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THE ROLE OF ARBITRATION IN RESOLVING TAX TREATY CONFLICTS: LESSONS FROM THE LONE STAR AWARD

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Introduction

In an era of rapidly growing cross-border investments, an emerging concern over the adjudication of international tax treaty disputes is apparent. In this regard, arbitration as a remedy has proved to be a consistent and cost-effective method of dispute resolution. However, the efficacy and the merit of such arbitral awards have been frequently subject to critique.

Tax treaty disputes often arise under Bilateral Investment Treaties ["**BITs**"] and Double Tax Treaties ["**DTTs**"] both of which aim to prevent double taxation and ensure protection for investors. Although, the objective of such treaties is to benefit the interests of investors of the contracting States, investors from third countries sometimes benefit from them through treaty shopping. For instance, if India and South Korea have a DTT, then Indian companies can avoid double taxation while investing in South Korea. At the same time, an Australian company could, in turn, set up a shell or a conduit company in India and channel its investment through it to gain the same benefit even though Australia is not a party to the India-South Korea DTT.

To counter such strategies, host States have come up with anti-tax avoidance doctrines such as the Substance Over Form Doctrine ["**SOFD**"], which allow them to pierce through formal legal structures and assess the real beneficiary of a transaction. While such doctrines aim to protect the tax base, they also introduce uncertainties in the interpretation of such doctrines by the Courts and Tribunals, thus undermining the goals of BITs and DTTs – protection of investors.

Against this backdrop, this article begins by examining the nature and reasons for such conflicts in Part II. It then evaluates the interpretative framework for investment treaties under Part III while further examining how tribunals have approached the issue, with the *Lone Star v Korea* ["**Lone Star**"][1] award serving as a key illustration in Part IV. In Part V, it critiques the interpretative

[1] *LSF-KEB Holdings SCA & Ors. v Republic of Korea*, ICSID Case No. ARB/12/37, Award (30 August 2022).

overreach in such cases elucidating the risks associated, and then proposes a way forward which is treaty consistent and strict in nature under Part VI.

Understanding the Origin and Reasons for such Conflicts

Over time, an increasing overlap has emerged between international tax enforcement and investment treaty protection in investor-state arbitration. As countries adopt aggressive anti-avoidance rules to preserve their tax base, foreign investors increasingly find themselves caught in disputes where their treaty-based rights clash with evolving domestic tax enforcement tools.

i. The Rise of Anti-Tax Avoidance Doctrines in Arbitration

An anti-tax avoidance doctrine is a tool used by the Government to target the system of using shell companies to avoid taxes arising out of a DTT or a BIT. Prominent methods of identifying such avoidances have been achieved by identifying substantial owners of the income. In international commercial arbitration, SOFD is one such 'economic substance' doctrine used by Courts and Tribunals to identify the real ownership of an entity.[2] As the literal meaning suggests, it looks at the substance (real control of the company) over form (the nominal owner of the company). It is grounded in a legitimate public interest, and States have a right to curb tax avoidance that exploits treaty networks. However, this doctrine is inherently vague. The United States of America ["**USA**"] 9th Circuit Court in *Mazzei v Commissioner* limited the use of this doctrine.[3] In this case, the Congress had clearly written tax benefits into law, as it had done for Foreign Sales Corporations. The Court explained that the Internal Revenue Service cannot rely on SOFD to deny the tax benefits just because the arrangement looks artificial. Further, in the words of Philip Baker, such an approach was considered to be far-fetched and subjective.[4]

The origin of this doctrine can be traced back to the U.S Supreme Court judgment in *Gregory v Helvering,*[5] where the Court held that the change in taxpayers' economic position in a 'meaningful way' establishes 'economic presence'. In contrast, in the European Union ["**EU**"], the focus is on physical presence, substance, and business activity. The Court of Justice of the EU often looks for genuine connection between the companies and activity within the State. In India, the Supreme Court in *McDowell & Co. Ltd v CTO*,[6] has held that an increased tax was imposed on the substantive

[2] Błażej Kuźniacki, 'The Compatibility of the Substance over Form Doctrine with Tax and Investment Treaties: A Case Study of *Lone Star v the Republic of Korea*' (2024) 39 ICSID Rev 139.
[3] *Mazzei v Commissioner of Internal Revenue* No. 18-72451 (9th Cir., 2 June 2021).
[4] Philip Baker, 'Beneficial Ownership: After *Indofood*' (2007) 6 GITC Rev 15.
[5] *Gregory v Helvering* 293 U.S. 465 (1935).
[6] *McDowell & Co. Ltd. v CTO* (1985) 3 SCC 230.

owner of assets and not on the nominal owner. Similarly, in *Aditya Birla Nuvo Ltd. v Director of Income Tax*,[7] the Court held the parent company liable to pay tax under the Indian law rather than the conduit company which was just acting as a channel.

