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Direct Taxation, Tax Treaties and IIAs: Mixed Objectives, Mixed Results

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Introduction

This chapter explores the relationship between international taxation and FDI, and the ways double taxation conventions ("tax treaties") and IIAs address the rights and obligations of states, investors and taxpayers. We use the Canadian network of tax treaties and IIAs to illustrate the potential for interaction between the two types of agreements, as Canada has an interesting perspective as a jurisdiction that is both capital-importing and capital-exporting, and as a founding member of the OECD. Further, Canada has formulated a model FIPA¹ and has a demonstrable policy of concluding tax treaties with its IIA partners.²

Tax treaties and IIAs have much in common. They share the same purpose of facilitating FDI, and they provide similar legal protections, such as prohibitions of discriminatory treatment of non-nationals and access to binding dispute resolution. Among other objectives, they are intended to reduce risk and create security and predictability, allowing investors to plan and carry out commercially viable activities under the protection of an international legal regime. In this sense, they both contribute to ensuring the sustainability of FDI and the legal regimes

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1 See Department of Foreign Affairs and International Trade Canada (DFAIT), *Canada's FIPA Model*, online: DFAIT <<http://www.international.gc.ca/trade-agreements-accords-commerciaux/assets/pdfs/2004-FIPA-model-en.pdf>> [Canada's FIPA Model].

2 For the list of Canada's tax treaties, see Department of Finance Canada (DFC), online: DFC <http://www.fin.gc.ca/treaties-conventions/in_force-eng.asp> [Canada's tax treaties]. For the list of Canada's FIPAs and FTAs containing investment chapters, see online: DFAIT <<http://www.international.gc.ca/trade-agreements-accords-commerciaux/agr-acc/index.aspx>> [Canada's FIPAs].

that support it. There are other similarities as well. Tax treaties and IIAs have proliferated in tandem during the recent period of intensified globalization. Indeed, they are often negotiated with the same country in close temporal proximity. The same international organizations, the OECD and the UN, have been instrumental in setting standards and drafting models.

Despite their commonalities, international direct taxation and FDI policy as embodied in IIAs seem to inhabit separate spheres of international law and policy. Scholars who are specialists in both taxation and international trade and investment law are rare, although scholarship on taxation and trade and investment has increased in the last 15 years.³ This is undoubtedly in response to the WTO Agreements of 1994, especially the General Agreement on Trade in Services (GATS), the Agreement on Trade-Related Investment Measures (TRIMS), the Agreement on Subsidies and Countervailing Measures, as well as the exponential growth in the number of RTAs and IIAs, and the advance of globalization generally. In addition, with the reduction or elimination of tariff and non-tariff barriers to trade and investment, and with efforts to minimize investment risk through IIAs, the tax implications of cross-border investment have become more visible and more significant in the decision-making process of investors. In particular, the implications of the GATS for taxation of foreign investors in the services sector,⁴ the

3 To cite only a few examples of the literature, all of which cite numerous other works: H.D. Rosenbloom, "What's Trade Got to Do With It?" (1993/94) 49 *Tax L Rev* 593; Brian J. Arnold and Neil H. Harris, "NAFTA and the Taxation of Corporate Investment: A View From Within NAFTA" (1993/94) 49 *Tax L Rev* 530 [Arnold and Harris]; L. Friedlander, "The Role of Non-Discrimination Clauses in Bilateral Income Tax Treaties After GATT 1994" (2002) *Brit Tax Rev* 71 [Friedlander]; Arthur J. Cockfield, *NAFTA Tax Law and Policy—Resolving the Clash between Economic and Sovereignty Interests* (Toronto: Toronto University Press, 2005) [Cockfield]; Michael Daly, "Some Taxing Issues for the World Trade Organization" (2000) 48(4) *Can Tax J* 1053; John W. Boscariol, "The Impact of International Trade and Investment Agreements on Governments' Taxation Powers" 43 *Report of Proceedings of Fifty-Fifth Tax Conference, 2003 Tax Conference* (Toronto: Canadian Tax Foundation, 2004) at 1; Brenda C. Swick and Helen Gray, "Significant Developments in International Trade and Customs Law" 31 *Report of Proceedings of Fifty-Sixth Tax Conference, 2004 Tax Conference* (Toronto: Canadian Tax Foundation, 2005) ch 1 at 42–6 [Swick and Gray]; Michael Lang, Judith Herdina and Ines Hofbauer (eds), *WTO and Direct Taxation* (The Hague: Kluwer Law International, 2005).

4 Catherine Brown, "Tax Discrimination and Trade in Services: Should the Non-discrimination Article in the OECD Model Treaty Provide the Missing Link between Tax and Trade Agreements?" in Arthur Cockfield (ed), *Globalization and its Discontents: Tax Policy and International Investments* (Toronto: University of Toronto Press, 2010) at ch 13.

interaction of direct taxation with the non-discrimination rules in the NAFTA and EU Treaties⁵ and the Agreement on Subsidies and Countervailing Measures⁶ have been examined at length. The unsuccessful negotiations of a MAI in the late 1990s⁷ and the proliferation of IIAs in recent years have also sparked interest in the interaction of direct taxation and direct investment.

This chapter cannot cover all the significant tax impediments and incentives to FDI; it is intended merely to illuminate the linkages between international taxation and investment for non-tax specialists. Specifically, this chapter seeks to bring into focus the tax treaty provisions most relevant to FDI and their potential interaction with IIAs. Part I provides a general description of tax treaties, Canada's tax treaty network, and the relationship between tax treaty claims and investor-state claims under IIAs. Part II examines some important provisions of tax treaties (and Canadian domestic law) that promote or impede the flow of FDI between Canada and its tax treaty partners to ensure tax compliance and to prevent differential treatment of investors.

Tax and treaties and IIAs

After a brief introduction to tax treaties in general, Canada's practice is described, followed by an analysis of the interactions between taxation and IIAs.

