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SERIES OF NOTES ON THE ENERGY CHARTER TREATY

Note 13

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Making Sense of the Taxation Provisions of the Energy Charter Treaty

Article 21

INTRODUCTION

1. Fiscal policies and in particular taxation measures remain an area where the chasm between an interdependent global economy and retention of economic sovereignty by States is at its widest. In terms of cross-border economic activities, foreign investment has been testing ground for how wide or narrow this chasm is.

2. On the one hand, foreign investors tend to perceive domestic tax policies as a serious political risk to their investments. It is understandable therefore that foreign investors have a keen interest in fencing-off their investment from alleged deleterious taxes and other unforeseen

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taxation measures. On the other hand, States are normally protective of their sovereign prerogative to engineer their domestic tax regimes in a manner they deem fit.

3. Reconciling these two seemingly antithetical aims in the energy sector lies at the heart of Article 21 (entitled "Taxation") of the Energy Charter Treaty ("ECT").[1] However, Article 21 ECT is difficult to understand: its provisions are abstruse and contain some laboured syntactical constructions, all of which defy assured comprehension. It is, therefore, likely that the provisions of Article 21 ECT will continue to be subject to interpretive disagreements between disputing parties, as each side will naturally attempt to advocate one of the two main policy objectives that have shaped the taxation provisions of the ECT.

4. This Note provides an explanatory foray into the salient features of Article 21 ECT. It must be stressed at the outset that nothing in this Note is intended to predetermine or prejudge future judicial or arbitral cases concerning the application and interpretation of Article 21 ECT; nor is the intent to advocate or support directly or indirectly any specific interest – be it that of a Contracting Party of the ECT or that of an investor. The Note merely presents the author's *current* understanding based on the analysis of the complex structure of Article 21 ECT, in light of its negotiating history and the relevant arbitral awards.[2]

THE STRUCTURE OF ARTICLE 21 ECT[3]

Overall

5. Article 21(1) ECT embodies the principle that applies to "Taxation Measures". Since this important paragraph is awkwardly drafted, it may be useful to recast it conveniently as follows:

[1] A quick review of the available ECT' *travaux* indicates that the underpinning policy objective of the drafters of Article 21 ECT was to put in place investment-friendly tax arrangements without compromising the *fiscal* domestic sovereign powers of the State. Thus, it proved difficult to agree on the finalised text of the Article since it appeared. As we shall see in this Note, a balance had to be struck between protecting investments of investors against the burdens of double taxation and discriminatory taxation measures while simultaneously protecting the discretion of Contracting Parties regarding their taxation policies. Each modification to the Article represented a step closer to achieving this perceived balance. However, the constant reshaping of the Article through numerous versions clearly demonstrated the difficulty in addressing all concerns. This eventually led to an attempt to reconcile the various positions with the complex multi-layered final draft.

[2] *Yukos Universal Limited (Isle of Man) v. The Russian Federation* (PCA Case No. AA 227); *Hulley Enterprises Limited (Cyprus) v. The Russian Federation* (PCA Case No. AA 226); *Veteran Petroleum Limited (Cyprus) v. The Russian Federation* (PCA Case No. AA 228); *Plama Consortium Limited v. Republic of Bulgaria* (ICSID Case No. ARB/03/24).

[3] The genesis and the present structure of Article 21 ECT lie in a proposal submitted by the USA (see BA 13 dated 19 June 1992, at p. 81).

a. Taxation Measures of Contracting Parties shall not create rights or impose obligations, unless provided otherwise in Article 21 ECT;
b. In the event of inconsistency between any of the provisions of Article 21 ECT and other provisions of the ECT, the former shall prevail.

6. In order to appreciate fully the analysis undertaken below concerning the specific obligations that might apply to a taxation measure it is useful to highlight first the core features of Article 21 ECT. These may be summarised broadly as follows:

a) In general, Taxation Measures of Contracting Parties shall not be held to be in breach of the ECT obligations;

b) However, certain ECT obligations have been excepted and modulated from the general rule stated in (a);

c) The above are set out in Articles 7(3), 10(2), 10(7), 13 and 29 of the ECT.

"TAXATION MEASURES": OPEN-ENDED DEFINITION

7. Article 21 ECT deals predominantly with "Taxation Measures", a phrase open-endedly defined in paragraph (7)(a) of Article 21, which reads as follows:

> "For the purposes of this Article:
>
> a. The term "Taxation Measure" includes:
> i. any **provision** relating to taxes of the domestic law of the Contracting Party or of a political subdivision thereof or a local authority therein; and
> ii. any **provision** relating to taxes of any convention for the avoidance of double taxation or of any other international agreement or arrangement by which the Contracting Party is bound."[4]

8. The ECT *travaux* do not explain the inconvenient placing of the definitional provisions at the end of the Article. Nothing, however, should be read into this choice of placing, except inconvenience. It is also noticeable that the definition of "Taxation Measure" has been left open-ended. This seems clear from the conscious choice of the word "*includes*" instead of

[4] Emphasis added. See Article 21(1) and 21(7) of the ECT.

"means". The word "includes", however, allows Contracting Parties to continue enjoying a broad discretion in their legislative efforts to prescribe (any provisions relating to taxes) both at the domestic and international levels. Nevertheless, it could be argued that the present structure of the definition identifies two essential features of what constitutes a "Taxation Measure":

a. The measure must be a legal provision, in the sense that its source must either be domestic legislation or an international agreement or other similar arrangement; and
b. The provision must be causally or logically connected to taxes.

