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Letter No.: DGCJN.511.06.360.02

Mexico City, 8 May 2002

Re: Marvin Roy Feldman Karpa vs. United Mexican States
ICSID Case No. ARB(AF)/99/1

Members of the Tribunal
Attention: Alejandro Escobar
Secretary of the Tribunal
ICSID –1818 H Street, N.W.,
Washington, D.C. 20433
United States of America

This submission responds to the questions raised by the Tribunal in the Secretariat's letter dated April 17, 2002, namely:

a) How should the Tribunal, in rendering its opinion on the merits, treat the pending parallel court actions in Mexico (other than the 1993 *Amparo* proceeding), given that the Mexican courts are considering under Mexican law some of the same issues that this Tribunal is considering under NAFTA and international law?; and

b) Are the pending Mexican court proceedings consistent with the waiver requirements of NAFTA Article 1121(2)(b), taking into account, inter alia, the exception of extraordinary relief, and notably the apparent differences between the English and the Spanish versions of that Article?

This submission also responds to the Claimant's request that the Tribunal should, upon receipt of the parties' submissions, declare the proceedings closed pursuant to Article 45 of the ICSID Additional Facility Rules.

I. INTRODUCTION

1. The Tribunal will recall that by the end of the Written phase of this arbitration, two series of domestic court proceedings had been initiated by the Claimant. The first series (the 1998 Fiscal Court Proceedings –now, Federal Court of Fiscal and Administrative Justice) had been completed with all issues resolved in favor of the Secretaría Hacienda y Crédito Público (SHCP). The second series (the 1999 Fiscal Court Proceedings) were then ongoing and had resulted in divided success. The latter proceedings are still ongoing, a full year later.

A. The Completed 1998 Fiscal Court Proceedings

2. On 24 April 1998 CEMSA filed an action in the Fiscal Court challenging the rebate denials by SHPC for the months of October through December 1997 and January 1998, as well as SHPC's 24 February 1998 resolution in response to CEMSA's inquiry of 12 December 1997.

3. In that challenge, CEMSA argued that the law should be interpreted broadly to achieve what CEMSA claimed was its general purpose; an argument that the fact that SHCP had previously granted it rebates during in 1996 and 1997 meant that it had tacitly issued a favorable resolution regarding CEMSA's entitlement to rebates; CEMSA alleged that Lic. Gómez Bravo's 16 March 1997 letter had confirmed every exporter's right to a 0% rate; and it argued that the revocation of the tacit favorable resolution breached Article 36 of the Fiscal Code. CEMSA also complained that SHCP's application of the law gave manufacturers an export monopoly, and argued that the 1993 Supreme Court decision obtained by CEMSA and the 1996 Fiscal Court decision in the *Lynx* case compelled SHCP to grant CEMSA rebates (See Counter-memorial at paragraph 234). CEMSA made these exact same arguments to the Tribunal, but has attempted to characterize them as violations of the NAFTA.

4. The Fiscal Court rendered its decision against CEMSA on 24 November 1998 (CEMSA submitted its claim before in this proceeding on 30 April 1999, about five months later, while an *amparo* proceeding was pending against the resolution.) It upheld SHPC's resolution of 24 February 1998 and the legality of the rebate denials. The decision dealt with each of CEMSA's arguments.[1]

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[1] The Court concluded that:

-as for the rebate denials for October through December 1997 and January 1998, it confirmed that the record did not show that SHPC had resolved favorably the rebate of the IEPS tax to CEMSA in the 1996-1997 period, that is, there was no individual, favorable resolution made on CEMSA's behalf; rather, the only resolution —the one issued on 24 February 1998— was resolved unfavorably;

-Lic. Gómez Bravo's letter of 16 March 1997 did not constitute a resolution favorable to CEMSA, as it had been granted in general terms and had no applicability to the concrete situation in question, because as the letter itself stated, a specific rebate application would have to be analyzed in light of the provisions in force at the time;

