Spillover Effects in International Law: The Case of Tax Planning and Investor-State Dispute Settlement

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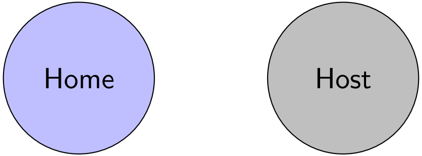
The classic ISDS case:



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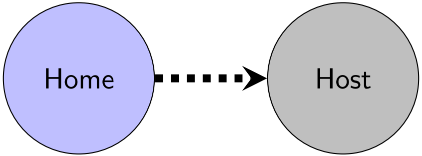

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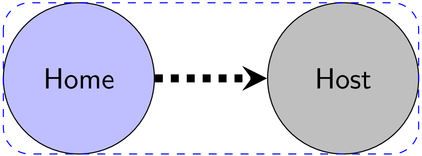

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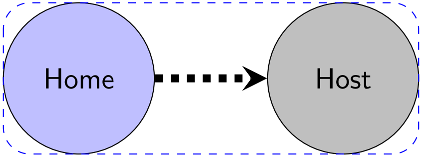

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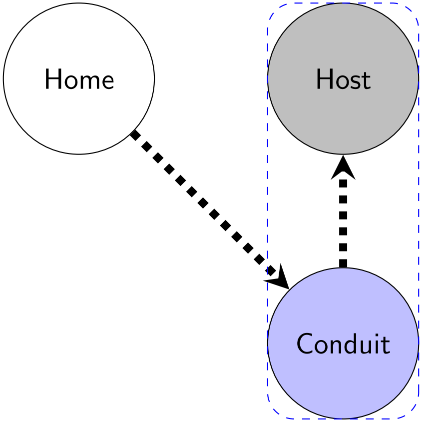
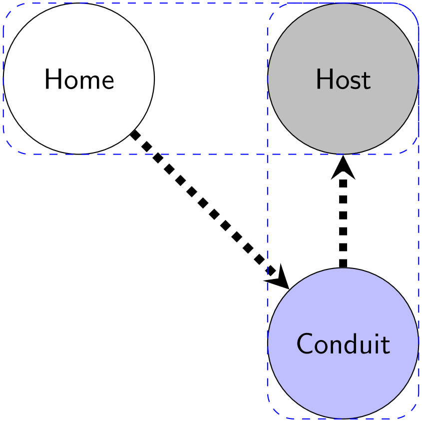
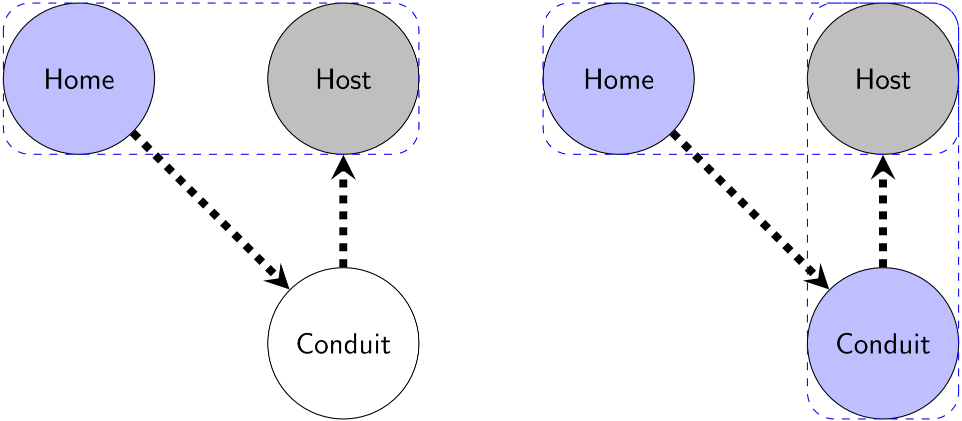


- "Proxy Arbitration" w/o standing - **16% of all ISDS cases**



- "Proxy arbitration" w/standing - **10% of all ISDS cases**



- Indirect investment w/o proxy arbitration - **14% of all ISDS cases**

Motivation

- Proxy arbitration increases **scope** of investment treaty regime, as well as host state liability.
- May undermine already tenuous legitimacy of ISDS.
- Recent work suggests that investors engage in strategic, *ex ante* BIT shopping (Betz, Pond and Yin 2020; Gray 2020).