9. It is worth highlighting here that the conjunction "**and**" adjoining sub-paragraphs (i) and (ii) in paragraph 21(7)(a) must not be understood as cumulative. This was not what the drafters intended. It seems that the intention was that the conjunction "and" reflected better the open-ended purpose of the word "includes" in the chapeau.

10. Finally, the word "arrangement" in sub-paragraph (ii) of the definition can be a source of interpretative difficulty. There is little in the *travaux* that may help in alleviating such difficulty. However, the context is of some assistance. First, "arrangement" has been presented along with tax conventions and international agreements; second, any arrangement must be legally binding on the Contracting Party whose measure is at issue. Examples may include EU regulations and, arguably, EU directives.

ECT OBLIGATIONS THAT APPLY TO TAXATION MEASURES

The Obligation Set out in Article 7(3) ECT Applies to Taxation Measures

11. The chapeau of Article 21(2) ECT provides that Article 7(3) ECT applies to Taxation Measures. Article 7(3) ECT reads as follows:

> "Each Contracting Party undertakes that its provisions relating to transport of Energy Materials and Products and the use of Energy Transport Facilities shall treat Energy Materials and Products in Transit in no less favourable a manner than its provisions treat such materials and products originating in or destined for its own Area, unless an existing international agreement provides otherwise."

12. The above provisions require a Contracting Party to treat Energy Materials and Products in Transit in no less favourable a manner *than* Energy Materials and Products originating in, or

destined for its own territory. This amounts to an obligation of non-discriminatory treatment. However, Article 21(2) ECT modulates this obligation when the measure in question is a Taxation Measure in the following manner:

a. *First*, if the Taxation Measure relates to taxes on "income or on capital",[5] such measure will not be covered by the non-discriminatory obligation of Article 7(3) ECT; in other words, for Article 7(3) to apply, the Taxation Measure in question should relate only to indirect taxes.

b. *Second*, in the event a Contracting Party accords a *favourable* tax treatment to certain Energy Materials and Products transiting its territory, such favourable treatment will not be in breach of Article 7(3) ECT, if it is accorded as a result of a provision of any agreement or other binding arrangement.

c. *Third*, Taxation Measure aimed at effective collection of taxes is not subject to the non-discriminatory obligation of Article 7(3). However, Article 7(3) ECT applies if and only if the measure "arbitrarily discriminates against Energy Materials and Products originating in, or destined for the Area of another Contracting Party or arbitrarily restricts benefits accorded under Article 7(3)."

13. It is not difficult to imagine a number of contentious issues that may arise from the interpretation and application of the above provisions, particularly those concerning the scope of the non-discriminatory obligation incumbent on Contracting Parties. Let us highlight just two such issues.

14. The first is whether ECT Contracting Parties are obliged to treat Energy Materials and Products in Transit in the same manner as they treat energy materials and products transported exclusively within their territory (i.e., domestic transportation of energy). The answer to this question rests on the interpretation of the phrase "originating in, or destined for …" is.[6]

15. The second contentious issue is whether the non-discrimination treatment contained in Article 7(3) ECT extends to the modes of production of the energy that is transiting the territory of a Contracting Party. To illustrate this critical question let us consider the following hypothetical example.

16. Let us assume that, due to a change in its national energy policy, State (A) introduces a new excise tax (indirect tax) on electricity produced by nuclear power plants, but not on electricity produced by other energy sources (e.g., gas or renewables). Let us assume that State (A) is a

[5] For the reason of completely excluding taxes on income or on capital, see paragraphs 38-43 below.

[6] It is to be noted that Article 7(3) ECT was subject to a continuous discussion during the Transit Protocol negotiations (1999-2004). The main contentious point was the perceived ambiguity of the phrase "originating in, or destined for its own Area", a matter that was not settled in the end (both the Russian Federation and the EU not managing to agree to disagree).

strategically placed transit country. As a result of its energy policy, the government of State (A) imposes said taxes on electricity produced by nuclear fusion in State (B) but not on electricity produced by gas turbines in State (C). The question thus is whether State (A), by introducing such a taxation measure, is in breach of its obligation to accord Most-Favoured-Nation ("MFN") treatment to the transiting electricity produced by a nuclear power plant in State (B). Put differently, is State (A) under obligation to treat transiting electricity produced by nuclear fusion in the same manner (no less favourably than) it treats transiting electricity produced by gas-powered turbines in State (C)?

17. This question relates directly to the scope of the MFN obligation provided for in Article 7(3): does the non-discriminatory obligation embodied in Article 7(3) extend to the modes of production?

18. As we shall see presently, the question concerning the scope of the non-discrimination obligation may be a more critical issue in the context of applying Article 10(7) ECT to Taxation Measures (see paragraphs 28-35).

