Exploring Potential Investor-State Treaty Challenges to the OECD's Pillar Two Model Tax Rules

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Contents

The Pillar Two model rules released by the Organization of Economic Cooperation and Development (OECD) in December 2021 (Model Rules) aim to achieve a 15% global minimum tax on the earnings of large multinational businesses. Adoption of the Model Rules is gaining momentum in several jurisdictions, even in the face of significant concerns about encroachment on state sovereignty, the impact on economic development and the absence of implementation details.

While international tax treaties provide one potential mechanism for challenging Pillar Two legislation, bilateral or multilateral investment treaties (BITs) provide an alternative route, potentially allowing entities affected by the imposition of a Pillar Two rule in a particular jurisdiction to recover compensation from the state to redress economic loss. This alert addresses whether multinational enterprises (MNEs) might challenge the adoption of the Pillar Two framework by way of investor-state dispute settlement (ISDS) claims brought under bilateral or multilateral investment treaties against relevant OECD member states.

The Pillar Two Framework

Pillar Two is part of an OECD initiative intended to address certain perceived tax challenges arising from the digitalization of the global economy. Beginning in the early 2010s, the OECD began considering potential solutions to increasing digitalization in a bid to replace various unilateral tax measures that were proliferating across the world and risked leading to potential trade disputes.

Over the last decade, the OECD has identified two major areas of concern: (1) the strain on historic taxation norms involving sourcing profits and nexus to a jurisdiction in light of new business models that do not require a substantial physical presence, and (2) global factor mobility potentially exacerbating harmful tax competition between countries that resulted in a corporate tax "race to the bottom." Pillar Two attempts to address the second of these concerns. The OECD's proposals take the form of Model Rules, which the OECD expects will be adopted by the 138 OECD countries that joined an October 2021 OECD statement in support of Pillar Two and expressed an intention to incorporate the proposed rules into their domestic legislation.[1]

[1] The text of the Model Rules is available on the OECD's website.

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The Model Rules apply to MNEs with an annual revenue of at least €750 million (currently about $795 million). In the case of income earned by the MNE in countries that do not have a 15% domestic minimum rate (achieved either through their existing tax system or the adoption of a so-called Qualified Domestic Minimum Top-up Tax), two inter-linked charging provisions are intended to secure broader adoption of the 15% minimum rate.

The primary charging provision is the income inclusion rule (IIR) requiring parent entities to pay "top-up tax" in respect of low-taxed income of group members. Putting it simply, the amount of top-up tax that is payable is the shortfall by which the effective tax rate on an MNE's profits in a given jurisdiction for Pillar Two purposes is less than the designated 15% minimum rate. The IIR, which has some similarities with existing "controlled foreign company" (CFC) regimes that traditionally apply to passive income earned in countries with limited local activity, is most analogous to the United States Global Intangible Low-Tax Income (GILTI) rules, albeit with significant differences in application. As such, while the IIR requires many states to significantly expand their CFC rules, it is not a fundamental departure from international tax norms.

The innovative aspect of the Model Rules lies in the secondary charging mechanism, the undertaxed profits (or payments) rule (UTPR), which is likely to be much more significant for many MNEs. The UTPR is designed to create a new taxing right that operates as a backstop where the jurisdiction of the parent (or intermediate parent) entity has not adopted Pillar Two (and therefore IIR). In that case, the profits of any MNE entity which are (a) not taxed elsewhere through an IIR, and (b) not subject to at least 15% tax in their jurisdiction of source, are effectively taxed and paid by any company in the same financial accounting consolidation group in a jurisdiction that has adopted the Pillar Two rules. The policy justification for the UTPR appears to be that, if a low-taxed entity's parent jurisdiction has not levied sufficient tax through the IIR, jurisdictions in more remote or subsidiary parts of the group structure should be permitted to tax those same profits.

As a technical matter, the Model Rules operate by denying a deduction or making "an equivalent adjustment under domestic law" in levying the UTPR. A number of jurisdictions — including potentially South Korea (where Pillar Two implementing legislation has been passed) and the United Kingdom (which raised multiple options in its public consultation) — may conclude that this "equivalent adjustment" language permits them to simply collect the amount of the top-up tax from the MNE entity in their jurisdiction.

