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PARTIES MAY BE AWARDED TOO LITTLE, OR PAY TOO MUCH, IN DAMAGES, IF THEY DO NOT ADDRESS CORPORATION TAXES PROPERLY OR AT ALL.

The impact of corporate taxation on economic losses

James Nicholson[1]

INTRODUCTION

Taxes, and particularly taxes on corporate profits, are a fact of life in many jurisdictions. As a result, the treatment of tax in the calculation of awards of compensation made by tribunals in international commercial and investment treaty arbitration can have a significant impact on the value of an award to a recipient. Claimants can be over- or under-compensated for economic losses when taxes are not considered appropriately or at all.

The treatment of taxation in relation to awards of damages may, depending on the circumstances, be a question of the law of damages before it is a question of the assessment of economic loss. In this chapter, I focus on questions of economic loss arising in this context. These issues can be complex, given the nature of the calculation of an award, its timing and the international context in which many claims are made. Perhaps partly as a result, this area has often been given limited attention by tribunals and parties to disputes.

This paper describes some of the issues that can contribute to the distortion of after-tax award values, and explores some simple steps that can be taken to mitigate such distortions and thereby achieve more equitable compensation awards.

TREATMENT OF ARBITRATION AWARDS

i Why does tax matter?

Famously, the calculation of an award of monetary damages in bilateral investment treaty (BIT) arbitrations is based on the principle established by the Permanent Court of International Justice (predecessor to the International Court of Justice) in *Chorzow Factory* (1928):

"[…] reparation must, as far as possible, wipe out all the consequences of the illegal act and re-establish the situation which would, in all probability, have existed if that act had not been committed."

The ex ante position should be restored.

A substantially similar principle generally applies in international commercial arbitration – that the claimant should be restored to the position it would have enjoyed but for the breaches found by the tribunal. I shall call this the 'principle of full compensation'.

Taxation of corporate profits is well established in most jurisdictions (although individuals are often parties to international arbitration, we focus in this chapter on the situation of corporations). Such taxes would often have applied to additional profits a claimant would have made but for the financial implications of its injuries, and also often apply to any award received by a claimant.

The principle of full compensation would therefore imply that any award should, post tax, restore the claimant to the same post-tax position that it would have enjoyed but for its injuries, and it follows that this in principle requires consideration of the tax treatment of both the hypothetical additional profits and also the award claimed.

In my experience, the question of tax is often largely and sometimes entirely disregarded by the parties to a dispute. The sources of this neglect are understandable:

a damages calculations are often already complex, time-consuming and expensive for the parties before consideration of tax issues;

b tax is itself a complex area often requiring separate experts if it is to be examined in detail; and

c because the amount of taxes that would have been or will be paid in certain scenarios can depend on the performance in the future or hypothetical position of the legal entity being considered, the treatment of tax issues may require yet further analysis and estimation.

Moreover, to assess the extent of taxes that a claimant will pay on any award, it is often necessary to make estimations concerning the future actual performance of the claimant (because, for example, a loss-making company may pay no taxes on an award while the same company, if profitable, would). Any such estimation underlying an award can be compared to the future actual performance of the business and is hence a potential source of dissatisfaction for one of the parties affected by an award of damages.

The treatment of taxation by tribunals in setting awards can make an important difference to the net proceeds of an award to a claimant and therefore whether the principle of full compensation has been met. Most simply, if an award itself is subject to tax and the value of the award has been calculated by reference to profits lost on a post-tax basis, under-compensation of a claimant is likely to arise. In such circumstances, the principle of full compensation might at its most straightforward imply that it would be necessary for the claim to include a gross-up for tax payable on the award.

Below I discuss some of the conceptual issues involved in considering the tax implications of damages awards, before giving an overview of tax issues in selected jurisdictions and discussing some possibilities for moving closer to the principle of full compensation in considering tax and awards.

ii Issues raised by tax analysis

To illustrate the issues at hand, consider a straightforward case in which a claimant is only seeking compensation for trading losses suffered in its home jurisdiction.

