DEVELOPMENT OF TAX CARVE-OUT PROVISIONS IN INTERNATIONAL INVESTMENT AGREEMENTS AND CHINA'S RESPONSIVE APPROACH

Chen Jingxian

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Due to the lack of coordination between international investment law and international tax law, many contracting parties in the negotiations of old-generation international investment agreements (IIAs) lacked a full understanding of the impact of these agreements on tax measures. As a result, old-generation IIAs often have deficiencies in addressing tax matters, thereby challenging the tax sovereignty of host countries. In recent years, an increasing number of countries have introduced standalone tax carve-out provisions in IIAs, and the United Nations Conference on Trade and Development has increasingly focused on the impact of IIAs on tax measures, calling for strengthened coordination between investment and tax policymakers. Therefore, it is necessary for China to explore more efficient ways to improve the tax carve-out provisions in its network of IIAs, making them more balanced, coordinated, and consistent.

International investment law and international tax law are two distinct yet interconnected fields of international economic law. In the process of economic globalization, countries have established extensive networks of international investment agreements (hereinafter referred to as IIAs) and double taxation agreements (hereinafter referred to as DTAs), which constitute mutually independent rule systems. Currently, approximately 3,400 DTAs and about 2,500 IIAs are in force worldwide.[1] Typically, IIAs and foreign investment laws of a country lie within the competence of its trade, commerce, or investment departments, while DTAs and tax policies are usually formulated by the finance or tax authorities. Due to a lack of

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1 IBFD TAX TREATY DATABASE, at https://research.ibfd.org/ (Last visited on February 17, 2025); UNCTAD DATABASE, at http://investmentpolicyhub.unctad.org/IIA (Last visited on February 17, 2025).

coordination between different government departments, there are many conflicts and frictions between international investment law and international tax law, a problem often referred to as the fragmentation of international economic law.[2]

Especially in the negotiations of old-generation IIAs, many contracting parties lacked a clear understanding of the impact of IIAs on tax measures and did not include carve-outs for tax measures in all or certain IIA provisions. Unfortunately, over time, an increasing number of countries, especially developing ones, have found that the broad and vague IIAs substantive obligations and the pro-investor investor-state dispute settlement (ISDS) mechanism are posing significant challenges to their tax sovereignty, which is considered the core component of sovereignty. Many countries did not foresee this problem when they signed IIAs decades ago. To address this problem, some countries have introduced standalone tax carve-out provisions in IIAs in recent years, which is a notable development trend. Meanwhile, international organizations such as the United Nations Conference on Trade and Development (UNCTAD) have increasingly focused on the impact of IIAs on tax measures, and have called for enhanced coordination between investment and tax policymakers.[3] The overall trend is to achieve a rebalance between investor rights and host country's tax sovereignty, and to promote the coordinated development of international investment law and international tax law. In the case of China, many of its IIAs were signed relatively early and lacked clear and scientific provisions regarding tax issues, posing challenges to China's tax sovereignty. Therefore, it is necessary for China to pay attention to the development trends of tax carve-out provisions in IIAs and modernize such clauses according to its unique position.

This paper aims to study the modernization of tax carve-out clauses in IIAs from the perspective of the intersection and coordination between international investment law and international tax law. The first part analyzes

2 *See* UNITED NATIONS, FRAGMENTATION OF INTERNATIONAL LAW: DIFFICULTIES ARISING FROM THE DIVERSIFICATION AND EXPANSION OF INTERNATIONAL LAW, at https://legal.un.org/ilc/documentation/english/a_cn4_l702.pdf (Last visited on February 17, 2025).

3 *See* UNCTAD, INTERNATIONAL INVESTMENT AGREEMENTS AND THEIR IMPLICATIONS FOR TAX MEASURES: WHAT TAX POLICYMAKERS NEED TO KNOW, at https://unctad.org/system/files/official-document/diaepcbinf2021d3_en.pdf (Last visited on February 17, 2025).

the deficiencies of old-generation IIAs in addressing tax matters and the challenges they pose to the tax sovereignty of host countries. The second part outlines the recent development trends of tax carve-out provisions in IIAs. The final part analyzes the current situation of tax carve-out provisions in Chinese IIAs and proposes recommendations for improvement.

I. DEFICIENCIES OF OLD-GENERATION IIAS AND CHALLENGES TO HOST COUNTRY'S TAX SOVEREIGNTY

The UNCTAD defines 'old-generation IIAs' as those concluded approximately before 2010.[4] Approximately 3,400 IIAs were concluded between 1959 and 2011, representing over 85% of all IIAs ever signed; about 2,300 of these old-generation IIAs are still in force. Their substantive treatment standards are formulated in a broad and vague manner, with few exceptions or safeguards. Such old-generation IIAs serve as the basis for virtually all existing ISDS claims.[5] In the negotiations of old-generation IIAs, many contracting parties lacked a clear understanding of the impact of IIAs on tax measures. As a result, old-generation IIAs often have deficiencies in addressing tax matters, thereby challenging the tax sovereignty of host countries.

A. Deficiencies of Old-Generation IIAs in Addressing Tax Matters

The roots of the deficiencies of old-generation IIAs in addressing tax matters are multifaceted. Firstly, for a considerable period since their inception, IIAs have primarily served as tools for capital-exporting countries to protect their nationals and for capital-importing countries to attract foreign investment. The majority of obligations established by IIAs are obligations on the host state to protect the investor and investment, which results in an asymmetry favoring investors over host states.[6] Therefore, the

4 *See* UNCTAD, PHASE 2 OF IIA REFORM: MODERNIZING THE EXISTING STOCK OF OLD-GENERATION TREATIES, at https://unctad.org/system/files/official-document/diaepcb2017d3_en.pdf (Last visited on February 17, 2025).

5 UNCTAD, TRENDS IN THE INVESTMENT TREATY REGIME AND A REFORM TOOLBOX FOR THE ENERGY TRANSITION, at https://unctad.org/system/files/official-document/diaepcbinf2023d4_en.pdf (Last visited on February 17, 2025).

6 Frank J. Garcia, Lindita Ciko & Apurv Gaurav et al., *Reforming the International Investment Regime: Lessons from International Trade Law*, 4 Journal of International Economic Law 861, 870 (2015).

regulatory power of host countries, including in areas such as taxation, is often significantly restricted by old-generation IIAs. Secondly, international investment law and international tax law have long developed in a fragmented and uncoordinated manner. In the negotiations of old-generation IIAs, negotiators generally lacked a clear understanding of the specificity of taxation. As a result, they failed to make comprehensive, systematic, and detailed provisions regarding tax matters in the agreement texts.

In general, the deficiencies of old-generation IIAs in addressing tax matters can be summarized into three aspects: (1) the absence of standalone tax carve-out provisions, (2) a lack of clear guidance regarding the relationship between tax measures and substantive investment obligations, and (3) the legitimacy crisis faced by the ISDS mechanism and its inconsistency with international tax dispute resolution mechanisms.

1. The Absence of Standalone Tax Carve-Out Provisions. — In general, IIAs stipulate a series of substantive protection standards such as national treatment (hereinafter referred to as NT), most-favored-nation treatment (hereinafter referred to as MFN), fair and equitable treatment (hereinafter referred to as FET), expropriation, and transfer of funds. These standards impose various restrictions on the host country's regulatory power, including its taxing power. For example, non-discrimination clauses require that the host country's tax measures shall not discriminate against investors of different nationalities; the FET clauses require that tax measures shall not undermine investors' legitimate expectations; expropriation clauses require that tax measures shall not result in substantial deprivation of investments;[7] and transfer-of-funds clauses require that tax measures shall not restrict investors from transferring their investments and profits abroad. Unless explicitly excluded by IIAs, typically through tax carve-out provisions, the host country's tax measures will be subject to the constraints imposed by IIAs.

Therefore, it is essential to introduce specialized tax carve-out provisions in IIAs. Taxation is a vital aspect of national sovereignty, serving as the primary source of government revenue and a key tool for macroeconomic regulation and social redistribution. Applying the general rules of IIAs too strictly could limit the host country's ability to exercise tax sovereignty and

7 Sonia E. Rolland, *The Impact of Trade and Investment Treaties on Fiscal Resources and Taxation in Developing Countries*, 1 Chicago Journal of International Law 48, 63-64 (2020).

implement effective tax policies. Meanwhile, tax measures are diverse and complex, often involving intricate legal and technical issues. The general rules of IIAs typically lack detailed provisions needed to address these complexities, potentially leading to disputes. Specialized tax carve-out provisions can clearly delineate which tax measures are protected as exceptions, thereby reducing such disputes. These provisions provide clear guidance to both the host country and investors, reducing disputes arising from tax measures and increasing policy predictability and stability. Moreover, as the global tax environment evolves, countries need to flexibly adjust their tax policies to address new economic and technological challenges. Tax carve-out provisions enable host countries to undertake necessary tax reforms without violating IIAs.