In other countries, the UTPR is interpreted to operate more literally by denying a deduction for otherwise deductible expenses in that Pillar Two-compliant jurisdiction in an amount sufficient to result in the MNE entity having an additional cash tax expense equal to the top-up tax allocated to that jurisdiction. Denying a taxpayer a deduction generally increases the cash tax expense for a taxpayer by increasing the net income subject to tax. Accordingly, in a technical sense, where a deduction is denied, the UTPR results in a higher rate of taxation in respect of locally sourced profits (those in respect of which the deductions are denied). In whatever manner the UTPR is implemented, its aim is to levy tax in respect of profits that are not sourced in that jurisdiction but have been "undertaxed." Where there are multiple jurisdictions within an MNE's structure that have implemented the UTPR, the top-up tax to be collected is allocated between them in proportion to the employee headcount and the value of tangible assets within the jurisdiction.

As of December 16, 2022, 138 countries have agreed to introduce Pillar Two. However, each such jurisdiction will need to enact the Model Rules into local law. The OECD proposal requires domestic legislative adoption of the IIR and Pillar Two generally to be effective for accounting periods after December 31, 2023, with the UTPR scheduled to come into effect 12 months later.

The U.S. has not adopted (nor signaled an intention to adopt) the Model Rules, and doing so is likely to be difficult politically in advance of the December 31, 2024, UTPR implementation date. The U.S. already has a number of regimes that are similar in intention to Pillar Two but which are not categorized as being equivalent to it for the purposes of the Model Rules. As a result, if a U.S.-headed MNE is entitled to tax incentives (such as deductions for foreign income or non-refundable tax credits) that reduce its effective tax rate on profits sourced in the U.S. below 15%, there will be top-up tax to be collected elsewhere in its group by its subsidiaries or permanent establishments in other countries.

The UTPR reverses the customary tax paradigm, in which parent entities are frequently taxed on profits of their subsidiaries in other jurisdictions as part of measures to avoid tax deferral, which is justified by virtue of the economic control of those profits that the parent entities have. We are not aware of any measure such as that found in the Model Rules creating taxing rights for the subsidiary entities in respect of the profits of its parent in a wholly different jurisdiction.

Given this departure from what some might argue are the fundamental "norms" on which the global tax system has been based for at least the last century, it is no surprise that the UTPR is of particular concern for large MNE groups, which often have subsidiary entities in a wide variety of jurisdictions with different tax profiles in their group structures.

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Potential Investment Treaty Challenges to the Adoption of the Pillar Two Framework

A discussion of potential investment treaty claims to challenge Pillar Two implementing legislation must start from the principle that states have the right to regulate in their own public interest, and taxation is a common and inherently sovereign regulatory exercise. International investment treaties typically protect investors against a state's illegal conduct, including conduct that is expropriatory, discriminatory or that violates an investor's right to "fair and equitable treatment." While it is generally understood that such protections can and do apply to tax measures, it is difficult to successfully challenge taxation measures based on treaty claims given that taxation is an inherent fiscal power of the state.

Further, many treaties contain express "carve-out" provisions that limit investors' rights to bring challenges against taxation measures. Other treaties have partial limitations on such claims; for example they will allow challenges only to some types of taxes, or only where the taxes are alleged to amount to expropriation. Importantly, some newer treaties — in particular those entered by the European Union within the last decade — contain more specific tax carve-out language that potentially could be used to rebut investment treaty challenges to Pillar Two.[2]

Despite these limitations, successful tax challenges have been brought under existing BITs. Perhaps the most famous example is the case of *Yukos v. Russia*, in which a group of shareholders in the Yukos Oil Company challenged the Russian Federation's imposition of a series of adverse measures, including large tax assessments, under the investment protection provisions contained in the Energy Charter Treaty (ECT).[3] Russia argued that the adverse actions it had taken were within the exercise of its inherent sovereign taxation powers, and therefore were subject to the carve-outs on tax claims in the ECT. The arbitral tribunal rejected this defense, accepting instead the Yukos shareholders' argument that Russia's acts were not *bona fide* taxation measures, but instead were expropriatory and abusive acts carried out "under the guise of taxation,"[4] thereby breaching several provisions of the ECT.