Introduction to tax treaties

Tax treaties apply only to direct taxation in the form of income, corporate profits and capital taxes. They do not apply to indirect taxes, except in limited or exceptional ways.⁸ Value added taxes, excise taxes and customs duties are a central concern in international agreements for the liberalization of trade in goods and services, and also give rise to investor-state disputes under IIAs. In contrast, as this chapter will

5 Catherine Brown and Martha O'Brien, "Tax Discrimination and the Cross-Border Provision of Services—Canada/UK Perspectives" in Christopher P.M. Waters (ed), *British and Canadian Perspectives in International Law* (Leiden: Martinus Nijhoff, 2006) at ch 16.

6 Friedlander, *supra* note 3 at 98.

7 Michael Daly, "Some Taxing Questions for the Multinational Agreement on Investment (MAI)" (1997) 20(6) *The World Economy* 787.

8 It is quite common to extend the non-discrimination article to all taxes imposed by a contracting state. See the discussion of non-discrimination provisions in tax treaties below in Part II.

discuss, direct taxation is generally expressly excluded from the scope of such agreements.

The OECD and the UN have both contributed to the development of model tax treaties. Since 1961, the OECD Committee on Fiscal Affairs has been more influential. The OECD Model⁹ was drafted and has evolved from the perspective of its members, all relatively wealthy industrialized democracies, and is generally viewed as favoring the interests of capital exporting countries. The UN Model reflects more closely the interests of capital importing countries. The first UN Model Convention was published in 1980, and a revised UN Model was published in 2001.¹⁰

The Committee on Fiscal Affairs of the OECD is composed of senior officials of the tax authorities of the member countries, and now includes a number of non-member countries participating as observers and offering their views on proposed revisions. The Model was originally intended as a template for tax treaty negotiations between OECD members, although it is widely used in negotiations by non-member countries as well. OECD members are not bound by the Model or commentaries, and may reserve their position, and enter recorded observations, in respect of particular articles or commentaries.¹¹

The current OECD and UN Models are broadly similar in their scope, organization and content. While the OECD Model assumes that the contracting states will be more or less equal in economic and industrial development, bargaining power and the two-way exchange of services, capital and investment, the UN Model is designed to balance the disparate interests of developed and developing countries. Accordingly, the UN Model tends to favor taxation on the basis of source over residence, so that a capital importing country's tax base is not unduly eroded by concessions to investors from capital exporting nations.¹²

Today there are approximately 3,000 bilateral tax treaties based on the OECD Model¹³ in force globally. Tax treaties traditionally state their

primary purposes in the title: "for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income."¹⁴ But beyond these stated goals, they undoubtedly also provide predictability and certainty to international investors, and access to legally binding dispute resolution between taxpayers and the contracting states (as well as a state-to-state dispute resolution by a mutual agreement procedure). Although tax treaties are concluded between states, they are normally made part of the binding tax law of the contracting states, often with priority over domestic law to the extent of any inconsistency.¹⁵

Most countries tax their residents on their worldwide income and non-residents on income derived from sources within their territory, raising the obvious potential for juridical double taxation, or the taxation of the same taxpayer on the same income by two states. Tax treaties apply to residents of one or both contracting states, and apportion taxing jurisdiction on income that flows between the state of source and the state of residence. Tax treaties are said to be relieving, that is, they cannot increase, but may reduce a taxpayer's liability as determined under a contracting state's domestic law. In a tax treaty, the contracting states reciprocally renounce the full measure of tax sovereignty they may otherwise assert (and do assert) in their domestic law. Thus one effect of tax treaties is to reduce or eliminate juridical double taxation.

In resolving disputes concerning tax treaties, the very extensive commentaries to the UN and OECD Models, as well as the treaty interpretation principles of the Vienna Convention¹⁶ are consulted and generally applied by the national courts of the contracting states with jurisdiction in tax matters. National courts also frequently consider the interpretations given in rulings of other jurisdictions so that a fairly consistent international jurisprudence of tax treaty interpretation and application has developed.¹⁷ However, as there is no international tax court and no world tax organization, it should not be assumed that the

9 *OECD Model Tax Convention on Income and on Capital*, loose-leaf (Paris: OECD) (Published in loose-leaf since 1992) [OECD Model Tax Convention].

10 A much more comprehensive history of the development of the model tax conventions is found in United Nations, Dept of Economic and Social Affairs, *United Nations Model Double Taxation Convention between Developed and Developing Countries* (New York: United Nations, 2001) at vi–xxii (introduction) [UN Model DTC].

11 See OECD Model Tax Convention, *supra* note 9 at paras 30–2.

12 See UN Model DTC, *supra* note 10, Introduction at vii–viii, paras 4–5.

13 This estimate appears in OECD Centre for Tax Policy and Administration, *The Granting of Treaty Benefits with Respect to the Income of Collective Investment Vehicles* (Paris: OECD, 2009) at 7 para 22.

14 See e.g. titles of Canada's tax treaties, *supra* note 2.

15 The status of tax treaties in the legal hierarchy of a contracting state obviously varies considerably, and a discussion of the various ways they are enforced in national legal systems is beyond the scope of this chapter. Canada brings its tax treaties into force by Act of Parliament. Each such Act provides that the scheduled tax treaty takes priority over any inconsistent law. See e.g. *Tax Conventions Implementation Act*, SC 2010, c.15, ss 3–5.

16 *Vienna Convention on the Law of Treaties*, May 23, 1969, 1155 UNTS 331, 8 ILM 679.

17 See e.g. *Saipem UK Ltd v R*, 2011 TCC 25 and *American Income Life Insurance Co v R*, 2008 TCC 306 for two recent cases where the Tax Court of Canada refers to judgments of other jurisdictions' tax courts.

interaction of tax treaties with domestic and foreign tax laws is the same, or predictable in each jurisdiction.