However, in practice, most old-generation IIAs do not include standalone tax carve-out provisions to address tax matters in a comprehensive, systematic, and detailed manner. Some IIAs do not exclude tax measures at all. For instance, the *1961 Germany-Liberia Bilateral Investment Treaty* (BIT) makes no mention of the term 'tax measures', implying that all tax measures are covered by the treaty. Clearly, this pattern severely restricts the tax sovereignty of the host country.

Some IIAs partially exclude tax measures from their scope, but such provisions are not standalone articles; instead, they are included within substantive protection clauses such as NT, MFN, etc. For example, article 3(4) of the *2002 Germany-Thailand BIT* stipulates: 'The treatment granted under this article (NT and MFN) shall not be applicable to advantages which either contracting party accords to investors of third states by virtue of a double taxation agreement or other agreements regarding matters of taxation.' This pattern of clause excludes tax measures to some extent, helping to avoid the overlap and conflicts between IIAs and DTAs in terms of investment/tax treatment. However, its limitations are still evident. Firstly, since tax carve-outs are not standalone provisions but rather subsidiary to other substantive protection clauses, their provisions regarding tax measures are often brief, lacking systematic and comprehensive coverage. Secondly, many other provisions of IIAs still apply to tax measures, some of which may be very broad and vague, thereby still posing significant challenges to the host country's tax sovereignty.

2. Lack of Clear Guidance Regarding the Relationship Between Tax Measures and Substantive Investment Obligations. — In the absence of standalone tax carve-out provisions in IIAs, there is a lack of clear guidance regarding the relationship between the host country's tax measures and the NT, MFN, FET, expropriation, and transfer-of-funds provisions in IIAs. In practice, it often falls to arbitration tribunals to determine whether the host country's tax measures violate IIAs. In some cases, multiple substantive protection clauses may be involved simultaneously.[8] This lack of guidance not only increases the likelihood of disputes, but also leaves arbitration tribunals' interpretative authority without effective limitations.

In terms of investment/tax treatment, there are distinct differences in customary practices between international investment and taxation, which can become potential sources of disputes. IIAs typically adopt nationality as the determining feature of non-discrimination, requiring host countries not to discriminate between domestic investors and foreign investors, or among investors from different foreign countries. In contrast, the determining feature of non-discrimination in the taxation domain is tax residency.[9] In practice, countries typically categorize taxpayers as resident taxpayers and non-resident taxpayers, and provide them with different tax treatments. For instance, resident taxpayers usually bear unlimited tax obligations (i.e., on a worldwide basis), while non-resident taxpayers only bear limited tax obligations (i.e., on a source basis).[10] Additionally, non-resident taxpayers are often subject to withholding taxes. However, in many old-generation IIAs that include broad NT or MFN clauses without tax carve-outs, disputes may arise as to whether these practices violate the investment treatment clauses.

As for the FET provision, old-generation IIAs typically include a FET provision drafted in a minimalist and open-ended manner. The FET provision is the most likely standard to be invoked in tax-related ISDS cases. In practice, arbitration tribunals have gradually developed elements such as expectations of regulatory stability and compliance with the legitimate

8 Zhan Tao, *Research on the Arbitrability Issues in International Investment Tax Disputes*, 5 Studies in Law and Business 79, 83 (2012).

9 Maira de Melo Vieira, *The Regulation of Tax Matters in Bilateral Investment Treaties: A Dispute Resolution Perspective*, 1 Dispute Resolution International 63, 83 (2014).

10 Zhang Zeping, *Analysis of the Scope of Non-Discrimination Clause in International Tax Agreements*, 2 ECUPL Journal 165, 171 (2018).

expectations of investors, expectations of transparency and participation in governmental decision-making, and proportionality tests for state measures.[11] Among these, the standards of regulatory stability and legitimate expectations are closely related to international tax reform. For a long time, many countries, especially developing ones, have often provided tax incentives to investors through general legislation, tax stabilization clauses, or tax rulings to attract foreign investment. However, in recent international tax reforms, preferential tax regimes of countries may be required to be modified or abolished if they do not comply with international standards. For example, the base erosion and profit shifting (BEPS) Action 5 has established a peer review mechanism for harmful preferential tax regimes. As of August 2024, 326 preferential tax regimes have been reviewed, with more than 130 regimes with harmful features being or in the process of being abolished or amended.[12] Another noteworthy reform is the global minimum tax (GMT) reform committed by 139 jurisdictions under the BEPS Inclusive Framework, which establishes a bottom line for corporate income tax competition. Under the GMT reform, many countries need to raise their effective tax rates to 15%, whether by raising statutory tax rates, levying a qualified domestic minimum top-up tax, or adjusting tax incentives. In these scenarios, tax incentives previously enjoyed by foreign investors are likely to be withdrawn, thereby raising questions about whether they violate the FET provision. According to existing arbitration practice, in cases where the host country and the investor have signed a tax stabilization clause, the host country's revocation of tax incentives is likely to be considered a violation of the FET provision.[13] This would place the host country in a dilemma between complying with IIAs obligations and implementing the international tax reforms they have already committed to. In the absence of a tax stabilization clause, the decisions of different arbitration tribunals are not consistent. Most arbitration tribunals believe that without such an agreement, the

11 UNCTAD, *supra* note 3.

12 *See* OECD, INCLUSIVE FRAMEWORK MEMBERS MAKE FURTHER PROGRESS IN ADDRESSING HARMFUL TAX PRACTICES, at https://www.oecd.org/en/about/news/announcements/2024/08/inclusive-framework-members-make-further-progress-in-addressing-harmful-tax-practices.html (Last visited on January 8, 2025).

13 *See* UNCTAD, THE GLOBAL MINIMUM TAX AND INVESTMENT TREATIES: EXPLORING POLICY OPTIONS, at https://unctad.org/system/files/official-document/diaepcbinf2023d7_en.pdf (Last visited on February 17, 2025).

investor should not expect the host country's tax laws to remain unchanged.[14] However, a few arbitration tribunals believe that investors can generally form legitimate expectations based on general legislation.[15] Clearly, such a broad interpretation would significantly lower the threshold for investors to claim against the host country and excessively restrict the policy space for tax law reforms in the host country.

With regard to indirect expropriation, old-generation IIAs typically do not delineate the relationship between taxation and expropriation. The general view is that *bona fide* taxation measures usually do not constitute expropriation, but 'confiscatory' taxation is considered as expropriation. 'Confiscatory' taxation refers to a tax measure that substantially deprives investors of the value of their investment. However, the threshold for 'substantial deprivation' is usually undefined in IIAs and subject to the case-by-case determination of arbitral tribunals. This results in a high degree of uncertainty for states and tax authorities regarding where an arbitral tribunal will draw the line between permissible tax measures and tax measures that amount to confiscation or expropriation of an investment and require compensation.[16]

Regarding the transfer-of-funds provision, old-generation IIAs typically do not explicitly mention that transfers related to an investment may be restricted if tax obligations have not been fulfilled. In practice, many tax measures adopted by countries may impose restrictions on investor's fund transfers, such as withholding taxes, transfer pricing rules, thin capitalization rules, exit taxes, and others. Some argue that even if IIAs do not explicitly address the relationship between tax measures and fund transfers, as long as the host country does not implement tax measures in a selective, arbitrary, or excessive manner, it may be hard to characterize them as a violation.[17] However, the lack of clear guidance in IIAs on this issue means that decisions need to be made by arbitral tribunals on a case-by-case basis, thereby introducing uncertainty for the host country.

3. The Legitimacy Crisis Faced by the ISDS Mechanism and Its

14 *Sergei Paushok, CJSC Golden East Company and CJSC Vostokneftegaz Company v. The Government of Mongolia*, UNCITRAL, Award on Jurisdiction and Liability, April 28, 2011.

15 *Occidental Exploration and Production Company v. The Republic of Ecuador*, LCIA Case No. UN3467, Final Award, July 1, 2004.

16 UNCTAD, *supra* note 3.

17 Sriram Govind & Laura Turcan, *Cross-Border Tax Dispute Resolution in the 21st Century: A Comparative Study of Existing Bilateral and Multilateral Remedies*, 5 Derivatives & Financial Instruments 1, 13 (2017).

Inconsistency with International Tax Dispute Resolution Mechanisms. — The ISDS mechanism is an integral part of IIAs. In many old-generation IIAs, investors can directly sue the host country as independent parties before an arbitral tribunal, without being subject to preconditions such as exhausting local remedies. Arbitral tribunals can review whether the host country's tax measures violate the substantive protection obligations in IIAs, and if so, may require the host country to provide monetary compensation. The arbitral awards can typically be enforced according to different international treaties, depending on the arbitration institution involved.