This lack of uniformity creates unpredictability for investors.[8] A transaction that qualifies for DTT protection in one country may be taxed aggressively in another. Investors structure their transactions based on treaty protections, often using intermediary companies in jurisdictions with favourable tax treaties. These structures, while seen as avoidance by some States, are often perfectly legal and transparent. This position warrants questioning on the need for such doctrines, and the difference between tax avoidance and tax evasion.

Further, the States' constant attempts to preserve their taxing rights has given birth to major international policy developments, such as Base Erosion and Profit Shifting ["**BEPS**"].[9] This framework aims to combat tax avoiding methods which exploit loopholes in tax rules of a State. To strengthen the ground, the Organisation for Economic Co-operation and Development ["**OECD**"] introduced the Principal Purpose Test ["**PPT**"],[10] and Limitation on Benefits ["**LOB**"], clauses in BITs and DTTs to legitimately hold parties accountable for tax avoidance. However, the legitimacy of such doctrines can be realized by States only if the same are codified as clauses, and included in the treaties. The inclusion of such doctrines, especially when the treaties do not explicitly allow for such inclusive interpretations, under the garb of purposive interpretation during adjudication will only result in inconsistency, and blurs the line between tax avoidance and tax evasion.

ii. The Doctrinal Misconception surrounding Tax Avoidance and Tax Evasion

The terms tax avoidance and tax evasion sound similar but have different meanings. Lord Tomlin, while reinstating the form over substance doctrine, enunciated the difference between tax avoidance and tax evasion. He noted, "*every man is entitled, if he can, to order his affairs so that the tax attaching under the appropriate acts is less than it otherwise would be. If he succeeds in ordering them so as to secure this result, then, however unappreciative the Commissioners of Inland Revenue or his fellow taxpayers maybe of his ingenuity, he cannot be compelled to pay an increased tax*" [emphasis added].[11]

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[7] *Aditya Birla Nuvo Ltd. v Director of Income Tax* [2011] SCC OnLine Bom 899.
[8] Sanskriti Mohanty and Satyajeet Panigrahi, 'Substance-Over-Form Doctrine: Reshaping India's Corporate Tax Regime' (2018) 7 GNLU JL Dev & Pol 36.
[9] 'Base Erosion and Profit Shifting (BEPS)' (*OECD*) <https://www.oecd.org/en/topics/policy-issues/base-erosion-and-profit-shifting-beps.html> accessed 24 July 2025.
[10] OECD, *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6 - 2015 Final Report* (OECD Publishing 2015).
[11] Mohanty (n 8).

This principle came to be known as the Westminster principle which suggested that tax planning with an objective of legally obviating tax liability is a legitimate right of the taxpayers and anything otherwise is illegal tax evasion. Thus, tax avoidance doctrines do not lack an objective or aim per se but lack consistent interpretation, which results in the abuse of investor rights. Therefore, doctrinal vagueness concerning tax avoidance allows States and Tribunals to treat lawful avoidance as illicit conduct, thus resulting in a disproportionate curtailment of investor rights resulting in increased conflict.

The Interpretative Framework for Investment Treaties

There exists mainly two ways of interpreting an investment treaty; the strict word-to-word interpretation,[12] and the liberal interpretation, which involves expansion of the wording of the treaty to give it a wider connotation. In our opinion, the latter interpretation will lead to uncertainties and further undermine the object of protecting investors from unfair treatment by the governments of host countries.