To analyse fully the tax treatment of the hypothetical lost profits, the following would need to be taken into account:

a Over which periods would the profits have arisen?

b What is the effective tax rate that should be applied to those profits, which itself depends on the answers to the following questions:

- What is the applicable corporation tax rate in each period?
- What is the basis of the calculation of taxable profits in each period (e.g., taking account of allowances, depreciation of assets for tax purposes and other factors)?
- To what extent are other losses available for offset either within the period, brought forward from earlier periods or surrendered from affiliates?

A similar analysis would be required in relation to the award claimed in compensation for the lost profits, which would need to take into account the following:

a On what basis will the award be subject to tax? It may follow the taxation of the lost profits or be treated as a separate source of income or gains subject to different rules.

b In which period would it be subject to tax? At the time of the claim, both the timing of any future award payment and the tax position of the claimant in the tax periods in which the award may be received are likely to be uncertain.

Further considerations come into play when the injury causes loss to an asset. Depending on the applicable jurisdiction, damage to an asset may result in a deemed disposal or part disposal of the asset for tax purposes, and any compensation for such loss may be treated as proceeds for such disposal. This may apply when the asset is tangible property, or intangible property such as a brand, which may be a recognised asset on the claimant's balance sheet. The capital gain or loss will be calculated according to applicable tax principles, deducting allowable costs (of acquisition, etc.) from the proceeds of disposal. This calculation may not be consistent with the method used to calculate the award, which may be by reference to loss of revenue, and this would need to be taken into account to ensure appropriate post-tax compensation.

Further refinement would be needed in cases in which a claimant seeks compensation for profits that would have been generated partly or entirely in jurisdictions other than its home jurisdiction. This is very often the case in BIT cases, for jurisdictional reasons, and also in those commercial cases in which a parent company is claiming for losses suffered by its foreign subsidiaries.

Although international law may apply to the arbitration process, tax law is not international. Each jurisdiction has sovereign power to determine the taxation of companies resident or active in that jurisdiction. The diversity of approach taken by different jurisdictions to taxation of corporate profits can be illustrated by the table below, which summarises headline corporation tax rates for 2017.[2] The calculation of the profits subject to tax, taking account of reliefs, exemptions, losses and affiliated company tax positions, also varies.

Corporation tax rates in selected jurisdictions (2017)

Jurisdiction	Corporation tax rate (%)
China	25
France	33.33
Germany	15
Hong Kong	16.5
Ireland	12.5
Singapore	17
Switzerland	8.5
UAE	0
UK	19
US	35
Venezuela	34

In cross-border cases, therefore, it is necessary to consider whether there is symmetry of taxation between the lost profits on one hand, hypothetically subject to tax in the home jurisdiction of the injured company, and the award on the other, potentially taxable as income or capital gains when received by the injured company or an affiliate in another jurisdiction.

This situation also raises the question of equity between jurisdictions as well as between claimants and defendants; where tax is lost in one jurisdiction due to the injury inflicted on one company and paid in another jurisdiction as a result of compensation paid to a parent or affiliate in that other jurisdiction, some form of settlement might be expected between jurisdictions. However, there is no mechanism in the established tax treaty system for tax fortuitously received in one jurisdiction to be reimbursed to another, so such a process is not yet formally possible (in commercial cases at least). (Although see below regarding the tax treatment in France - and potentially other jurisdictions - of compensation for expropriations).

There is also the possibility of a claimant receiving a pre-tax award on the basis that it will pay tax on that award, and then for whatever reason not in fact paying the associated taxes. Such over-recovery would also be a violation of the principle of full compensation.

iii Perspectives from the UK, the US and France

As the brief survey above indicates, the issues involved are complex, and a detailed analysis of tax issues risks creating a separate arbitration within the arbitration, requiring further evidence of fact, evidence from tax experts, etc. I have never sensed an appetite among parties and tribunals for such a detailed investigation – an understandable attitude given the potential for excessive technical detail, creative assumptions and uncertainty of tax outcomes outside the control of a tribunal. However, I question whether, in avoiding analysis, parties sometimes err too far in the direction of avoiding issues of taxation altogether, leading to over or under-compensation.