Despite the importance of the ISDS mechanism for investors seeking remedies, it has many flaws, leading to a legitimacy crisis in recent years. Firstly, due to the lack of clear guidance in IIAs on the relationship between tax measures and substantive investment obligations, arbitral tribunals have significant discretion in their interpretation. Some arbitral tribunals tend to favor investors in their arbitral decisions, disregarding the host country's public interests and unduly restricting its tax sovereignty. Secondly, in past practice, it is not uncommon for arbitral tribunals to provide different or even conflicting interpretations of similar or identical provisions. This makes it difficult for host countries to accurately assess the legality of their tax legislation, and administrative and judicial actions under IIAs, creating uncertainty in exercising tax sovereignty.[18] Thirdly, the legal and arbitration costs of ISDS are often very high,[19] which many developing countries find difficult to afford. Fourthly, taxation is a complex and technical legal field. Tax-related disputes often involve taxpayers' intricate tax planning and the state's public interests, requiring expertise for proper handling. However, many arbitrators in investment arbitration tribunals are not tax experts, which may result in flawed decisions based on a limited understanding of substantive law.[20]

In addition to the flaws of the ISDS mechanism itself, its lack of coordination with international tax dispute resolution mechanisms is also a significant problem. In international tax dispute resolution mechanisms, states have so far relinquished very limited sovereignty. As the primary

18 Liu Sun, *The Issue of Inconsistency in International Investment Arbitration Rulings and Its Resolution*, 6 Studies in Law and Business, 139, 139 (2009).

19 Cui Xiaojing & Sun Yi, *International Investment Arbitration: A New Way to Solve International Tax Disputes*, 4 Journal of Huaqiao University (Philosophy & Social Sciences) 80, 87 (2022).

20 Sriram Govind & Laura Turcan, *supra* note 17.

mechanism for resolving international tax disputes, mutual agreement procedures (MAP) are state-led, and taxpayers are not independent parties. Although some countries have introduced international tax arbitration in recent years, it remains a mechanism for resolving disputes between states, with taxpayers not having independent standing. Moreover, many developing countries still hold reservations or opposition to international tax arbitration, so the scope of its application remains very limited. This sharp contrast with the ISDS mechanism, where investors have independent standing and extensive procedural rights, once again reflects the fragmentation between international tax law and international investment law. As some have pointed out, fragmenting dispute settlement can trigger undesired practices, such as treaty and forum shopping.[21] Given IIAs' broader investment protection standards and pro-investor ISDS mechanism, foreign investors may prefer to bypass international tax dispute resolution mechanisms and resort to the ISDS mechanism to challenge the host country's tax measures. As a result, many tax disputes might end up before investment arbitration tribunals.[22] For countries that are unwilling to relinquish their tax sovereignty, this situation is unexpected and unacceptable.

B. Challenges to Host Country's Tax Sovereignty Posed by Old-Generation IIAs

Tax sovereignty is indeed a cornerstone of national sovereignty. Taxation serves as a primary source of revenue for most modern nations. For instance, Organization for Economic Co-operation and Development (OECD) statistics reveal that between 1965 and 2023, the average tax-to-GDP ratio in OECD countries increased from 24.9% to 33.9%,[23] indicating their growing reliance on taxation over the years. Without the authority to levy and collect taxes, a government would face significant obstacles in fulfilling its typical responsibilities, including infrastructure development, national defense,

21 Javier García Olmedo, *The Fragmentation of International Investment and Tax Dispute Settlement: A Good Idea?*, 3 Leiden Journal of International Law 617, 618 (2023).

22 Julien Chaisse, *Investor-State Arbitration in International Tax Dispute Resolution: A Cut Above Dedicated Tax Dispute Resolution?*, 2 Virginia Tax Review 149, 219 (2016).

23 *See* OECD, REVENUE STATISTICS 2024: HEALTH TAXES IN OECD COUNTRIES, at https://doi.org/10.1787/c87a3da5-en (Last visited on January 8, 2025).

education, healthcare, and other public services.[24] Moreover, taxation is often utilized by countries to achieve various social and political objectives, such as wealth redistribution, support for domestic industries, and addressing regional disparities.[25]

The language used in a tax carve-out clause is crucial because it determines whether taxes are fully or partially excluded from the substantive and/or procedural provisions of IIAs, significantly impacting the tax sovereignty of host countries.[26] As mentioned earlier, old-generation IIAs exhibit limitations in addressing tax matters, thereby challenging the tax sovereignty of host countries. Firstly, the broad and vague substantive protection standards in old-generation IIAs may inappropriately constrain the flexibility of host countries' tax policies. Secondly, the lack of clear guidance in old-generation IIAs regarding the relationship between tax measures and substantive investment obligations, along with the inconsistency in arbitral decisions by international investment arbitration tribunals, can create uncertainty for host countries in their tax legislation, enforcement, and judicial activities, potentially leading to disputes over their legality under IIAs. Lastly, subjecting the taxing powers of host countries to an independent arbitration tribunal, which is an unelected and unaccountable body rather than national parliament, might undermine national sovereignty and limit the states' discretion over tax policies.[27]

More specifically, the challenge to tax sovereignty manifests in the potential conflict between the universally adopted and reasonable tax measures implemented by countries and the obligations under IIAs. In the realm of international taxation, countries have long established various practices based on legitimate regulatory objectives, such as the differentiation between tax residents and non-residents, withholding taxes, and anti-avoidance measures. At the bilateral level, countries have established extensive networks of DTAs to eliminate international double taxation and combat international tax evasion and avoidance. At the multilateral level, countries have increasingly

24 Jennifer Bird-Pollan, *The Sovereign Right to Tax: How Bilateral Investment Treaties Threaten Sovereignty*, 32 Notre Dame Journal of Law, Ethics & Public Policy 107, 119 (2018).

25 Thomas Walde & Abba Kolo, *Investor-State Disputes: The Interface Between Treat-Based International Investment Protection and Fiscal Sovereignty*, 8 Intertax 424, 431 (2007).

26 Jana Kubicová, *BITs and Taxes*, 5 Derivatives & Financial Instruments 1, 6 (2017).

27 Thomas Walde & Abba Kolo, *supra* note 25.

cooperated with each other based on common objectives in recent years. These tax measures, distinct from those characterized by arbitrariness, discrimination or confiscation (which are the ones IIAs should genuinely restrict), are founded on legitimate regulatory objectives and enjoy widespread international acceptance, or are backed by commitments from a broad range of countries. However, the fragmentation between international tax law and international investment law may lead to the unwarranted restriction of countries' *bona fide* exercise of tax sovereignty under IIAs. The previously mentioned GMT reform is a typical example, where an international tax reform committed to by 139 jurisdictions potentially conflicts with the non-discrimination, FET, and expropriation provisions of IIAs. As some have pointed out, this conflict will place many jurisdictions in a dilemma. If they do not implement the GMT, they would suffer fiscal revenue losses due to other jurisdictions imposing top-up taxes. However, if they implement the GMT, they face the risk of violating IIAs.[28] Thus, it is evident that the challenge posed by old-generation IIAs to tax sovereignty has become increasingly prominent and pressing, highlighting the need for comprehensive resolution.

II. RECENT DEVELOPMENT TRENDS OF TAX CARVE-OUT PROVISIONS IN IIAS

In response to the legitimacy crisis of IIAs and the sovereignty challenges they pose, the international community has been reforming the provisions of IIAs in recent years to make them more modern, balanced, and coordinated. One important measure to balance investor rights and host country's regulatory power is to explicitly specify the rights and obligations of contracting parties and investors in IIAs, especially by introducing exception clauses to preserve space for the sovereignty and public interests of contracting parties.[29] Appropriately designed exception clauses can ensure more certainty regarding the interaction between the right to regulate and investment protection, particularly by restricting arbitration tribunals'

28 Zhang Zhiyong, *Global Anti-Base Erosion Rules: Tax Unilateralism Under Multilateral Consensus*, 10 International Taxation in China 37, 43 (2022).

29 Yu Jingsong, *On the Balancing of Investor's Interests and Host Country's Interests in International Investment Treaty Arbitration*, 2 China Legal Science 132, 142 (2011).

interpretive discretion.[30] Furthermore, to address the fragmentation of international law, the principle of systemic integration has been proposed to minimize conflicts between different legal fields and promote their coordination.[31] For example, the UNCTAD has already pointed out that tax policymakers could participate in the development of new IIAs and model agreements, as well as the overall reform of old-generation IIAs, to preserve tax policy space.[32] Against this backdrop, in recent years, an increasing number of countries have paid greater attention to the specificity and importance of taxation when negotiating or amending IIAs.

This article selects several model BITs and free trade agreements (FTAs) since 2012 as samples for the study. Model BITs can reflect the negotiating position of a country, while FTAs can reflect consensus among different countries. As shown in Table 1, tax carve-out clauses in recent model BITs and FTAs have exhibited the following trends: Firstly, standalone tax carve-out clauses have been included, which are more comprehensive and systematic in content. Secondly, the relationship between the substantive protection standards of IIAs and tax measures has been clarified. Finally, joint tax veto mechanisms have been introduced.