In addition to its remedies against either host or home country in the courts, an investor that alleges it has not been granted the treatment to which it is entitled under a tax treaty can request the competent authority of its state of residence to review and resolve the problem, if necessary through mutual agreement with the other contracting state's competent authority. Provisions for the resolution of disputes regarding the application of tax treaties by arbitration binding on both contracting states are still quite rare, but are becoming more common in tax treaties, although they are subject to the consent of both contracting states and sometimes also the taxpayer.¹⁸

Overview of Canada's tax treaties

Canada has concluded 92 tax treaties, 88 of which are in force as of March 2011.¹⁹ Canada's network includes treaties with its NAFTA partners, all OECD member countries,²⁰ all the EU Member States, the so-called BRIC emerging economies and South Africa, and numerous developing countries.²¹ Canada's treaties are based on the OECD Model,

18 Article 23 of Canada's tax treaty with Mexico is an example of the mutual agreement procedure. The Canada-Mexico and Canada-United States tax treaties also provide for binding arbitration where the mutual agreement procedure is unsuccessful. Paragraph 1 is typical of tax treaties based on the OECD Model:

1. Where a person considers that the actions of one or both of the Contracting States result or will result for that person in taxation not in accordance with the provisions of this Convention, that person may, irrespective of the remedies provided by the domestic law of those States, address to the competent authority of the Contracting State of which that person is a resident an application in writing stating the grounds for claiming the revision of such taxation. To be admissible, the said application must be submitted within three years from the first notification of the action which gives rise to taxation not in accordance with the Convention.

Convention Between the Government of Canada and the Government of the United Mexican States for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, online: DFC <http://www.fin.gc.ca/treaties-conventions/mexico_1-eng.asp> at art 23(1) [Canada-Mexico Tax Treaty].

19 See Canada's tax treaties *supra* note 2.

20 The treaty with Turkey is signed, but not yet in force as of March 2011. See *Agreement Between Canada and the Republic of Turkey for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital*, online: DFC <http://www.fin.gc.ca/treaties-conventions/turkey_1-eng.asp>.

21 The only G-20 member with which Canada does not have a tax treaty is Saudi Arabia. Brian J. Arnold, *Reforming Canada's International Tax System Toward Coherence and Simplicity* (Toronto: Canadian Tax Foundation, 2009) at ch 12 suggests that Canada's network has become too large and unwieldy.

but adopt provisions of the UN Model in some aspects, reflecting either the preference of the other contracting state, or the fact that Canada is a capital importing state in relation to some countries, and an exporter in relation to others, and that its older treaties may reflect its former status as a net importer of capital.²² Also, Canada has reserved in relation to a number of OECD Model provisions, in particular with respect to the non-discrimination obligations discussed in more detail in Part II. Canada's reservations are reflected in its tax treaties.

Canada's tax treaties do not apply to provincial, territorial or local taxation, or indirect taxes such as the GST/HST, excise taxes or import duties. In Canada, tax treaties are brought into force by federal statute, and take precedence over inconsistent federal law.²³ Foreign investors in Canada are entitled as taxpayers to the relief provided by Canadian tax treaties in determining their Canadian tax liabilities. If the Canada Revenue Agency ("CRA") denies the benefit of a tax treaty to an investor, the Tax Court of Canada has exclusive original jurisdiction to resolve the dispute following a trial on the merits with full procedural safeguards. Thus there is a transparent, public, judicial process for taxpayer-state dispute resolution.

IIAs and direct taxation

The wall separating international direct tax policy from trade and investment policy in Canada's international affairs is demonstrated by the fact that DFAIT is responsible for negotiating trade and investment agreements, while officials from the Department of Finance are charged with tax treaty negotiations. When a country with which Canada is negotiating a FIPA suggests a change to the taxation provision (Model FIPA article 16),²⁴ the matter may be referred to the finance department. Otherwise, no one from the first department participates in the negotiations led by the second, or *vice versa*.

Canada's unofficial policy seems to be to have a comprehensive tax treaty in place before, or within a short time after, entering into an IIA with a particular country.²⁵ The official position of DFAIT is that FIPA

22 See the *Final Report of the Advisory Panel on International Taxation* (Ottawa: Department of Finance, 2008) at 5 paras 2, 9.

23 See *supra* note 15.

24 See Canada's FIPA Model, *supra* note 1 at art 16.

25 One might note the early precedent of Canada's conclusion of a tax treaty with Mexico (1991, replaced 2006) coincident with the NAFTA negotiations, and with Chile (1992, replaced 1999) in tandem with the Canada-Chile FTA of 1997. As of

partners are selected according to potential commercial benefit and need for protection of Canadian investors, as well as the likelihood of concluding an agreement, together with "trade policy or other foreign policy interests."²⁶ The latter may be interpreted as including international tax policy. However, it may no longer be true to say Canada insists on having a tax treaty in place with its FIPA partners, given the new policy of negotiating Tax Information Exchange Agreements (TIEAs) with jurisdictions that have no interest in a comprehensive tax treaty, but may be destinations for significant outbound foreign investment.²⁷

So far, there has been only one (unsuccessful) arbitral tribunal ruling in a case where a direct tax measure was alleged to contravene an IIA.²⁸ This is undoubtedly because IIAs, and RTAs which include investment protection, generally "carve out" tax measures from their application by stating that nothing in the agreement applies to tax measures (or "tax matters"), and that any dispute is to be resolved as provided by an applicable tax treaty.²⁹ There are normally limited exceptions to the

July 2010, Canada has signed FIPAs (or RTAs with investment chapters) with only three countries with which it has no tax treaty or Tax Information Exchange Agreement, and with which it has no negotiations underway: Panama, El Salvador and Uruguay. Most notably, Canada has not announced negotiations for a tax treaty or TIEA with Panama, despite having signed a free trade agreement with that country on May 14, 2010, which includes provisions on trade in services, investment protection corresponding to the Model FIPA, and government procurement guarantees. In contrast, Canada's very significant two-way trade and investment with Hong Kong and Taiwan has not yet resulted in tax treaties with these jurisdictions. See Canada's tax treaties and Canada's FIPAs *supra* note 2.

26 DFAIT, "Canada's FIPA Program: Its Purpose, Objective and Content", online: DFAIT <http://www.international.gc.ca/trade-agreements-accords-commerciaux/agr-acc/fipa-apie/fipa-purpose.aspx?lang=en&menu_id=43&menu=R>.