Before I discuss the relatively simple steps that parties and tribunals can take towards implementing the principle of full compensation as far as taxation is concerned, I explore certain perspectives arising in the UK, the US and France.

UK perspective

The English law of damages is developing, but the 1880 speech of Lord Blackburn in *Livingstone v. Rawyards Coal Co* defining the measure of damages has often been cited with approval: 'The sum of money which will put the party who has been injured, or who has suffered, in the same position as he would have been in if he had not sustained the wrong for which he is now getting his compensation or reparation'.

British Transport Commission v. Gourley[3] confirmed that general principle. However, the degree of approximation with which this principle is applied to the treatment of taxation on damages is variable.

The UK corporation tax treatment of an award of compensation is determined by the nature of the loss to which the award refers. When corporate trading activity has been damaged, and the award is calculated by reference to the loss of trading profits, it will be treated as taxable trading income. The timing of taxation of an award is likely to follow the period in which the award is recognised in the recipient's accounts.

When the tax position of a claimant is known for the period of the loss and can be anticipated for the period of the award, any analysis of taxation (if applicable) may not be overly complex. Relevant considerations here include whether there are tax losses or changes in the calculation of the tax base affecting the amounts of tax paid either but for the injury or in actuality, and whether the applicable rate of tax is consistent across the relevant periods.

When uncertainties exist over the tax position, it may still be possible to make assumptions for UK tax purposes to identify the relevant post-tax positions. Even when the situation is more complex (e.g., when claims for losses involve group companies, restricted loss relief is available or the timing is not clear), a simplified calculation may often be possible, identifying the uncertainties and adopting a pragmatic approach that is comprehensible to the tribunal and reasonable for the parties.

When compensation is claimed for damages other than loss of trade profits, it is necessary to determine whether the claim is in respect of a capital or revenue loss, and for capital losses, whether the loss relates to an underlying asset treated as chargeable for corporation tax purposes. A significant body of case law addresses the capital and revenue distinction, and UK statute defines chargeable assets. The area is complex, and the facts will determine the UK tax treatment.

When compensation is claimed for permanent damage or for deprivation of use of a fixed capital asset, it is possible that an award will be treated as a capital receipt. The tax treatment of the award will then be determined on the basis of whether the damage can be related to underlying property that is a chargeable asset for the purposes of calculating corporation tax on disposal (e.g., plant and machinery). In such cases, an award may be considered a deemed disposal or part-disposal of the asset, and a capital gain or loss would then arise for corporation tax purposes. It was established in *Zim Properties* that the right to take court action in pursuit of compensation or damages is in itself an asset for capital

gains tax purposes.[4] This case related to damages for professional negligence, and under current UK practice a punitive tax cost can arise.

Intangible assets such as goodwill were also historically treated as chargeable assets for corporation tax purposes; however, specific rules now apply to intangibles acquired (from third parties) or created after April 2002 such that gains or losses on disposal will be treated as revenue income or loss.

A capital receipt not related to an underlying chargeable asset will not be subject to corporation tax under general principles. However, the basis on which receipts are characterised as non-taxable capital is dependent on the underlying facts, subject to a wide range of case law precedent, and therefore not clearly defined. In such circumstances, a claimant might prudently assume that an award subject to uncertainty of characterisation will be taxed as revenue, implying full taxation of the award. This is particularly the case when the amount of the award has been calculated assuming full taxation of the related hypothetical lost profit.

However, this assumption may not preclude a claimant from taking an alternative position for tax return purposes, claiming a proportion of the award as a non-taxable capital receipt and thereby unduly benefiting from the award.