Table 1: Overview of Tax Carve-Out Provisions in Selected Model BITs and FTAs

Model BITs and FTAs		Standalone Tax Carve-Out Clauses	Definition of Terms	Clarifying the Priority of DTAs over IIAs	Clarifying the Relationship Between the Substantive Protection Standards of IIAs and Tax Measures	Introducing Joint Tax Veto Mechanisms
Model BITs	*European Union Model Clauses for BITs of 2023*	√	√	√	√	×

30 Robert Brew, *Exception Clauses in International Investment Agreements as a Tool for Appropriately Balancing the Right to Regulate with Investment Protection*, 25 Canterbury Law Review 205, 217 (2019).

31 Asif Qureshi, *Coherence in the Public International Law of Taxation: Developments in International Taxation and Trade and Investment Related Taxation*, 10 Asian Journal of WTO & International Health Law and Policy 193, 214 (2015).

32 UNCTAD, *supra* note 3.

Model BITs and FTAs		Standalone Tax Carve-Out Clauses	Definition of Terms	Clarifying the Priority of DTAs over IIAs	Clarifying the Relationship Between the Substantive Protection Standards of IIAs and Tax Measures	Introducing Joint Tax Veto Mechanisms
Model BITs	*Bulgaria Model BIT of 2023*	√	√	√	√	√
	Canada Model BIT of 2021	√	√	√	√	√
	Slovakia Model BIT of 2019	√	√	√	√	√
	Netherlands Model BIT of 2019	√	×	√	√	×
	Brazil Model BIT of 2015	√	×	√	√	×
	United States Model BIT of 2012	√	×	√	√	√
FTAs	*EU-Canada Comprehensive Economic and Trade Agreement* (CETA)	√	√	√	√	√
	Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP)	√	√	√	√	√
	United States-Mexico-Canada Agreement (USMCA)	√	√	√	√	√
	Regional Comprehensive Economic Partnership (RECP)	√	√	√	√	×

A. Inclusion of Standalone Tax Carve-Out Provisions

Unlike tax carve-outs in old-generation IIAs, which are not standalone provisions but rather subsidiary to other substantive protection clauses, a number of recent model BITs and FTAs have introduced standalone tax carve-out provisions. Such clauses are typically referred to as 'taxation measures' and appear alongside general exceptions, national security exceptions, and other carve-out provisions. A typical standalone tax carve-out provision usually includes the following elements: Firstly, it defines terms such as 'taxation measure', 'tax convention', 'residence', and 'competent tax authorities'. Secondly, it clarifies the priority of DTAs over IIAs. Thirdly, it specifies which taxation measures undertaken by the contracting parties are not subject to the substantive protection standards of IIAs to safeguard the contracting parties' tax sovereignty. Fourthly, it introduces a joint tax veto mechanism. Currently, the tax carve-out provision in the CETA is one of the most comprehensive and detailed provisions, comprising eight paragraphs.

Compared to subsidiary tax carve-out provisions, standalone tax carve-out provisions offer several distinct advantages: Firstly, they reflect the greater importance attached by the contracting parties to taxation matters. It is noteworthy that a number of developed economies, such as the United States, Canada, the Netherlands, and the European Union, have introduced such clauses in their model BITs. This is because even developed and capital-exporting countries heavily rely on tax policies, particularly direct taxes, to meet their budgetary requirements and other economic goals.[33] Therefore, tax carve-out provisions are of paramount significance for both developing and developed countries. Secondly, they enable a more balanced treatment of the relationship between the tax sovereignty of the host country and the protection of investor rights. On the one hand, by specifying that legitimate and reasonable taxation measures taken by the host country are not subject to the substantive protection standards of IIAs, they help to safeguard the host country's tax sovereignty. On the other hand, because host countries may misuse taxation measures to unfairly treat or even destroy the

33 Maira de Melo Vieira, *supra* note 9, 79.

investments of foreign investors, many IIAs do not entirely exclude taxation measures, so as to protect the legitimate rights of investors. Finally, they help to promote the coordinated development of international investment law and international tax law. By coordinating the rules of the two legal domains at the substantive and procedural levels, they help to reduce conflicts and frictions between international investment law and international tax law and prevent forum-shopping issues.

B. Clarification of the Relationship Between IIAs Substantive Obligations and Tax Measures

An important trend in recent IIAs is the explicit clarification of the relationship between substantive protection standards and taxation measures. They specify which taxation measures shall be subject to the substantive protection standards in IIAs, and which ones can be carved out. It can be observed that increasing deference is being granted by recent IIAs to prevailing practices in the field of international taxation, such as the distinction between tax residents and non-residents, and taxation measures aimed at preventing tax avoidance or evasion. This is significant for rebalancing the tax sovereignty of host countries and the rights of investors. However, as there is no universally accepted model BIT in the field of international investment, akin to the model tax convention of the OECD or the United Nations in the tax realm, there are significant differences in the provisions of different IIAs regarding this issue. Therefore, there remains a necessity to coordinate and improve the provisions of IIAs regarding this matter. The following part will discuss in more detail how recent IIAs address the relationship between IIAs substantive obligations and taxation measures.

1. Priority of DTAs over IIAs. — As mentioned earlier, DTAs and IIAs have evolved into relatively independent treaty networks. In some cases, tax matters may be subject to regulation by both DTAs and IIAs, leading to potential rule conflicts. To address this issue, many recent IIAs stipulate that they should not affect the rights and obligations of contracting parties under any tax convention. In the event of any inconsistency between IIAs and any such tax convention, the tax convention shall prevail to the extent of the inconsistency. The model BITs of the European Union, Bulgaria, Canada, Slovakia, the Netherlands, Brazil, and the United States, as well as FTAs such as CETA, CPTPP, USMCA, and RCEP, all include this provision. This is based on the *lex specialis* principle, meaning that a tax treaty, being more specific in nature, should prevail over the general rules that affect taxation in IIAs.[34] Therefore, in situations where there are inconsistencies between DTAs and IIAs, this provision helps ensure that tax issues are handled in accordance with the provisions of DTAs, which better aligns with the specificity of taxation.[35]

2. Different Models of Exempting Tax Measures from IIAs Substantive Obligations. — The extent to which tax measures are excluded from IIAs determines the extent to which the host country's tax policy space is preserved. On this issue, there are significant differences in the provisions of different IIAs. One pattern is that IIAs generally do not apply to tax measures, except where otherwise provided. For example, the model BITs of Canada, Slovakia, and the United States provide that except as set out in the taxation carve-out clause, the IIAs do not apply to a taxation measure. Among them, Canada's model BIT provides that NT, MFN, umbrella clause, and expropriation provisions apply to taxation measures, subject to relevant exceptions or conditions. Slovakia's model BIT provides that FET and expropriation provisions apply to tax measures. The United States' model BIT provides that the expropriation and performance requirements apply to tax measures.

Another pattern is that IIAs generally apply to tax measures, except where otherwise provided. For example, the model BITs of the European Union and Bulgaria provide that non-discriminatory treatment and transfer-of-funds provisions shall not apply to an advantage accorded by a contracting party pursuant to a tax convention. Additionally, they provide that certain measures aimed at ensuring the equitable or effective imposition or collection of direct taxes shall not be affected by IIAs.

The high degree of heterogeneity among different IIAs on this issue may be due to the long-standing lack of a unified understanding in the international community regarding the extent to which IIAs substantive obligations should apply to tax measures, reflecting the fragmented structure

34 Sriram Govind & Laura Turcan, *supra* note 17, 12.

35 Cui Xiaojing & Chen Jingxian, *Analysis of Taxation Measures Clause in the CPTPP and China's Countermeasure*, 2 Journal of Henan Normal University (Philosophy and Social Sciences Edition) 53, 55 (2020).

within the international investment law system. For a particular host country, if the degree of constraint on its tax measures varies significantly under different IIAs, this may bring uncertainty to its exercise of tax sovereignty. Therefore, there is a need for the international community to strengthen coordination on this issue.

3. Consideration of Tax Residency in Assessing the 'Same Situation'. — As mentioned earlier, international investment law and international tax law use different standards in determining non-discrimination, which may lead to conflicts. To address this issue, article 28.7(1) of the CETA provides that 'nothing in this agreement shall be construed to prevent a contracting party from adopting or maintaining any taxation measure that distinguishes between persons who are not in the same situation, in particular with regard to their place of residence or with regard to the place where their capital is invested'. Similar provisions can also be found in the model BITs of the European Union and Bulgaria.

