AVOIDING DOUBLE TAXATION ON INTERNATIONAL ARBITRATION AWARDS

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I. INTRODUCTION

In the recent international arbitration case between Venezuela Holdings B.V. et al. and Venezuela, the Tribunal included the following commentary in the Award:[1]

> *The Claimants contend that compensation should be calculated and payable in an amount net of any taxes, domestic or foreign. Accordingly, they request that compensation be calculated on an after-tax basis and that the quantum of the compensation be increased to include the amount of any tax levied by the Respondent and the amount of any tax liability that may be incurred as a result of the Award and as a consequence of the Respondent's wrongful measures. The Claimants consider that 'at the very least', the Tribunal should specify that the compensation established in the Award is 'net of taxes and shall be automatically grossed up to offset any Venezuelan tax liability that may be imposed or purportedly may arise from that compensation'…*
>
> *Regarding taxation by Venezuela, the Tribunal recalls that the compensation awarded to the Claimants has been calculated taking into account all taxes to be paid to the Venezuelan authorities. As a consequence, that compensation should be paid net of any Venezuelan tax.*

The Tribunal's decision in this case raises interesting issues that warrant further discussion and analysis. For example, what is

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[1] *Venezuela Holdings B.V. et al. v. Bolivarian Republic of Venezuela,* ICSID Case No. ARB/07/27 (2014).

the basis of the Claimants' request that "compensation be increased to include the amount of any tax levied by the Respondent and the amount of any tax liability that may be incurred as a result of the Award" and why did the Tribunal agree that "compensation should be paid net of any Venezuelan tax"? In this article I will discuss taxation in the context of international arbitration awards and analyze some of the key issues that arise when considering the potential taxation of an award as part of the calculation of economic damages.

It is generally accepted in the context of investment treaty arbitration that an award of damages is meant to place the Claimant in the same economic position that it would have occupied absent or 'but-for' the alleged wrongful actions of the Respondent.[2] The origin of this principle is commonly attributed to the international law case of *Factory at Chorzów* (1928) and it is often referred to as "Full Reparation". The application of the Full Reparation framework may mean that the amount that would fairly compensate the Claimant is higher than the fair market value ("**FMV**")[3] of the Claimant's investment, which is often the value definition applied in international arbitration cases for the purposes of determining compensation.

In order to achieve Full Reparation, a calculation of economic damages should consider the impact that the taxation of an award would have on the overall compensation received by the Claimant. Failing to properly consider the issues relating to the taxation of an award could potentially result in a material under-compensation or over-compensation to the Claimant.

This issue can be demonstrated through the following simplified example. For purposes of this example, assume that 'but-for' the

[2] The cash flows that would have been earned by the Clamant 'but-for' the alleged wrongful actions of the Respondent are often referred to as the 'counterfactual' cash flows.

[3] According to the International Glossary of Business Valuation Terms (CICBV Practice Bulletin No. 2), fair market value is defined as "[t]he price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at arms-length in an open and unrestricted market, when neither is under compulsion to buy or sell and when both have reasonable knowledge of the relevant facts."

alleged wrongful acts, the Claimant would have earned pre-tax cash flows of $100 and would have incurred a flat corporate tax rate of 30%. This means that the Claimant would have earned after-tax counterfactual cash flows of $70.[4]

Furthermore, assume that if the Claimant were to obtain an award of damages of $70 (i.e. based on the after-tax counterfactual cash flows), it would be taxed upon the receipt of this award, also at a rate of 30%. This would mean that the Claimant would end up with only $49 after the payment of income tax upon the receipt of the award. Thus, the effect of this double taxation is that if an award of damages is based on the investment's after-tax cash flows, the Claimant would retain $21 less than it would have earned absent the alleged wrongful acts (i.e. $49 vs. $70).

In this example, one way to achieve Full Reparation would be to award the Claimant economic damages based on its counterfactual pre-tax cash flows of $100, or to 'gross-up' the award by $30, from $70 to $100. This way, after paying the 30% income tax on the $100 award, the Claimant would be left with $70, which is the same amount it would have earned but for the alleged wrongful acts.

Thus, in the case where the taxes applicable to the counterfactual cash flows and on the award are the same, an award based on the investment's pre-tax counterfactual cash flows would help the Claimant to achieve Full Reparation.

The above example is summarized in the chart below:

[4] The impact of the time value of money and the different tax jurisdictions of the Claimant (i.e. the investor) and its subsidiary (i.e. its subsidiary) is ignored for purposes of this simplified example.