In the case of the Pillar Two Model Rules, there are several potential challenges that may be available under standard investment treaty provisions. The implementation of the UTPR appears susceptible to challenge by MNEs invested in states that adopt the UTPR, where a relevant treaty exists (the "investment" being the shares in the subsidiary now caught by the UTPR). The UTPR's imposition of taxation on global income regardless of the nexus with the host state may be considered to violate several investment protections; differences in interpretation of how to implement the taxation (as discussed above) may make some measures more vulnerable to challenge than others.

While any analysis of how the UTPR might violate a state's investment treaty protections is necessarily fact-specific and dependent on the specific treaties in force, we discuss below several potential claims under standard investment treaty provisions. We focus on two main protections found in most BITs: first, the "fair and equitable" or FET standard, which typically includes protection against discrimination; and secondly, expropriation. We also discuss an argument to potentially overcome the tax "carve-outs" that exist in many BITs, thus expanding the number of jurisdictions whose UTPR implementation may be challenged.

(1) Violation of the Standards of Fair and Equitable Treatment and Non-Discrimination

The most immediately obvious way in which the UTPR may be challenged is that it violates the FET standard that exists in many BITs. The FET standard includes the protection of the investor's legitimate expectations, requirements of transparency, reasonableness and non-arbitrariness, protection against discrimination and the requirement that the state offer a stable and predictable legal framework. An investor's legitimate expectations may be based on the host state's legal framework, as well as on any undertakings and representations made explicitly or implicitly by the host state at the time the investment was made.[5]

There are at least three ways in which the UTPR may (depending on how it is implemented in an individual state) violate the FET standard, as follows.

[2] *See, e.g.*, EU-Singapore Investment Protection Agreement (2018), Article 4.6(3) ("Nothing in this Agreement shall prevent either Party from adopting or maintaining any taxation measure which differentiates between taxpayers based on rational criteria, such as taxpayers 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."); Canada-EU Comprehensive Economic and Trade Agreement ("CETA") (2016), Article 28.7(4)(d) ("Nothing in this Agreement or in any arrangement adopted under this Agreement shall apply . . . (d) to a taxation measure of a Party that is aimed at ensuring the equitable and effective imposition or collection of taxes, including a measure that is taken by a Party in order to ensure compliance with the Party's taxation system.").

[3] *Yukos Universal Ltd. (Isle of Man) v. Russian Federation*, PCA Case No. AA 227, Award, 18 July 2014.

[4] *Yukos* at ¶¶ 1375, 1407. Article 21 of the ECT generally carves out taxation measures at Article 21(1), but enumerates specific tax-related claims that are included, or clawed back in, at Articles 21(2)-(5), including claims related to most favored nation status and those involving expropriation.

[5] Rudolf Dolzer and Christoph Schreuer, *Principles of International Investment Law*, 145 (2d ed. 2008).

(a) Does the UTPR violate an investor's legitimate expectations?

The first way in which the UTPR may violate the FET standard is by breaching an investor's legitimate expectations. As a general matter, "In the absence of a specific commitment from the host State, the foreign investor has neither the right nor any legitimate expectation that the tax regime will not change, perhaps to its disadvantage, during the period of the investment."[6] The state therefore maintains a high degree of flexibility to respond to changing circumstances in the public interest.

However, some states offer individual investors specific assurances about its regulatory, legal or tax regime in order to encourage foreign direct investment. For example, assurances may arise out of negotiations with the state (ministers, government departments and the like) prior to an MNE making an investment decision. Such assurances may give rise to "legitimate expectations," the breach of which by the state at a later date may amount to a breach of the FET standard in an applicable investment treaty. So, for example, in one case, a state was held to be in breach of the FET standard where it had promised an investor certain VAT refunds which it subsequently revoked.[7]

It is likely to be a relatively unusual case that an investor will have a specific assurance from a host state regarding taxation. Where such assurances are made, they are usually enshrined either in legislation or what is termed a "stabilization agreement," which effectively seeks to freeze the regulatory and legal environment at the date of investment in one form or another. Companies seeking to evaluate potential challenges to the UTPR may look to the circumstances of their investment and the specific commitments made at the time as a basis for challenge.