Such provisions help to afford deference to prevailing practices in international tax law. In tax law theory, tax residents and non-residents are generally considered to be in different situations. For tax residents, since they derive significant personal benefits from the country, such as public goods and services, taxing them regardless of the source of their income is justified.[36] In contrast, due to the limited connection between non-resident taxpayers and the source country, and the general lack of detailed knowledge and control over the global income of non-residents by tax authorities, the source country typically only taxes the income earned by non-resident taxpayers within its borders. Given these distinct characteristics, the reasonable tax measures implemented by host countries to differentiate between tax residents and non-residents should not be construed as violating the NT or MFN provisions of IIAs.

4. Upholding the Right of Host Countries to Implement Measures to Prevent Tax Evasion or Avoidance. — Since its inception, tax laws have been inherently susceptible to evasion or avoidance by taxpayers. With the development of economic globalization, many multinational corporations have exploited the differences and mismatches in tax systems between

36 BRIAN J. ARNOLD, INTERNATIONAL TAX PRIMER, at 30 (Wolters Kluwer, 2016).

countries to reduce the overall tax burden of their groups, highlighting the issue of international tax evasion and avoidance. This not only erodes the tax base of countries, but also undermines the fairness of international taxation.

In recent years, the international community has been strengthening cooperation to combat international tax avoidance and evasion. To implement the outputs of the BEPS Action Plan, many countries have introduced anti-avoidance rules in their tax laws, such as controlled foreign companies, thin capitalization, transfer pricing, and offshore indirect transfers. These anti-avoidance rules, by denying or adjusting taxpayers' tax avoidance arrangements, restrict taxpayers from obtaining undue tax benefits through the abuse of tax laws. In some cases, measures taken by host countries to prevent tax evasion or avoidance may conflict with obligations under IIAs.

To address this issue, article 28.7(2) of the CETA and article 10(2) of the *Netherlands Model BIT* provide that 'nothing in this agreement shall be construed to prevent a contracting party from adopting or maintaining any taxation measure aimed at preventing the avoidance or evasion of taxes pursuant to its tax laws or tax conventions'. Such provisions not only are crucial for maintaining the ability of host countries to combat tax evasion or avoidance, but also align with the recent trend in the international tax arena to address BEPS problems.

However, the aforementioned provisions seem not to impose any restrictions on 'taxation measures aimed at preventing the avoidance or evasion of taxes'. This unrestricted approach can be problematic, because some countries may adopt aggressive anti-tax avoidance measures that adversely affect the legitimate rights of investors. For example, India has been embroiled in controversy with foreign investors due to its retroactive taxation of offshore indirect transfer transactions. Under *India's Income Tax Act of 1961*, India only had the jurisdiction to tax direct transfer transactions and not tax indirect transfer transactions. Around 2006, multinational companies such as Vodafone Group and Cairn Energy PLC engaged in large-scale indirect transfer transactions. In 2007, Indian tax authorities issued tax notices to these companies, attempting to tax the indirect transfer transactions, with Vodafone Group and Cairn Energy PLC facing tax demands of up to $2.1 billion and $1.6 billion respectively. In response to the tax actions of Indian tax authorities, some multinational companies sought domestic legal remedies in India. In 2012, the Supreme Court of India ruled in the *Vodafone* case that Indian tax authorities do not have the jurisdiction to tax indirect transfer transactions.[37] However, in 2012, the Indian government proposed a tax law amendment to overturn the Supreme Court's judgment, expanding the scope of *India's Income Tax Act of 1961* to include indirect transfer transactions and retroactively applying the amendment to April 1, 1962. Subsequently, Indian tax authorities restarted tax proceedings against Vodafone Group and Cairn Energy PLC and took enforcement measures such as forced asset sales.[38] In the case of *Cairn v. India*, despite India's claim that its measures were anti-tax avoidance measures, the arbitration tribunal found that India's tax measures were not specifically targeted at tax avoidance, but applicable to any type of indirect transfer transaction. Furthermore, the arbitration tribunal noted that India's modification of tax laws and the 50-year retroactive period deprived investors of the ability to plan their activities considering the legal consequences, imposed new tax burdens on them, and violated the principle of legal certainty included in the FET provision.[39] This practice was widely considered to seriously undermine the legitimate rights of investors and worsen India's investment and business environment, affecting its international image.[40]

Therefore, it is necessary to limit the qualified tax measures that are eligible for exclusion from IIAs to prevent host countries from adopting arbitrary, unreasonable, and aggressive anti-tax avoidance measures. For example, the *European Union Model BIT* requires that 'such measures are not applied in a manner which would constitute a means of arbitrary or unjustifiable discrimination between countries where like conditions prevail, or a disguised restriction on trade and investment'.

5. Clarifying the Right of Host Countries to Prospectively Amend Tax Laws. — As discussed earlier, amendments to tax laws by the host countries may increase the tax burden on investors, leading to disputes over whether such amendments violate the FET standard. Some international investment

37 Supreme Court of India, *Vodafone International Holdings B.V. v. Union of India*, Civil Appeal No. 733 of 2012 (arising out of S.L.P. (C) No. 26529 of 2010), Judgment, January 20, 2012.

38 *Vodafone International Holdings BV v. Government of India* [I], PCA Case No. 2016-35.

39 *Cairn Energy PLC and Cairn UK Holdings Limited v. The Republic of India*, PCA Case No. 2016-07, Final Award, December 21, 2020.

40 Prabhash Ranjan, *Country Note: Retroactive Taxation, Investor-State Dispute Settlement, and India: Life Comes a Full Circle*, 11 Intertax 824, 835 (2022).

arbitration tribunals adopted a broad interpretation, considering that investors can generally form legitimate expectations based on general legislation,[41] thus limiting the ability of host countries to reform tax laws.

To address this issue, article 28.7(5) of the CETA clarifies that 'the fact that a taxation measure constitutes a significant amendment to an existing taxation measure, takes immediate effect upon announcement, clarifies the intended application of an existing taxation measure, or has an unexpected impact on an investor or covered investment, does not, in itself, constitute a violation of the FET standard'. This provision distinguishes between retroactive and prospective tax measures. According to the principle of non-retroactivity, it is generally believed that tax laws should only apply to events that occur after their enactment.[42] In the case of *Cairn v. India*, the arbitration tribunal also pointed out that tax laws should not retroactively apply unless justified by public interest and proportionality.[43] In contrast, prospective amendments to tax laws are generally considered within the scope of tax sovereignty. Investors should be aware that laws may change over time and should not expect the host country's tax laws to remain unchanged.[44] In the absence of specific commitments to stabilize tax laws, the fact that a host country makes prospective changes to its tax laws should not be considered a violation of the FET standard, as long as such changes are not arbitrary or discriminatory. By clarifying the relationship between tax law reform and the FET standard, article 28.7(5) of the CETA can limit the discretion of international investment arbitration tribunals and safeguard the right of host countries to make prospective changes to their tax laws.

6. Allowing Host Countries to Prevent or Delay Transfers Through Bona Fide Application of Tax Laws. — As mentioned earlier, many tax measures adopted by countries may impose restrictions on investors' fund transfers. In order to avoid rule conflicts, some recent IIAs have made fulfillment of tax obligations a prerequisite for such transfers. For example, article 10.9(3) of the RCEP stipulates that a contracting party may prevent or delay a transfer through the equitable, non-discriminatory, and good-faith application of its

41 *Supra* note 15.

42 Xiong Wei, *The Rule of Law in Finance and Taxation: From Ideal Scenarios to Practical Demands*, 5 Tsinghua Law Journal 22, 31 (2014).

43 *Supra* note 39.

44 *Supra* note 14.

laws and regulations relating to taxation. It further elaborates that the term 'taxation' also includes the adoption or enforcement of any taxation measure aimed at ensuring the equitable or effective imposition or collection of taxes, including any taxation measure that differentiates between persons based on their place of residence or incorporation.

This provision is detailed and balanced. Firstly, it allows host countries to prevent or delay transfers through taxation and provides a broad definition of 'taxation'. This helps prevent investors from transferring funds out of the host country without fulfilling tax obligations, which would make it difficult for the host country to effectively collect taxes. Secondly, it requires host countries' tax laws to be applied in an equitable, non-discriminatory, and good-faith manner, which can prevent the host country from abusing tax measures to restrict investors' legitimate fund transfers.

C. Introduction of Joint Tax Veto Mechanisms

In terms of the resolution of tax-related investment disputes, an important development trend has been the introduction of joint tax veto mechanisms in recent IIAs. The model BITs of Bulgaria, Slovakia, Canada, and the United States, as well as FTAs such as CETA, CPTPP, and USMCA, all include such mechanisms. A typical joint tax veto mechanism usually stipulates that if an issue arises regarding whether there is an inconsistency between IIAs and DTAs or whether the host country's tax measures violate obligations under IIAs, the issue shall be referred to the designated authorities of the contracting parties for consultation and joint determination. The designated authorities of the contracting parties shall make a determination on the issue within a certain period (e.g., six months). During this period, ISDS proceedings shall be suspended. A joint determination by the parties shall be binding on the arbitration tribunal. However, if the contracting parties fail to agree to consider the issue within the prescribed period or fail to make a joint determination, the suspension of the ISDS proceedings shall no longer apply, and the investor may proceed with its claim. Additionally, each party shall ensure that its delegation for the consultations includes persons with relevant expertise in taxation, including representatives from relevant tax authorities of each party.