Claimant's cash flows but for the alleged wrongful acts			
Pre-tax cash flows		$ 100	
Income tax payable on but for cash flows		(30)	
After tax cash flows	***A***	$ 70	
Claimant's cash flows upon the receipt of an award			
		Award Based on Pre-tax Cash Flows	Award Based on After-tax Cash Flows
Award		$ 100	$ 70
Income tax payable upon receipt of award		(30)	(21)
After-tax cash flows	***B***	$ 70	$ 49
Over/(under) compensation	***B - A***	$ -	$ (21)

Unfortunately the tax issues that arise in the calculation of economic damages in the context of international arbitration cases involving multi-jurisdiction investor-investee relationships[5] are far more complex than the simplified example presented above. Many factors may cause the tax payable on the award to differ from the tax that would have been paid on the counterfactual cash flows, such as the timing of the tax payments, applicable tax rates, the taxable entity, the relevant jurisdiction for tax purposes, and available tax losses that may offset taxes payable etc. I discuss each of these issues in greater detail below.

There are several ways to address the issue of double taxation in assessing damages in investment treaty arbitration, and the approach ultimately taken in each case will depend on the specific circumstances of the case and the quality of information available. As will be demonstrated below, the complexity and uncertainty involved in these calculations often makes it quite difficult to arrive at an empirically accurate solution. However, ignoring the issue altogether can cause a material under-compensation or over-compensation to the Claimant which would be inconsistent with the principle of Full Reparation. Despite the difficulties prevalent in each of the approaches discussed below, as stated by 20th century British philosopher Carveth Read: “It is better to be vaguely right than exactly wrong”.

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[5] I.e. in cases where the Claimant has made an offshore investment, whereby the investee pays income taxes in the offshore jurisdiction, while the Claimant pays income taxes in its home jurisdiction.

The balance of this article is organized as follows: Section B discusses the approaches that could be applied to avoid double taxation in international arbitration. Section C discusses how the issue of the double taxation has been considered in recent international arbitration awards. Section D provides an overall conclusion on the issues discussed in this article.

II. HOW TO AVOID DOUBLE TAXATION IN INTERNATIONAL ARBITRATION

The following section will discuss three general ways that the issue of double taxation can be addressed in the context of international arbitration: 1) Calculate damages on a pre-tax basis; 2) Calculate damages on an after-tax basis and include an income tax gross-up; and, 3) Calculate damages on an after-tax basis and request that the Respondent indemnify the Claimant for taxes that would be owing upon the receipt of an award.

1) Calculate damages on a pre-tax basis, and make the assumption that any taxes owing upon the receipt of an award would approximate the taxes that would have been paid on the counterfactual cash flows.

Under this approach, an award of damages would be based on the pre-tax counterfactual cash flows. Based on the simplified example outlined in the introduction section above, this would imply that the Claimant would receive a total damages award of $100.

An award based on the pre-tax counterfactual cash flows would be higher than the FMV of the Claimant's investment.[6] However, according to the principle of Full Reparation, it may be necessary for the total award to be greater than the FMV of the investment in order to compensate the Claimant for taxes that would payable upon the receipt of an award.[7]

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[6] In the simplified example presented in the introduction section, the FMV of the Claimant's investment is assumed to be based on the after-tax cash flows of $70.

[7] It is the investee's after-tax cash flows that would have been available to the Claimant (i.e. the investor), but-for the alleged wrongful acts. Therefore, if an award based on after-tax cash flows is taxed again in the jurisdiction of the investee, or if the award would result in a greater amount of tax in the Claimant's home jurisdiction than it would have incurred on the counterfactual

Providing an award based on the investment's pre-tax cash flows is a relatively simpler way to address the issue of double taxation in a calculation of economic damages. It requires fewer steps than a calculation of after-tax cash flows, and would therefore be less complicated and easier to follow. However, there are two fundamental concerns that may create difficulties in the application of this approach:

- The assumption that the tax payable on the award will equal the tax payable on the counterfactual cash flows; and,
- The mathematical issues relating to calculating a pre-tax discount rate.

These two issues are discussed in further detail below.

A. Taxation of Award vs. Taxation of Counterfactual Cash Flows

Calculating damages on a pre-tax basis requires an assumption that the total combined tax payable on the award (i.e. between the Claimant and the investee) will equal the total combined tax that would have been paid on the counterfactual cash flows. While in certain cases it would be reasonable to apply this assumption, in other cases it would be difficult to assess the plausibility of this assumption due to the various contingencies that would impact how an award of damages would ultimately be taxed.