(b) Does the UTPR violate the principle of non-discrimination?

The second way in which the UTPR may violate the FET standard is by breaching the principle of non-discrimination. It is also sometimes a free-standing protection under applicable BITs, as well as being separately protected under bilateral tax treaties (which give rise to international law commitments by the state).

The imposition of the UTPR is likely to cause disparate tax treatment of certain investors that could readily run afoul of these investment treaty protections. Much will depend on the manner in which the UTPR is adopted and applied in any given jurisdiction. A simple example illustrates how adoption of the UTPR may give rise to an actionable discrimination claim:

An MNE (Group X) that is not based in a Pillar Two jurisdiction has a subsidiary (Sub A) that is located in a jurisdiction that has implemented Pillar Two (Jurisdiction A) and is subject to 20% corporation tax. Sub A has two sister companies (Subs B and C) in non-Pillar Two jurisdictions that charge only 5% tax. Neither of Subs B or C are caught elsewhere in the group by any other intermediate parents in a Pillar Two jurisdiction, so Sub A has to pay the UTPR for both Subs B and C. For purposes of the illustration, assume that each of the subsidiaries has the same amount of profit, and that Sub A's effective tax rate (ETR) as a result of the UTPR is 40%. Compare that with the ETR of 20% paid by the subsidiary operation of a group wholly owned in Jurisdiction A, and the disparity becomes immediately apparent.

For investment treaty purposes, investors may argue that Jurisdiction A is discriminating against Sub A on the basis that Sub A is owned by/part of an MNE group that does not reside (or have its source income) in a Pillar Two jurisdiction. Similar circumstances have been found to violate the non-discrimination provisions in tax treaties,[8] which are a relevant source of law likely to inform the proper interpretation of BITs.[9]

Jurisdiction A might seek to explain the difference (and resist the argument that it is discriminatory) by reference to the increased capital to which Sub A has access by virtue of its ownership by Group X. But that is not the standard for discrimination, at least under most tax treaties (and BITs), which simply require like-for-like treatment and non-discrimination, including in particular on the grounds of residence.[10]

Such discrimination (were it made out) may violate the broad protections under the FET standard. It might also violate those BITs that contain free-standing non-discrimination protections.

[6] *EnCana Corp. v. Republic of Ecuador*, LCIA Case No. UN3481, Award ¶ 173, 3 February 2006.

[7] *Occidental Petroleum Corp. v. Republic of Ecuador*, LCIA Case No. UN3467, Award ¶ 196, 1 July 2004.

[8] In *Felixstowe Dock and Railway Company v. HMRC* [2011] UKFTT 838 (TC), the U.K. tax tribunal found that the inability of a U.K. member of a group of companies, which was indirectly owned by a Luxembourg entity, to obtain group relief was a violation of the non-discrimination provision of the U.K.-Luxembourg Double Taxation Convention, as incorporated into U.K. law. The tribunal concluded that the measure was discriminatory on the basis that the inability to obtain group relief arose solely on the ground that the U.K. member was indirectly owned by the Luxembourg entity.

[9] *See Murphy Exploration & Production Co. Int'l v. Republic of Ecuador (II)*, PCA Case No. 2012-16, Partial Final Award ¶¶ 156-64, May 6, 2016 (in which the tribunal held that the content of a state's tax treaties may inform the interpretation of a bilateral investment treaty under Article 31 of the Vienna Convention on the Law of Treaties, depending on the particular facts of a given case).

[10] See Article 24 of the OECD's 2017 Model Tax Convention on Income and on Capital ("Nationals of a Contracting State shall not be subjected in the other Contracting State to any taxation or any requirement connected therewith, which is other or more burdensome than the taxation and connected requirements to which nationals of that other State in the same circumstances, in particular with respect to residence, are or may be subjected").

