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Iranian investment protection: BITs, DTTs and JCPOA

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Overview

Since the lifting of UK and EU sanctions post-Implementation Day under the Joint Comprehensive Plan of Action, there has been a surge of investment activity looking to capitalise on potential opportunities in Iran across a broad swathe of asset classes. In this second in our series of Iran-focussed articles, Dentons partners Andrew Cheung, Michelle Bradfield and Jeremy Cape analyse (i) the current application of sectoral sanctions and key points when assessing investment decisions, (ii) the extra-territorial protections available to investors when structuring transactions (including bilateral and multilateral investment treaties) and (iii) the current tax environment, including looking at the possible use of Iran's network of double-tax treaties and protecting against future tax changes, which overlays onto the BIT analysis. Taken collectively, these "background" issues will underpin major investment, and this article sets out a suggested regime for assessing opportunities in what promises to be both an exciting and challenging jurisdiction.

Sanctions snap-back

One of the most talked about aspects of the Joint Comprehensive Plan of Action ("JCPOA") was the potential for sanctions to "snap-back" in the event of non-compliance and the implications this would have on foreign direct investment. There are a number of misconceptions about snap-back, how it is triggered and what impact it has and these all need to be addressed before investors can be clear on the status of their investment and degree of exposure snap-back causes.

Snap-back forms part of the dispute resolution mechanism under the JCPOA and is enshrined in *2231 Council Resolution UN Security (2015)* ("Resolution 2231"). In the event a party to the JCPOA considers that Iran or the P5+1 (other parties to the JCPOA) were not meeting their commitments under the JCPOA, they could refer to matter to a Joint Commission for resolution over a 30 day period. If not resolved, then the dispute could be referred to the UN Security Council ("UNSC") to vote on whether it believed the issue constitutes significant non-performance[1]. If the UNSC does not vote to continue to lift sanctions, then the provisions of the old UN sanctions would be reinstated. This mechanism is mirrored in EU and US sanctions implementing legislation.

Most importantly, once triggered the mechanism weighs in favour of snapping back sanctions. The UNSC needs to vote positively to lift sanctions i.e. sanctions will snap back unless the UNSC takes a positive step to ensure they do not.

But precisely what does snap-back actually mean? Paragraph 37 of the JCPOA makes it plain that the reinstatement of UN sanctions against Iran would not affect any contracts concluded with Iran or any Iranian person prior to snap-back.

This is reflected in the EU's information note on the JCPOA, issued on 23 January 2016. This confirms that in the event of snap-back, all lifted EU sanctions against Iran will be re-introduced, "consistent with previous provisions when sanctions were originally imposed" (paragraph 62). However, it goes on to clarify that sanctions will not be reinstated with retro active effect. Contracts concluded after Implementation Day will be permitted "in order to allow companies to wind down their activities" (paragraph 63).

This means that any contracts for the production, transport and sale of natural oil, petroleum products, petrochemicals and gas, if concluded while the JCPOA is in effect and sanctions are lifted will be not be affected even if prohibitions for these activities under EC Regulation 267 of 2012 are reinstated on snap-back[2].

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1 Paragraph 36 of the JCPOA

However, the amnesty for contracts concluded prior to snap-back is not absolute. It is complicated where a contract has been concluded with a previously sanctioned entity. Whilst the reinstatement of sanctions may not invalidate a validly concluded agreement it may nonetheless block performance of that agreement, to the extent it involves dealing with the funds and economic resources of a sanctioned entity. Those dealings would be prohibited when asset freezes for that entity are reinstated under snap-back.

For example, if you are contracting now with the National Iranian Oil Company (NIOC), which was a key sanctioned entity under the old EU sanctions regime, then after snap-back it would be unlawful without a licence to receive from or make available to NIOC any funds or economic resources under the contract or otherwise. Any transfer of funds or economic resources from NIOC would need to be undertaken before snap-back takes effect (i.e. within at least two months of the dispute resolution mechanism under the JCPOA being invoked).

As a result, any agreement with long-term or continuing performance obligations (eg the new Iranian Petroleum Contract) is at risk, even if entered into prior to snap-back with an organization that was not, at that time, itself a sanctioned entity.