1. An Award for Damages May Fall into Multiple Different Categories of Taxable Income

One factor that may cause the taxation of an award to differ from the tax that would have been paid on the counterfactual cash flows relates to the how the relevant tax jurisdiction would treat the income received from a damages award.

For example, under Canadian income tax legislation, it is not uncommon for a damages award to fall into multiple categories of taxable income, and prior to the issuance of the actual award, there is often no clear answer as to what category a particular

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cash flows, then this would result in double taxation to the Claimant. These issues are discussed in greater detail below.

receipt would fall into given the unique facts and circumstances of each individual case.[8]

In cases where the award would be taxable to the Claimant, prior to the issuance of the award, it is often unclear whether the award would be taxed as an income receipt (whereby 100% of the award would be taxable) or as a capital receipt (whereby only a portion of the total award may be taxable), and part of this determination may depend on how counsel has pleaded the case.

As an example, in Canada, when assessing whether an award of damages would be considered an income receipt or a capital receipt, Canadian tax courts have typically applied the *surrogatum* principle, whereby the appropriate tax treatment is determined based on the nature of the amount that the compensation meant to replace.[9] For instance, if the Claimant sustained a loss of operating profits that would have been taxed as income for tax purposes absent the loss, the award that replaces this income would also be taxed as income (rather than as a capital gain).

In certain cases, a damages award may not be taxable at all in the Claimant's home jurisdiction. For example, in France, no taxes are payable on compensation provided to a French company impacted by a measure of nationalization, expropriation or other similar measures carried out by a foreign government.[10] Therefore, no double taxation would result if an award to a French investor is based on the after-tax cash flows of its investee, as long as the award is not subject to any additional taxation in the Respondent's jurisdiction.

Calculating damages on a pre-tax basis effectively assumes that the award would be taxed as an income receipt. Therefore,

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[8] Canadian Tax Journal (2008) Vol. 56, No 4, pg. 883. Canada Revenue Agency, IT-365R2, "Damages, Settlements and Similar Receipts", paragraph 10 states that compensation provided in an award for loss of business income or loss of business properties could fall into one of four categories: "(a) a non-taxable receipt; (b) an income receipt; (c) a receipt resulting from the disposition of a capital property, or (d) an eligible capital amount".

[9] Ernst and Young, "Whether a settlement amount received is taxable", October 2014.

[10] French Tax Code, Article 238 bis C.

calculating damages on a pre-tax basis may potentially over-compensate the Claimant if the award is ultimately taxed as a capital receipt, or if it is not taxable at all to the Claimant.

2. The Impact of Changing Tax Rates

It is fairly common for tax rates to change from one year to the next, and when this occurs, the tax rate that would have been applicable to the counterfactual cash flows would not be the same as the tax rate that would apply to an award of damages. In this case, damages based on pre-tax cash flows could over or under compensate the Claimant, depending how the tax rates changed between the two dates. The following example demonstrates what would happen if the tax rate at the valuation date was lower than the tax rate at the time of the award:

Claimant's cash flows but for the alleged wrongful acts - as at the valuation date					
Pre-tax cash flows		$	100		
Income tax payable on but for cash flows: 30%			(30)		
After tax cash flows	***A***	$	70		
Claimant's cash flows upon the receipt of an award - as at the current date					
		Award Based on Pre-tax Cash Flows		Award Based on After-tax Cash Flows	
Award		$	100	$	70
Income tax payable upon receipt of award: 40%			(40)		(28)
After-tax cash flows	***B***	$	60	$	42
Over/(under) compensation	***B - A***	$	(10)	$	(28)

3. Different Tax Rules in the Claimant's Jurisdiction and the Respondent's Jurisdiction

One of the important ways that international arbitration differs from domestic litigation is that the Claimant resides in a different tax jurisdiction from the investment that was impacted by the alleged wrongful acts. Therefore, the total taxes that would have been paid by the Claimant on the counterfactual cash flows generated in the Respondent's tax jurisdiction would likely not be equal to the total taxes that would be payable on an award if it is paid directly to the Claimant and taxed in the Claimant's tax jurisdiction. Aside from the different tax rates, other differences may arise due to the particular rules relating to foreign tax credits, withholding taxes, and how the Claimant would have ultimately extracted the funds it would have earned on the counterfactual cash flows in the Respondent's jurisdiction. In order to achieve Full Reparation, an award of economic damages should in theory consider all taxes that would potentially be payable on an award in both the Respondent's and the Claimant's jurisdiction, however in practice it is often difficult to calculate this amount accurately without making significant assumptions about the Claimant's future tax position. Damages based on pre-tax cash flows may therefore over or under compensate the Claimant depending on the different tax rules applicable in the Claimant's jurisdiction vs. the Respondent's jurisdiction.