-the 1993 Supreme Court decision and the 20 February 1996 decision in the *Lynx* case were irrelevant to the case before it since they related only to a specific provision of the law applied in 1991 and 1992, respectively;

-fiscal law is to be interpreted strictly, in accordance with Article 5 of the Fiscal Code, and therefore, the broad interpretation sought by CEMSA was unavailable.-

-as for exports made in 1998, although exports generally triggered IEPS at a 0% rate, the exception provided for in Article 11 of the Law in force in 1998 —stating that the tax shall not be paid on sales subsequent to those to the retailer, and in no case shall there be accreditation or rebate of the tax— applied to CEMSA's cigarette exports; and

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5. CEMSA subsequently filed an *amparo* proceeding before a Federal Circuit Court, and the Court affirmed the Fiscal Court's decision on 24 August 2000. This was a final decision against which no further appeal or proceeding could be brought.

6. The Respondent has previously argued that the Federal Circuit Court's judgment establishes, as a juridical fact in this proceeding, that CEMSA was not legally entitled to receive payment of IEPS rebates on cigarettes exported in the October to December 1997, and that this juridical fact alone is sufficient to defeat the claim in this proceeding that SHPC's denial of IEPS rebates in late 1997 was tantamount to expropriation of CEMSA's so-called cigarette export business[2].

B. The 1999 Fiscal Court Proceedings

7. CEMSA initiated separate proceedings in the Fiscal Court to challenge the results of the 1998 audit and seek nullification of the 1 March 1999 resolution to reassess CEMSA for IEPS rebates that it received on cigarette exports in 1996 and 1997.

8. In addition to challenging the audit on procedural grounds, CEMSA contended, *inter alia*, that although it bought cigarettes from vendors that were not taxpayers and to whom the tax was not transferred expressly and separately, it was still entitled to rebates of the tax incorporated into the price of the cigarettes it had purchased. As to its exports to Honduras, CEMSA denied having made them on the premise that the evidence adduced by SHPC showed that DILOSA (the purported Honduran importer) did not exist and thus CEMSA could not therefore have exported to a low tax jurisdiction. Again, these same issues were presented to this Tribunal.

9. SHPC argued that compliance with the express requirements contained in the IEPS Law could not be excused on a discretionary basis. SHPC contended that CEMSA had no right to IEPS rebates since it did not comply with the express legal provisions set out in the IEPS Law, and that CEMSA could not be allowed to fabricate the IEPS in its favor through invoices that did not comply with the legal requirements.

10. On 16 June 2000, the Fiscal Court issued a decision holding in favor of SHPC on some points and in favor of CEMSA on others. The Court confirmed the correctness of the authorities' conduct in respect of procedural matters and also determined that CEMSA only had the status of taxpayer for final cigarette exports made to countries not considered as low tax jurisdictions. But the Fiscal Court resolved that SHPC could not require invoices with the IEPS expressly transferred and stated separately, on the basis that it was a requirement that was

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-applying the relevant provisions of the Law in a comprehensive manner, SHPC had correctly concluded that CEMSA was not entitled to obtain rebates because it could not comply with the requirements of Article 4 to have IEPS transferred to it expressly and separately, as Article 11 expressly precluded transferring the tax and any rebates for sales subsequent to those to the retailer.

2 See Counter-memorial paragraphs 359-389, Rejoinder paragraphs 26-31, and Transcript of Hearing, July 13, 2001, at pages 220-222

impossible to comply with in the case of cigarette exports. The Court determined that CEMSA was entitled to recover the tax that the producer actually paid on the first sale, being that it was the only taxable sale prior to exportation, of cigarettes actually exported to a country that is not considered as a low tax jurisdiction.

11. As to DILOSA, the Court rejected CEMSA's arguments and granted full probative value to the documents issued by the Government of Honduras and CEMSA's own *pedimentos* and invoices. The Court confirmed that the rebates obtained for exports made to Honduras were improper.