A similar position exists under US sanctions. According to a recent publication by OFAC FAQs[3]:

"After Implementation Day, secondary sanctions continue to apply to the following activities: (i) Iran persons who remain or are placed on the SDN (Specifically Designated Nationals) (ii) the IRGC and its designated agents or affiliates and (iii) any other persons on the SDN list designated under Executive Order 13224 or Executive Order 13382".

OFAC has, however, indicated that:

a. The US has committed not to retroactively impose sanctions on legitimate activities undertaken after Implementation Day. However, transactions conducted after the snapback occurs, could be sanctionable to the extent they involve activity for which sanctions have been re-imposed.

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[2] According to Article 10 of the Council Regulation (EU) No 267/2012 concerning restrictive measures against Iran and repealing Regulation (EU) No 961/2010, the prohibitions in Articles 8 and 9 shall not apply to: "transactions required by a trade contract concerning key equipment or technology in the exploration of crude oil and natural gas, production of crude oil and natural gas, refining, liquefaction of natural gas concluded before 27 October 2010, or ancillary contracts necessary for the execution of such contracts, or by a contract or agreement concluded before 26 July 2010 and relating to an investment in Iran made before 26 July 2010, nor shall they prevent the execution of an obligation arising there from".

"After Implementation Day, secondary sanctions continue to apply to the following activities: (i) Iran persons who remain or are placed on the SDN (Specifically Designated Nationals) (ii) the IRGC and its designated agents or affiliates and (iii) any other persons on the SDN list designated under Executive Order 13224 or Executive Order 13382."

b. The US Government has in the past worked with US or third-country companies to minimise the impact of sanctions on legitimate activities undertaken prior to the imposition of sanctions, and they anticipate doing the same in the event of a JCPOA sanctions snapback.

c. In the past, the US Government has authorised a wind-down period when new sanctions came into effect to allow companies to disengage from the sanctioned country. Whether and how long a wind-down period would be in the event sanctions are re-imposed on Iran is unknown.

There are, therefore, a number of key points to consider when analysing snap-back risk:

a. What is the profile of your return on investment for Iranian investments? The longer the period the more exposed to snap-back risk you could be.

b. What contractual mechanisms can you put in place to manage snap-back (termination event, political force majeure, performance bond etc) and when can they be triggered,

c. What arrangements can you put in place to transfer an investment either (i) during the period where a dispute has been referred to determination and snap-back has taken effect , or (ii) after snap-back during a predetermined permitted contract winding down period?

d. Will your investment require financing, insurance or EU currency transfers that would be frustrated by a snap-back of sanctions?

e. Is your Iranian business partner or counter-party a previously designated entity or person or are they owned or controlled by such an entity or person?

[3] Dated 8 June 2016 https://www.treasury.gov/resource-center/sanctions/Programs/Documents/jcpoa_faqs.pdf

Investment treaty protections

Beyond the threat posed by snap-back of sanctions, the reality of transacting in Iran is that investors must deal with national political risk and instability. A significant, but often overlooked, source of protection for investors is provided by way investment treaties, whether they are bilateral (BITs) or multilateral (MITs). These investment treaties offer a simple and cost-effective method of minimising political risk and can create significant savings as compared with political risk insurance. Appropriate structuring of an investment can provide investors with substantive protections directly against a State that has interfered with its investment.

In relation to an investment in Iran, there are three ways to gaining this type of protection.

Iranian BITs

Over 50 States have BITs with Iran that are currently in force, including China, France, Germany, Italy and Spain. Several States known for their high levels of foreign capital investment, including the US and the UK, do not yet have a BIT with Iran. American and British investors, however, may be able to benefit from the protections afforded in existing BITs by inserting a holding company in its corporate chain which is registered in one of the States that does have a BIT with Iran.

A BIT is a treaty between two States that gives rights and protections to individuals and companies of one of those States when investing in the other. In order to benefit from these rights and protections, the individual or company need only be a national of one of the States. It is not necessary for them to enter into any direct contractual relationship with a government. The network of treaties is significant and there are in excess of 3,500 BITs worldwide.

Where a BIT is in force, it will generally provide a number of protections for an investor, including where the State:

- expropriates an investment without compensation;
- fails to treat an investor fairly and equitably;
- treats an investor less favourably than its own nationals or nationals from a third State;
- fails to provide sufficient protection for the investment; or
- impedes the transfer of payment out of the State.