Under a strict interpretive approach, doctrines or obligations not explicitly stated in the treaty cannot be read in. For instance, unless SOFD has been expressly incorporated into BIT or DTT, it cannot be presumed to apply. Such an approach upholds treaty stability, reinforces the principle of *pacta sunt servanda* illustrated under Article 26 of Vienna Convention on the Law of Treaties ["**VCLT**"], and protects against the arbitrary insertion of domestic legal standards into the international legal framework.[13]

Further, Article 31 of VCLT emphasizes that treaties should be interpreted in good faith according to the ordinary meaning of their terms, in their context and in light of their object and purpose.[14] Article 32 of VCLT,[15] permits supplementary means only when the interpretation under Article 31 of VCLT leaves ambiguity or leads to absurd results. The nature of SOFD is such that it affects how DTTs are interpreted and applied, which should be done in accordance with the principles of interpretation of the VCLT.[16]

How Tribunals have Approached Interpretation of Treaties

[12] Alfred Verdross, Stephan Verosta and Karl Zemanek, 'Publications of the Permanent Court of International Justice' (1968) Springer.
[13] Rudolf Dolzer and Christoph Schreuer, *Principles of International Investment Law* (2nd edn, OUP 2012) 189, 191.
[14] Vienna Convention on the Law of Treaties (adopted 23 May 1969, entered into force 27 January 1980) 1115 UNTS 331, art 31 ("**VCLT**").
[15] VCLT, art 32.
[16] OECD, *Model Tax Convention on Income and on Capital: Condensed Version* (OECD Publishing 2017) 55-90.

Investment Tribunals are not tax courts. Their core function is not to validate or invalidate national taxation measures per se but to assess whether a State's actions are consistent with its obligations under international treaties, particularly BITs and DTTs.[17]

In the *Lone Star*, one of the latest awards in tax-related investment treaty disputes, the Tribunal addressed SOFD for the first time in an investment treaty context. A brief overview of the facts of the case is necessary to delve into the depths of the Tribunal's reasoning pursuant to the application of SOFD. Following the 1997–98 Asian financial crisis, South Korea encouraged foreign investment through DTTs, and Special Purpose Entities ["**SPEs**"].[18] Lone Star, a USA-based private equity firm, structured its investments in Korea using Belgian entities to benefit from the Korea–Belgium DTT. However, Korean tax authorities applied SOFD by arguing that the real control rested with Lone Star's USA parent company and not the Belgian entities. Subsequently, Lone Star initiated arbitration under the 2011 BLEU–Korea BIT,[19] and the Convention on the Settlement of Investment Disputes between States and Nationals of Other States ["**ICSID Convention**"], [20] alleging violations of investment protections. The Tribunal upheld the application of SOFD despite even though the SOFD doctrine had not been contemplated in the treaty.[21] It relied on an oversimplified 2003 commentary of the OECD on SOFD which only briefly addressed domestic anti-tax avoidance rules.[22] In fact, the 2017 OECD commentary,[23] an updated documentation which discussed the application of SOFD, was blatantly overlooked by the Tribunal.[24]

To provide an alternative perspective, in regards to India, cases like *Cairn PLC v India* ["**Cairn**"],[25] and *Vodafone International Holdings BV v India* ["**Vodafone**"],[26] show Tribunals pushing back against overreach. In *Vodafone*, the PCA ruled that retrospective application of India's tax legislation violated the fair and equitable treatment ["**FET**"] standard, by emphasizing on stability and legitimate expectations. Similarly, in *Cairn*, the Tribunal criticised India's retrospective taxation as being a breach of its BIT obligations.

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[17] Dolzer (n 13) 23–25.
[18] ibid.
[19] Agreement between the Belgium-Luxembourg Economic Union and the Government of the Republic of Korea for the Reciprocal Promotion and Protection of Investments (signed 12 December 2006, entered into force 27 March 2011) 2779 UNTS 141.
[20] Convention on the Settlement of Investment Disputes between States and Nationals of Other States (signed 18 March 1965, entered into force 14 October 1966) 575 UNTS 159.
[21] *LSF-KEB Holdings* (n 1) [471].
[22] ibid [758].
[23] OECD, *Model Tax Convention on Income and on Capital: Condensed Version* (n 15).
[24] Kuźniacki (n 2).
[25] *Cairn Energy PLC and Cairn UK Holdings Ltd. v Republic of India,* PCA Case No. 2016-07, Award (21 December 2020).
[26] *Vodafone International Holdings BV v Republic of India,* PCA Case No. 2016-35, Award (25 September 2020).

Further, in a ruling under the India–Mauritius Double Taxation Agreement, India's Tax Tribunal held that beneficial ownership cannot be read into Article 13, regarding capital gains, of the DTA unless explicitly stated.[27] The Tribunal grounded its view in the VCLT and the *pacta sunt servanda* principle, stating that if the contracting States deliberately chose not to include this kind of requirement, then a treaty should be interpreted to reflect that intention.[28] This principle, applied to investment arbitration, further supports the argument that doctrines like SOFD must only be used when textually anchored in the treaty.