Motivation

- Proxy arbitration increases **scope** of investment treaty regime, as well as host state liability.
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My argument:

1. BIT protection does not justify costs of indirect investment; tax avoidance does.
2. Proxy arbitration is actually a **spillover effect** from int'l tax treaty regime.
3. Investors use intermediate subsidiaries to access other states' tax treaties – as a side benefit, they gain access to other states' investment treaties.

Road map

1. **Theory**: Tax Planning and ISDS
2. **New data**: Ownership structures of ISDS claimants, 1987-2015
3. **Research design + results**: Investors choose conduit locations that maximize tax treaty access, not investment treaty access.

Theory: tax planning

- Multinational firms want to (legally) minimize their tax burdens
- Two common tax planning techniques to achieve this:
  1. Minimize **income tax** by profit-shifting
  2. Minimize **withholding tax** using network of bilateral tax treaties
- Both techniques typically involve investing *indirectly* through conduit subsidiaries

→ Conduit subsidiaries created for tax planning can be repurposed for ISDS if a dispute arises

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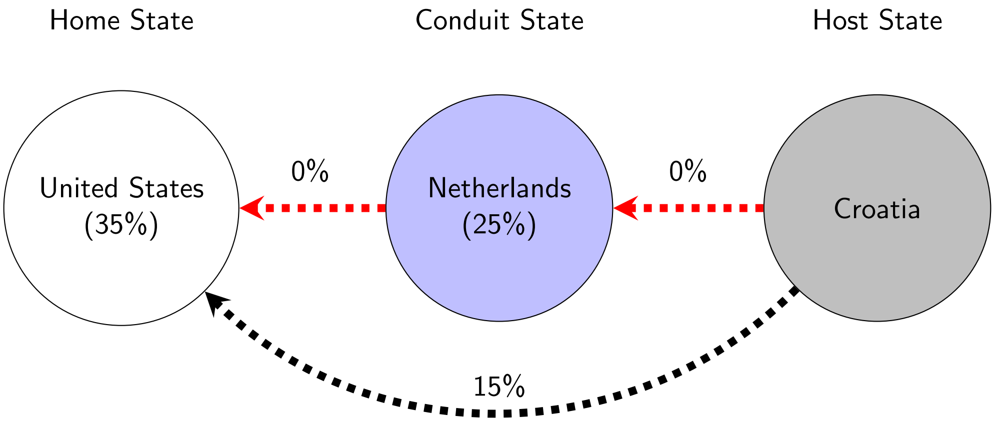
Example: *B3 Croatian Courier v. Croatia*, ICSID 2015



Observable implications

- Indirect investors should choose conduit locations that:

H1 Offer access to the tax treaty network.

H2 Offer lower withholding tax rates.

H3 Have lower corporate income tax rates.