It can be seen that the provisions regarding the joint tax veto mechanism are very detailed, covering matters of consultation, deadlines, personnel, and binding force. As a pre-procedure to the traditional ISDS mechanism, the joint tax veto mechanism has the following important functions.

Firstly, the joint tax veto mechanism can handle the tax sovereignty of contracting states and the rights of investors in a more balanced manner. Under the joint tax veto mechanism, the tax authorities of the contracting parties have priority in dealing with tax-related investment disputes. This essentially puts the decision on challenging the host country's tax measures into the hands of the investor's home country. Since the sovereign rights of the home country might also be challenged, it has an incentive to consider the issue in a more cautious and balanced manner. In other words, the home country needs to consider not only safeguarding the interests of its investors, but also the potential challenges to its tax sovereignty.[45] If the contracting parties jointly determine that the tax measures do not violate the obligations under IIAs, the investor can no longer challenge the host country's tax measures through the ISDS mechanism. Therefore, the joint tax veto mechanism can serve as a 'filter' for international investment arbitration cases and a 'safety valve' for national tax sovereignty. However, if the contracting parties fail to make a joint determination, the investor can still resort to the ISDS mechanism for relief.[46]

Secondly, the joint tax veto mechanism can ensure that tax-related investment disputes are handled by persons with expertise in taxation. As mentioned earlier, taxation is a complex and technical legal area, but many arbitrators in investment arbitration tribunals are not tax experts. By requiring persons participating in consultations to have tax knowledge, especially including representatives from the tax authorities of the contracting parties, the joint tax veto mechanism can ensure the professionalism of dispute resolution and better consider the public interests reflected in taxation.

Finally, the joint tax veto mechanism can promote more coordinated development of dispute resolution mechanisms in the fields of international investment and taxation. As mentioned earlier, there is an obvious fragmentation in the dispute resolution mechanisms in the fields of

45 Jennifer Bird-Pollan, *supra* note 24, 129.

46 Li Qingling, *A Brief Discussion on the Tax Arbitration in the International Investment Agreements: A Perspective on Chinese Treaty Experience*, 1 World Trade Organization Focus 68, 72 (2013).

international investment and taxation. The introduction of the joint tax veto mechanism makes the dispute resolution mechanisms in these two fields structurally more similar, namely the two-tier structure of 'political consultation — legal arbitration'. For one thing, the joint tax veto mechanism is very similar to MAP, as both involve consultations by the contracting parties, have obvious political characteristics, and serve as pre-procedures for arbitration. For another, if the contracting parties fail to reach an agreement, investors/taxpayers can still resort to international investment/tax arbitration. This not only provides a fail-safe mechanism for the rights relief of investors/taxpayers, but also incentivizes the contracting parties to strive for consensus in consultations as much as possible, thereby avoiding the possibility of arbitration. This coordinated development of dispute resolution mechanisms in the fields of international investment and taxation helps alleviate the problem of forum shopping.

III. CURRENT SITUATION AND IMPROVEMENT RECOMMENDATIONS FOR TAX CARVE-OUT PROVISIONS IN CHINESE IIAS

A. Current Situation of Tax Carve-Out Provisions in Chinese IIAs

This section will provide a quantitative and qualitative analysis of China's IIAs' tax carve-out provisions. Based on the quantitative and qualitative analysis, it will identify the limitations of the tax carve-out provisions in China's IIAs.

1. Quantitative Analysis on Tax Carve-Out Provisions in Chinese IIAs. — According to the UNCTAD database, as of January 8, 2025, China has 134 IIAs (including BITs and FTAs) currently in effect.[47] A quantitative analysis reveals the following characteristics of tax carve-out provisions in Chinese IIAs.

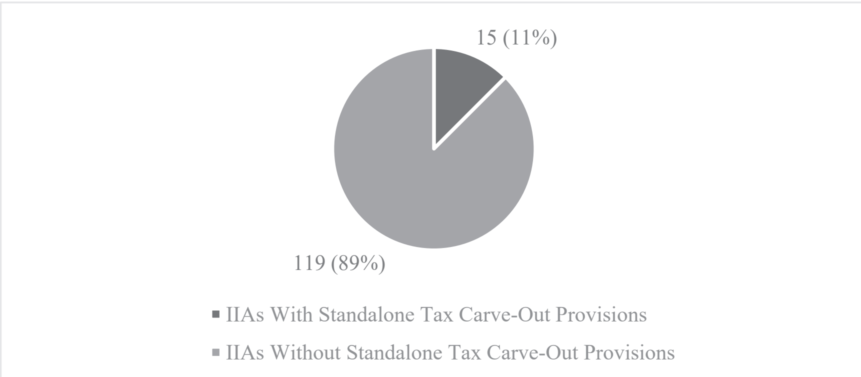
Firstly, as illustrated in Figure 1, only 15 IIAs contain standalone tax carve-out provisions,[48] accounting for approximately 11% of all IIAs. This is mainly because most of China's IIAs were signed in earlier years when the

47 UNCTAD DATABASE, *supra* note 1.

48 Including: *China-Angola BIT of 2023*, *China-Ecuador FTA of 2023*, *China-Nicaragua FTA of 2023*, *RCEP of 2020*, *Cambodia-China FTA of 2020*, *China-Mauritius FTA of 2019*, *China-Georgia FTA of 2017*, *Australia-China FTA of 2015*, *China-Korea, Republic of FTA of 2015*, *China-Iceland FTA of 2013*, *Canada-China BIT of 2012*, *China-Japan-Korea, Republic of Trilateral Investment Agreement of 2012*, *Chile-China FTA Investment Agreement of 2012*, *China-Peru FTA of 2009*, and *China-New Zealand FTA of 2008.*

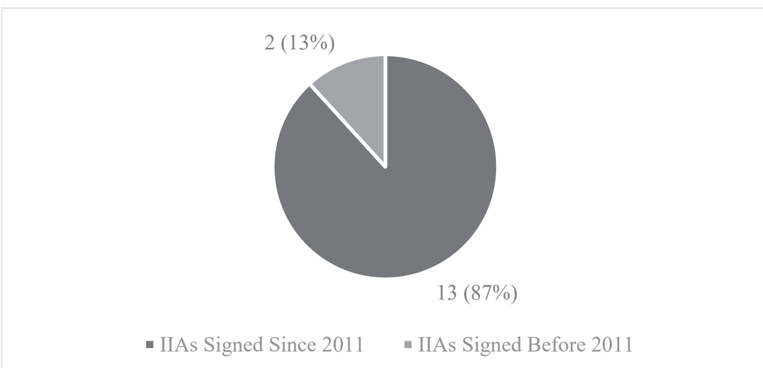
negotiators lacked sufficient understanding of taxation matters, resulting in old-generation IIAs that did not comprehensively or systematically address taxation issues. The absence of standalone tax carve-out provisions in most of China's IIAs may pose challenges to China's tax sovereignty.

Figure 1: Presence of Standalone Tax Carve-Out Provisions in China's IIAs



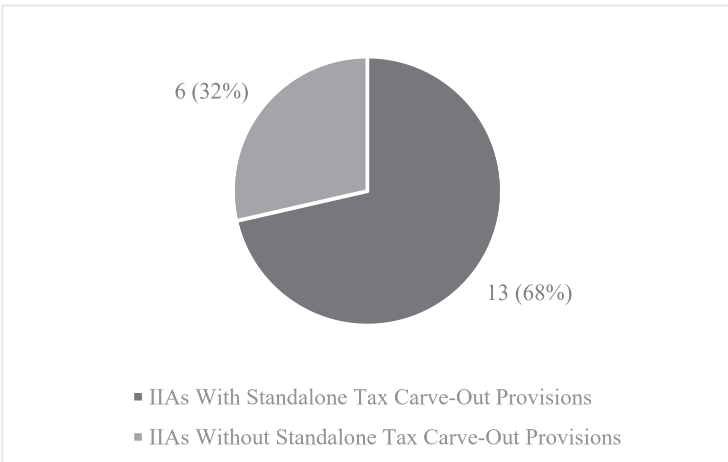
Secondly, as shown in Figure 2, out of the 15 IIAs containing standalone tax carve-out provisions, 13 have been signed since 2011, accounting for approximately 87% of all IIAs with such clauses. This reflects China's increasing attention to the specificity and importance of taxation and its conscious introduction of standalone tax carve-out provisions in the new-generation IIAs (especially in FTAs), which is a positive trend.