12. The Fiscal Court nullified the resolution of 1 March 1999, but only "for the purpose that the authority issue a new one that recognizes the right of CEMSA to accredit the tax that results from applying the tax as determined, as a function of the price to the retailer that the producer or manufacturer has declared for tobacco actually exported to countries that are not 'low tax jurisdictions' without this impeding the authority from verifying that the other requirements established in article 4 of the Special Law on Production on Services for the said tax to be accreditable have been complied with."[3] The resolution of 1st of March, 1999 remained in force as to the other findings.

13. Both CEMSA and the authority were dissatisfied with the Fiscal Court's ruling and challenged it through different means.

14. On 6 September 2000, CEMSA filed an *amparo* proceeding before the Federal Circuit Court in which it primarily attacked the probative value that the Fiscal Court conferred to CEMSA's *pedimentos* regarding exports to Honduras. CEMSA argued that its own documents were "completely lacking in probative value" and asserted, as it had to the Fiscal Court, that the Honduran Government's statement that DILOSA did not exist proved that CEMSA has made no exports to Honduras.

15. CEMSA also challenged the determination of the Fiscal Court that the rebates for exports to Honduras were improper. It argued that CEMSA had established that it was not related to DILOSA, and therefore had complied with the requirement in Rule 6.1.1. It also argued that the law should not distinguish in respect of whether the country of destination is or is not considered a low tax jurisdiction, notwithstanding that it abided by the provision requiring notice pursuant to Rule 6.1.1.

16. On 18 September 2000, SHPC initiated a distinct appeal of the Fiscal Court's ruling (*recurso de revisión*) before the Circuit Court. SHPC argued that the requirements to have

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[3] In addition, as to the determination of the omitted 85% tax rate, the nullification of the challenged resolution is for the purpose that the new resolution issued by the authority consider that the zero rate does not apply to final exports of processed tobacco to countries considered as "jurisdictions of low tax imposition", and that the 85% rate corresponds exclusively to the first sale of said goods within the national territory or their importation.

Finally, the authority is correct in considering as improper those rebates for exports made to Honduras, since said country is considered as being of "low tax imposition", as has already been indicated, and that these exports do not benefit from the zero rate. See CM 054433.

invoices that transfer the IEPS expressly and separately stems from a clear legal provision (article 4, section III of the IEPS Law), compliance with which is mandatory. In addition, it argued that these requirements were not impossible to comply with, as nothing prevents CEMSA from acquiring the goods directly from the producers or manufacturers. Whether producers and manufacturers sell directly to CEMSA is a matter between private parties that cannot be attributed to SHPC.

17. Thus, at the end of the Written Procedure, the status of the 1999 Fiscal Court Proceedings was as follows:

a) the Fiscal Court had remanded the matter to SHPC with directions to calculate CEMSA's entitlement to IEPS rebates on all exports, except those to Honduras, by calculating the actual amount of IEPS contributed by the producers of the goods that CEMSA exported;

b) the question of whether CEMSA was entitled to obtain IEPS rebates without having purchase invoices that separately state the IEPS was *sub judice* in SHPC's appeal of the Fiscal Court ruling;

c) the question of whether CEMSA was entitled obtain IEPS rebates on its exports to Honduras was *sub judice* in CEMSA's *amparo* against the Fiscal Court ruling; and

d) CEMSA had not challenged the remand directions of the Fiscal Court for SHPC to calculate CEMSA's entitlement to IEPS rebates on the basis of the amount of IEPS actually contributed by the producers.

18. Given that even the Mexican tribunals had not definitively ruled on these questions and that the judicial proceeding was (and remains) on course, there existed the possibility that SHPC would be able to recover all of the IEPS rebates paid to CEMSA on the basis that it did not obtain purchase invoices separately stating the IEPS as required by Article 4, III of the IEPS law. It was also seen to be possible, albeit unlikely, that the Claimant would be entitled keep some amount of the IEPS rebates received on its exports during the pertinent period, including its exports to Honduras, but calculated on the basis of the amounts actually paid by the producers, not on the basis of the inflated calculation methodology CEMSA applied on its own initiative.