BITs are governed by the "norms" of international law as interpreted by arbitral tribunals and not necessarily the domestic law of one of the States. This means that countries cannot hide behind their own law or domestic courts to justify their actions. The dispute is decided by a neutral international tribunal, appointed by the parties. The awards are final and binding on the State and are not subject to a merits-based review by national courts.

The content and scope of protection can vary between BITs, so an investor needs to ensure that even if there is a BIT in place, its terms provide the desired protection to the specific investment. Investors should also be cognisant that some Iranian BITs require investors to obtain a licence from the Organisation for Investment, Economic and Technical Assistance of Iran (OIETAI) before the investment will be afforded protection. Investors granted a licence will also benefit from the protections and guarantees offered under the Foreign Investment Promotion and Protection Act (FIPPA), as discussed below.

Multi-lateral investment treaties

Iran is also a signatory to two multilateral investment protection treaties, which can provide protections to investors. The protections under these treaties are more limited in nature than that typically afforded in BITs.

First, Iran has signed The Agreement on Promotion, Protection and Guarantees of Investments amongst the Member States of the Organisation of the Islamic Conference 1981 **(OIC Treaty)**. Iran signed the OIC Treaty. It has been signed by 33 OIC member states and ratified by 27. The OIC Agreement sets out minimum standards applicable to capital and investment between member States. The protections are not as extensive as those specified in a BIT and there are very few cases that have been initiated under this treaty. If would be far more advantageous to have the protection of a BIT rather than the OIC Treaty.

Second, Iran has signed The Agreement on Promotion and

Protection of Investment among Member States of the Economic Cooperation Organisation 2005 **(ECO Treaty)**. Other signatories include Afghanistan, Azerbaijan, Kazakhstan, Kyrgyz Republic, Pakistan, Tajikistan, Turkey, Turkmenistan, Uzbekistan. Provisions include an undertaking to encourage and create favourable conditions for their investors to invest in the territories of the other Contracting Parties; a specific undertaking to admit investments by investors from other Contracting Parties; fair and equal treatment with national investors; and a guarantee against expropriation and nationalisation. It also provides for UNCITRAL arbitration. These protections only apply to member States.

Iranian Investment Protection Legislation

Iran has also implemented the Foreign Investment Promotion and Protection Act (FIPPA) and the Implementation Regulations (approved in 2002). FIPPA and the Regulations are designed to encourage and protect foreign investments in Iran whether by way of equity investment in Iranian companies or in the financing of Iranian projects.

Protection under the legislation requires certain conditions to be met and only provides recourse to the domestic courts.

Pursuant to FIPPA, all areas of the Iranian economy are open to private sector investment, under build, operate and transfer (BOT) Schemes, buy-back agreements and civil partnership. In these areas, foreign investors benefit from the same rights and exemptions available to local investors. FIPPA contains provisions whereby foreign investors cannot be deprived of their ownership rights unless such expropriation is in the public interest, and then only in accordance with a prescribed procedure and the payment of fair compensation. Generally speaking, however, FIPPA does not grant sufficient protection unless supported by the protection of a BIT (as described above). For example, FIPPA does not provide foreign investors with guarantees of fair and equitable treatment.

However experience shows that the FIPPA licence reduces bureaucracy and facilitates certain administrative issues, such as residency and work permits for employees of the foreign investor.

It is therefore likely that an investor's preferred option will be to structure its investment in Iran in a manner which benefits from the greatest possible BIT protection.

Tax considerations

Our survey of Iran's tax system suggests it is somewhat underdeveloped by international standards – the 1987 Direct Taxation Law, the foundation of the system, has not been extensively reviewed since 2001. The relatively low levels of foreign investment the country has seen since its 1979 revolution, as well as its over-reliance on oil revenues, have left the system under-equipped to deal with the complexities of international taxation. This, coupled with questions over financial transparency and a weak rule of law, means that the certainty over the tax treatment of investments, that is often sought by investors, may be lacking.

That being said, Iran's tax system currently has some superficially attractive elements. Corporate income tax is set at a not-too-aggressive 25 per cent, withholding tax on interest is low at five per cent, and there is no withholding tax on dividends. Importantly for foreign investors, there is currently no capital gains tax on non-residents disposing of shares in Iranian companies.