Figure 2: The Signing Periods of China's IIAs with Standalone Tax Carve-Out Provisions



However, as depicted in Figure 3, out of the 19 IIAs signed by China since 2011, 6 still do not contain standalone tax carve-out provisions,[49] accounting for approximately 32% of the new-generation IIAs. Therefore, despite the increasing importance of tax carve-out clauses in China's new-generation IIAs, they have not yet become a universally applied standard. Among these IIAs that do not include standalone tax carve-out provisions, a considerable portion belongs to the BIT category. This suggests that China's focus on tax carve-out clauses appears to be less pronounced in BIT negotiations compared to negotiations involving FTAs.

Figure 3: The Status of Standalone Tax Carve-Out Provisions in China's New-Generation IIAs



2. Qualitative Analysis on Tax Carve-Out Provisions in Chinese IIAs. — For the 15 IIAs containing standalone tax carve-out provisions, several common characteristics can be observed: Firstly, many agreements define concepts such as 'taxation measures', 'tax conventions', and 'competent tax authorities'. Because FTAs typically include chapters related to trade that address tariff issues, they often exclude customs duties when defining taxation measures. Secondly, nearly all of these agreements emphasize that they do not affect the rights and obligations of the parties under any existing tax convention. In cases of inconsistency between the investment agreement and a

49 Including: *China-Serbia FTA of 2023*, *China-Turkey BIT of 2015*, *China-Switzerland FTA of 2013*, *China-United Republic of Tanzania BIT of 2013*, *China-Congo, Democratic Republic of the BIT of 2011*, and *China-Uzbekistan BIT of 2011*.

tax convention, the tax convention prevails to resolve the inconsistency. Some agreements further specify that the competent tax authorities of the contracting parties have sole responsibility for determining whether any inconsistency exists. Thirdly, nearly all of these agreements explicitly state that they do not apply to taxation measures unless specified otherwise. Fourthly, nearly all of these agreements introduce joint tax veto mechanisms. These rules have become key components of China's IIAs' tax carve-out provisions, aligning with the international development trends mentioned earlier.

However, these 15 IIAs containing standalone tax carve-out provisions still exhibit significant differences in their content. Regarding the models of exempting tax measures from IIAs substantive obligations, despite most of these agreements generally excluding taxation measures from their scope of application unless otherwise specified, there are still significant differences in specific provisions among different agreements.

Additionally, the tax carve-out provisions of these IIAs are still not comprehensive enough, lacking guidance on certain issues. Firstly, although many IIAs require investors asserting that a taxation measure involves expropriation to refer the case to competent tax authorities for consultation before initiating arbitration proceedings, they do not clarify the relationship between taxation measures and expropriation provisions from a substantive perspective. Only the *China-Angola BIT of 2023* and the *China-Nicaragua FTA of 2023* clarify that measures related to tax preservation or punishment against illegal activities, which are non-discriminatory and adopted or implemented to levy or collect taxes in a fair and effective manner, do not constitute expropriation. Secondly, only the RCEP allows host countries to prevent or delay transfers through *bona fide* application of tax laws, while other IIAs do not address this issue. Thirdly, only the RCEP and the *China-New Zealand FTA of 2008* stipulate that nothing in the IIAs shall obligate a party to extend to any other party the benefit of any treatment, preference, or privilege arising from any existing or future tax convention by which the party is bound. Furthermore, none of these IIAs provide any guidance on the compatibility of differentiated tax treatments based on tax residency, measures to prevent tax evasion and avoidance, or prospective changes in tax laws with IIAs obligations, as discussed earlier.

3. Limitations of Tax Carve-Out Provisions in Chinese IIAs. — Based on the quantitative and qualitative analysis above, several limitations of tax carve-out provisions in Chinese IIAs can be identified: Firstly, most of China's IIAs, classified as old-generation IIAs, do not include standalone tax carve-out provisions. The provisions related to taxation matters in these agreements are relatively simple and scattered, or even absent. This not only may challenge China's tax sovereignty, but also could lead to rule conflicts between international tax law and international investment law. Secondly, despite the positive trend of introducing standalone tax carve-out provisions in a number of new-generation IIAs signed by China, there are still some newly signed IIAs that do not include such provisions. Thirdly, the content of tax carve-out clauses in China's IIAs still needs more uniformity and comprehensiveness. For one thing, there are differences in provisions among different agreements. For another, these provisions still lack guidance on certain issues, particularly those related to frequently invoked clauses by investors such as FET and expropriation.

B. Recommendations for Improving Tax Carve-Out Provisions in Chinese IIAs

The improvement of tax carve-out provisions in China's IIAs is a systematic project. At the level of general principles, a more balanced and coordinated approach should be adopted. In terms of the content of the provisions, it is necessary to relatively unify the expression of tax carve-out clauses. Furthermore, given the vast network of China's IIAs, it is essential to explore more efficient ways to upgrade tax carve-out provisions.

1. Adopting a More Balanced and Coordinated Approach. — As discussed earlier, the international trend regarding tax carve-out provisions in IIAs is to shift from an unbalanced and fragmented approach towards a more balanced and coordinated approach. This provides beneficial guidance for China to enhance its tax carve-out provisions. As China has transitioned from a large capital importer focused on absorbing foreign direct investment to a country with a dual identity as both a capital importer and exporter, emphasizing both foreign investment attraction and outbound investments,[50]

50 Wu Qiaofang, *Research on Enhancing Bilateral Investment Protection in the 'Belt and Road' Countries: Based on the Current China-Sri Lanka BIT*, 1 China Legal Science 3, 16 (2024); Shen Wei, *International Investment Agreements' Structural Re-Orientation and China's Responsive Approach*, 2 Journal of Comparative Law 191, 203 (2024).

it is crucial to achieve a balanced protection of tax sovereignty and investor rights through carefully crafted provisions in IIAs.

On one hand, taxation plays a fundamental, pivotal, and safeguarding role in China. Taxation has long been the primary source of fiscal revenue in China, accounting for around 79.6% of fiscal revenue in 2024.[51] Moreover, taxation is a critical tool for macroeconomic regulation in China, playing important roles in encouraging investment and innovation, promoting industrial and regional development, and achieving income redistribution. Additionally, China has been actively pursuing domestic tax reforms and participating in numerous international tax reforms under frameworks like the Inclusive Framework on BEPS and the United Nations. Therefore, when designing tax carve-out provisions, it is necessary to uphold China's tax sovereignty.

On the other hand, in recent years, as the scale of Chinese outbound investment has continued to grow, Chinese enterprises have encountered increasing tax legal risks in host countries. The reasons for these tax risks are multifaceted: The first reason is the imperfect tax systems in some host countries, characterized by sketchy and unstable tax legislation, unrestricted discretion of tax authorities, and a lack of independence and expertise of courts. Secondly, since the implementation of the BEPS Action Plan, countries have adopted increasingly complex and stringent anti-tax avoidance measures. Some countries may implement overly aggressive and poorly designed anti-tax avoidance measures that infringe upon investors' legitimate rights. Moreover, with the rise of trade and investment protectionism, some countries may abuse tax measures, turning them from legitimate tools for fiscal revenue and macroeconomic regulation into barriers to trade and investment. A typical example is the large-scale tax audit conducted by Indian tax authorities on Chinese smartphone companies such as Xiaomi and OPPO in 2022. During this tax investigation, Chinese smartphone companies became one of the primary targets. India not only summoned some executives of Xiaomi in India and froze its substantial funds, but also sought to recover substantial tax payments from these Chinese enterprises. Such discriminatory tax investigations will infringe upon the legitimate rights of Chinese enterprises, posing serious threats to their operational security and

51 *See* STATE COUNCIL, FISCAL REVENUE AND EXPENDITURE REPORT FOR 2024, at https://www.gov.cn/lianbo/bumen/202501/content_7001088.htm (Last visited on February 17, 2025).

competitiveness. Therefore, it is important to note that the significance and sensitivity of tax sovereignty do not justify the operation of taxation outside the rule of law. As an external constraint on tax sovereignty, IIAs can play a role in promoting the rule of law in taxation.[52] When designing tax carve-out provisions, it is necessary to distinguish between the reasonable exercise and abuse of tax sovereignty, and to impose necessary constraints on host countries' tax measures. In other words, tax measures should be applied in a *bona fide* and non-discriminatory manner and should not constitute a disguised restriction on trade and investment. In addition, a notable trend in recent years is that a few countries like India have completely excluded tax measures from the scope of application in their model BITs.[53] Although this approach maximizes the host country's policy space for taxation, it fails to provide necessary protection for investors. In cases where host countries misuse tax measures to destroy the investment, investors would be unable to seek remedies under IIAs. Therefore, this approach should be avoided during treaty negotiations.