The Risks of Expansive Treaty Interpretation

In practice, liberal interpretations of BITs or DTTs can erode their value and intended purpose. The method of interpretation under VCLT is not synonymous with an expansive and liberal interpretation. The inclusion of the term 'good faith' does not license Tribunals to expand the treaty meaning beyond what the partis intended, rather calls for the meaning being in line with the intention of the parties.[29]

BITs and DTTs include investor protection clauses such as FET, national treatment, and most-favoured-nation ["**MFN**"] status. These ensure stability, non-discrimination, and due process. While some treaties carve-out these provisions for taxation, most do not authorise the use of domestic doctrines like SOFD.

For instance, as previously discussed, in the *Lone Star* award, the Tribunal applied SOFD even though neither the BLEU-Korea BIT nor the Korea-Belgium DTT,[30] explicitly mentioned SOFD. This opens the door to ambiguous doctrines being used to override the core principles of investor protections. Such reasoning weakens the credibility of arbitration, and makes treaty protections unreliable.

When Tribunals adopt expansive readings, they create systemic uncertainty. Investors, often described as "*guests in an alien country*", rely on the predictability and legal protection guaranteed by investment treaties.[31] If core protections, such as FET and legitimate expectations, can be overridden by vague and discretionary doctrines, the credibility of the international investment

[27] *Blackstone FP Capital Partners Mauritius V Ltd. v Deputy Commissioner of Income Tax* [2022] SCC OnLine ITAT 1520.
[28] *Canada v Alta Energy Luxembourg S.A.R.L.* (2021) 3 SCR 590.
[29] VCLT, art 31.
[30] *LSF-KEB Holdings* (n 1).
[31] United Nations Conference on Trade and Development, *World Investment Report 2012: Towards a New Generation of Investment Policies* (United Nations 2012) 96–98.

protection regime becomes fundamentally compromised. These are the risks the investment arbitration carries with an expansive form of treaty interpretation.

The Way Forward

Tribunals must strike a careful balance between respecting a State's efforts to prevent tax abuse and upholding the legal certainty. Their role should focus strictly on whether a State's action aligns with its international obligations, not its domestic tax policy goals. If a BIT or DTT expressly includes provisions relating to anti-avoidance rules, such as a SOFD or PPT, then Tribunals can legitimately apply them.[32] However, in the absence of such provisions, the Tribunals must refrain from reading these doctrines into the treaty.

This does not mean States cannot fight tax avoidance. They can and should. However, they must do so through clearly worded treaty provisions, legislative amendments, or renegotiated treaties. Tribunals must assess whether the State's actions are consistent with its international obligations, not whether they are justifiable under domestic law. Tribunals must, in appropriate cases, invoke principles such as abuse of rights, fraud or denial of benefits, provided that the treaty includes such clauses.[33] What Tribunals must not do, is to fill gaps in the treaty' language by using domestic tax doctrines that were never negotiated or consented to. That path leads not to balanced adjudication but to judicial overreach and legal unpredictability.

Conclusion

The role of arbitration in international tax treaty disputes is crucial and warrants a pragmatic approach. As such disputes grow, the responsibility of Tribunals grows requiring them to decide between stable interpretation of tax treaties and accommodating evolving tax avoidance doctrines. The mode of interpretation must align with international policies and conventions such as the OECD and VCLT, which influence international trade realm as a whole. Arbitral awards, closely followed and scrutinised by all the stakeholders, tend to hold high persuasive value, and one inconsistent award could compromise the principles of investor protections, subsequently denting the confidence of such investors to approach the dispute settlement system contemplated under International Centre for Settlement of Investment Disputes ["**ICSID**"]. The risk is not just to investors but to the credibility of arbitration itself. In this context, the *Lone Star* award should not

[32] Multilateral Convention to Implement Tax Treaty related Measures to Prevent Base Erosion and Profit Shifting (signed 7 June 2017, entered into force 1 July 2018) arts 6,7.
[33] *Plama Consortium Ltd. v Republic of Bulgaria,* ICSID Case No. ARB/03/24, Award (27 August 2008) [140]; *Phoenix Action Ltd. v Czech Republic,* ICSID Case No. ARB/06/5, Award (15 April 2009) [144].

be treated as a model. This is specifically important to note that none of parties have initiated a motion to annul the award, and negate its effect under Article 52 of the ICSID Convention. In other words, the award should not be treated as the 'lone' star.