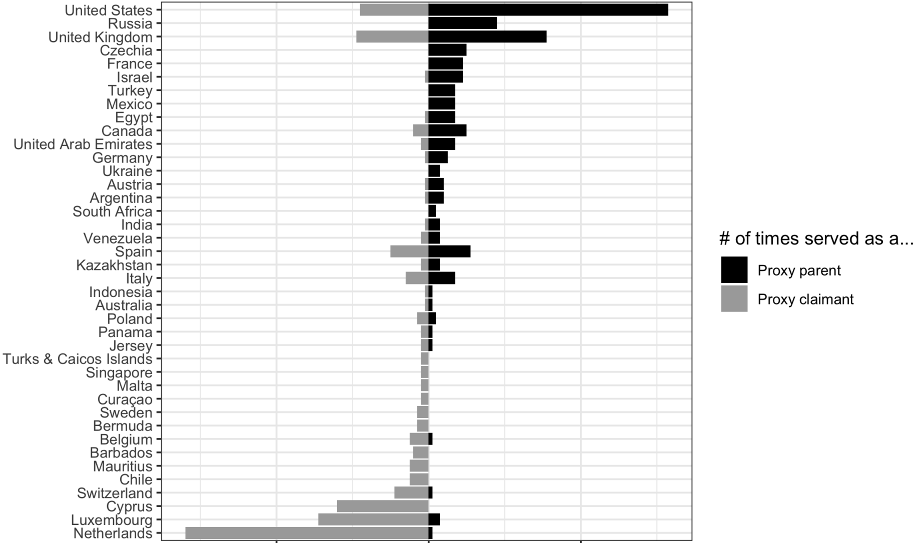
- In contrast, BIT/IIA-shopping investors should choose conduit locations that:

H_A Expand the investor's BIT portfolio.

Data

- To test hypotheses, I need data on the ownership structures of ISDS claimants
- For 1,000+ claimants in 726 cases filed between 1987-2015, I collect data on:
  1. The name and nationality of the claimant's owner/controller, if any
  2. Whether the claimant held ownership of the host state assets through a conduit
- Consulted business databases, corporate registries, offshore leaks, and host of other sources

How does proxy arbitration affect distribution of ISDS claimants?



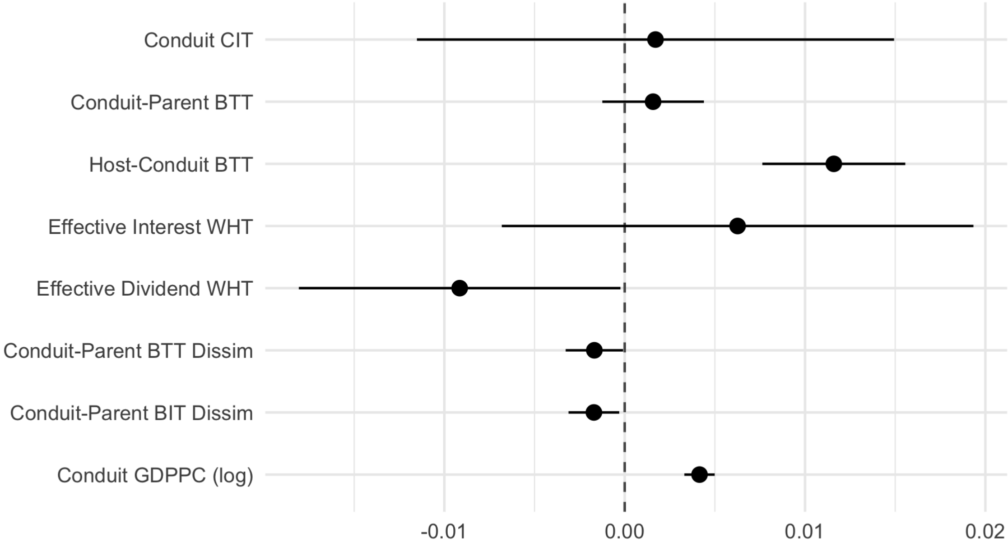
Research design: conduit location models

- Limit to observed cases of indirect investment.
- Do tax planning concerns influence conduit **location**?
- Key tax variables:
  - H1 Tax treaty between host-conduit and conduit-home [predicted sign: $+$]
  - H2 Effective interest and dividend WHT rates [predicted sign: $-$]
  - H3 Conduit state CIT [predicted sign: $-$]
- Controls:
  - H_A Conduit-Home BIT dissimilarity
  - Conduit state GDP per cap, Year+Case FE, Netherlands dummy

Data structure: conduit location models

Case ID	Home	Host	Conduit (observed)	Conduit (potential)	Chosen
1	USA	Venezuela	Netherlands	Algeria	0
1	USA	Venezuela	Netherlands	Angola	0
⋮	⋮	⋮	⋮	⋮	⋮
1	USA	Venezuela	Netherlands	Netherlands	1
2	UK	Ukraine	Cyprus	Algeria	0
⋮	⋮	⋮	⋮	⋮	⋮