Additionally, as with most other countries, tax and investment matters in China are overseen by different government departments. The negotiation of IIAs falls under the responsibility of the Ministry of Commerce, while the formulation of tax policies and negotiations of DTAs are managed by the Ministry of Finance and the State Taxation Administration. Due to the lack of a normalized inter-departmental coordination mechanism to synchronize investment and tax policies, China faces similar fragmentation issues between tax laws and investment laws. Therefore, it is necessary to strengthen cooperation between tax and investment authorities. When negotiating IIAs, the investment department can invite representatives from the tax department to better address the relationship between IIAs and tax measures. Similarly, when formulating tax policies that may impact foreign investment, the tax department can consult with the investment department to avoid conflicts with IIAs obligations. In this regard, a normalized

52 Cai Congyan, *Taxation Measures in International Investment Treaties*, 2 Wuhan University International Law Review 113, 116 (2010).

53 Article 2.4 of the *2015 India Model BIT* stipulates that the treaty shall not apply to any law or measure regarding taxation, including measures taken to enforce taxation obligations. For greater certainty, it is clarified that where the state in which investment is made decides that conduct alleged to be a breach of its obligations under this treaty is a subject matter of taxation, such decision of that state, whether before or after the commencement of arbitral proceedings, shall be nonjusticiable and shall not be open to any arbitration tribunal to review such decision.

inter-departmental coordination mechanism established through legal documents, with clearly defined responsibilities, cooperation models and procedures, can ensure efficient and stable cooperation between investment and tax departments.

2. Relatively Unifying the Expression of Tax Carve-Out Provisions. — As previously mentioned, the content of tax carve-out clauses in China's IIAs still needs more uniformity and comprehensiveness. Therefore, it remains necessary to relatively unify the expression of tax carve-out provisions to provide a clearer, more stable, and more predictable environment for China to exercise its tax sovereignty and for Chinese investors seeking remedies abroad. Developing a model tax carve-out clause by the investment and tax authorities, based on China's national stance and reflecting international trends, can serve as a useful benchmark for China in treaty negotiations.

The model clause could include the following elements: Firstly, concepts such as 'taxation measures', 'tax convention', and 'competent tax authorities' should be clearly defined. Among these, the definition and interpretation of 'taxation measures' are crucial, determining whether the measures taken by the host country can be exempted under the tax carve-out provisions. Secondly, given China's extensive network of DTAs and IIAs, it is necessary to clarify the priority of DTAs over IIAs and the exclusive authority of tax authorities to determine any inconsistency between them. Thirdly, the following tax measures taken by the host country in an equitable, non-discriminatory, and good-faith manner should not be restricted by the IIA: (1) measures that distinguish between persons who are not in the same situation, particularly regarding their place of residence or the place where their capital is invested, (2) measures aimed at preventing the avoidance or evasion of taxes pursuant to its tax laws or tax conventions, (3) measures to implement widely endorsed international tax reforms such as the global minimum tax reform, and (4) measures to prevent or delay transfer. This clause respects common practices in international tax law while preventing the host country from abusing tax measures. Fourthly, it should be clearly stated that the fact that a taxation measure constitutes a significant amendment to an existing measure, takes immediate effect as of its announcement, clarifies the intended application of an existing measure, or has an unexpected impact on an investor or covered investment, does not, in and of itself, constitute a violation of the FET standard. Fifthly, detailed provisions on the joint tax veto mechanism, including the matters for consultation, time limits, personnel involved, and its binding nature, should be specified.

3. Exploring More Efficient Ways to Upgrade Tax Carve-Out Provisions. — For China and other countries, a significant portion of IIAs belong to the old generation. This means that upgrading tax carve-out provisions by individually revising IIAs through bilateral negotiations with contracting partners would be a highly burdensome task, reducing the likelihood of successful and efficient reforms. In this regard, international investment law can learn from the successful experience of international tax law in modernizing DTAs.

In fact, both the international tax and investment systems face essentially the same problem of how to rapidly amend thousands of bilateral agreements to address the legitimacy crises. Almost a decade ago, the multilateral instrument was developed in the field of international tax law as an innovative solution. To address the BEPS issues, the 2015 BEPS Action Plan proposed a package of international minimum standards to update DTAs. However, revising over 3,000 DTAs through bilateral negotiations would be time-consuming and costly, and it would be difficult to ensure the relative uniformity of the treaty texts. Therefore, the OECD innovatively developed the *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS* (BEPS MLI), the first multilateral instrument in the field of international tax law, to update existing DTAs in bulk. In the GMT reform, to introduce the Subject to Tax Rule (STTR) into DTAs, the OECD released the *Multilateral Convention to Facilitate the Implementation of the Pillar Two Subject to Tax Rule* (STTR MLI) in October 2023, which is the second multilateral instrument in international tax law.

As powerful tools for modernizing DTAs, multilateral instruments have several advantages that are also crucial for the international investment system. Firstly, as a multilateral tool, the MLI can efficiently update bilateral agreements, whether it involves modifying a series of provisions (like the BEPS MLI) or just a specific provision (like the STTR MLI). Contracting parties only need to match each other's positions under the framework of the MLI to amend bilateral agreements, rather than renegotiating them one by one.

Secondly, since the MLI is merely a tool for modifying bilateral agreements, rather than a traditional multilateral convention that stipulates rights and obligations, it can retain rather than replace the bilateral governance structure of the tax or investment regime, thus reducing the intensity of the reforms and the obstacles faced. Thirdly, by setting international minimum standards while offering states the opportunity to select from different compliance options and to contract out of or around its provisions, the MLI can maintain a balance between uniformity and flexibility.[54]

In terms of feasibility, the UNCTAD has already identified the MLI as a potential model for reforming IIAs.[55] However, due to significant differences in countries' positions on IIA reforms, using the MLI to amend the entire IIAs might face substantial challenges. Therefore, it is more feasible to use the MLI to amend a specific provision of IIAs, on which countries can relatively easily reach a consensus. Since tax issues under the framework of IIAs have gained increasing attention from international organizations and countries in recent years, tax carve-out provisions can be a good starting point for exploring the use of the MLI. Therefore, China can strengthen its cooperation with international organizations such as the UNCTAD to explore the development of an MLI to upgrade the tax carve-out provisions in existing old-generation IIAs.

IV. CONCLUSION

In the past, there has been a lack of coordination between international tax law and international investment law. In negotiations of old-generation IIAs, many contracting parties did not fully understand the impact of IIAs on tax measures, resulting in deficiencies in addressing tax matters. Most old-generation IIAs do not include standalone tax carve-out provisions, leading to disputes over whether tax measures of the host country violate various provisions such as NT, MFN, FET, expropriation, or transfer of funds. Additionally, the ISDS mechanism faces legitimacy crises and is incoherent with international tax dispute resolution mechanisms. These deficiencies

54 Wolfgang Alschner, *The OECD Multilateral Tax Instrument: A Model for Reforming the International Investment Regime?*, 1 Brooklyn Journal of International Law 1, 4-5 (2019).

55 *See* UNCTAD, WORLD INVESTMENT REPORT 2015: REFORMING INTERNATIONAL INVESTMENT GOVERNANCE, at https://unctad.org/system/files/official-document/wir2015_en.pdf (Last visited on February 17, 2025).

challenge tax sovereignty, which is a cornerstone of national sovereignty.

Against this backdrop, the impact of IIAs on tax measures has garnered increasing attention from many countries and international organizations. The overall trend aims to rebalance investor rights and host country's tax sovereignty while promoting coordinated development of international investment law and international tax law. This article analyzes tax carve-out clauses in recent model BITs and FTAs, highlighting their features: the inclusion of standalone tax carve-out clauses with comprehensive and systematic content, clarification of the relationship between substantive protection standards of IIAs and tax measures, and introduction of joint tax veto mechanisms.

For China, most old-generation IIAs do not include standalone tax carve-out provisions. Despite the positive trend of introducing such provisions in some new-generation IIAs signed by China, there are still newly signed IIAs in need of such modification. Moreover, compared to international trends reflected in UNCTAD reports and IIAs of other countries, the content of tax carve-out clauses in China's IIAs needs more uniformity and comprehensiveness. Therefore, this article proposes recommendations for improving tax carve-out provisions in Chinese IIAs: adopting a more balanced and coordinated approach, relatively unifying the expression of tax carve-out clauses, and exploring more efficient ways to upgrade them given China's vast network of IIAs.

(Edited by Gong Li)

国际投资协定税收措施条款的发展与中国因应

内容提要 由于以往国际投资法和国际税法的发展缺乏协调，在早期国际投资协定的谈签过程中，许多国家的缔约者对于国际投资协定对税收措施带来的影响缺乏充分认识。这导致早期国际投资协定在处理税收事项上往往具有局限性，进而对东道国的税收主权带来了挑战。近年来，越来越多的国家开始在国际投资协定中引入专门的税收措施条款，联合国贸易和发展会议也愈发关注国际投资协定对税收措施的影响，并呼吁加强投资和税收政策制定者之间的协调。为此，中国有必要探索更加高效的方式完善国际投资协定网络中的税收措施条款，推动其向更加平衡、协调和一致的方向发展。