THE OBLIGATIONS SET OUT IN ARTICLE 10(2) AND 10(7) ECT APPLY TO TAXATION MEASURES

19. The chapeau of Article 21(3) provides for the general rule that: (a) the *obligation* contained in Article 10(2) ECT applies to Taxation Measures; and (b) the *obligation* contained in Article 10(7) also applies to Taxation Measures. However, Article 21(3) ECT modulates these obligations to read as follows:

> "Article 10(2) and (7) shall apply to Taxation Measures of the Contracting Parties other than those on income or on capital, except that such provisions shall not apply to:
>
> (a) impose most favoured nation obligations with respect to advantages accorded by a Contracting Party pursuant to the tax provisions of any convention, agreement or arrangement described in subparagraph (7)(a)(ii) or resulting from membership of any Regional Economic Integration Organization; or
>
> (b) any Taxation Measure aimed at ensuring the effective collection of taxes, except where the measure arbitrarily discriminates against an Investor of another Contracting Party or arbitrarily restricts benefits accorded under the Investment provisions of this Treaty."

20. It is imperative to remember that the obligations set out in Articles 10(2) and 10(7) ECT apply to two distinct phases of the investment cycle: Article 10(2) ECT applies to the Making of Investments phase, whereas Article 10(7) ECT applies to post-investment phase. Not appreciating this important distinction can be a source of confusion and misapplication of the ECT.

21. For this reason, this Note examines paragraphs (2) and (7) of Article 10 of the ECT separately below.

Article 10(2) ECT

22. Article 10(2) ECT, which identifies the scope of the obligation and its object, reads as follows:

> "Each Contracting Party shall endeavour to accord to *Investors* of other Contracting Parties, as regards the Making of Investments in its Area, the Treatment described *in paragraph (3).*"[7]

23. Paragraph (3) of Article 10 defines "Treatment" as follows:

> "[…] treatment accorded by a Contracting Party which is *no less favourable than that which it accords to its own Investors or to Investors of any other Contracting Party or any third state, whichever is the most favourable.*"[8]

24. It is clear that paragraph (2) must be read in conjunction with paragraph (3). By doing so, the following emerges: as far as the "Making of Investments"[9] is concerned, each Contracting Party shall endeavour to treat *investors* of other Contracting Parties in a manner no less favourable than that which it accords to its own investors or to investors of any other Contracting Party or of any third state, whichever is the most favourable.

25. Two points need to be highlighted here. First, the obligation contained in Article 10(2) ECT is hortatory (also known as soft law).[10] The second point is that the object of the non-

[7] Emphasis added.
[8] Emphasis added.
[9] Making of Investments, as defined in Article 1(8) ECT, means "establishing new Investments, acquiring all or part of existing Investments or moving into different fields of Investment activity." In other words, Article 10(2) ECT concerns only pre-investment phase. And, as is clear from Article 10(4), the Making of Investments phase obligation was left out for the so-called supplementary treaty, which was negotiated, but not adopted.
[10] The reason behind the "soft law" provision of Article 10(2) was the intention of the Treaty's drafters to negotiate a separate treaty for the pre-investment stage. See Article 10(4) of the ECT envisaging the establishment of a supplementary treaty thereto. Negotiations on this Supplementary Treaty started in 1996; however, the final text has not been adopted.

discriminatory treatment is the *investor*, as opposed to the investment (as we shall see presently, the latter is the object of the non-discriminatory treatment of Article 10(7)). The reason for such a distinction is understandable. At the "Making of Investment" stage (i.e., pre-investment phase), the recipient or the target of the treatment is the Investor and not the Investment; this is so because the Investment has yet to be made.

26. Therefore, the reference to Article 10(2) in Article 21(3) ECT should be understood in accordance with the above analysis. Not doing so is a recipe for confusion.

27. As important to remember is that Article 21(3) ECT modulates the obligations of Article 10(2) when the measure in question is a Taxation Measure:

    a) *First*, Taxation Measures on income or on capital (i.e., direct taxes) are not covered by the 10(2) obligation;

    b) *Second*, the MFN obligation of Article 10(2) does not apply if the favourable treatment in question has been accorded to an *investor* in accordance to provisions relating to taxes of any convention for the avoidance of double taxation or of any other international agreement or arrangement requiring a Contracting Party to accord such a treatment. The same principle applies if the advantage in question has been accorded to Investors because the relevant Contracting Party is a member of a Regional Economic Integration Organization (REIO).[11] It is important to note that this modulation of Article 10(2) obligation concerns only the MFN obligations and not the National Treatment. Thus, any advantage accorded by a Contracting Party to its own Investors by way of Taxation Measures shall equally be accorded to Investors of other Contracting Parties.

    c) *Third*, Taxation Measure aimed at effective collection of taxes is not subject to the non-discriminatory obligation of Article 10(2). However, Article 10(2) ECT applies if and only if such a measure arbitrarily discriminates against an *Investor* of another Contracting Party or arbitrarily restricts benefits accorded under the Investment provisions of the ECT.

Article 10(7) ECT

28. Article 10(7) of the ECT reads as follows:

> "Each Contracting Party shall accord to Investments in its Area of Investors of other Contracting Parties, and their related activities including management, maintenance, use, enjoyment or disposal, treatment no less favourable than that which it accords to Investments of its own Investors or of the Investors of any other Contracting Party or any third state and their related activities including management, maintenance, use, enjoyment or disposal, whichever is the most favourable."

[11] REIO has been defined in Article 1(3) ECT as "an organization constituted by states to which they have transferred competence over certain matters a number of which are governed by this Treaty, including the authority to take decisions binding on them in respect of those matters."

29. Article 10(7) ECT embodies a complex legal concept that combines two fundamental principles of international law: obligations stemming from the application of the principles of (i) *MFN* and (ii) *National Treatment*.

