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OECD Pillar Two: possible ISDS claims?

Authors

Lorraine de Germiny
Partner
London

Teresa Queirós
Senior Associate
London

In this post, we explore how ISDS claims could arise from the OECD Pillar Two tax reforms, as well as the potential hurdles such claims could face.

ISDS and Pillar Two – a new frontier?

Tax disputes are not new to investor-State arbitration (often called "investor-State dispute settlement" or "ISDS"). According to UNCTAD, there were 165 ISDS cases challenging tax measures[i] between 1987 and 2021, with the percentage of ISDS cases involving tax measures also doubling during that time.

With OECD Pillar Two tax reforms[ii] being implemented across the globe, multinationals affected by such measures may be able to challenge – through ISDS – a given State's implementation of these reforms.

As previously explained,[iii] investment treaties or agreements usually offer foreign investors the right to initiate ISDS against a host State. This differs from arbitration under tax treaties where the foreign investor (and taxpayer) cannot bring claims against the host State.

In this article, we look at the issues that should be considered when contemplating launching or responding to a claim.

Does the investment treaty include a tax carve-out?

Whether you are a multinational considering a claim, or a State on the receiving end of one, it is important to check whether the relevant treaty includes a tax carve-out. There are two types: a general tax carve-out, or a tax carve-out for specific protections (e.g., some treaties do not extend protections, such as that granted by a most favoured nation treatment ("**MFN**") clause, to tax matters).

Older generation investment treaties generally do not include a carve-out for tax measures (with some exceptions, such as the treaty at the heart of *Schooner v Poland*[iv]), but this has started to change and certain model BITs now explicitly exclude taxation. For example, article 2.4(ii) of the 2015 India Model BIT states that the treaty does not apply to any law or measure regarding taxation, including measures taken to enforce taxation obligations. This was one of the measures that India took to reform its investment policy framework after facing a number of investment claims, including claims challenging certain taxation measures.[v]

Can States object to a tax claim even if the treaty contains no tax carve-out?

Even in the absence of a general tax carve-out, States have been known to object to a tribunal's jurisdiction on the basis that the dispute relates to tax matters. India did so in *Cairn v India* (unsuccessfully). The *Cairn* tribunal noted that the dispute concerned whether India's conduct in tax matters breached the BIT's standards of protection and that the BIT only expressly carved out tax matters with regard to the national treatment and MFN protections.[vi]

Is a tax carve-out the end of a claim?

Not necessarily. It all depends on the wording of the carve-out and the facts giving rise to the dispute. In addition, several tribunals (*Yukos* being perhaps the best-known example), have held that a tax carve-out (in that case article 21(1) of the Energy Charter Treaty) can apply only to "bona fide taxation actions".[vii] Thus, the way in which a State implements Pillar Two tax measures – and whether done in good faith or not – may give rise to a claim. Context, from the language of the treaty to the measures themselves and their impact on multinationals, will be important in determining the existence and strength of a possible ISDS claim.

Is there an overlap between investment treaties and Double Taxation Treaties ("DTTs") and what impact could this have on ISDS claims?

ISDS claims over domestic tax policies could overlap with the subject matter of DTTs (see our previous article explaining this). The *Cairn* tribunal rejected India's jurisdictional objection that the relevant treaty should be read so as to exclude matters regulated by a DTT – in part, because it concluded that the BIT and the DTT governed different subject matters.[viii] In *Schooner v Poland,* the relevant treaty provided that an investor could only bring a claim if it was not subject to the dispute settlement mechanism in a DTT, or if the claim had been raised under the DTT but not resolved within a reasonable time. The *Schooner* tribunal ultimately found that the dispute was not covered by the DTT and not subject to the DTT's dispute settlement clause.[ix]

What investment protections does an investment treaty typically include?