27 See The Budget Plan 2007, online: DFC <<http://www.budget.gc.ca/2007/pdf/bp2007e.pdf>> Ann 5 at 422–3.

28 See *Plama Consortium Ltd v Bulgaria*, Award, ICSID Case No. ARB/03/24 (ECT) (August 27, 2008) [*Plama*]. Another possible case is *Antoine Goetz and Others v Republic of Burundi*, Award, ICSID Case No. ARB/95/3 (February 10, 1999). In that case, Belgian investors claimed that the withdrawal by Burundi of a free zone certificate entitling their company, AFFIMET, established under Burundian law, to benefit from general exemptions for both tax and customs duties was an expropriation of their investment prohibited by the BIT between the Belgian-Luxembourg Economic Union and Burundi. It is not clear whether the free zone certificate exempted AFFIMET from direct taxes as well as indirect taxes, but it is reasonable to assume this was the case. The claim was settled without a formal award, but the tribunal did find that Burundi's actions were tantamount to an expropriation. See the discussion in *Swick & Gray*, *supra* note 3 at 43–4.

29 Canada's Model FIPA, *supra* note 1 at art 16 para 1, is not atypical:

Except as set out in this Article, nothing in this Agreement shall apply to taxation

general exclusion of tax measures from the protection of the IIA, and the exceptions vary widely from one agreement to another. Many IIAs do not exclude tax measures from their protections where the tax measures violate obligations assumed under an investment agreement between the host state and the investor, or amount to an expropriation of the investment.³⁰

The NAFTA also generally excludes taxation measures from the state parties' obligations.³¹ NAFTA article 2103(1) provides that "Except as set out in this Article, nothing in this Agreement shall apply to taxation measures."³² Article 2103(2) provides that the rights and obligations of a Party under a tax convention shall be unaffected, and the tax convention shall apply to the extent of any inconsistency. The national treatment and MFN obligations of NAFTA Chapter 11 (Investment) are specifically excluded in respect of direct taxes (article 2103(4)(b)).

In the sole arbitral award to date on the compatibility of a direct tax measure with the ECT's investment protection guarantees, *Plama*, the tribunal found no discriminatory treatment, expropriation or breach of the obligation of fair and equitable treatment.³³ The investor, a Cyprus corporation, purchased shares of a Bulgarian corporation in a series of transactions, which had disastrous tax consequences for it under Bulgarian tax law. Although the investor was later able to obtain a remission of the tax

measures. For further certainty, nothing in this Agreement shall affect the rights and obligations of the parties under any tax convention. In the event of any inconsistency between the provisions of this Agreement and any such convention, the provisions of that convention shall apply to the extent of the inconsistency.

30 See e.g. the Canada-Latvia FIPA (2009), *supra* note 2 at art XII(3), (4).

31 See Catherine Brown and Martha O'Brien, "Tax Discrimination and the Cross-Border Provision of Services—Canada/UK Perspectives" in Christopher P.M. Waters (ed), *British and Canadian Perspectives in International Law* (Leiden: Martinus Nijhoff, 2006) at 324–7 (where these provisions of the NAFTA are described and analyzed in more detail). See also the discussion of the relationship between tax and trade arbitration in William W. Park, "Arbitration and the Fisc: NAFTA's 'Tax Veto'" (2001) 2 Chicago J Int'l L 231; Canada-Mexico Tax Treaty, *supra* note 18 at art 23 para 6 acknowledges the potential application of the GATS, but requires the agreement of both treaty partners that a measure is not within the scope of the tax treaty for a dispute to be brought under the GATS. The *Convention Between Canada and the United States of America With Respect to Taxes on Income And on Capital*, June 14, 1983, online: DFC <http://www.fin.gc.ca/treaties-conventions/USA_-eng.asp> at art XXIX(6) treaty creates a different hierarchy between the GATS and the tax treaty.

32 See *North American Free Trade Agreement Between the Government of Canada, the Government of Mexico and the Government of the United States*, December 17, 1992, Can Ts 1994 No 2, 32 ILM 289 at art 2103(2) [NAFTA].

33 See *Plama*, *supra* note 28.

liability, during the interim period it had to pay the tax, which it claimed made it impossible to obtain the necessary financing to operate the acquired investment. The tribunal noted that article 21 of the ECT specifically excluded taxation measures of a contracting state from the ECT's investment protection. Where a tax measure is alleged to be discriminatory or an expropriation, the issue must be referred to the host state's tax authority, which was not done. The tribunal went on to find "no action by [Bulgaria] which comes anywhere near to being unfair or inequitable treatment or amounting to expropriation."³⁴

Despite the dearth of arbitral tribunal rulings on IIAs and direct taxation, there have been some notable decisions concerning indirect taxes (not covered by tax treaties) that could be relevant when such a case arises. As a threshold test, it has been held that to constitute a tax, a levy must be "imposed by law" and must "[impose] a liability on classes of persons to pay money to the State for public purposes."³⁵ The general exclusion of tax matters from the guarantees provided by an IIA applies to both direct and indirect taxes.³⁶

Differential taxation by a host (or source) country can undoubtedly constitute a breach of the national treatment commitments made in an IIA (unless taxation is expressly excluded from such guarantees).³⁷ The

³⁴ *Ibid* at para 267.

³⁵ *EnCana Corp v Republic of Ecuador*, Award, UNCITRAL (February 3, 2006) at para 142(4) [*Encana*]. We thank Andrew Newcombe and Céline Lévesque for their assistance in our research of investment arbitration awards related to taxation. Any errors or misstatements in this respect are, however, our own.

³⁶ It was argued in *Occidental Exploration and Production Co v The Republic of Ecuador*, Final award, London Court of International Arbitration Administered Case No. UN3467 (July 1, 2004) [*Occidental*] that only direct tax measures, and not the value added tax that was at issue in that case, were excluded under the IIA provision, since tax conventions only apply to direct taxes. The arbitration tribunal chose to avoid ruling on this point at para 69. In *EnCana*, *supra* note 35, at para 142(2), the arbitral tribunal held that the term "taxation" was not limited to direct taxation; the tribunal in *Duke Energy Electroquil Partners & Electroquil S.A. v Republic of Ecuador*, Award, ICSID Case No. ARB/04/19 (August 18, 2008) followed the *EnCana* tribunal on this point.