Results: conduit location (all indirect)



Conclusion

Takeaways:

1. Structure of tax treaty network affects functionality of investment treaty network
2. Overlapping, bilateral treaty regimes for regulating MNCs $\rightarrow$ spillover effects
3. Importance of firm-centric approach to regime complexity

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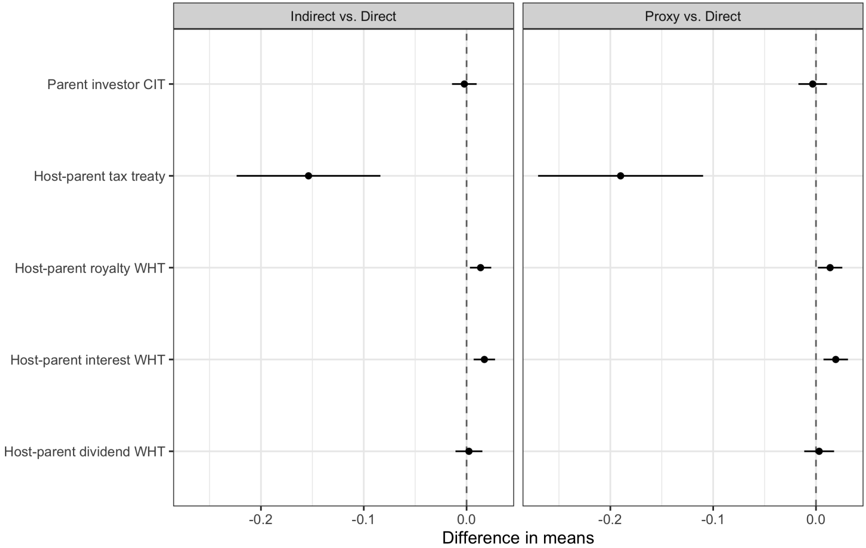
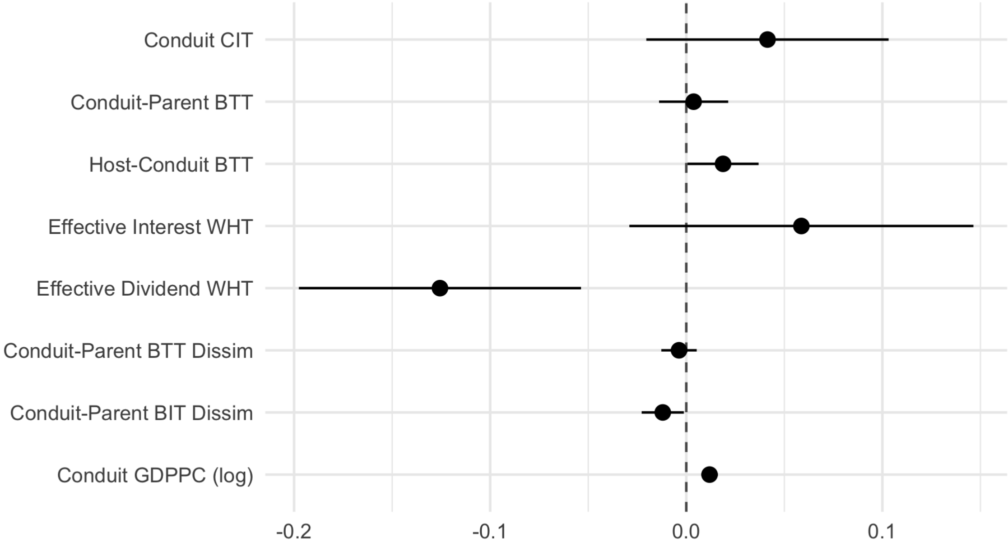
Investing indirectly for tax purposes: proof of concept



Results: conduit location (most-likely IIA shopping)



Results: conduit location (tax haven models)