While ISDS tribunals give some deference to a State's right to regulate in the tax sphere, and there is a general presumption that State measures are intended to further the common good,[x] the devil is in the detail. As the *Manolium v Belarus* tribunal noted, "[t]he proposition that States must be granted deference in matters of taxation cannot be misconstrued to grant States discretion whether or not to comply with their international treaty obligations… the State's sovereign right to impose taxation and enforce tax laws can also be misused…".[xi]

Typical investment treaties include the following protections:

- protection against expropriation without compensation;
- a right to fair and equitable treatment ("**FET**");
- anti-discrimination provisions (typically national treatment or MFN clauses); and
- umbrella clauses.

We consider each of these in light of Pillar Two.

Expropriation

As we noted in our previous article, most investment treaties prohibit the host State from expropriating the investments of foreign investors without paying prompt and adequate compensation. While the normal imposition of taxes cannot be seen as an expropriatory act, [xii] the mere fact that a measure is a taxation measure does not mean it can never amount to expropriation.[xiii]

As the *Tza Yap Shum* tribunal noted, there is "a considerable consensus that the imposition and application of tax measures can acquire expropriatory character if these are confiscatory, arbitrary, abusive or discriminatory".[xiv] With regard to confiscatory measures, the *Burlington v Ecuador* tribunal noted that "[t]he most important factor to distinguish permissible from confiscatory taxation is the effect of the tax"[xv] and that "confiscatory taxation constitutes

an expropriation without compensation and is unlawful."[xvi]

Could Pillar Two measures ever result in an expropriation?

This cannot be ruled out. These measures could lead to an expropriation if:

- the Global Anti-Base Erosion Model (GloBE) Rules result in the imposition of a sufficiently large top-up tax, although the effect of this on the claimant company will be key. In a different context, a tribunal found (by majority) that a law taxing 99 per cent of amounts by which the market price of oil exceeded the price of oil at an earlier point in time did not amount to expropriation. This is because in this case the tribunal found that the measure did not amount to a substantial deprivation of the value of the investment as the investment preserved its capacity to generate a commercial return.[xvii]
- the undertaxed profits rule (UTPR) operates so as to tax the whole of a sister company's profits and in so doing destroys the value of that sister company's shares.
- prior to the imposition of Pillar Two, a company had tax-free status that had been guaranteed for a specific period of time and it now loses that status.

A relevant case to consider is that of *Ampal-American Israel v Egypt*, in which the tribunal found that Egypt's decision to remove an investor's tax-free status "took away a defined and valuable interest that had been validly conferred according to Egyptian law at the time that the investment was made and that had been guaranteed by the State for a defined period".[xviii] The tribunal concluded that revocation of this tax exemption was tantamount to an expropriation as there was no compensation offered, although the tribunal acknowledged this was enacted for public purposes and was not discriminatory.[xix]

More recently, in 2022, Canadian company First Majestic Silver Corporation brought a NAFTA claim alleging that Mexico ignored an advanced pricing agreement with its subsidiary, which First Majestic considered was the basis for taxing silver sales from a particular mine between 2010 and 2014. Mexico, in turn, has claimed (among other things), that First Majestic's subsidiary kept its silver prices artificially low to pay less tax.[xx] This dispute is ongoing, it may well end up being a precedent for multinationals in a similar situation as a result of the implementation of Pillar Two.

FET

There is no precise definition of the FET standard, which has evolved over time and is expressed in different terms in different treaties. That said, it is generally understood to mean that:

- a State must act transparently and in good faith;
- a State's conduct cannot be arbitrary, grossly unfair, unjust, idiosyncratic, discriminatory or lacking in due process; and
- a State must respect procedural propriety and due process and an investor's reasonable and legitimate expectations.[xxi]

It is up to each tribunal to decide whether, in all the circumstances, the conduct complained of meets the FET standard. Some tribunals have considered that legitimate expectations can arise from a legal framework itself.[xxii]

States may fall foul of the FET standard where they drastically alter their regulatory framework in breach of an investor's legitimate expectations, or where they treat investors in a grossly unfair or arbitrary manner.

