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Lone Star Award: Substance Over Form Doctrine under Double Tax Treaties and Their Interaction with IIAs

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The *Lone Star v. Korea* (*Lone Star*) Award issued on 30 August 2022 is one of the latest investment awards in tax-related investment treaty disputes and the first one in which a tribunal, *inter alia*, dealt with the application of an anti-tax avoidance substance over form doctrine (SOFD) under a double taxation treaty (DTT). The *Lone Star* tribunal (the Tribunal) should have included a detailed analysis of the tax expert evidence in the Award's text instead of including only simplified observations from the 2003 OECD Commentary, which generally state that SOFDs are compatible with DTTs. Consequently, the Tribunal found that applying one of the Korean SOFDs did not violate the 2011 BLEU-Korea Bilateral Investment Treaty (BIT) (paras. 390-410, 469-479).

After briefly setting out the central ISDS tax-related question of relevance to the *Lone Star* proceedings, this post argues that the Tribunal relied on a partly incorrect (oversimplified) view of the OECD guidelines and overlooked a pivotal part of the OECD Commentary regarding relations between SOFDs and DTTs. Finally, this post highlights the importance of thoroughly and critically examining the OECD's documents and guidelines when arbitral tribunals decide on claims of violations of International Investment Agreements (IIAs) due to the incorrect application of DTTs by states.

The Tax Issues Raised in the *Lone Star* Proceedings

Lone Star, a private equity fund from Texas, seeking assets it considered undervalued, was one of the foreign investors that invested in Korea during the Asian Debt Crisis (paras. 114, 118, 146). Lone Star invested in Korea indirectly utilizing "upper tier" limited partnerships from Delaware. These partnerships, through various intermediate entities located in jurisdictions like Bermuda, then transferred the investments to Special Purposes Entities (SPEs) from Belgium and Luxembourg. These SPEs ultimately became the direct owners of the assets (shares and real estate) located in Korea (*see* para. 554). In 2012, these SPEs initiated arbitration proceedings against the Republic of Korea under the 1976 BIT before an ICSID Tribunal. The Claimants primarily contested in arbitration proceedings two measures implemented by the Respondent (paras. 1-11). Firstly, they challenged the arbitrary and unreasonable acts of the Financial Services Commission (FSC) pertaining to the sale of shares in Korean Exchange Bank (KEB) to Hana, which led to a decrease in the value of their shares. Secondly, they contested the taxation of income generated from their four Korean investments, which took place by denying the SPEs benefits under the 1979

Korea-Belgium DTT through the application of the Korean SOFD in an arbitrary and discriminatory way by the Korean tax authorities and courts (para. 430), thereby violating the fair and equitable treatment (FET) standard under the 2011 BLEU-Korea BIT. This post focuses only on the latter allegation.

Concerning the second allegation, the *Lone Star* Tribunal was required to determine whether a violation of the 1979 Korea-Belgium DTT was relevant in determining alleged breaches of the 2011 BLEU-Korea BIT, including the FET standard (paras. 296, 372 (b), 390). The Tribunal had to indirectly evaluate the compatibility of the Korean tax authorities' and courts' applications of the Korean SOFD with the 2011 BLEU-Korea BIT. This assessment required evaluating its compatibility with the 1979 Korea-Belgium DTT. The Tribunal concluded that Korea's SOFD had not been applied arbitrarily or discriminatorily since its application was based on evidence, was "well within the legal boundaries of international-accepted tax policy," and was quite consistently "with international standards, including the OECD Guidelines." (paras. 469, 480).

The Tribunal primarily relied on references from tax expert witnesses to the 2003 OECD Commentary to reach this finding. According to the Tribunal's interpretation, the SOFD forms "part of the basic rules for determining the facts that give rise to tax liability," and thus it is not affected by DTTs and generally does not contradict them (paras. 407-410).

Critique of the *Lone Star* Tribunal's Treatment of Tax-Related Issues

The *Lone Star* Tribunal failed to acknowledge that the observations of the OECD are partly incorrect. Further, it overlooked a pivotal part of the OECD Commentary, which conditions the compatibility of SOFDs with DTTs on the so-called *guiding principle*.

Tax scholars, such as Professor Zimmer, Professor Brian Arnold, and Professor Stef van Weeghel, argue that SOFDs and other domestic anti-tax avoidance measures are heavily interpretative in nature rather than fact-determining. Their application typically involves recharacterizing facts solely for tax purposes, *e.g.*, income may be reattributed from one entity to another (from a subsidiary company to its parent). This recharacterization and re-attribution is based on economic criteria rather than legal or factual criteria, and it is determined during tax proceedings. The Korean tax authorities and courts applied the SOFD in this way, disregarding Belgian SPEs (LSF-KEB and Star Holdings SCA) in the application of the 1979 Korea-Belgium DTT and reattributing income from profits sourced in Korea (dividends and capital gains) to U.S. and Bermudan investment entities. The tax authorities considered that the Belgian SPEs did not have enough economic substance, *i.e.*, that they were (i) mere conduits established for the sole purpose of avoiding withholding taxation (WHT) in Korea rather than for the efficient management and operation of the fund's investment capital and investment assets, and that they were (ii) deprived of any substance and any purpose other than those related to avoiding WHT in Korea (paras. 432, 447-461). This denial of benefits under the DTT took place despite the absence of any requirement to have an economic substance in the relevant provisions (Articles 1, 4(1), and 13(3) of the 1979 Korea-Belgium DTT).