However, a potential hurdle to the latter claim is that an investor may also need to show that a given state's implementation of the UTPR not only results in unequal treatment of foreign versus domestically owned companies, but that the state's implementation was arbitrary, grossly unfair, unjust or idiosyncratic. For example, a tax measure was found to be arbitrary and unjustified and therefore to violate a free-standing non-discrimination protection where its purpose and effect was to protect the domestic market from foreign competitors. In ADM v. Mexico, Mexico had introduced a 20% tax on soft drinks containing a corn syrup sweetener, but had not introduced an equivalent tax for soft drinks sweetened with sugar cane. Finding for the claimant, the tribunal held that the tax was enacted for the purpose of protecting the domestic Mexican sugar cane industry from foreign competitors and that the effect of the tax was that U.S. producers and distributors received less favorable treatment in violation of the North American Free Trade Agreement.[11]

Given that the ultimate purpose of the UTPR is effectively to force all those countries that do not adopt the Pillar Two rules to do so (and to prevent non-adopting states from "undercutting" the minimum 15% tax), a similar argument could be made that this is not a legitimate or just purpose for the discriminatory treatment of an individual entity.

(c) Does adoption of Pillar Two give rise to other potential violations of BITs under the FET standard?

Finally, given the novelty of the Pillar Two regime and the very fact-specific nature of the potential tax consequences for any particular company, one can imagine a number of other FET-styled claims.

For example, a jurisdiction with a low effective tax rate (say, 5%) might choose to protect itself against the impact of Pillar Two by imposing a flexible tax rate, *e.g.*, it might provide that resident companies with no members of their group in a Pillar Two jurisdiction would continue to enjoy the 5% rate. However, companies with any member of their group resident in a Pillar Two jurisdiction, which would thereby claim the UTPR on that company's income, would pay 15% to prevent the collection of the top-up elsewhere.

The purpose of this flexible rate is obvious (and even arguably understandable):[12] If a domestic company's revenues are going to be taxed elsewhere up to 15%, the home state may seek to capture those revenues itself, even while maintaining its attractive lower tax rate for other entities.[13] However, when viewed through the lens of a BIT and its non-discrimination protections, the potential treaty violation becomes apparent.

(2) Taxation as Expropriation

The other common (and perhaps best known) provision that exists in most BITs is the protection against "expropriation," which arises either directly (*e.g.*, where a state nationalizes a particular foreign-owned interest) or indirectly (*e.g.*, dispossession and deprivation of use, without affecting the legal title). For the purposes of the UTPR, the focus is likely to be on indirect expropriation.

Taxation measures rising to the level of expropriation may be challenged, and even those treaties that carve-out tax measures often allow claims against a tax measure alleged to constitute an indirect expropriation. Generally speaking, tribunals will examine whether the measure results in a "substantial deprivation" of the investment, such that its value is effectively destroyed.[14] Some tribunals have imposed a higher standard, requiring that the tax measure also be abusive, arbitrary or discriminatory.

The UTPR has the potential to constitute an indirect expropriation, depending on the circumstances. If we return to the example using Group X above and apply some actual figures for income earned in the group (with numbers in millions), where X does not have an IIR but is subject to 15% on income of $2,000, *i.e.* X pays $300 in tax; Sub A pays 20% tax on income of $10 (before UTPR), *i.e.* Sub A pays $2 in tax; and both Subs B and C pay 5% tax on income of $200 each, *i.e.* $10 in tax each.

The UTPR "top-up" for Subs B and C is $40 (15% tax on $400 income, or $60, less the $20 already collected). If Jurisdiction A adopts the OECD "clear rule" of disallowing deductions, Sub A's ETR will be 200% (because Jurisdiction A will be collecting $2 of tax on Sub A's income and $18 of top-up tax in respect of Subs B and C, having disallowed $90 of deductions, with the remainder collected in future years). If Jurisdiction A does not follow the Model Rules and instead imposes the UTPR as a

[11] Archer Daniels Midland Co. v. United Mexican States, ICSID Case No. ARB(AF)/04/05, Award ¶¶ 210-13, 21 November 2007.

[12] This "defensive" behavior by jurisdictions is a key part of how the OECD hopes that there will be a broader adoption of the 15% minimum rate even by jurisdictions that would customarily prefer to impose a lower rate of corporation tax.

[13] The authors understand that Jersey has proposed a flexible tax rate along these lines, subjecting only in-scope Pillar Two MNEs to its proposal for a 15% minimum corporation tax rate. See "OECD Pillars 1 & 2: tax policy reflections," published by the Government of Jersey in April 2022.