³⁷ Discriminatory application of (indirect) tax measures has been held to violate the national treatment obligation of the investment chapter of the NAFTA in *Feldman v Mexico*, Award on Merits, ICSID Case No. ARB(AF)/99/1 (December 16, 2002) [*Feldman*] and in the trio of sweeteners cases against Mexico, including *Archer Daniels Midland Company and Tate & Lyle Ingredients Americas, Inc. v Mexico*, ICSID Case No. ARB(AF)/04/05 (November 21, 2007) [*ADM*]; *Corn Products International, Inc. v Mexico*, Decision on Responsibility, ICSID Case No. ARB(AF)/04/01 (January 15, 2008) [*CPI*] and *Cargill Incorporated v Mexico*, Award, ICSID Case No. ARB(AF)/05/2 (September 18, 2009) [*Cargill*].

MFN obligation could also clearly conflict with specific maximum tax rates and other provisions of tax treaties with third countries if tax is not carved out from this commitment. It has been established in arbitral awards concerning IIAs that tax measures can constitute indirect or creeping expropriation prohibited by an IIA,³⁸ and can also constitute a breach of the general obligation of fair and equitable treatment.³⁹ It should be noted, however, that Canada's FIPAs carve out this obligation in relation to taxation in the absence of an expropriation in ways that other countries' IIAs do not. This explains the divergent results in *Occidental* and *EnCana*.⁴⁰

Canada's Model FIPA article 16 is particularly strict in excluding taxation from the obligations of the agreement.⁴¹ The technique that is used allows a Party to refer the issue of whether a measure is a tax measure to the tax authorities of the Parties. Their determination, if made within six months of the reference, is binding on the investor-state or state-to-state arbitral tribunal. If the tax authorities of both states jointly determine that a measure is a taxation measure, then the dispute would be excluded from the jurisdiction of the arbitral tribunal or panel unless the investor claims that the tax measure is in breach of an investment agreement (article 16(3)) or constitutes an expropriation (article 16(4)).⁴²

The issue of whether a tax measure is a breach of an investment agreement between the investor and the host state, or constitutes an expropriation, is also initially to be determined by the tax authorities of the Parties.⁴³ The investor may only submit the claim to arbitration where, six months after the reference of the issue, the tax authorities have not jointly determined that the tax measure is not a breach of an investment agreement or does not constitute an expropriation. While one might think that the tax authorities would have an incentive to agree, in order

³⁸ See *Feldman*, *supra* note 37; *Occidental*, *supra* note 36 at para 187. No expropriation was found to have occurred in the circumstances of these cases.

³⁹ *Occidental*, *supra* note 36, and *Pan American Energy LLC and BP Argentina Exploration Co v Argentine Republic*, Decision on Preliminary Objections, ICSID Case No. ARB/03/13 (July 27, 2006); *El Paso Energy International Co v Argentine Republic*, Decision on Jurisdiction, ICSID Case No. ARB/03/15 (April 27, 2006).

⁴⁰ See William W. Park, "Tax Arbitration and Investor Protection" in Catherine A. Rogers and Roger P. Alford (eds), *The Future of Investment Arbitration* (Oxford: Oxford University Press, 2009) ch 12 at 239–44 (where the author discusses the two cases and compares the IIAs in issue).

⁴¹ See Canada's FIPA Model *supra* note 1 at art 16.

⁴² See *ibid* at art 16(3)–(6).

⁴³ *Ibid* at art 16(5).

to preclude the claim, some cases show otherwise. For example, in the three sweetener cases against Mexico, the tax authorities of the United States and Mexico could not agree that the (indirect) tax at issue did not constitute an expropriation in violation of NAFTA article 1110 (expropriation) and as a result the tribunals ruled on this issue.⁴⁴

In conclusion, Canada's FIPAs, and many other IIAs, carve out most tax matters comprehensively. There are sound policy reasons to keep the non-discrimination obligations of tax treaties and IIAs separate.⁴⁵ In Canada's case, there was already a significant network of tax treaties in place when it entered into its first IIA in 1989. Excluding tax measures from the IIA reduces uncertainty as to which agreement was intended to apply in any particular case, the possibility of multiple fora for resolution of the dispute, and the potential for inconsistent rulings from courts and tribunals. It also recognizes the critical link between taxation and state sovereignty and capacity, the need for a country to be able to adjust its tax system to meet economic challenges and the expectations of its citizens, and the political importance of these aspects of taxation.

On the other hand, there is value in identifying the disparities in tax treatment that can inhibit FDI. The literature on international tax competition⁴⁶ supports the proposition that tax incentives to FDI have a discernible effect on location decisions, even if they are not very efficient (i.e. the granting of the incentive costs more than the value of the investment attracted). If that is true, then imposing a heavier tax burden on foreign investors in comparison with resident investors logically should inhibit investment. Some of the disparities in treatment that can be viewed as discriminatory and their relationship to tax treaty provisions are outlined in the following section.

The consequences of tax treaties for foreign direct investment

Tax laws can dramatically affect the rates of return on invested capital and consequently have long been regarded as an important determinant of investment decisions. Tax laws are particularly important as determinants of FDI since the returns on such investments might be

44 See *Cargill*, *supra* note 37 at paras 16–17; *ADM*, *supra* note 37 at para 15.

45 See Cockfield, *supra* note 3, and Arnold and Harris, *supra* note 3.

46 See Alec Easson, "Tax Competition and Investment Incentives" (1996/97) 2(2) EC Tax J 63 at 70–1 [Easson]; Jacques Morisset and Nede Pirnia, "How Tax Policy and Incentives Affect Foreign Direct Investment: A Review" (2005) Research Working Paper No. 2509, online: SSRN <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=632579>.

subject to tax in both the originating and the host country. As noted above, many countries levy income tax on corporate profits both on a residency basis (on the worldwide profits of corporations resident in the jurisdiction) and a source basis (on corporate profits with a source in the jurisdiction). Moreover, fundamental tax concepts and detailed rules often differ substantially between countries. Hence, it is easy to see that without coordination between countries, FDI could be discouraged, or at least influenced in unintended ways, through the interaction of domestic tax systems. In both the economic and legal literature there has been an extended debate over whether bilateral tax treaties have in fact facilitated FDI.⁴⁷

Tax treaties serve three primary functions in relation to FDI: reducing administrative barriers, reducing tax costs to cross-border activity, and ensuring a level playing field for non-nationals. Tax treaties also reduce opportunities for tax avoidance and assist administrators to combat tax evasion.