Along with this, generous tax exemptions and holidays are available for a wide range of activities, including some mining operations, oil and gas operations, agriculture and industry, which is common in countries opening up to foreign investment.

Tax reform

Moreover, factors such as the thawing of relations between Iran and the West and the recent shifts in the global oil markets are bringing in reforms, with a more efficient and stable tax system being on the Iranian Government's agenda. The Government is keen to decrease its dependency on oil revenues and is turning to taxation as an alternative. The focus has been on increasing the tax base by means of better record keeping and IT systems, and stronger enforcement of existing laws, rather than on increasing tax rates or introducing new taxes. This is not likely to last.

Whilst these moves have not been universally applauded by Iran's political elite (in particular, initiatives to tax business under the control of the Revolutionary Guard Corps, who carry out some of the county's largest infrastructure projects, have caused some tension), the general direction has been positive. In September 2015, the Iranian Government's tax revenues were reported to exceed its oil income for the first time in 50 years. As investment into and trade with Iran increases in coming years, we would expect continued modernisation of the Iranian tax system.

Double taxation agreements

Double taxation occurs where under the laws of two or more countries, tax is levied on the same income or gains. To avoid the heavy burden that double taxation would otherwise place on cross-border businesses, many countries have entered into bilateral double taxation agreements (DTAs), which assign taxing rights in respect of a given income or gain to only one of the countries.

Crucially, DTAs generally limit the withholding tax applicable to payments of interest, dividends or royalties paid by an entity in one contracting country to an entity in the other. A strong network of DTAs is crucial to support foreign investment in a country.

Maybe a little surprisingly for a country that was until recently isolated from the international community, Iran has around 40 DTAs, many fewer than the UK's 120, but more than many countries. Whilst France, Germany, Switzerland and South Korea have DTAs with Iran, the majority of the country's agreements are with developing countries – particularly eastern European and central Asian states. Several major economies, including the US, the UK, India and Brazil, have yet to negotiate DTAs.

Ultimately, tax planning for investors is much more than looking to benefit from the most favourable tax treaty – in fact, such an unsophisticated approach is unlikely to work. Iran is likely to see significant change to its tax system in the medium term, but sophisticated modelling of various possibilities, understanding of the existing and future legal framework for tax, pro-active engagement with government and tax authorities, and alignment of the commercial and tax functions within an investor, should give investors the opportunity to end up with a fair and certain tax liability in Iran beyond the short term.

Iran's DTA network:

Country (year in force)	Dividend withholding rate (per cent)	Dividend withholding rate for certain qualifying companies (per cent)	Interest rate withholding (per cent)	Royalties withholding rate (per cent)
Algeria (2010)	5	5	5	5
Armenia (1997)	15	10	10	5
Austria (2004)	10	5	5	5
Azerbaijan (2010)	10	10	10	10
Bahrain (2008)	5	5	5	5
Belarus (2001)	15	10	5	5
Bulgaria (2006)	7.5	7.5	5	5
China (2003)	10	10	10	10
Croatia (2008)	10	5	5	5
France (1973)	20	15	15	10
Georgia (2001)	10	5	10	5
Germany (1968)	20	15	15	10
Indonesia (2010)	7	7	10	12
Jordan (2008)	7.5	5	5	10
Kazakhstan (1999)	15	5	10	10
South Korea (2009)	10	10	10	10
Kuwait (2011)	5	5	5	5
Kyrgyz Republic (2005)	10	5	10	10
Lebanon (2001)	5	5	5	5
Macedonia (2014)	10	10	10	10
Malaysia (2005)	25	25	15	10
Oman (2009)	10	10	10	10
Pakistan (2004)	5	5	10	10
Poland (2006)	7	7	10	10
Qatar (2010)	7.5	5	10	5
Romania (2008)	10	10	8	10
Russia (2002)	10	5	7.5	5
Serbia (2011)	10	10	10	10
South Africa (1998)	10	10	5	10
Spain (2006)	10	5	7.5	5
Sri Lanka (2001)	10	10	10	8

Sudan (2009)	10	5	7	5
Switzerland (2003)	15	5	10	5
Syria (2001)	7	7	10	17
Tajikistan (2012)	10	10	10	8
Tunisia (2005)	10	10	10	8
Turkey (2005)	20	15	10	10
Turkmenistan (1999)	10	10	10	5
Ukraine (2001)	10	10	10	10
Uzbekistan (2005)	8	8	10	5
Venezuela (2007)	10	5	5	5

Should you wish to discuss any of the issues raised in this article, or for an update on the current sanctions situation, please do not hesitate to contact any of the members of Dentons' dedicated Iran team using the details provided below.