[14] *Burlington Resources Inc. v. Republic of Ecuador*, ICSID Case No. ARB/08/5, Decision on Liability ¶ 397, 14 December 2012 ("When a measure affects the environment or conditions under which the investor carries on its business, what appears to be decisive, in assessing whether there is a substantial deprivation, is the loss of the economic value or economic viability of the investment.... The loss of viability does not necessarily imply a loss of management or control. What matters is the capacity to earn a commercial return. After all, investors make investments to earn a return. If they lose this possibility as a result of a State measure, then they have lost the economic use of their investment.").

tax directly, Sub A's ETR is 420% (because Jurisdiction A will be collecting the full $40 at once, in addition to the $2 of tax collected on Sub A's own income).

The effect of the UTPR in both examples is to eliminate the income of Sub A altogether. In these circumstances, the UTPR may be found to result in a "substantial deprivation" of the value of the shares in Sub A, thus giving rise to an indirect expropriation claim.

(3) Addressing the Tax "Carve-out" in Many BITs

As noted above, many investment treaties contain carve-outs for tax, so that tax measures may not be susceptible to challenge under the relevant BIT, for example, as a breach of the FET standard. (As noted above, even those BITs that contain tax carve-outs generally allow claims for expropriation.) This may limit the number of countries where the implementation of the UTPR may be challenged where the effect of the UTPR does not rise to the level of expropriation.

Tribunals typically interpret "taxation" quite broadly, namely: (i) there is a law; (ii) that imposes a liability on classes of persons; (iii) to pay money to the state; (iv) for public purposes.[15] However, whether a particular measure meets these criteria and is to be regarded as a tax is assessed on a case-by-case basis taking into account the individual circumstances of the case at hand.

Given the nature of the UTPR — and its potentially extreme effects (as illustrated above) — investors may argue that implementation of UTPR is not in fact a bona fide tax measure and its challenge is therefore not excluded even in a case where the relevant BIT contains such a tax carve-out. Indeed, the UTPR can be viewed as a complete departure from the fundamental norms on which the global tax system has been based. Unlike all other forms of taxation, it is charged regardless of source of income, residence or control — in other words, regardless of what might be argued are the customary principles relating to the "nexus" required for a measure to qualify as "taxation." Moreover, its purpose is not to ensure that the income of an entity is properly taxed at source, but rather to coerce those states who do not adopt Pillar Two to do so and to raise their levels of taxation to the OECD required minimum of 15%.

Thus, it could be argued that, rather than a tax measure, the UTPR is instead a (thinly) disguised economic sanction designed to alter the behavior of another state, regardless of impact on the investor. As such, although designed under the rubric of taxation, there is potential to argue that UTPR implementing legislation is not legitimately a "tax" measure as that term is meant in investment treaties and therefore does not fall within the measures excluded by any tax "carve-out" in a BIT.

Conclusion

The novelty of the UTPR and its potentially wide-ranging impacts may harm investors in a way that gives rise to direct claims of redress against the country adopting the Pillar Two Model Rules into its domestic law. The strength of those claims will depend heavily on the factual circumstances of the affected entity, the language and scope of the applicable investment treaties, and the particular mechanism of adoption by the state, and therefore will require close analysis. Nonetheless, investor-state dispute recourse is an important remedy in this space and potentially affected MNEs may wish to carefully consider their treaty options in light of Pillar Two's pending implementation.

Associates **Jessie Barnett-Cox** and **Kendall Huennekens** assisted in the preparation of this alert.

[15] *See, e.g.*, *EnCana v. Republic of Ecuador*, LCIA Case No. UN3481, Award and Partial Dissent ¶ 142, 3 February 2006; *Murphy Exploration & Production Co. Int'l v. Ecuador (II)*, PCA Case No. 2012-16, Partial Final Award ¶ 159, 6 May 2016; *Yukos v. Russian Federation*, PCA Case No. AA 227, Award ¶ 1407, 18 July 2014 (defining taxation measures under Article 21 ECT as "actions that are motivated by the purpose of raising general revenue for the State").