30. Article 10(7) ECT applies to the post-investment phase, as distinct from Article 10(2) which applies to the pre-investment phase. Thus, the application of the MFN and National Treatment principles in Article 10(7) ECT has a different focus from the pre-investment (or establishment) phase described above (see paragraphs 22-27 above).

31. Thus, the object of the treatment under Article 10(7) is "Investments" – as defined in Article 1(6) of the ECT.

32. Accordingly, the *object* of the obligation not to discriminate set out in Article 10(7) are investments owned or controlled by Investors of another Contracting Party. However, Article 21(3) ECT modulates the obligation of Article 10(7) ECT when the measure in question is a Taxation Measure:

    a) *First*, Taxation Measures on income or on capital (i.e., direct taxes) are not covered by the 10(7) obligation.

    b) *Second*, the MFN obligation of Article 10(7) does not apply if the advantage in question has been accorded by a Contracting Party to an Investment because it is required to do so by provisions relating to taxes of any convention for the avoidance of double taxation or of any other international agreement or arrangement. The same principle applies if the advantage in question has been accorded because the Contracting Party in question is a member of a REIO. It is important to note that this modulation of the obligation set out in Article 10(7) concerns the MFN obligation and not the National Treatment. Thus any advantage accorded to Investments owned or controlled by *national* Investors by way of Taxation Measures shall equally be accorded to Investments of Investors of other Contracting Parties.

    c) *Third*, Taxation Measure aimed at effective collection of taxes is not subject to the non-discriminatory obligation of Article 10(7). However, Article 10(7) ECT applies if and only if such a measure arbitrarily discriminates against an Investor of another Contracting Party or arbitrarily restricts benefits accorded under the *Investment* provisions of the ECT.

33. To highlight an important issue concerning the scope of application of Article 10(7) ECT in general and Article 21(3) in particular, it may be instructive to revisit, with slight modification, the fictitious example used above in examining the scope of the non-discriminatory obligation contained in Article 7(3) ECT (see paragraph 16).

34. The example assumes that State (A) introduces a new excise tax (indirect tax) on nuclear power plants generating electricity by nuclear fusion; such tax is not applied to plants powered by

other energy sources (e.g., gas, coal, solar). State (A) is a Contracting Party to the ECT. As a result of the taxation measure imposing said tax on nuclear power plants, the price of electricity produced by nuclear power plants is more expensive than electricity produced by other modes of energy production. Now, let us assume that the nuclear power plant is owned or controlled by an investor of State (B), which is also a Contracting Party to the ECT. The question then is whether State (A's) taxation measure is in breach of its obligations under Article 10(7) of the ECT. In other words, is State (A) under the obligation to treat electricity produced by nuclear fusion in the same manner (no less favourably than) it treats electricity produced by the use of other energy materials?

35. It is clear that the above fictitious example raises a number of important questions with serious policy implications.

ARTICLE 29(2) TO 29(6) ECT APPLY TO TAXATION MEASURES

36. Article 29 ECT, entitled "Interim Provisions on Trade-Related Matters" provides that "[t]he provisions of this Article shall apply to trade in Energy Materials and Products while any Contracting Party is not a party to the GATT and Related Instruments".

37. Article 21(4) ECT aims to ensure that Taxation Measures other than those on income or on capital are consistent with Article 29(2) to (6). The latter provisions extend GATT rules,[12] amongst other issues, to non-WTO Members that are Contracting Parties to the ECT. It is also to be noted in this regard that Annex D to the ECT contains interim provisions for trade related disputes.

THE OBLIGATIONS NOT TO DISCRIMINATE SET OUT IN ARTICLE 7(3), 10(2), 10(7), AND 29(2) TO 29(6) ECT DO NOT APPLY TO TAXES ON INCOME OR CAPITAL

38. As we saw above, taxes on income or capital are excluded from the ECT's non-discrimination provisions. This exclusion was the result of a conscious policy aim to prevent inconsistency of application and interpretation with other relevant agreements.

[12] See Annex G to the ECT in which the application of certain provisions of the GATT and Related Instruments has been identified as not applicable under Article 29 ECT.

39. Thus, an important task incumbent on the Taxation Sub-Group, established by the Chairman of Working Group II during the ECT negotiations, was to "[r]emove potential doubts in the text [of Article 21] regarding the supremacy of bilateral tax agreements and their dispute settlement". Relatedly, the Taxation Sub-Group was asked to "[i]nvestigate the potential use of the OECD – model text (Chapter 6, Article 24)".

40. The drafters of Article 21 ECT were aware that the majority of the Contracting Parties were party to double taxation treaties with one another, and most, if not all, of these treaties were based on the OECD Model Tax Convention on Income and on Capital. The central obligation of these agreements and indeed the OECD's Model was the obligation not to discriminate. For this reason Taxation Measures on income or on capital were explicitly excluded from the scope of paragraphs (2) to (4) of Article 21 ECT.

41. It is interesting to note, however, that Article 21(7)(b) provides the definition for what shall be regarded as taxes on income or on capital. It reads as follows:

> "There shall be regarded as taxes on income or on capital all taxes imposed on total income, on total capital or on elements of income or of capital, including taxes on gains from the alienation of property, taxes on estate, inheritances and gifts, or substantially similar taxes, taxes on the total amounts of wages or salaries paid by enterprises, as well as taxes on capital appreciation."[13]

42. Therefore, to establish whether a taxation measure relating to taxes on capital or on income is discriminatory the standard contained in a Double Taxation Treaty between the two Contracting Parties involved will be determinative.[14]

43. In contrast, we shall examine next whether taxes on income or on capital are measures that fall within the scope of measures that may breach the obligation set out in Article 13(1) ECT, namely, not to expropriate investments of investors of a Contracting Party.