B. Pre-Tax vs. After-Tax Discount Rate

When preparing a calculation of economic damages that requires a valuation of a future stream of cash flows, the damages expert needs to apply a risk-adjusted discount rate to convert the stream of future cash flows into a present value. If damages are calculated on a pre-tax basis, the damages expert must then consider whether it would be appropriate to apply a "pre-tax discount rate" or an "after-tax discount rate".

1. The Present Value of Pre-Tax Cash Flows Discounted at a Pre-Tax Discount Rate Does Not Necessarily Equal the Present Value of After-Tax Cash Flows Discounted at an After-Tax Discount Rate

A fundamental principle of valuation is that the discount rate and the cash flows need to be consistent with one another. For example, a nominal discount rate would need to be applied to nominal cash flows, and a real discount rate would need to be applied to real cash flows,[11] and both approaches should technically result in the same value conclusion. While in theory, the same principle would apply for pre-tax and after-tax discount rates; in practice, pre-tax cash flows discounted at a pre-tax discount rate are only equal the after-tax cash flows discounted at an after-tax

[11] Nominal cash flows and discount rates include adjustments on account of inflationary growth, while real cash flows and discount rates are prepared in constant dollars and do not include adjustments on account of inflationary growth.

discount rate when the cash flows are carried out into perpetuity, and where there is either no growth or constant growth.[12] In cases where the cash flows are incurred over a finite time period, pre-tax cash flows discounted at a pre-tax discount rate can be materially higher than after-tax cash flows discounted at an after-tax discount rate, which creates a mathematical inconsistency.[13]

For example, assume that an investment is expected to earn $100 of pre-tax cash flows one year into the future at a tax rate of 30%, yielding $70 after-tax. Let us further assume that the appropriate after-tax discount rate is 7%. This would imply that the present value of the after-tax cash flows would be $65.42. For simplicity, assume that the appropriate pre-tax discount rate can be calculated as follows: 7% / (1 – 30%) = 10%. This would imply that the present value of the pre-tax cash flows would be $90.91, as outlined in the chart below:

		Pre-tax calculation	After-tax calculation
Forecasted cash flows one year into the future	***A***	$ 100	$ 70
Discount rate	***B***	10%	7%
Present value	***A / (1 + B) ^ 1***	$ 90.91	$ 65.42

This result from the above example can be contrasted to a case where the cash flows are expected to be received into perpetuity, without any growth, whereby a pre-tax analysis would result in the same conclusion as an after-tax analysis, as outlined below:

		Pre-tax calculation	After-tax calculation
Forecasted cash flows into perpetuity - no growth	***A***	$ 100	$ 70
Discount rate	***B***	10%	7%
Present value	***A / B***	$ 1,000	$ 1,000

[12] A calculation of economic damages would typically only require a calculation of the cash flows into perpetuity when there is a complete taking of the asset that would otherwise have had an indefinite life, rather than some other measure that would result in a discrete loss for a specific period of time.

[13] Lonergan, Wayne "Pre and Post Tax Discount Rates and Cash Flows – A Technical Note". JARAF, Volume 4 Issue 1 2009.

From a purely economic perspective, calculating the present value of pre-tax cash flows at a pre-tax discount rate over a finite time period would overstate the FMV of an investment. It would be illogical from an economic perspective for a buyer to pay $90.91 (i.e. the present value of the pre-tax cash flows with a pre-tax discount rate in the example above) to acquire an investment when this is more than the value of the after-tax cash flows, even if they are received immediately (i.e. $70 in the example above).

However, the fact that damages calculated on a pre-tax basis using a pre-tax discount rate over a finite time period are higher than damages calculated on an after-tax basis and an after-tax discount rate is not necessarily problematic from a damages perspective. According to the principle of Full Reparation, the Claimant would need to receive additional compensation in order to be fairly compensated for any income taxes that it would need to be pay upon the receipt of an award.[14] Nevertheless, depending on the length of the damages period, and the way that the award would ultimately be taxed to the Claimant, it would be difficult to determine whether such an approach would correctly quantify the additional compensation required to achieve Full Reparation.