Reducing the administrative barriers to cross-border activity

One potential barrier to FDI is the administrative cost of complying with a country's tax rules when the level of investment in the jurisdiction is modest. Many countries impose their income tax on any foreign corporation "carrying on business" in the jurisdiction.⁴⁸ Consequently, a foreign corporation that opens an office in a country to engage in preparatory and auxiliary activities prior to deciding whether to expand its operations in the country, or otherwise undertakes business activities for only a limited purpose or period of time, might well be found to be carrying on business in the country and be liable to tax and required to

47 Interestingly, the evidence is inconclusive as to whether tax treaties or investment agreements actually increase FDI. See Andrew Newcombe and Lluis Paradell, *Law and Practice of Investment Treaties* (The Netherlands: Kluwer Law International, 2009) at 62; Fabian Barthel, Mathias Busse and Eric Neumayer, "The Impact of Double Taxation Treaties on Foreign Direct Investment: Evidence from Large Dyadic Panel Data" (July 2010) 28(3) Contemporary Economic Policy 366; W. Steven Clark, "Tax Incentives for Foreign Direct Investment: Empirical Evidence on Effects and Alternative Policy Options" (2000) 48(4) CanTax J 1139; Bruce Blonigen and Ronald Davies, "Do Bilateral Tax Treaties Promote Foreign Direct Investment?" (June 1, 2001) University of Oregon Economics Working Paper No. 2001–12; Tsilly Dagan, "The Tax Treaties Myth" (2000) 32 NYUJ Int'l L & Pol 939 [Dagan].

48 "Carrying on business" may be very broadly defined, as in the Canadian *Income Tax Act*, *infra* note 50 at s 253 where merely offering something for sale or soliciting orders in Canada, without any physical presence, may constitute carrying on business in Canada.

file tax returns. This added administrative cost might discourage corporations from undertaking preliminary steps or modest business activities in another country.

Tax treaties contain a number of articles that reduce the compliance costs for exploratory, auxiliary, or small-scale activities by exempting them from tax in the source country. The most significant of these articles is the business profits article. In all treaties, this article provides that an enterprise resident in one treaty partner will be taxed in the other treaty partner only if it has a permanent establishment in that jurisdiction. The precise definition of a permanent establishment varies from treaty to treaty but generally it requires that the enterprise have a fixed place of business through which the business of the enterprise is wholly or partly carried on. A fixed place of business is defined to include a place of management, branch, office, factory, etc.⁴⁹

Reducing the tax imposed in the source country

All countries seek to alleviate double taxation unilaterally. Most commonly, this is done by providing a tax credit (or exemption) for any foreign taxes paid by residents of that country on income that has a source in another country. Hence, it might appear that the tax imposed in a source country would not affect cross-border investment since that tax would always be credited against the taxes paid in the resident country. However, among other concerns, not all taxes paid in source countries would be fully credited in the resident country. For example, most countries impose a relatively high flat withholding tax on the gross amount of most forms of income from capital and other periodic payments. Canada imposes a 25 per cent withholding tax on interest, dividends, rents and royalty payments made to non-residents.⁵⁰ In the residence country, only the net amount of this payment (that is, after deducting the expenses of earning the income) would be subject to tax, and thus in many cases the tax in the source country on the gross payment would exceed the amount that could be credited against the tax liability in the resident country. Consequently, tax treaties invariably

49 For more on the permanent establishment threshold see e.g. Brian Arnold, "Threshold Requirements for Taxing Business Profits under Tax Treaties" (2003) Bulletin for International Fiscal Documentation 476; International Fiscal Association, "Is There a Permanent Establishment?" 94a Cahiers de droit fiscal international (The Hague: Sdu Uitgevers, 2009) at 169; Dale Pinto, "The Need to Reconceptualize the Permanent Establishment Threshold" (July 2006) IBFD-Bulletin at 266.

50 See *Income Tax Act*, RS C 1985, c 1 (5th supp), s 212 [*Income Tax Act*].

reduce the rate of withholding tax that applies to cross-border investment returns. Over the past couple of decades many treaties have reduced these withholding tax rates to 10 or 5 per cent and often have abolished them altogether.⁵¹ In its treaties, normally in article 12, Canada frequently exempts royalties related to computer software, patents, know-how and copyrights from withholding tax.⁵²

As another illustration of how tax treaties might reduce the tax cost of foreign investment, the business profits article prescribes the scope of taxation once a business has a permanent establishment in the jurisdiction. So, for example, pursuant to article 7 in most tax treaties, the enterprise is only taxable on profit that the permanent establishment might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities.⁵³ In other words, it clarifies and restricts the amount of income that might be thought to be taxable in the source jurisdiction.

Ensuring a level playing field for non-nationals

Tax treaties usually contain a non-discrimination clause that provides that one signatory country will not discriminate against nationals of the other signatory country. These provisions are not nearly as strong or as effective as similar provisions in trade and investment agreements. The OECD Model provides in article 24(1) that "[n]ationals of [Country A] shall not be subjected in [Country B] to any taxation or any requirement connected therewith, which is other or more burdensome than the taxation and connected requirements to which nationals of [Country B] in the same circumstances, in particular with respect to residence, are or may be subjected."⁵⁴ This provision has been interpreted strictly, both

51 For a discussion of the taxation of dividends, interest and royalties see e.g. Stef van Weeghel, "Dividends (Article 10 OECD Model Convention)" in Michael Lang (ed), *Source Versus Residence: Problems Arising From the Allocation of Taxing Rights In Tax Treaty Law And Possible Alternatives* (Austin [Tex]: Wolters Kluwer Law and Business, 2008); Niv Tadmor, "Royalties (Article 13 OECD Model Convention)" in Michael Lang (ed), *Source Versus Residence: Problems Arising From the Allocation of Taxing Rights in Tax Treaty Law and Possible Alternatives* (Austin [Tex]: Wolters Kluwer Law & Business, 2008).