[13] In contrast Article 2(2) of the OECD Model reads as follows: "[t]here shall be regarded as taxes on income and on capital all taxes imposed on total income, on total capital, or on elements of income or of capital, including taxes on gains from the alienation of movable or immovable property, taxes on the total amounts of wages or salaries paid by enterprises, as well as taxes on capital appreciation." The reason for this slight difference between Article 2(2) of the OECD Model and Article 21(7)(b) ECT was to make sure that the latter covered all kind of the investment covered by Article 1(6) ECT (See Room Document No. 1 of the Taxation Sub-Group, 10 November 1992).

[14] Of course, the question remains as to what if there is no Double Taxation Treaty between the relevant Contracting Parties. See paras. 63-64 below.

THE OBLIGATION SET OUT IN ARTICLE 13 ECT APPLIES TO "TAXES"

44. It is to be noted at the outset that Article 21(5)(a) ECT begins by stating that, "Article 13 shall apply to taxes."

45. Article 13 ECT, entitled "Expropriation", reads in relevant part as follows:

> "(1) Investments of Investors of a Contracting Party in the Area of any other Contracting Party shall not be nationalized, expropriated or subjected to a measure or measures having effect equivalent to nationalization or expropriation (hereinafter referred to as "Expropriation") except where such Expropriation is:
>
> (a) for a purpose which is in the public interest;
> (b) not discriminatory;
> (c) carried out under due process of law; and
> (d) accompanied by the payment of prompt, adequate and effective compensation.
>
> [...]"

46. It is useful to say first a few words about the scope of application of Article 13(1) ECT.

47. Article 13(1) ECT contains the main obligation concerning expropriation. It prohibits a Contracting Party from nationalising or expropriating the *Investments* of Investors of another Contracting Party, or taking a measure or measures the effect of which is equivalent to expropriation. The obligation not to expropriate has four *conditions*, listed in Article 13(1)(a)-(d).

48. Therefore, an Investor alleging a breach of obligation under Article 13(1) ECT has the burden of establishing that a particular measure or measures undertaken by the respondent Contracting Party have resulted in expropriation of the Investment subject of the dispute. The respondent will either deny direct or indirect expropriation (as the case may be) or, alternatively, seek to establish that the expropriatory measure(s) were: (a) for purposes which are in the public interest; (b) not discriminatory; (c) carried out under due process of law; *and* (d) accompanied by the payment of prompt, adequate and effective compensation.

49. It is important to note that the conditions enumerated in Article 13(1) of the ECT are *cumulative* (as indicated by the conjunction "and"): that is, in order for an expropriation to be *lawful*, all of the four conditions must be present, otherwise there will be a breach of Article 13(1) of the ECT, thus rendering the expropriatory measure *unlawful*.

50. It is against this backdrop that Article 21(5) ECT should be analysed.

51. For convenience, the ensuing analysis of Article 21(5) ECT is done in two separate sections. The first deals with the question as to why does Article 21(5) ECT use the word "taxes" instead of "Taxation Measures". The second section examines briefly the unique mechanism set up in Article 21(5)(b) ECT which comes into effect when two questions are at issue: (a) whether "*a tax constitutes an expropriation*", and (b) "*whether a tax alleged to constitute an expropriation is discriminatory*". Before we attempt to answer these two important questions, let us briefly look at why Article 21(5) ECT refers to taxes instead of "Taxation Measures" when it comes to expropriation.

WHY TAXES AND NOT TAXATION MEASURES?

52. Article 21(5) ECT uses the word "taxes" in the English version, rather than "Taxation Measures", the latter of which is used in the French and Italian texts of Article 21(5) ECT.[15] Questions of interpretation as to this discrepancy are likely to arise.[16] It is to be noted that the earlier English drafts of Article 21(5) ECT used the term "taxation measure", which was not replaced until June 1993. There is nothing in the *travaux* that indicates why the drafters decided to substitute "taxation measures" for "taxes".

53. Recently in the *Yukos* cases, the Arbitral Tribunal was faced with the issue of the terminology swap in Article 21(5)(a) ECT. In these cases the parties disagreed on whether the term "taxes" is wider in scope than the expression "Taxation Measure".[17] First, the Tribunal confirmed that the *travaux préparatoires* of the ECT did not furnish "much helpful guidance" in relation to the above issue.[18] The Tribunal, then, noted that "if the replacement [of "Taxation Measures" with "taxes" in a draft of Article 21(5) of the ECT circulated in June 1993] had been motivated by the intention of the negotiators to limit the scope of the claw-back provision in Article 21(5) of the ECT compared to the scope of the carve-out in Article 21(1), the Tribunal would expect such a

[15] In the French version, the term "taxes" ("*impôts*") appears in Article 21(5)(a) as in the English version, but disappears in the rest of Article 21(5) ECT to get back to the term "Taxation Measures" ("*measures fiscales*"). On the other hand, the whole of Article 21(5) ECT of the Italian version refers only to "Taxation Measures" ("*misure fiscali*"). Yet, Article 50 of the ECT stipulates clearly that the *"English, French, German, Italian, Russian and Spanish"* versions of the Treaty are equally authentic.