19. The Counter-Memorial pointed out that these juridical facts would not be known until the domestic legal proceedings were finally concluded, but in any event, SHPC would calculate CEMSA's entitlement to IEPS rebates by applying the 85% tax rate to the *precio al detallista* — as the IEPS law provides and as the Fiscal Court had directed.

20. All these matters were presented to the Tribunal during the course of the arbitration. As should be evident from the above description, and the more detailed descriptions contained in the parties' pleadings, the disputes before the Mexican courts have involved technical issues of domestic tax law, which as a practical matter are not readily susceptible to review by a NAFTA tribunal. The legal reasons why the Tribunal should not endeavor to rule on such issues are discussed below.

II. QUESTION 1—TREATMENT OF PENDING JUDGMENTS OF THE MEXICAN COURTS

21. The Tribunal has already observed in its Interim Decision that:

> ...its jurisdiction under NAFTA Article 1117(1)(a), which is relied upon in this arbitration, is only limited to claims arising out of an alleged breach of an obligation under Section A of Chapter Eleven of the NAFTA. Thus, the Tribunal does not have, in principle, jurisdiction to decide upon claims arising because of an alleged breach of ...domestic Mexican law. Both the aforementioned legal systems (general international law and domestic Mexican law) might become relevant insofar as a pertinent provision to be found in Section A of Chapter Eleven explicitly refers to them, or in complying with the requirement of Article 1131(1) that "A Tribunal established under this Section shall decide the issues in dispute in accordance with this Agreement and applicable rules of international law." Other than that, the Tribunal is not authorized to investigate alleged violations of either general international law or domestic law.[4]

22. The Respondent has further submitted that this Tribunal has no jurisdiction to decide questions of Mexican law, and it cannot resolve questions that are found to be *sub judice* before national tribunals. The tribunal also does not act as a court of appeal with authority to review the rulings of national courts..

23. Here, as in the *Azinian* case, the Claimant could only succeed if he advanced a claim disavowing the findings of the domestic courts as amounting to a denial of justice. The Claimant has not submitted such a claim to arbitration. Indeed, any such claim would be premature until all appeals have been exhausted. Even then he would have to establish that the judgments of the domestic courts were based on a clear and malicious misapplication of the law[5]. Here, as in *Azinian*, no such complaint has been made.

24. The tax rebate denials for late 1997 and early 1998, as well as the illegality of the rebates after 1998, were upheld by the Mexican Tribunals in the 1998 proceeding by a final decision. The final decision issued in the 1999 proceeding only concerned the SHCP's decision issued on March 1, 1999, related to the final assessment against CEMSA.

25. If CEMSA prevails in the 1999 proceeding, which cannot be anticipated, the Tribunal cannot presume that SHCP will not comply with the ultimate ruling of the courts in the 1999 case; to the contrary, Mexico has demonstrated that SHCP complied fully with the ruling in the 1993 case, and affirms that SHCP will comply with the court's decisions. However, the outcome of the 1999 proceeding is not yet final.

26. Mexico submits that the material facts remain unchanged from the time of the hearing, indeed from the time of the written submissions. Mexico's Counter-Memorial included the following summary of the domestic litigation:

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[4] Interim Decision at paragraph 61.

[5] *Azinian and Others v. The United Mexican States*, Award, November 1, 1999, at paragraphs 99-103.

11. Thus, one set of Mexican courts upheld the fiscal authorities' position on the invoice requirement. It is correct that another court in proceedings that are not yet complete (the "1999 Fiscal Court Proceedings") decided the question differently. That decision is being appealed by both parties and is the subject of an *amparo* by CEMSA in those ongoing proceedings. The claimed right to rebates has not been finally determined in Mexican law. The first required element of the expropriation claims, *i.e.*, a right, is not yet determined. The Claimant is asking this Tribunal to substitute itself to resolve these issues on the basis of expert evidence of Mexican law on the existence of this right even though the courts rejected it in one case and the decision in the second case is on appeal and *sub judice* in the Mexican courts.