52 See Canada's tax treaties, *supra* note 2.

53 *Ibid.*

54 Articles of the Model Convention with Respect to Taxes on Income and on Capital, January 28, 2003, online: OECD <<http://www.oecd.org/dataoecd/52/34/1914467.pdf>> at art 24(1). For more on the non-discrimination article see e.g. American Law Institute, "Part Four: Non-Discrimination—I. Basic Concept" in Federal Income Tax Project: International Aspects of United States Income Taxation II: Proposals on

in Canada and abroad, so as to allow discrimination on the basis of residence, even where the non-resident is in substantially the same tax circumstances as a resident would be.⁵⁵ Further, Canada has a reservation on the non-discrimination article of the OECD model treaty and generally offers a more restricted non-discrimination article to its treaty partners. Notably, Canada preserves its ability to impose a branch tax on non-resident nationals who carry on business in Canada, restrict the deduction of interest payments where a company is thinly capitalized, and provide Canadian-controlled private corporations with generous tax incentives that are not available to foreign corporations, or Canadian corporations controlled by non-residents.

Occasionally, tax treaties include MFN clauses. These clauses guarantee that if treaty partner A offers a more favorable arrangement (e.g. a lower withholding tax rate) to treaty partner C, that treatment will be extended to the treaty partner B, the partner to the tax treaty that includes the MFN clause.⁵⁶ Canada sometimes includes an MFN clause in its non-discrimination article, with respect to Canadian enterprises controlled by residents of the other contracting states. The NAFTA Parties extend the non-discrimination article in their three tax treaties to all taxes, not just the usual corporate profits and income taxes to which the treaties generally apply. However, this probably does not add anything to the guarantees in the NAFTA regarding indirect tax measures, and Canada still retains its reservation allowing it to impose differential taxation on residents of the other NAFTA parties and on Canadian corporations controlled by their residents.

United States Income Tax Treaties (San Francisco, May 13, 1991); John F. Avery Jones, "The Non-discrimination Article in Tax Treaties Part 2" (1991) 11/12 *Brit Tax Rev* 421; Richard M. Hammer, "Nondiscrimination in the International Tax Context: A Look at OECD Model Article 24" (2005) 12 *Tax Management International Journal* 700; Ruth Mason, "A Theory of Tax Discrimination" (2008) NYU Jean Monnet Working Paper 09/06; Ruth Mason and Herman Bouma, "Non-discrimination at the Crossroads of International Taxation" (2008) 93b *Cahiers de Droit Fiscal International*.

⁵⁵ See the discussion in Friedlander, *supra* note 3 at 77–86. Canada's restrictive approach to its non-discrimination obligations in tax treaties has been affirmed (in the first Canadian case on the issue) in *Saipem UK Ltd v The Queen* 2011 TCC 25 (appeal pending).

⁵⁶ For more on MFN provisions see e.g. Albert J. Rädler, "Chapter 1: Most-Favoured-Nation Concept in Tax Treaties" in Michael Lang et al (eds), *Multilateral Tax Treaties: New Developments in International Tax Law* (London and Boston: Kluwer Law International, 1998).

Reducing tax avoidance and evasion

The other primary objective of tax treaties is to prevent or reduce the opportunities for international tax avoidance and evasion. "Double non-taxation" through the use of hybrid entities and "treaty shopping" (to be discussed below) may be prevented through specific types of tax treaty provisions limiting access to the benefits of treaties where artificial or conduit structures are used. Prevention of avoidance and evasion are enhanced by provisions allowing the tax authorities of the treaty partners to exchange tax information regarding any person, not just residents of their respective jurisdictions, and extending to all forms of taxes. While these objectives are not aimed at promoting FDI, they are significant in shaping the decision-making of investors as to where to invest, and the form that investment takes.

Reducing opportunities for tax avoidance

The domestic tax laws of two countries often treat private legal constructs differently. Over the past few decades, international tax planners have become increasingly resourceful in exploiting these differences. A typical international tax arbitrage arrangement might involve the use of a legal entity that is classified as a taxpayer in one country (Country A) but a flow-through entity in another country (Country B). Often these are referred to as hybrid entities, and across countries there are a large variety of such legal entities. If a corporation in Country A sets up a hybrid entity in Country B to receive royalties that originate in Country B the result might be that the royalties will escape tax completely. They will not be taxed in Country B, where they originate, since Country B will look through the hybrid entity in its country and regard the royalties as having been received by the corporation in Country A. They will not be taxed in Country A either, since that country will view them as having been received by the hybrid entity in Country B, which it regards as a legal taxpayer. In the past, tax treaties have not reduced these kinds of opportunities for tax arbitrage but countries are increasingly using their treaties to attempt to prevent the non-taxation of international capital flows.

Tax treaties present an opportunity for tax avoidance by allowing for what is known as treaty shopping. For example, a multinational that is a resident in Country A and receiving royalties from Country B may have some tax withheld on the payment pursuant to the tax treaty between Countries A and B. However, Country B might have a tax treaty with Country C under which the withholding tax on royalties is

less or even completely removed. Therefore, the multinational might establish a presence in Country C for the sole purpose of receiving royalties from Country B free of withholding tax. There is some dispute in the literature as to whether this type of tax planning is appropriate⁵⁷ and not all countries are concerned about it. However, tax treaties increasingly provide some form of anti-treaty-shopping mechanism, often referred to as a limitation-of-benefit provision.⁵⁸ These provisions restrict the ability of taxpayers to access the beneficial provisions of tax treaties where the taxpayer lacks a real connection to the jurisdiction that is a signatory to the treaty.⁵⁹ Specific articles of tax treaties also often contain anti-abuse clauses. For example, some treaties preclude access to reduced withholding tax rates on investment returns where the recipient in the treaty jurisdiction is not the beneficial owner of the shares or debt.⁶⁰

To combat conduit practices, tax treaties may contain provisions that restrict the ability of companies to claim they are residents of a treaty partner where the company is essentially serving as a conduit. For example, Canada's treaty with Mongolia provides that the convention shall not apply where a company is beneficially owned or controlled, directly or indirectly, by non-residents if the amount of tax imposed is substantially lower than the amount that would be imposed by that state if the entity was owned primarily by residents.⁶¹ Similarly, some

57 See e.g. Andrian Candu, "Abuse of Tax Treaties" in Michael Schilcher and Patrick Weninger (eds), *Fundamental Issues and Practical Problems in Tax Treaty Interpretation* (Vienna: Linde, 2008); David G. Duff, "Responses to Treaty Shopping: A Canadian Perspective" (Paper Prepared for the Conference on Tax Treaties from a Legal and Economic Perspective, Vienna, Austria, March 18–20, 2010); Raffaele Russo, "Chapter 3: Guiding Concepts for International Tax Planning" in *Fundamentals of International Tax Planning* (Amsterdam: IBFD, 2007).