[16] Such issues are to be resolved in accordance with the rules of interpretation set out in Articles 31 to 33 of the Vienna Convention on the Law of Treaties of 23 May 1969.

[17] The Respondent argued that the word "taxes" is narrower than the term "Taxation Measure", as defined in Article 21(7)(a). The Claimants argued to the contrary.

[18] See, for example, paragraph 1415, *Yukos case*, Final Award, 18 July 2014.

motivation to have found some additional expression in the record".[19] The Tribunal explained the reason for not accepting the respondent's argument that the word "tax" has a narrower meaning than the expression "Taxation Measure": "the ordinary meaning of 'tax' in Article 21(5) cannot be narrower than the meaning of 'Taxation Measure' used in Article 21(1)" because otherwise it "would result in a wide carve-out and a narrow claw-back, reinstating protection from expropriation under Article 13 only in relation to 'charges and payments', but not collection and enforcement measures or interests and fines. […] Such an interpretation would lead to a gaping hole in the ECT […]".[20]

54. Nevertheless, it seems that the ECT *travaux* hints at the reason for replacing the "taxation measures" with "taxes" in Article 21(5) ECT. In its Memorandum to the Chairman of Working Group II, dated 05 March 1993, the Legal Sub-Group expressing its concern about the issues of referral to the Competent Tax Authorities, noted that "[t]he risks are aggravated by the lack of clear definition in Article 20 [as it then was] of when an issue has arisen under Article 18 [now Article 13] that meets the characteristics of the first sentence of paragraph (b) [of Article 21(5) ECT]; for example, "taxation measure" is identified only by illustration in paragraph (6.1) [now paragraph 7.(a) of Article 21]."[21] It was after this brief comment that the drafters changed the phrase "taxation measures" in Article 21(5) ECT to "taxes".

55. This was a sensible change. The word "taxes", which is undefined, is more of generic and indeed wider in scope than a "Taxation Measure". Article 21(7)(a) ECT refers to the "Taxation Measure" as "**any provision** relating to taxes […]". Thus a "Taxation Measure" is confined to the provisions of the law. Such provisions must be connected logically or causally (related) to *taxes*.

56. Additionally, the use of the word "taxes" seems to sit logically well with the obligation concerning expropriation, in which expropriation is understood both as an outright taking as well as a disguised or indirect expropriation, for example, through *taxes*.

[19] *Yukos Universal Limited (Isle of Man) v. The Russian Federation* (PCA Case No. AA 227), Final Award, 18 July 2014, paragraph 1415. See also, *Hulley Enterprises Limited (Cyprus) v. The Russian Federation* (PCA Case No. AA 226); *Veteran Petroleum Limited (Cyprus) v. The Russian Federation* (PCA Case No. AA 228).
[20] *Ibid*., paragraph 1413. Footnote omitted.
[21] See Memorandum from the Chairman of the Legal Sub-Group to the Chairman of Working Group II, dated 05 March 1993.

57. Few would disagree that the word "taxes" covers all kinds of contributions to the State revenue levied by the government on investors and having a compulsory nature. Thus, "taxes" include taxes on income and capital, Value Added Tax (VAT), charges, fees and duties imposed by a Contracting Party in connection with the exploitation of its energy resources.

58. We shall now turn to the second issue concerning the application of the expropriation article to taxes, namely: "[w]henever an issue arises under Article 13, to the extent it pertains to whether a tax constitutes an expropriation or whether a tax alleged to constitute an expropriation is discriminatory […]".[22] Each of these two scenarios will be examined briefly below under separate headings.

THE DETERMINATION AS TO WHETHER A TAX CONSTITUTES AN EXPROPRIATION

59. According to Article 21(5)(b)(i) ECT, when the question whether a tax constitutes an expropriation is at issue, it **shall** be referred to the Competent Tax Authorities ("CTA").[23] Failing such referral by the Investor or the Contracting Party, the body called upon to settle the dispute under Articles 26(2)(c) or 27(2) ECT[24] must refer the claim to the CTA. Thus, it seems that referral to the CTA is mandatory (see paragraphs 67-69 below).

60. Upon such referral, the relevant CTA must strive to resolve the issue of whether the tax in question constitutes an expropriation, within the period of six months. It is to be noted that the scope of the question upon which the CTA have to decide is confined to the question as to whether or not expropriation has taken place; it cannot decide, for example, on the legality of the expropriation.

61. Article 21(5)(b)(iii) ECT makes clear that arbitral tribunals seized under Article 26 ECT "**may** take into account any conclusions arrived at by the Competent Tax Authorities regarding whether the tax is an expropriation." Thus, an arbitral tribunal seized under Article 26 ECT has

[22] Article 21(5)(b) ECT.
[23] According to Article 21(7)(c) ECT, "[a] "Competent Tax Authority" means the competent authority pursuant to a double taxation agreement in force between the Contracting Parties or, when no such agreement is in force, the minister or ministry responsible for taxes or their authorized representatives."
[24] Article 26 ECT deals with Settlement of Disputes between an Investor and a Contracting Party, whereas Article 27 deals with Settlement of Disputes between Contracting Parties.

wide discretion in deciding whether or not to accept or even to consider the decision of the CTA in this regard.