The process of denial of benefits under a DTT through the application of SOFD requires legal consideration that is influenced by DTTs. This influence is subject to the rules and principles of interpretation of treaties under the Vienna Convention on the Law of Treaties (VCLT) as it affects

the interpretation and application of DTTs. The Tribunal did not recognize this because of its overreliance on the OECD documentation, which did not acknowledge that SOFDs are primarily interpretative anti-tax avoidance rules instead of evidence/fact-determining rules.

Second, the Tribunal completely overlooked the conclusive part of the 2003 OECD Commentary on Article 1 (para. 22.1), according to which the SOFDs' compatibility with DTTs is subject to *a guiding principle*. It means that SOFDs may be applied to deny DTT benefits in a compatible manner with their provisions when the "main purpose for entering into certain transactions or arrangements was to secure a more favorable tax position and obtaining that more favorable treatment in these circumstances would be contrary to the object and purpose of the relevant provisions." The fact-determining nature of the Korean SOFD – however doubtful – was, therefore, not a sufficient factor for affirming its compatibility with the 1979 Korea-Belgium DTT. This observation is further reinforced by the 2017 OECD Commentary, which completely abandoned the previous interpretation. Instead, the 2017 OECD Commentary (paras. 74, 77 on Article 1) considers that there is no conflict as long as local tax authorities and courts deny DTT's benefits via domestic anti-tax avoidance rules in the same circumstances in which they would have been denied under the principal purposes test (PPT) or a guiding principle (if the DTT does not include the PPT).

Need for a Careful Consideration of the OECD Documentation by Arbitral Tribunals

On its surface, the *Lone Star* Award demonstrates that the OECD documentation could be relevant for arbitral tribunals to determine the compatibility of a host state's fiscal conduct with DTTs and with investment protection standards under IIAs (*see* Chapter 11). However, a deep dive into that Award reveals that tribunals still need to examine the views of the OECD through independent analysis of the subject matter in accordance with the rules and principles of interpretation of the VCLT and the true nature, purpose, and effect of the questioned tax measures *vis-à-vis* DTTs and IIAs. While referring to the OECD commentaries, it should also be noted that these are interpretative materials for tax authorities primarily and do not necessarily reflect an appropriate and impartial interpretation of DTTs and their interactions with the domestic tax laws of contracting states.

Conclusion

The *Lone Star* Award demonstrates that taxation by a host state is deemed a breach of an IIA only in exceptional circumstances. Accordingly, despite certain issues with the Tribunal's reasoning concerning the denial of benefits under the 1979 Korea-Belgium DTT by the Korean tax authorities and courts through the Korean SOFD, it is evident that the denial of benefits did not violate the DTT through an extreme deviation from the OECD's perspective and a guiding principle. The same holds true for the rules and principles of interpretation of the VCLT.

Neither the Korean tax authorities nor the courts violated the 1979 Korea-Belgium DTT (if at all) enough to violate the 2011 BLEU-Korea BIT. This, coupled with the quite blatant DTT shopping scheme by Lone Star, significantly influenced the Tribunal's reasoning against tax-related claims.

Apparently, the Tribunal did not deem it necessary to conduct a comprehensive analysis of the

OECD's view to conclude the compatibility of the Korean SOFD's application with the 2011 BLEU-Korea BIT in the context of the Lone Star tax scheme. The Tribunal assumed that the Claimants in *Lone Star* did not have a legitimate expectations under the BIT to benefit from the 1979 Korea-Belgium DTT due to their own wrongdoing, namely establishing a tax avoidance scheme that domestic courts (including the Supreme Court) evaluated as an abuse of the DTT (paras. 443, 465, 469, 479). However, the quality of the *Lone Star* Award could be significantly enhanced by subjecting the OECD's viewpoint to a thorough examination in line with the rules and principles of interpretation of treaties outlined in the VCLT. This is particularly important considering the widespread criticism of that viewpoint within scholarship. The Tribunal could further improve the quality of the Award, promote the rule of law, and greatly benefit the entire ISDS and international tax community by explicitly relying on the principle of abuse of rights while evaluating the compatibility of the Korean SOFD with the BIT and the DTT. Referring to other relevant principles of law – as the *Cairn* tribunal did concerning legal certainty, predictability, and proportionality (paras. 1788, 1796) – would also enhance the quality of the Award. Such an approach could significantly contribute to a systemic interpretation of DTTs and IIAs (*see* section 25.5) concerning the application of substance over form approach to deny benefits under these treaties.

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