58 There are additional provisions in Canada's domestic tax legislation that assist in reducing international tax avoidance. See e.g. *Income Tax Act*, *supra* note 50 at s 245, the general anti-avoidance rule, which applies to deny benefits where there has been a misuse of the provisions of a tax treaty.

59 The 2007 protocol to the Canada-United States treaty includes a limitation on benefits provision that is applicable to both Canada and the United States.

60 For a discussion of these kinds of provisions, see e.g. C. Brown, "Beneficial Ownership and the Income Tax Act" (2003) 51 Can Tax J 402; J.D.B. Oliver et al, "Beneficial Ownership and the OECD Model" (2001) Brit Tax Rev 27; Vern Krishna, "Treaty Shopping and the Concept of Beneficial Ownership in Double Tax Treaties" (August 2009) 19 Can Current Tax 129 at 138.

61 *Convention Between the Government of Canada and the Government of Mongolia for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital*, online: DFC <http://www.fin.gc.ca/treaties-conventions/mongolia_eng.asp> at art 28(3).

countries, most notably the United States, have included limitation on benefits provisions in their tax treaties.

Combating tax evasion

It is relatively easy for a tax department to obtain information about a resident taxpayer in order to combat tax evasion if the information is within the jurisdiction of the department. However, if the information is outside the jurisdiction then it is usually very difficult, if not impossible, to obtain it. For that reason, most capital exporting countries that tax the worldwide income of their residents have insisted that their tax treaties contain an exchange-of-information provision.⁶² Indeed, in recent years even jurisdictions that are not parties to a double taxation agreement have been entering into stand-alone Tax Information Exchange Agreements.⁶³ Many commentators have questioned the effectiveness of these provisions since in order to obtain information from another country pursuant to them the requesting tax administration generally has to have reasonable grounds for suspecting that a specified person has evaded taxes. Further, the requesting tax administration must identify the person under investigation, the information sought, the tax purpose for which it is sought, and the grounds for believing that the information requested is held by the jurisdiction of which the request is made.⁶⁴ The OECD is engaged in an on-going project of increasing both the scope and adoption of exchange of information agreements.⁶⁵ In addition to cooperating by exchanging information, in some limited cases, tax treaties may enable one jurisdiction to enforce the tax judgments of another jurisdiction and to assist in tax collection.

This brief listing of the functions of tax treaties is sufficient to illustrate why there is a contentious debate about their role in encouraging and directing FDI. Some commentators argue that on balance they are likely to have no, or only a trivial, effect on FDI flows.⁶⁶ But whatever their effect, the fact that they are bilateral agreements between countries

62 See e.g. Vito Tanzi and Howell Zee, "Taxation in a Borderless World: The Role of Information Exchange" in *International Studies in Taxation: Law and Economics* (London: Kluwer Law International, 1999).

63 See Tax Information Exchange Agreements, online: DFC <<http://www.fin.gc.ca/treaties-conventions/tieaerf-eng.asp>>.

64 See e.g. Michael McIntyre, "How to End the Charade of Information Exchange" (October 26, 2009) Tax Notes Intl 255.

65 See OECD, *Tax Co-operation: Towards a Level Playing Field—2008 Assessment by the Global Forum on Taxation* (Paris: OECD, 2008).

66 See e.g. Dagan, *supra* note 47.

limits their scope. It is easy to see why this mechanism for reconciling the effects of different domestic tax systems emerged near the beginning of the last century when only a relatively small number of countries were involved in international trade and investment and domestic tax systems were quite different. However, in the modern era of globalization many have argued that it is time to move to multilateral double tax treaties along the lines of multilateral trade and investment agreements.⁶⁷

Conclusion

A comparison of tax treaties and IIAs reveals some interesting commonalities. Simply to illustrate, both tax treaties and IIAs need to address the pre-establishment period of investment to reduce barriers to entry; tax treaty and IIA negotiators have had to grapple with the appropriate limits on non-discrimination clauses; limitation of benefits clauses have been employed as a means of restricting abuses; tax treaties and IIAs both have to address the resolution of complex disputes; and information sharing concerns have been significant in both contexts. Nevertheless, even in the absence of any obvious and recorded reluctance to merge tax and investment treaty negotiations, the two have remained on parallel but distinct tracks. Ultimately, this chapter highlights that lack of connection. In some respects, tax treaties serve as effective vehicles for bilaterally coordinating domestic tax regimes and for facilitating investment. In other ways, though, they fall short.

Various proposals have been introduced for the better harmonization of international tax arrangements. In fact, as noted above, tax scholars have been taken by the WTO as a model for harmonization of international tax treaties (and tax practices more generally). It seems there is much that tax, trade and investment policy makers could learn from working more closely together.

⁶⁷ See, e.g. Reuven Avi-Yonah, "Treating Tax Issues Through Trade Regimes" (2000–01) XXVI Brook J Intl L 1683; Arthur Cockfield, "The Rise of the OECD as Informal 'World Tax Organization' Through National Responses to E-Commerce Tax Challenges" (2006) 9 Yale Journal of Law and Technology 59; Frances Horner, "Do We Need an International Tax Organization?" (2001) 24 Tax Notes International 179; Dale Pinto, "A Proposal to Create a World Tax Organisation" (2003) 9 New Zealand Journal of Taxation Law and Policy 145; Vito Tanzi, "Is there a Need for World Tax Organization?" in Assaf Rzin and Efraim Sadka (eds), *The Economics of Globalization* (New York: Cambridge University Press, 1999) at 173; Adrian Sawyer, *Developing a World Tax Organisation: The Way Forward* (UK: Fiscal Publications, 2008); Richard Vann, "A Model Tax Treaty for the Asian-Pacific Region? (Part II)" (April 1991) International Bureau of Fiscal Documentation 151 at 160–1.