to dispute settlement procedures;

- The introduction of a system for appeals; and
- The creation of a standing international investment court.

These issues should be included within the study along with an examination of issues such as

- Bilateral treaties and domestic law
  - Vienna Convention on interpretation of treaties;
  - The status of bilateral treaties in relation to national law depends on the nature of each country's legal system.
- Practical experience of DTAs and BITs:
  - Comparison of dispute resolution under tax/investment treaties;
  - Other aspects e.g. problems of implementation, treaty override etc.
- Trend towards multilateral treaties, such as
- Multilateral investment treaties, including Multilateral investment guarantee treaty, Regional economic communities (RECs);
- Free trade agreements and the impact of the WTO agreements.
- Multilateral tax treaties, such as regional double tax treaties.[6]
- Tax measures within regional groupings – e.g. EU parent subsidiary, interest/royalties and mergers directives and EU Arbitration Convention;
- Multilateral tax treaties – e.g. Convention on mutual administrative assistance in tax matters, OECD work on tax transparency and information exchange, (BEPS) Action 15.[7]

Conclusion

While there is some debate on the utility of BITs and DTAs, there is still widespread interest in such agreements. Many governments still see the benefit of such agreements in protecting and guaranteeing investments and in enhancing trade and economic cooperation between the countries. ITIC sponsors, who endorse a pro-growth, investment friendly and open world economy, have a strong interest in such agreements, and it is expected that support will be available from the sponsor community to conduct this research and communicate it to the relevant policy stakeholders worldwide.

Endnotes

[1] See "Kenyatta to visit Nigeria May 4, to sign bilateral agreements" http://www.dailytimes.com.ng/article/kenyatta-visit-nigeria-may-4-sign-bilateral-agreements

[2] http://www.vodafone.com/content/index/media/vodafone-group-releases/2012/bit.html

[3] "Indonesia to terminate more than 60 bilateral investment treaties" http://www.ft.com/cms/s/0/3755c1b2-b4e2-11e3-af92-00144feabdc0.html

[4] https://icsid.worldbank.org/ICSID/StaticFiles/basicdoc/CRR_English-final.pdf

[5] Owens, Jeffrey and Lang, Michael "The role of tax treaties in facilitating development and protecting the tax base" http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2398438

[6] Nordic tax treaty, Andean community tax treaty.

[7] Aims to develop a multilateral instrument to implement measures developed under the action plan and to amend bilateral tax treaties.