FET and Pillar Two?

Claims for breach of FET could arise out of Pillar Two reforms if, for instance:

- a State tax authority were to apply the GloBE Rules[xxiii] in an unfair or arbitrary manner, or where the taxpayer is denied the opportunity to appeal a tax assessment in accordance with applicable legal processes;
- a State goes beyond what is required to implement Pillar Two, if it applies a Pillar Two measure in bad faith, or (in some circumstances) retroactively. There are precedents for tribunals finding that retroactive laws breach a FET standard's principle of stability and predictability (e.g., *Cairns*); or
- a company can prove that it legitimately expected that a certain tax treatment would continue despite the implementation of Pillar Two, for example, by showing that this was confirmed by authorised State representatives through a stabilisation agreement, or otherwise.

Again, the circumstances of each case will be important to determine whether a taxpayer could bring ISDS claims against the host State.

National treatment and MFN

National treatment and MFN clauses respectively require States to treat foreign investors at least as favourably as they would treat their own investors, or investors of third States, in like circumstances.

In terms of Pillar Two, as UNCTAD has noted, there is a potential tension arising from the difference in treatment accorded to entities to which Pillar Two applies and those to which it does not apply. This is particularly so given that multinationals are caught by Pillar Two based on whether their wider group is in scope and Pillar Two does not apply to purely domestic companies.[xxiv] This difference in treatment could potentially give rise to claims of discriminatory treatment.

While "ISDS awards at times recognise that differences in treatment are justified where they arise as a consequence of a globally coordinated approach",[xxv] the circumstances of the particular case will be key in determining whether there is a valid claim in connection with Pillar Two.

For example, if only one company part of a wider global group is taxed in a particular State, and dozens of comparable national companies are not, a claimant may be able to persuade a tribunal that this amounts to discrimination and breach of national treatment.

Umbrella clauses

Umbrella clauses bring within the ambit of an investment treaty contractual obligations that a State has entered into in connection with an investment. This means that an investor can, under certain conditions, bring an ISDS claim arising from the breach of an agreement between the State and the investor.

Investment agreements often include stabilisation clauses (i.e., where the State provides contractual guarantees against regulatory change). Multinationals may be able to invoke such clauses against States implementing the GloBE Rules, if their application results in tax treatment falling foul of the stabilisation clause in question.

In *Freeport-McMoran Inc. v Republic of Peru* – a recent case involving a stability agreement (though not an umbrella clause) – the tribunal dismissed the claims, finding by majority that the terms of the particular stability agreement had not been violated, as the agreement had a limited scope and only covered the investment project for which the agreement was signed, and not subsequent projects.[xxvi]

Other potential hurdles

Claimants or States assessing a possible Pillar Two claim should also consider other potential hurdles, such as:

- **Fork-in-the-road provisions**, which are included in some investment treaties, require an investor to choose between pursuing their claims through the investment treaty or other fora (e.g., domestic courts). Once a choice is made, this is final and investors can be prevented from starting the same claim under an investment treaty if they opted to start a domestic claim first. An investor could, for example, be prevented from starting an ISDS claim if it had already proceeded with a different tax dispute resolution procedure available to it (e.g., by starting a domestic claim).
- If there is a requirement for **exhaustion of local remedies**, requiring the investor to exhaust all available tax dispute processes.

In conclusion, multinationals affected by Pillar Two may be able to bring ISDS claims arising from a number of different scenarios, such as:

- how Pillar Two was implemented by a particular State;
- the impact of Pillar Two;
- whether Pillar Two represents a breach of a multinational's legitimate expectations as to what fiscal framework would apply to it and for how long.

However, States may have defences, including whether:

- the relevant treaty carves out tax disputes;
- there is an overlap with DTTs; or,
- more generally, that the State is entitled to regulate and introduce tax measures and that implementing Pillar Two measures is a valid exercise of sovereignty.