2. There Is No Mathematically Reliable Way to Convert an After-Tax Discount Rate into a Pre-Tax Discount Rate

In the above examples, the pre-tax discount rate was calculated based on dividing the after-tax discount rate by 1 minus the tax rate. While this approach is appealing due to its relative simplicity, there are certain mathematical issues relating to calculating a pre-tax discount rate in this manner.

The discount rate that is typically used to convert future cash flows into a present value is referred to as the Weighted Average Cost of Capital ("**WACC**"). The WACC represents the weighted average of the cost of equity and the cost of debt for a particular investment / company. One of the most commonly accepted methods

[14] I.e. in the example above, if the Claimant would receive an award of $90.91 based on the pre-tax cash flows discounted at a pre-tax discount rate, and would need to pay tax on this award at a rate of 30%, it would end up with $63.64, which would be relatively close to the present value of the after-tax cash flows discounted at an after-tax discount rate (of $65.42).

used to calculate the cost of equity component of the WACC formula is the Capital Asset Pricing Model ("**CAPM**").

The CAPM calculates the expected rate of return on equity based on a risk free rate (which is a pre-tax rate) that is converted into an after-tax rate through the application of a beta factor and a market risk premium. The beta factor and the market risk premium are meant to reflect the returns on equity investments over and above the risk free rate, and are derived from stock market returns of publicly traded companies. The stock market returns of publicly traded companies are based on the after-tax profits of these companies as equity investors are ultimately interested in the after-tax returns of a company, rather than the pre-tax returns. Therefore, the cost of equity component of the WACC formula is inherently an after-tax figure.

In this regard, there is no mathematically reliable way to determine a "pre-tax cost of equity" to use within the WACC formula, and by extension, there is no mathematically reliable way to convert an after-tax discount rate into a pre-tax discount rate.[15]

This concept is summarized in a well-respected textbook on corporate finance as follows:[16]

> *Always estimate cash flows on an after-tax basis. Some firms do not deduct tax payments. They try to offset this mistake by discounting the cash flows before taxes at a rate higher than the opportunity cost of capital. Unfortunately, there is no reliable formula for making such adjustments to the discount rate.*

In a calculation of economic damages, discounting after-tax cash flows at an after-tax discount rate would not fairly compensate the Claimant for the income taxes that would payable upon the receipt of an award, and would therefore be inconsistent with the principle of Full Reparation. Therefore, an alternative methodology would need to be applied to consider the potential

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[15] Lonergan, Wayne "Pre and Post Tax Discount Rates and Cash Flows – A Technical Note". JARAF, Volume 4 Issue 1 2009.

[16] Richard Brealey, Stewart Myers, and Franklin Allen "Principles of Corporate Finance," 10th Edition, 2011 p. 128.

double taxation that would occur if damages were calculated on an after-tax basis, and the award itself is taxable.

3. Pre-Tax Cash Flows at an After-Tax Discount Rate

An approach suggested by some damages experts to solve the issue of double taxation is to discount the counterfactual pre-tax cash flows by an after-tax discount rate.[17]

The mathematics behind this approach is summarized in the following chart:

Claimant's cash flows but for the alleged wrongful acts - Year 1			
Forecasted pre-tax cash flows at Year 1		$	100.00
Income tax payable on but for cash flows			(30.00)
Forecasted after tax cash flows at end of Year 1		**$**	**70.00**
Damages calculation: pre-tax cash flows at after-tax discount rate			
Forecasted pre-tax cash flows one year into the future		$	100.00
After-tax discount rate			7%
Present value		$	93.46
Claimant's cash flows upon the receipt of an award - Year 0			
Award based on pre-tax cash flows at an after-tax discount rate		$	93.46
Income tax payable on award: 30%			(28.04)
Claimant's after-tax cash flows at Year 0	***A***	$	65.42
Pre-tax rate of return*	***7% / (1 - 30%) = B***		10%
Assumed value of Claimant's investment at Year 1*	***C = A * (1+B)***	$	71.96
Tax payable on growth in Claimant's investment*	***(C - A) * 30%***		(1.96)
Claimant's net cash flows at end of Year 1		**$**	**70.00**

* *This approach assumes that the after-tax cash flows of $65.42 received at Year 0 would be invested by the Claimant and would growat a rate of 10% per annum (the assumed pre-tax rate of return), and would thereby become $71.96 at the end of Year 1. The assumption is then that the Claimant would need to pay tax on the growth in its investment over the year (i.e. $71.96 - $65.42) at the same tax rate of 30%, and therefore would owe $1.96 of taxes on the growth in the value of its investment at the end of Year 1.*