A UK-based claimant would therefore need to identify the nature of the lost profits (whether capital or revenue) to analyse the tax treatment of the amount claimed. To restore the *ex ante* position, the calculation of the amount of the award should take account of the tax treatment of both the loss and the award itself. For example, when the award is calculated by reference to lost trading profits net of tax, to restore the *ex ante* position a gross-up would be required to adjust for any tax payable on the award when it is recognised for tax purposes.

The treatment in the UK of cross-jurisdictional issues will depend on the circumstances. As one example, in the case of a French branch of a UK company, a claim made in respect of injury suffered in France would be calculated by reference to the taxation of the profits of the branch in France according to French tax rules. To evaluate the total post-tax loss, any UK tax also arising in respect of the branch profits would need to be taken into account. A UK head office may elect to exempt branch profits from UK tax, and specific information relating to both the UK tax rules and the circumstances of the claimant would need to be taken into account. If the award is then payable to the branch, again the French and UK tax treatment of the award would need to be considered. If the award is payable either directly to the head office or to an affiliated company, such as a holding company in a third jurisdiction, the tax treatment of the award in that jurisdiction would need to be considered together with the accounting treatment by the company of revenue arising in one entity in respect of a loss suffered by an affiliated entity. Such transaction may take the form of an intercompany loan or a dividend, depending on the ownership structure between the relevant entities, and each will give rise to different tax consequences. Although the detail of these issues may be complex, a coherent simplified approach with clear assumptions and implemented by a tax specialist would allow for a practical outcome on a case-by-case basis.

US and French perspectives

US courts have approached the issue of taxation of arbitration awards in the context of employment tribunal cases adopting a 'make whole' purpose that is broadly consistent with the principle of full compensation.[5] These anti-discrimination cases are not directly relevant to the discussion relating to international commercial and investment treaty awards, but some insightful guidance emerges, such as tribunals emphasising the significance of the particular facts of each case, and placing the burden of proof on claimants to establish any adverse tax consequences to be taken into account.

Turning to investment treaty cases involving US-based claimants, the award in *Chevron and Texaco v. Ecuador* included lengthy analysis of the tax consequences in Ecuador of profits lost.[6] After the Republic of Ecuador agreed that no further tax or penalties or interest would be payable on the award, the award was calculated on a net-of-tax basis.

In *Corn Products v. Mexico*, the net of tax award was made to a US parent rather than to the Mexican subsidiary to ensure no additional taxes were payable in Mexico.[7] It is not clear whether US taxes would ultimately have been payable by the claimants in these cases or whether this was relevant in the calculation of the award. If the awards were subject to tax in the US, the *ex ante* position may not have been restored unless the profits lost in Mexico would also ultimately have been subject to US tax.

A final point of fairness arises in the context of investment treaty awards. In the case of the expropriation of a company by a government, the value taken by the expropriating government is, as a first approximation, the after-tax value of the relevant entity. If an award against a government is paid to the parent company, as is often the case for BIT awards, and that award is taxed in the parent company's jurisdiction, then there is a possibility of the losing government paying an award greater than the value taken. The excess between the value taken and the amount paid would then effectively be a tax windfall for the government of the parent company's jurisdiction.

It is perhaps to guard against such an outcome that the French Tax Code stipulates that the French state will levy no taxes on awards paid in relation to expropriation or similar measures by a foreign government.[8]

Simple steps towards the principle of full compensation

One formula I often see used by a claimant is to state its claim before any corporation taxes the affected entity would have paid, on the grounds that any award will itself be taxed, leaving the claimant's net position in line with the principle of full compensation. This formula is appropriate if the taxation of the lost profits would have been broadly in line with the taxation of the award both by reference to the method of calculation and the marginal tax rate for the periods in question.

An alternative formula often used is for a claimant to state its claim after the taxes the entity would have paid, and to leave it to the tribunal to award an amount that leaves the claimant's position after the taxation of the award such that it receives full compensation on a net basis. This formula essentially defers the question of taxation to the hearing or post-hearing stage. Such approach would be appropriate if it is clear that the award itself would not be subject to tax. However, when the tax treatment of the award is not addressed at all, the claimant would be at risk of under-compensation.