27. This is essentially the same situation as exists today: the 1999 Fiscal Court Proceedings are continuing, and the decision is *sub judice.* At the same time, the 1998 Fiscal Court Proceedings remain final, just as they were before.

28. Mexico has stated its position regarding these points in detail. Therefore, Mexico urges the Tribunal to review again its detailed explanation of why the Tribunal should not undertake to investigate questions of domestic law, as set out at pages 6 through 10 of Mexico's Rejoinder. That discussion has the same relevance with respect to the question now posed by the Tribunal.

29. The Tribunal should also be mindful that there are other defenses that completely dispose of the second expropriation claim, including the Respondent's submissions that:

a) CEMSA's claim to entitlement to receive IEPS rebates was not "investment" within the meaning of Article 1139—rather, it was at most a claim to money which is expressly excluded from the definition of investment;

b) CEMSA's so-called cigarette export business was not an "investment";

c) CEMSA's cigarette export business in 1996-1997 had no commercial value upon proper calculation of the IEPS rebate—the evidence clearly shows that IEPS rebates in the amount actually contributed by cigarette producers would have resulted in a negligible profit margin on all sales of Marlboro and other international brands that CEMSA exported;

d) the entire claim should be dismissed on grounds of public policy—as noted above, the Tribunal can properly infer that cigarettes purportedly exported to the United States ultimately re-entered Mexico and were resold in the Mexican market.

III. QUESTION 2—APPLICATION OF THE ARTICLE 1121 WAIVER TO PENDING PROCEEDINGS IN THE MEXICAN COURTS

30. The Respondent has submitted in its pleadings that the terms of the waiver that the Claimant submitted pursuant to Article 1121 did not preclude CEMSA from continuing either the 1998 Fiscal Court Proceedings or the 1999 Fiscal Court Proceedings after the claim was submitted to arbitration. In the view of Mexico, the domestic proceedings are (or were) the

appropriate remedy to determine the Claimant's and CEMSA's status and rights under the Fiscal Code and the IEPS law[6].

IV. CLAIMANT'S REQUEST FOR A DECLARATION THAT THE PROCEEDING IS CLOSED

31. Article 45 – *Closure of the Proceeding* – provides as follows:

> (1) When the presentation of the case by the parties is completed, the proceeding shall be declared closed.
>
> (2) Exceptionally, the Tribunal may, before the award has been rendered, reopen the proceeding on the ground that new evidence is forthcoming of such a nature as to constitute a decisive factor, or that there is a vital need for clarification on certain specific points.

32. At the conclusion of the hearing, after confirming that each party was satisfied that had it been given a sufficient opportunity to present its case, the President of the Tribunal stated:

> ...As far as the two issues which I have enunciated are concerned, I conclude by saying first that the hearing is being terminated and no further -- no further briefs are expected.
>
> Second if the tribunal finds that during their deliberations there is a further need for information, the tribunal would address both parties the same applies if the need arises to employ an assistant.
>
> Thank you again for your cooperation. Enjoy your weekend.

33. The Respondent believes that the President's remarks constituted a declaration that the proceeding was closed. Assuming that is correct, it would be for the Tribunal to determine whether pending proceedings in the domestic courts are expected to produce new evidence of a decisive nature, and whether it sees the need for clarification on certain specific points.

