



Negotiating Group on the Multilateral Agreement on Investment (MAI)

Expert Group No.3 Expert Group No.3 on Treatment of Tax Issues in the MAI

**ISSUES RAISED BY MAI DRAFTING GROUP N°1:
SELECTED TOPICS CONCERNING INVESTMENT PROTECTION**

(Note by the Chairman)

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I. INTRODUCTION

1. Drafts of provisions dealing with investor protection are found in a report by DG1 (DAFFE/MAI/DG1(95)3). These provisions concern general treatment (Article A), expropriation and compensation (Article B), protection from strife (Article C), transfers (Article D) and subrogation (Article E). Possible provisions concerning the protection of investor rights arising from other agreements are discussed in a separate report (DAFFE/MAI/DG1(96)1/REV1).
2. This note addresses the tax issues that may arise in relation to these provisions. Dispute settlement matters will be taken up at the Group's next meeting in May.

II. GENERAL TREATMENT

3. The purpose of the "General Treatment" article is to set a minimum absolute standard of treatment for foreign investments that host countries must meet. It goes beyond national treatment and MFN which are relative standards that may provide insufficient protection in cases where domestic legal regimes are inadequate. The text contains principles familiar from customary international law and bilateral investment treaties.
4. Draft Article A.1 provides that Contracting Parties must accord "fair and equitable treatment and full and constant protection and security" to foreign investments in their territories, and that the treatment accorded to such investments be no less favourable than that required by international law.
 - It may be desirable to clarify "fair and equitable treatment" as far as taxation is concerned.
 - In addition, the reference to "international law" might be construed to import tax obligations associated with tax treaties into the MAI, thereby subjecting these obligations to the MAI disputes settlement procedure. The latter issue is discussed further in a subsequent report (DAFFE/MAI/DG1(96)1/REV1).
5. Draft Article A.2 requires that Parties do not "impair by [unreasonable or discriminatory] [unreasonable and discriminatory] measures the operation, management, maintenance, use, enjoyment or disposal of investments". This could open the possibility for the testing of tax measures against a new criterion of reasonableness and/or discrimination.

Question:

Is there a need for specific treatment of taxes regarding Article A, in the text or commentary, for example with respect to "fair and equitable", and "reasonable and/or discriminatory"?

III. EXPROPRIATION AND COMPENSATION

A. *Main Issues*

6. Article B allows host states to expropriate in defined circumstances subject to prompt adequate and effective compensation. It contains a broad concept of expropriation, namely "expropriate or nationalise directly or indirectly.... or take measures having equivalent effect".

7. While taxation is necessary to the function of government and, as such, an accepted cost of doing business, certain extraordinary tax measures (retroactive taxes? windfall profits tax? seizure of assets for unpaid taxes?) could be considered expropriatory . This raises three issues, namely:

- the appropriate definition of a tax;
- deciding which tax measures are expropriatory; and
- given the difficulty in defining expropriatory tax measures, the manner in which disputes in this regard might be resolved.

B. *Existing disciplines*

8. The definition of a tax is partly discussed in the Chairman's note (DAFFE/MAI/EG2(96)3), which contains definitions and a classification of various forms of taxes agreed by OECD Member countries.

9. In both the ECT and NAFTA, decisions as to whether or not a tax constitutes expropriation are left to the relevant competent tax authority. In addition, under the NAFTA, investors may, if need be, submit its claim to arbitration in accordance with Article 1120. No such provision for arbitration is found in the ECT.

C. *The MAI*

10. In the light of the foregoing considerations, experts are invited to discuss to the following questions.

Questions:

- a) If taxation were covered by the obligations pertaining to expropriation and compensation, how does one decide whether taxation constitutes expropriation (without compensation)?
- b) What taxes (at what effective rates) might be considered expropriatory?

IV. PROTECTION FROM STRIFE

11. Draft Article C.1 requires that, in the event of an investor suffering losses relating to its investment in the territory of a Contracting Party due to war, state of emergency, etc., that Party shall accord the investor the more favourable of national or MFN treatment in respect of restitution, indemnification, compensation or any other settlement.

12. Under draft Article C.2, however, prompt, adequate and effective restitution or compensation would have to be provided in respect of losses occurring as a result of the requisition or destruction of an investment.

13. The latter raises a question with respect to special taxes levied to raise additional revenue in times of war. If investment is defined to include any asset or return on an investment, as is likely, the term "requisition" might be understood to apply to a tax or surtax that is introduced as a war tax.

Question:

Would it be desirable to include special provisions on tax matters in this article or in a commentary, for example to deal with the application of "requisition" to war taxes?

V. TRANSFERS

14. Article D requires Contracting Parties to ensure that all payments relating to an investment in its territory can be freely transferred into and out of its territory without delay. The Article contains a non-exhaustive list of transfers to which this obligation applies. The list includes, among other things, capital assets, the returns earned on such assets (that is, profits, dividends, capital gains, interest, royalties), and compensation under Articles B and C.

15. The taxation of cross-border flows of income and capital clearly affects the net amounts of such transfers. The most relevant taxes in this regard are withholding taxes, particularly those on cross-border dividend, interest and royalty payments.

16. However, the imposition of withholding taxes has been viewed historically as consistent with the provisions in bilateral tax treaties protecting the free transfer of funds, a view supported by the IMF. Thus, although such taxes are not mentioned in Article D, paragraph 2 of the comments does clarify the fact that the Article refers to the transfer of funds net of withholding and social security taxes.

17. Experts may also wish to discuss whether paragraph 6 of draft Article D offers adequate protection in relation to third party obligations for unpaid taxes and rules requiring confirmation that taxes have been paid before allowing liquidation of assets or distribution of the returns on assets.

18. In the light of the foregoing considerations, experts are invited to consider the following question:

Question:

Should special provision for tax considerations be made in relation to Article D, in particular with respect to withholding taxes?

VI. SUBROGATION

19. Draft Article E.1 provides that if a Contracting Party makes a payment under an indemnity, guarantee or contract of insurance relating to an investment in the territory of another Contracting Party, the latter shall recognise the assignment of any right or claim of the investor to the former.

20. Draft Article E.2 clarifies that the fact that an investor has received indemnification or other compensation under an investment insurance or contract cannot be invoked by a Part as a defence or counter-claim in a dispute settlement proceeding.

21. This particular draft Article does not appear to raise any issues concerning taxation.

VII. PROTECTION OF INVESTOR RIGHTS ARISING FROM OTHER AGREEMENTS

(To follow.)