In certain cases, this approach may fairly compensate the Claimant for the tax that would be payable upon the receipt of an award, however there are several complicating factors that would

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[17] Schweihs, Robert P. "Measuring Lost Profits Economic Damages on a Pretax Basis" Willamette – Insights – Summer 2010.

limit the mathematical accuracy of this approach. For example, this approach assumes that the tax treatment of the award will equal the tax that would have been paid on the investment. However as outlined above, it is not always appropriate to make this assumption. Additionally, this approach assumes that an after-tax rate of return can be converted into a pre-tax rate of return by dividing the after-tax discount rate by 1 minus the tax rate. However as outlined above, there are mathematical issues relating to converting an after-tax discount rate into a pre-tax discount rate. Lastly, this approach assumes that the tax rate applicable to the growth in the Claimant's investment would equal the tax rate applicable to the award; but tax rates applicable to investment income (i.e. dividends, capital gains etc.) may differ from the tax rates applicable to business income, depending on the jurisdiction.

4. Conclusion – Calculating Damages Based on Pre-Tax Cash Flows

Calculating damages based on the counterfactual pre-tax cash flows is one potential way to address the issue of double taxation in investment treaty arbitration. While this approach is appealing in its simplicity, the required assumptions make its application potentially subjective and difficult to implement.

2) Calculate damages on an after-tax basis and gross-up the value to account for the income taxes that would be payable by the Claimant upon the receipt of an award.

Another way that the issue of double taxation can be addressed is to calculate damages on an after-tax basis, with an after-tax discount rate, and then gross up the value to account for the income taxes that would be payable by the Claimant upon the receipt of an award. Under this approach, the income tax gross-up would be added to the value of the asset in order to achieve Full Reparation. Depending on the complexity of the damages analysis and the Claimant's overall tax structure, a tax expert may be required to opine on the parameters of the income tax gross-up.

A. Benefits of an After-Tax Plus Income Tax Gross-Up Approach

The main benefit of this approach is that it does not require one to assume that the tax payable on the award will equal the tax payable on the counterfactual cash flows. Therefore, by calculating damages on an after-tax basis with an income tax gross-up, the damages expert would eliminate some of the issues relating to calculating damages on a pre-tax basis which have been described above. For example, under the after-tax plus an income tax gross-up approach, the damages expert can control for changing tax rates between the valuation date and the date of the award, different tax rates in the jurisdiction of the investment vs. the jurisdiction of the Claimant etc. The expert would also eliminate issues relating to converting an after-tax discount rate into a pre-tax discount rate, since the analysis would apply an after-tax discount rate to after-tax cash flows. The following chart presents a simplified example of an income tax gross-up calculation, whereby the tax rate applicable to the damages award is lower than the tax rate applicable to the counterfactual cash flows.

Calculation of economic damages with an income tax gross-up

Pre-tax but-for cash flows			$	100
Tax rate applicable to but for cash flows	30%			
Income tax payable on but for cash flows				(30)
After tax but-for cash flows		***A***	**$**	**70**
Tax rate applicable to damages award	20%	***B***		
Income tax gross-up		***A / (1-B) - A***	$	18
Total Award			$	88

Claimant's cash flows upon the receipt of an award

		After-tax Cash Flows
Total Award	$	88
Income tax payable upon receipt of award: 20%		(18)
After-tax cash flows	**$**	**70**

B. Issues with Using an After-Tax Plus Income Tax Gross-Up Approach

Despite the benefits of using an after-tax plus income tax gross-up approach in the calculation of economic damages, there are still several issues with this approach that would create uncertainty in the calculation of the income tax gross-up.

1. Uncertainty Relating to How the Award Would Ultimately Be Taxed to the Claimant

As outlined above, it is often unclear whether an award of damages would be considered to be a replacement of lost income (in which case 100% of the award would be taxable), a replacement of lost capital (in which case only a portion of the award would be taxable), not taxable at all to the Claimant, or some combination of the above. Part of this determination may be dependent on how the Tribunal ultimately rules on the case.[18] Furthermore, the Respondent may argue that if the Claimant would have sold its business in the counterfactual scenario, it would still be obligated to pay tax on any capital gains that would arise from this disposition, and therefore this tax would need to be netted out against the tax that would need to be paid upon the receipt of an award.

When calculating the income tax gross-up at the damages phase of the arbitration, the expert would need to make an assumption as to how the award would be taxed to the Claimant, and this assumption may not necessarily reflect what will actually transpire once the award is issued.