34. The Tribunal will recall that during the hearing, the Respondent tendered in evidence the decision of the Circuit Court in SHPC's appeal, rendered on May 31, 2001. In its decision, the Court made the following findings:

> a) It is illegal that the Fiscal Court held that Articles 2, section III and 4, section III of the IEPS Law are incompatible, because Article 2 set up the applicable tax rate according to the acts or activities carried out. Moreover, Article 4 states the rules in order to credit the respective tax. Thus, it is clear that these two provisions complement each other and there is no contradiction as the Fiscal Court referred it;

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[6] See Rejoinder paragraphs 46-51.

b) The Fiscal Court illegally replaced the arguments in the claim, because it resolved issues that were not submitted by CEMSA. This is, CEMSA did not challenge that its exportation to a low income countries, were considerate as sells within the national territory in accordance to Article 2, section I of the IEPS Law, and thus it applied to those the 85% rate provided is such disposition, as it was argue by SHCP. Rather, CEMSA only argued that it did not make exportation to Honduras. The Fiscal Court resolved that the 85% rate was not applicable to the exportation made to Honduras, because such rate applies only to the sells made in the national territory and final exportations is a different case. Therefore, the Fiscal Court replaced illegally the arguments made in CEMSA's Claim.

c) Finally, the Circuit Court concluded that the Fiscal Court omitted to consider the arguments submitted in SHCP's counter-claim, regarding the official whom carried out the audit. The Circuit Court held that they were empowers pursuant the law in order to make the audit.

35. By letter dated 13 December 2001, the Respondent notified the Tribunal that the Fiscal Court had issued a modified judgment to implement the decision of the Circuit Court. The Respondent also advised the Tribunal that the Claimant had initiated an *amparo* against the decision of the Fiscal Court. This information and a copy of the modified judgment was provided to the Tribunal for information purposes. There was no request to accept the modified judgment as new evidence.

36. The Claimant replied the following day:

> Claimant urges the Tribunal to disregard Respondent's untimely communication dated December 13, 2001. As Respondent acknowledges, this is just another stage in an on-going process in the Mexican courts with no definite result. This case is on appeal and could go to the Supreme Court as well.

37. However, the Claimant wrote to the Tribunal on 9 April 2002, now purporting to advise that the decision of the Fiscal Court "has been vacated by the Mexican Court of Appeals (sic) ". He made the following submission:

> Consistent with the *amparo* issued by the Supreme Court in CEMSA's favor in August 1993, the Court of Appeals (sic) held two provisions of the IEPS law (1996-97) unconstitutional on grounds of discrimination in violation of Article 31(4) of the Mexican Constitution: (a) Article 2, III relating to exports to so-called low tax counties, and (b) Article 4 relating to separation of the IEPS tax. In discussing Article 4, the Court ruled that the requirement for separation of the IEPS tax discriminated unconstitutionally in favor of producers and first purchasers of cigarettes and against subsequent purchasers. Further, the Court noted that this requirement is one of form, not substance.

38. The Claimant wrote again to the Tribunal on 22 April 2002, requesting the Tribunal to "declare the proceeding closed ... and issue its award as soon as possible ..." upon receiving the parties' responses to the two questions posed the Tribunal.

39. The Claimant continues to ignore the findings and outcome of the 1998 Fiscal Court Proceedings where both the Fiscal Court and the Circuit Court upheld the validity of SHPC's

denial of CEMSA's rebate requests in late 1997 and January 1998, and SHPC's ruling that CESMA was not entitled to receive IEPS rebates without possessing purchase invoices with the IEPS separately stated. Instead, he asks the Tribunal to freeze the findings made in the 1999 Fiscal Court Proceedings that, for the moment, stand resolved in his favor with respect to certain points, and to apply these retroactively.

40. As the Respondent has explained in response to the Tribunal's first question, the juridical facts relevant to the expropriation claims that are properly before the Tribunal have already been established, and there is no need to take into account, as new evidence, developments in the 1999 Fiscal Court Proceedings that have occurred since the hearing, or to await the final outcome of those proceedings which could take considerable time in order for the Tribunal to issue its award.

41. The relevance of the decision, which was issue after the hearing, is that issues in dispute, which are questions of Mexican taxation law, it involves an ongoing proceeding where continue *sub judice*.

Sincerely,
Hugo Perezcano Díaz
[Signature in the original]