International Arbitration: Protection from Unforeseen or Unreasonable Tax Claims by Foreign Governments *by Accredited Tax Advisor (Income Tax) Mr Edwin Vanderbruggen, Partner,* VDB|*Loi*

Disputes between tax authorities and taxpayers about the valuation of goods and services for tax purposes are common in administrative appeals and tax courts. It is not so common to find such a dispute before an international arbitration tribunal. That is, however, exactly what happened in a dispute between a Chinese investor and the Government of Peru, which was decided in an arbitration before the International Centre for the Settlement of Investment Disputes on 27 July 2011.

The Chinese investor's company in Peru (TSG) received a reassessment from the Peruvian tax authorities (SUNAT). The reassessment was based on a revaluation of the price of raw materials used by TSG. According to the SUNAT, TSG had undervalued these prices in its accounts and tax calculation. This indirectly resulted in an additional assessment of revenue for TSG on a presumed basis, and a sizable tax claim. The investor considered that this claim and its enforcement measures were violations of the Bilateral Investment Treaty between China and Peru (the BIT). The BIT gives the investor the right to start an arbitration procedure.

Possible breaches of the investment treaty

Most BITs comprise more or less the same obligations that are imposed on the host state of an investment, although there are also important differences from one treaty to another. Most BITs have the following obligations:

1) **"Fair and Equitable" Treatment**

   Transparency and consistency in tax interpretation are key to investors. For example, in the *Occidental v. Ecuador case:* "The stability of the legal and business framework is thus an essential element of fair and equitable treatment. The Tribunal must note in this context that the framework under which the investment was made and operates has been changed in an important manner by the actions adopted by the [tax authorities]. … The tax law was changed without providing any clarity about its meaning and extent and the practice and regulations were also inconsistent with such changes." [1]

2) **National Treatment and Most Favored Nation Treatment**

   The general purpose of the national treatment and most favored nation treatment is to ensure that foreign investors are not treated less favorably than national investors or investors from other states. In essence, national treatment forbids (negative) discrimination. This was illustrated in *Feldman v Mexico*, where a foreign investor was refused excise tax refunds for exported cigarettes. The tax authorities claimed that the refund was refused because the foreign investor did not respect the regulations on the required information to be included on invoices entitled to a refund. These regulations were the same for national investors. The Tribunal considered however that these regulations were in practice waived or ignored for domestic cigarette resellers, and that this de facto discrimination is a violation of the national treatment standard in the relevant investment treaty.[2]

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[1] *Occidental v. Ecuador* par. 184 et seq.

[2] *Feldman v Mexico,* par 169

3) No expropriation without compensation

BITs and international customary law provide that even though states have the right to take the property of a foreign investor in the public interest, the state must pay prompt and adequate compensation. It is obvious that international rules to safeguard the property of aliens against expropriation would become meaningless if taxation would be *ipso facto* excluded from scrutiny in this respect. On the other hand, customary international law also recognises the right of the host state to levy taxation[3], and thus also the right to increase an existing tax, to introduce a new one, or to revoke an exemption. The difficulty is in making the distinction between legal taxation and illegal expropriation.

Tax Audit Followed by Blocked Bank Accounts

The Tza Yap Shum case (named after the Chinese owner of TSG) is a good example of how a tax dispute (under national law) can also be an investment dispute (under international law). In 2002, Mr. Tza Yap Shum established TSG with an investment of US$400,000. TSG purchases raw fish, delivers this fish to third-party factories to process it into fish meal, and exports the finished product. Sales reach US$20M per year.

In 2004, the SUNAT conducted a routine audit of TSG after TSG had requested sales tax refunds. During the tax audit, the SUNAT decided that TSG had not properly declared the amounts and values of raw materials it had purchased, which automatically led to the SUNAT's assuming that TSG had under-declared sales as well. The SUNAT issued a new tax assessment of US$4M based on this presumption. TSG disagreed with the assessment.

Shortly after the audit, the SUNAT also took so-called "interim measures" to enforce the tax assessment that had just been imposed and to secure money for the Treasury. All banks in Peru were directed to retain any funds passing through them related to TSG and to redirect them to the SUNAT. Nearly instantly, TSG's business became inoperable as it was unable to pay suppliers or receive money from its customers.

TSG commenced arbitration proceedings, and the Tribunal determined that the interim measures taken by the SUNAT did in fact amount to an expropriation. The Tribunal came to that conclusion mainly because the measures were excessive, and because the SUNAT did not respect the internal rules and guidelines for its own interim measures.

Conclusion

In certain circumstances, foreign investors may have the right to commence an international arbitration procedure in connection with unforeseen or unreasonable tax claims from tax authorities. There are approximately a dozen tax-related investment disputes that have been decided by international arbitration panels (for a more detailed discussion of selected cases and possible grounds for arbitration, see here). This alternative and additional protection may play an important role for investors in case of a high-profile tax dispute with a foreign government.

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[3] Albrecht, A.R., "The taxation of aliens under international law", 29 *BYiL* (1952), p. 172; 1961 Harvard Draft Convention on International Responsibility art. 10 par. 5; Christie, G.C., loc. cit., p. 332.; Hackworth, G. H., Digest of International Law, vol. III, p. 575.