THE DETERMINATION AS TO WHETHER THE ALLEGED EXPROPRIATORY TAX IS DISCRIMINATORY

62. The issue here is different from the one examined immediately above. There is a *prima facie* assumption that the tax is expropriatory, as a matter of fact, but the crucial question that remains to be answered is whether the tax in question is discriminatory against the entity alleging expropriation. This question is crucial for determining whether the expropriation is lawful or unlawful under Article 13(1) ECT.

63. In this case, the CTA that have to answer the above question must "[…] apply the non-discrimination provisions of the relevant tax convention, or if there is no non-discrimination provision in the relevant tax convention applicable to the tax or no such tax convention is in force between the Contracting Parties concerned, they [the CTA] shall apply the non-discrimination principles under the Model Tax Convention on Income and Capital of the Organisation for Economic Co-operation and Development [the OECD]".[25] The reason for this reference is uniformity and consistency in determining whether tax is discriminatory or not.

64. Thus, it is clear from this particular procedure that taxes on capital and income can also be expropriatory; but if the issue in dispute is whether the tax in question is discriminatory or not the standard to be applied is an existing tax convention. And, if such a convention does not exist, then the non-discrimination standard set out in Article 24 of the OECD Model shall apply.

65. Under this scenario, however, an arbitral tribunal seized under Article 26 ECT "**shall** take into account any conclusions arrived at … by the Competent Tax Authorities regarding whether the tax is discriminatory."[26] The prescriptive casting of this provision is understandable only if one is to assume that the CTA applies accurately the non-discrimination provisions of the relevant tax convention or the OECD's Model Tax Convention, as the case maybe.

66. To make sure: if a party alleges that a tax amounting to an expropriation is discriminatory under Article 13(1)(b) ECT, whether or not this case shall be decided against the standard

[25] It is to be noted that the matter of referral to CTA was first introduced into the negotiation of the taxation article by the USA (See, BA13, 19 June 1992, U.S. Position on Article 20, page 81).
[26] Article 21(5)(b)(iii). Emphasis added.

provided for in a relevant tax convention; or in accordance with Article 24 non-discrimination principles set out in the OECD Model Tax Convention. Therefore the standard of discrimination that applies to tax, as an expropriatory measure is different from that standard of discrimination that applies to other non-tax measures. In the latter case, the measure is determined according to the rules and principles of international law (Article 26(6) ECT).

67. One final issue that remains controversial is whether the referral of the above two questions to the CTA is mandatory; in other words, must these questions always be referred to the CTA when they are at issue? On face value, Article 21(5)(b)(i) seems to require such referral, before the dispute goes any further.

68. Interestingly the Legal Sub-Group in its Memorandum of 05 March 1993 voiced "substantial concern about the effects that paragraph (b) might have on investor dispute resolution under Article 23 [now Article 26]."[27] However, the drafters were not swayed by this concern, and thus maintained the *sui generis* mechanism when expropriatory taxes or taxes that are alleged to be discriminatory were at issue. Thus, Canada for example, observed that "[…] we believe that the paragraph [paragraph (b) of Article 21(5)] *reflects the intent of the parties; therefore, we are opposed to any modification that would change its substance*".[28] Additionally, Norway noted that "[t]he wording of sub-para (b) *received more attention in the tax sub-group than all the rest of the article, and it proved difficult to agree on the wording. As a result the wording represents a delicate balance of opinion. Having this in mind we would hesitate to reopen discussions on this subject. There was agreement in the tax-group that issues of allegedly discriminatory taxes must first be referred to the competent tax authorities of the countries involved in the dispute. By-passing this procedure would therefore seem inappropriate to us. As to concerns about the dispute resolution procedure, we do not see a basis for those concerns a) [f]ailure to refer will not delay eventual dispute resolution according to Article 23* [now 26] *or Article 24* [now 27]."[29]

69. Nevertheless, the referral requirement has been dealt with differently by two ECT arbitral tribunals. In the *Yukos* case, the Tribunal found that there was no need for such a referral if it is futile: "a referral must be regarded as clearly futile if there is no possibility that the relevant authorities would in fact be able to come to some timely and meaningful conclusion about the

[27] See Responses to Legal Sub-Group's Comments on Article 20, "Taxation", BA 37, dated 05 March 1993, page 5.
[28] *Ibid.* Emphasis added.
[29] *Ibid.* Emphasis added.

dispute or make any timely determinations that could potentially serve to assist the tribunal's decision-making".[30] Conversely, the Tribunal in the *Plama* case insisted on the literal interpretation of paragraph 5(b)(i) of Article 21 and pointed out that the Investor must refer the issue to the CTA in the event that a tax constitutes or is alleged to constitute an expropriation or is discriminatory.[31]

MISCELLANEOUS ASPECTS OF THE ECT'S TAXATION ARTICLE

70. During the drafting phase of the ECT, the Legal Sub-Group expressed concerns over a possible inclusion of the term "customs duties" in the definition of Taxation Measures. Although delegates appeared to view such an interpretation improbable,[32] it was decided to make it clear, for the avoidance of doubt, that "customs duties" were not considered "taxes" or "tax provisions", for the purposes of Article 21 ECT.[33] Thus, customs duties are not taxes; instead they are measures, which will be considered like any other measure for the purposes of the ECT.