2. Uncertainty Relating to the Jurisdiction Where the Award Would Be Taxable

There may be additional uncertainty relating to whether the award would be payable directly to the Claimant's subsidiary located within the Respondent's jurisdiction, or whether the award would be payable directly the parent company in the Claimant's jurisdiction and thereby be subject to different tax rules than would apply to the counterfactual cash flows.[19] Similarly, when

[18] For example, some awards may determine the compensation based on a hybrid of various damages approaches, and it would therefore be unclear if the damages would be taxed as an income or a capital receipt to the Claimant.

[19] As outlined in further detail in Section C below, in some international arbitration cases, the award would appear to be taxable in the Respondent's jurisdiction, and in others the award would appear to be taxable in the Claimant's jurisdiction. For example, in the Mobil Investments Canada Inc. & Murphy Oil Corporation v. Canada (2012), the Respondent argued that "under NAFTA Article 1135(2), the Tribunal has to award monetary damages to the "enterprise" which suffered the damages", i.e. rather than the parent company located in the Claimant's tax jurisdiction. (*Mobil Investments Canada Inc.et. al v.*

calculating the Claimant's total counterfactual after-tax cash flows, a question may arise as to how to properly account for any taxes or tax savings that would apply once the profits from the investment in the Respondent's jurisdiction would be extracted back to the Claimant's jurisdiction. For example, one may need to consider what foreign tax credits and withholding taxes would apply, and how these tax credits may differ between the counterfactual scenario and upon the receipt of an award.[20]

3. Uncertainty Relating to Tax Loss Carry-Forward and Other Tax Pool Balances

A separate issue applicable to the calculation of an income tax gross up relates to the tax loss carry-forward and other tax pool balances available to the Claimant and its subsidiaries as at the date of the award. These tax pool balances could potentially be used to reduce the overall taxes that would be paid upon the receipt of an award. For example, if a Claimant has a significant accumulation of tax loss carry-forward balances, it may be possible that little or no income taxes would ultimately be payable by the Claimant upon the receipt of an award. Further compounding this issue is that there may be uncertainty, whether in the absence of an award, the Claimant would have been able to make use of these tax pool balances.

When calculating the FMV of the investment, the tax pools held by the company would not impact its FMV, unless these tax pools could reasonably be transferred to an arm's length buyer of the business, or if it is reasonably likely that an arm's length buyer in the industry would have its own tax pool balances to offset future taxable income. For example, in some jurisdictions, extractive industries like mining and oil and gas have special tax pools to incent

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Canada, Decision on Liability and on Principles of Quantum ICSID Case no. ARB(AF)/07/4 (2012), par. 484.)

[20] For example, in certain cases, the counterfactual cash flows received by the investee would be taxable in the Respondent's jurisdiction, and the Claimant would receive a foreign tax credit for the taxes paid by the investee which would reduce the taxes that the Claimant would need to pay in its own jurisdiction. However, upon the receipt of an award, the Claimant may not benefit from any foreign tax credits and would thereby need to pay income taxes in its own jurisdiction, which could result in double taxation.

exploration activities that a likely buyer would have, and thus would reasonably be considered in the determination of FMV. However, when applying the principle of Full Reparation, the tax pools held by the company should still be considered even if they could not be transferred to an arm's length buyer, as long as they could have reasonably been used by the Claimant to reduce its taxable income. This highlights another important difference between the FMV and Full Reparation that would need to be considered in a calculation of economic damages on an after-tax basis.

4. Calculating the Income Tax Gross-Up once a Decision in the Dispute has been Rendered

Given the level of complexity and uncertainty involved in calculating the income tax gross-up, an alternative approach would be to defer this calculation until a decision in the dispute has been rendered, and the tax treatment of the award can be more reliably determined. This can be likened to the Claimant's and Respondent's submissions on costs incurred in connection with the arbitration, which only occurs towards the end of the proceedings, once the total costs incurred by both parties are known with greater certainty.

The main advantage of this approach is that it limits the number of assumptions that would apply to an income tax gross-up calculation carried out at the damages phase of the arbitration. As a result, calculating the income tax gross-up once a decision in the dispute has been rendered would create a more robust and empirically accurate calculation of the income tax gross-up.

However, unlike the Claimant's and Respondent's submissions on costs which can be calculated relatively easily, the calculation of the income tax gross-up would typically be a much more complicated analysis. Even after an award is issued, it may still be unclear how it would ultimately be taxed to the Claimant and how that tax treatment may differ from the tax treatment the Claimant would have experienced on the counterfactual cash flows. A disagreement amongst the parties as to how the income tax gross-up calculation should be calculated could potentially result in the need for additional submissions to the tribunal to provide a final decision, which may not be feasible.