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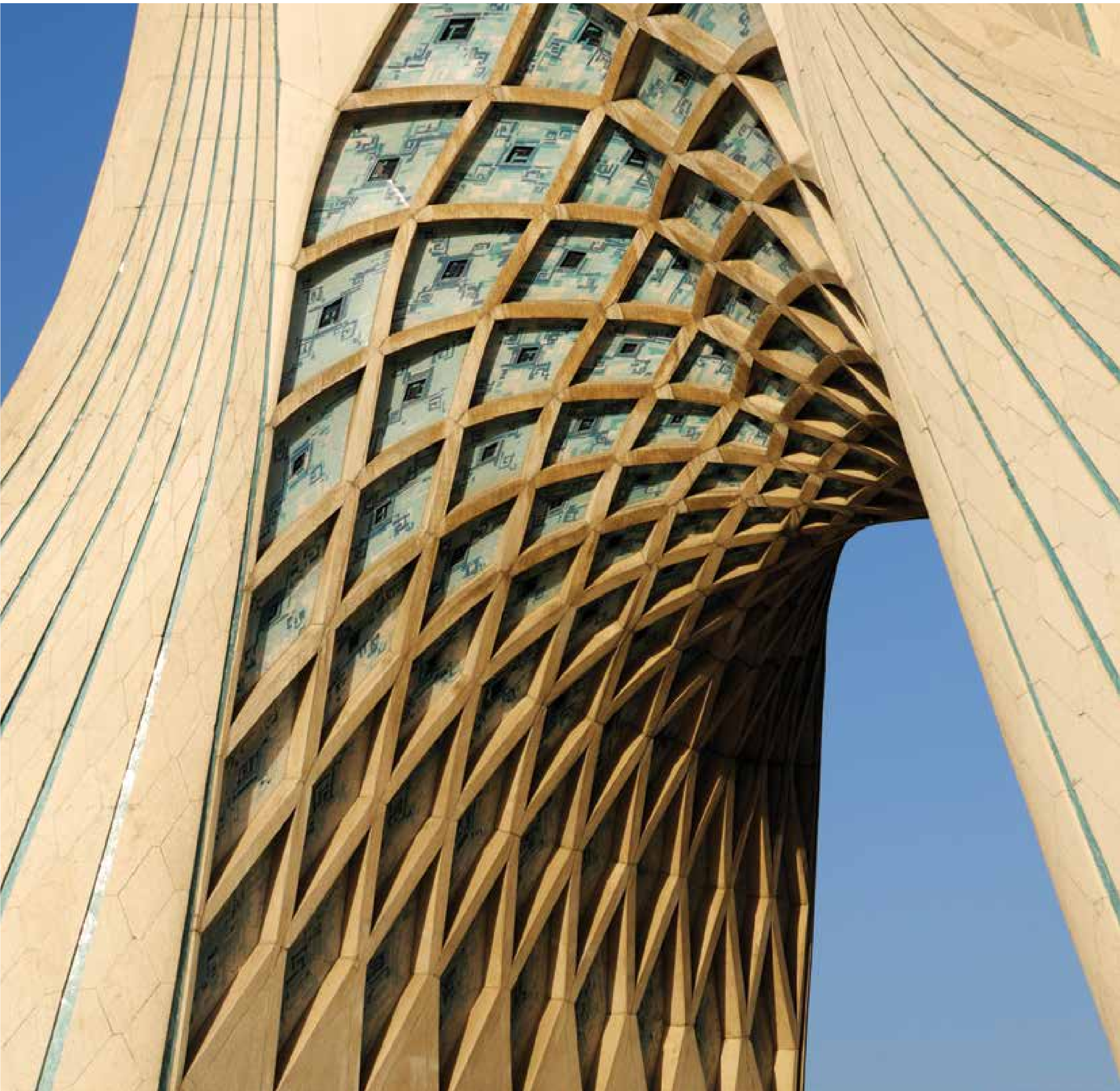

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