71. The other issue that was made explicit for the avoidance of doubt is that obligation set out in Article 14 ECT, which concerns the Contracting Parties' obligation to guarantee the freedom of transfers does not "limit the right of a Contracting Party to impose or collect a tax by withholding or other means."[34]

72. It is to be noted that arbitral tribunals have previously considered the question as to whether an increase of customs duties could amount to an expropriation in the context of Investor-to-State arbitration claims based on Bilateral Investment Treaties.[35]

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[30] *Yukos* case, *op.cit.*, paragraph 1426. This justification is reminiscent of the general international law doctrine of exhaustion of local remedies. However, it could be argued that the analogy is misplaced in the context of Article 21 ECT. The rule here was a clear *lex specialis* rule. It also seems that the requirement of mandatory referral was what the drafters intended.

[31] *Plama Consortium Limited v Republic of Bulgaria*, ICSID Case No. ARB/03/24, Award, paragraph 266.

[32] See Responses to Legal Sub-Group's Comments on Article 20, "Taxation", BA 37, dated 05 March 1993, page 1.

[33] Article 21(7)(d) ECT.

[34] Article 21(6) ECT.

[35] *Link-Trading Joint Stock Company v. Department for Customs Control of the Republic of Moldova*, UNCITRAL, Final Award, 18 April 2002. See also *Toto Costruzioni Generali S.p.A. v. The Republic of Lebanon* (ICSID Case No. ARB/07/12).

SUMMARY AND CONCLUSIONS

73. From the above analysis, a few conclusions may follow:

(a) This Note attempts to make sense of Article 21 ECT. To this end, the ECT's Taxation article is perceived as a modulator of selected existing ECT obligations. The alternative approach is to describe the provisions of Article 21 in terms of exclusions, carve-outs and claw-backs. However, this latter approach is cognitively difficult to comprehend and tends to complicate further an already convoluted and complex article.

(b) The strained structure of ECT taxation provisions is the result of several factors including: (a) political sensitivity of the subject matter; (b) substantial monopoly that was enjoyed by the Taxation Sub-Group in drafting the provisions of Article 21; (c) constraints that were imposed on the Legal Sub-Group in reviewing early drafts of the article. Thus, the ambiguities inherent in the construction of the provisions of Article 21 ECT were maintained with the aim of securing a final consensus.

(c) For those who are familiar with the long history of rules of public international law on the treatment of aliens and State responsibility, one thing is clear. The drafters of the ECT did not venture beyond what was already well established: States may not use taxes to discriminate between, and expropriate foreign-owned investments. As for the rest of the more recent obligations that have emerged in the context of investment treaties,[36] they were untested as far as taxes were concerned; thus risky to apply to taxation measures.

(d) For the purposes of the dispute settlement mechanisms of Articles 26 and 27 ECT, it is imperative to appreciate that in most cases in which a breach of obligations not to discriminate is invoked in connection with a taxation measure, the first question before the tribunal would be the scope of the substantive obligation in question, and the matter as such would relate to the merits of the case and not to the jurisdiction of the tribunal. Thus, the *Yukos* Tribunal was right in stating that any determination on jurisdiction cannot be made "in vacuum" and depends on the proper characterisation

[36] For example: the umbrella clause and fair and equitable treatment.

of the claim/obligation at stake.[37] Appreciating this is critical in order to avoid protracted and futile proceedings.

(e) Finally, as a matter of policy, the drafters of the ECT taxation provisions have created a sui generis mechanism for dealing with the two questions concerning expropriation as set out in Article 13. Consequently, when the question of whether a tax constitutes expropriation or whether a discriminatory expropriation arises, such an issue must be referred to the Competent Tax Authorities of the Contracting Party that has been accused of taking the taxation measure in question, regardless of how inconvenient such a referral may be. This is a *lex specialis* rule. It could, therefore, be argued that a tribunal that fails to refer any of the two questions to the CTA would unnecessarily expose its jurisdiction to a potential challenge and this should be avoided at all cost. The clear wish of the Contracting Parties must be respected at all times.

[37] *Yukos* case, *op.cit.*, Interim Award, paragraph 585.

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1. Statistical Analysis of Publicly Available Arbitration Cases under the Energy Charter Treaty (09 March 2014)
2. Background Note on the Energy Charter Treaty (10 March 2014)
3. The Process Involved in Interpreting A Treaty: With Special Reference to the Energy Charter Treaty (10 March 2014)
4. A Bird's Eye View of Article 18 of the Energy Charter Treaty: Sovereignty over Energy Resources (11 March 2014)
5. "Denial of Benefits" under the Energy Charter Treaty: Article 17(1) (12 March 2014)
6. Is Investment in "The Distribution of Heat to Multiple Premises" Covered under the Energy Charter Treaty? (16 March 2014)
7. Article 7(6) and (7) of the Energy Charter Treaty: Conciliation in the Case of Interruption or Reduction of Transit (16 March 2014)
8. Article 45 of the Energy Charter Treaty: Highlights of the Negotiating History of the Provisional Application (21 April 2014)
9. Does the Energy Charter Treaty apply to Gibraltar? (21 April 2014)
10. Russian Text of Article 26(4)(c) of the Energy Charter Treaty: Reference to the Arbitration Institute of the Stockholm Chamber of Commerce? (26 May 2014)
11. The Ukrainian Law on Sanctions and the Energy Charter Treaty (18 August 2014)
12. Italy's Withdrawal from the Energy Charter Treaty (05 May 2015)

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