This area of ISDS is only likely to grow in future as Pillar Two becomes more firmly entrenched in the world's fiscal landscape.

End notes:

[i] UNCTAD, Facts on Investor-State Arbitration in 2021: with a special focus on tax-related ISDS cases, Issue 1, July 2022, p. 1 and p. 5.

[ii] See "OECD: Pillar two tax disputes, an introduction", LALIVE blog, by Lorraine de Germiny and Robert Denison, dated 18 November 2024, describing the nature of these reforms.

[iii] *Ibid.*

[iv] *Vincent J. Ryan, Schooner Capital LLC, and Atlantic Investment Partners LLC v Republic of Poland*, ICSID Case No. ARB(AF)/11/3, Award dated 24 November 2015 ("**Schooner**"), para. 336

[v] See https://www.iisd.org/itn/en/2016/08/10/india-takes-steps-to-reform-its-investment-policy-framework-after-approving-new-model-bit/.

[vi] *Cairn Energy PLC and Cairn UK Holdings Limited v Republic of India*, PCA Case No. 2016-7, Final Award dated 21 December 2020 ("***Cairn***"), paras. 797-800.

[vii] *Yukos Universal v Russia,* Final Award, 18 July 2014, para. 1407.

[viii] *Cairn,* paras. 801-806.

[ix] *Schooner*, paras. 311-320.

[x] *OOO Manolium Processing v Republic of Belarus*, PCA Case No. 2018-06, Final Award dated 22 June 2021, para. 425.

[xi] *Ibid*, para. 426.

[xii] *Sr Tza Yap Shum v Republic of Peru*, ICSID Case No. ARB/07/6, Award dated 7 July 2011 ("***Tza Yap Shum***"), para. 173.

[xiii] *RosInvestCo UK Ltd. v The Russian Federation*, SCC Case No. V079/2005, Final Award dated 12 September 2010, para. 628.

[xiv] *Tza Yap Shum,* para. 181, authors' translation. This has since been cited in other awards with approval; see, for example, OOO Manolium-Processing v the Republic of Belarus, PCA Case No. 2018-06, Final Award dated 22 June 2021, para. 181.

[xv] *Burlington Resources Inc v Republic of Ecuador*, ICSID Case No. ARB/08/5, Decision on Liability dated 14 December 2012, para. 395.

[xvi] *Ibid.*

[xvii] *Ibid*, paras. 456 and 457.

[xviii] *Ampal-America Israel Corp., EGI-Fund (08-10) Investors LLC, EGI-Series Investments LLC and BSS-EMG Investors LLC v Arab Republic of* Egypt, ICSID Case No. ARB/12/11, Decision on liability and heads of loss, para. 183.

[xix] *Ibid*., paras. 184-187.

[xx] https://www.mining.com/first-majestic-takes-mexico-tax-row-to-arbitration/

[xxi] *Rumeli Telekom A.S. and Telsim Mobil Telekomunikasyon Hizmetleri A.S. v Republic of Kazakhstan*, ICSID Case No. ARB/05/16¸ Award dated 29 July 2008, para. 609.

[xxii] See for example *Cube Infrastructure Fund SICAV and Others v The Kingdom of Spain*, ICSID Case No. ARB/15/20.

[xxiii] See "OECD: Pillar two tax disputes, an introduction", LALIVE blog, by Lorraine de Germiny and Robert Denison, dated 18 November 2024, describing the nature of these reforms.

[xxiv] UNCTAD, The Global Minimum Tax and Investment Treaties: Exploring Policy Options, IIA Issues Note Issue 4, November 2023, pp. 11-12.

[xxv] *Ibid*., p. 12.

[xxvi] *Freeport-McMoran Inc on its behalf and on behalf of Sociedad Minera Cerro Verde S.A.A. v Republic of* Peru, ICSID Case No. ARB/20/08, award dated 17 May 2024. In this case, the tribunal also decided that certain tax claims fell outside its jurisdiction (see para. 1047(a)).