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Is Arbitration Based on "Treaty Shopping" In Jeopardy?

Pieter Bekker (Crowell & Moring LLP) · Wednesday, June 17th, 2009 · American Society of International Law (ASIL)

On May 4, 2009, the Obama administration proposed far-reaching measures designed to curb the tax benefits enjoyed by U.S.-based multinational corporations with offshore operations. Based on 2004 figures, those corporations are said to enjoy an effective tax rate of about 2.3% on their foreign revenue.

The measures seek to end the practice of U.S. multinationals avoiding U.S. tax on profits derived from the activities of their overseas affiliates and re-invested overseas while taking deductions on their U.S. tax returns for all the expenses supporting their overseas investments. According to a recent study, of the 100 largest U.S. corporations, 83 have subsidiaries in tax-friendly jurisdictions.

The U.S. administration's proposal raises the question: What impact will this proposal, and especially any possible implementing legislation adopted as a consequence, have on the phenomenon of "treaty shopping" and, therefore, on the ability of foreign investors to maximize their remedies vis-à-vis host States under existing bilateral or multilateral investment treaties by "shopping" for a "home country of convenience" that is a party to such treaties along with the host country? Does the proposal take into account the fact that multinational corporations are not exclusively guided by tax and/or accounting considerations when they establish overseas operations?

A White House fact sheet issued in connection with the administration's proposals lists Bermuda, Ireland, and The Netherlands as "low-tax" countries. According to the White House, nearly one-third of all foreign profit reported by U.S.-based multinational corporations comes from these three small countries.

The White House fact sheet prompted a May 4, 2009, press release by the Royal Netherlands Embassy in Washington, D.C., denying that The Netherlands, the fourth largest investor in the U.S., is a "low-tax country" by pointing to the fact that it has a corporate tax rate of 25.5%.

Moreover, the United States Council for International Business (USCIB) said in a statement released on May 5, 2009, that the changes to the taxation of the overseas earnings of U.S. multinational companies proposed by the Obama administration will have a negative impact on U.S. competitiveness, pointing out that such companies play a central role in underpinning U.S. economic growth and job creation. USCIB has urged the U.S. Congress "to act with caution and thoughtful deliberation to ensure no harm is done to the U.S. economy by adversely affecting the ability of U.S. multinationals to compete in the global marketplace."

Several rulings by investor-State tribunals have affirmed the practice of “treaty shopping,” which enables foreign investors to incorporate their business in countries other than their principal place of business, and to take advantage of treaties negotiated by other countries. It is submitted that the practice finds its origin in the absence of a multilateral investment code protecting all foreign investors regardless of their nationality, and in the attempt by multinational corporations to curb foreign investment risk as best as they can, rather than in an attempt to curb, or maximize deductions against, their taxes by inflating the amount of foreign tax paid by them.

A quick review of ICSID’s list of pending and concluded cases reveals that the basis of jurisdiction in a substantial number of ICSID cases is derived from the practice of “treaty shopping,” with treaties concluded by The Netherlands taking a prominent place. Regardless of whether the U.S. administration’s proposed tax changes will take effect, the continued absence of a multilateral investment code in combination with the deficient substantive and procedural protections offered by some host/home States in comparison to others will prolong the search by foreign investors for the most favorable protective treaty regime, especially when tribunals keep endorsing the practice of treaty shopping. Moreover, requiring U.S. businesses that establish foreign corporations to treat them as corporations for U.S. tax purposes leaves unaffected such corporations’ ability to gain the benefits derived from “treaty shopping” in terms of remedial management. In other words, the practice might soon lose some of its attractiveness for U.S. companies-especially those that are primarily tax-driven-but it otherwise is here to stay.

By Dr. Pieter H.F. Bekker, Partner & Head of Public International Law, Crowell & Moring LLP, New York City

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