In view of the limitations of the above formulae, in many cases it may improve the appropriateness of awards at an acceptable cost to pursue the issue of taxation slightly further. I am not urging a full and detailed analysis of taxation (although there may be cases in which that would be justified), but rather a small number of relatively simple steps to refine an award of damages, increase the tribunal's confidence that it is issuing an award in line with the principle of full compensation, or both.

Under such an approach, the most significant tax considerations would be taken into account, and credible and transparent assumptions applying reasonable parameters would be made. For example, lost profits would be attributed to appropriate periods, applicable rates used, tax losses used in accordance with normal practice, and account would be taken of restrictions on relief for past losses. Any cross-jurisdictional tax issues would need to be considered specifically for each jurisdiction. Such refinements could be made subject to a materiality threshold agreed between the parties or imposed by the tribunal to avoid unnecessary delay and cost.

A difficulty arises from the fact that the extent of taxation of an award may depend on the financial performance of the claimant in the future period in which the award is received, and may therefore be unknown at the date of the hearing or post-hearing briefs. It may be possible to address this difficulty through the use of payment into an escrow account of that part of an award relating to anticipated taxes on the award, pending a final determination of the tax impact of the award at the appropriate time.

Given the complexities involved in assessing taxes, even at a relatively simplified level it is likely to be useful to secure the input of individuals with hands-on experience of tax assessment in the relevant jurisdictions to validate the approach being undertaken. Such input may come from the parties' own finance teams, or existing external taxation advisers. A number of consulting firms active in the assessment of losses in international arbitration have tax groups that could also offer expertise in this area (including FTI Consulting).

III CONCLUSIONS

Taxes have an important effect on corporate profits in many jurisdictions, and accordingly have an important effect on the assessment of claims for losses and the value of resulting awards to claimants.

Tax issues can in many contexts quickly become complex, and we have outlined above some of these possible complexities. Perhaps partly due to this complexity, parties to disputes and tribunals have often considered tax issues only at the highest level or not at all. Such approach risks violating the principle of full compensation.

If there are relatively simple steps that can be taken that move the net result of an award of damages closer to meeting the principle of full compensation, and these can be undertaken without greatly increasing the cost and time involved in the arbitration process, then such steps may lead to an all-round improvement in the outcome of an arbitration.

In many cases it may improve the correspondence between an award and the principle of full compensation, and at an acceptable cost, to go slightly further in the consideration of tax issues than is often the case in the international arbitration procedures I have observed.

NOTES

1. James Nicholson is a senior managing director at FTI Consulting. This chapter was prepared with extensive input from the FTI Consulting EMEA tax practice.
2. OECD tax database, www.tradingeconomics.com, KPMG corporate tax rates table.
3. HL 1955.
4. *Zim Properties Ltd v. Proctor* 58 TC 371.
5. *Eshelman v. Agere Systems Inc.*
6. *Chevron Corporation (USA) and Texaco Petroleum Company (USA) v. Republic of Ecuador* (March 2010), PCA Case No. 2009-23, cited in Nhu-Hoang Tran Thang, *Tax Gross-Up Claims in Investment Treaty Arbitration*, February 2011.
7. *Corn Products International Inc v. United Mexican States* (March 2010), ICSID Case ARB(AF)/04/1, cited in Nhu-Hoang Tran Thang, Tax Gross-Up Claims in Investment Treaty Arbitration, February 2011.
8. Article 238 bis C.

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James is President of the Standing Committee of the ICC's International Centre for ADR, which advises the Centre in the application of the ICC's Expert Rules.

James was identified by The International Who's Who of Commercial Arbitration as one of the few 'Most Highly Regarded Individuals' in Europe in its 2015 (5 identified), and 2016 and 2017 (10 identified) rankings of more than 160 expert witnesses active in commercial arbitration.

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