5. Conclusion – Calculating Damages Based on After-Tax Cash Flows

Calculating damages on an after-tax basis with an income tax gross-up eliminates a number of issues that arise from calculating damages on a pre-tax basis. In order to calculate the income-tax gross-up properly, there is a practical need for additional evidence such as the Claimant's tax returns and corporate holdings structure, and what specific income taxes would apply on the counterfactual cash flows and on the receipt of an award. While this approach may provide a more empirically accurate solution than a calculation based on pre-tax cash flows, issues may still arise due to the inherent complexity and uncertainty involved in the calculation of the income tax gross-up. Therefore a tax expert may be required to opine on the parameters of the income tax gross-up calculation.

Leaving this calculation until the time when a decision in the dispute has been rendered would help to eliminate a number of these uncertainties, but disagreements amongst the parties as to how the income tax gross-up should be calculated could potentially result in the need for additional submissions to the tribunal to provide a final decision, which may not be feasible.

3) Calculate damages on an after-tax basis and request that the Tribunal order that the award be paid net of tax.

The last approach discussed in this article is to calculate damages on an after-tax basis (with an after-tax discount rate) and request that the tribunal indemnify the Claimant against any tax levied against the award in order to avoid double taxation.[21]

Similar to the after-tax cash flows plus income tax gross-up approach, the main benefit of this approach is that it does not require one to assume that the tax payable on the award will equal the tax on the counterfactual cash flows, and it does not require a calculation of a pre-tax discount rate. However, the additional advantage of this approach is that it does not require the preparation of complicated income tax gross-up calculation,

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[21] This approach would only be applicable in investment treaty arbitration, whereby the Respondent is a government entity that is in theory able to comply with a tribunal's ruling that it not tax the award.

which is likely to add an additional layer of uncertainty to the overall damages analysis, as well as the need to incur additional professional fees.

The difficulties with this approach relate primarily to legal issues that are beyond the domain of financial experts. For example, an argument may be made that an international arbitration tribunal does not have the jurisdictional authority to order how the Respondent can levy income taxes in its jurisdiction, or that the Tribunal cannot order to the Respondent to fulfil a claim that is "speculative and premature".[22] In cases where this jurisdictional authority is accepted, it often is not extended to indemnify the Claimant against any additional income taxes that may be levied on the award in the Claimant's home jurisdiction, as will be outlined in Section C below, and therefore Full Reparation may not be fully achieved.

III. EXAMPLES OF HOW THE ISSUE OF DOUBLE TAXATION HAS BEEN CONSIDERED IN RECENT INTERNATIONAL ARBITRATION AWARDS

As with other damages issues that often come up in international arbitration cases, such as country risk premiums, pre-award interest rates etc., based on my review of recent awards there does not appear to be a clear consensus as to how the issue of double taxation is addressed. The following section provides an example of how this issue has been considered in recent international arbitration awards, in order to demonstrate the variability in the way that the Tribunal viewed this issue in each case.[23]

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[22] In other words, the claim for an income tax gross-up or income tax indemnity relates to a head of damages that may or not be payable by the Claimant at some point in the future, whereby the amount that would need to be paid may not be able to be calculated with sufficient accuracy as at the damages phase of the arbitration. For example – see the Tribunal's decision on this issue in the *Occidental Petroleum Corporation et. al v. The Republic of Ecuador* summarized in Section C below.

[23] This section does not provide an exhaustive list of all international arbitration cases where the issue of double taxation has been addressed and does not include the *Venezuela Holdings B.V. et al. v. Venezuela* case which has already been summarized in the introduction section above.

A. Rusoro Mining Limited v. Venezuela *(2016)*[24]

The Claimant requested that it be indemnified for any taxation imposed by Venezuela on the award given that the calculation of economic damages was prepared based on after-tax cash flows. Therefore the Claimant argued that further taxation of the award would result in double taxation. The Claimant stated that this approach would be necessary in order to place it in the same financial position it would have been in but for Venezuela's breach of the Treaty.

The Respondent argued that the Claimant's request for tax indemnity from Venezuelan taxes was speculative and premature since the Claimant has not identified which taxes, if any, would be applicable to the award.

The Tribunal declared that the award would be paid on a net of tax basis, and ordered that Venezuela would need to indemnify the Claimant with respect to any Venezuelan taxes that would apply to the award. The Tribunal noted that this tax indemnity would be required since without it, the Respondent could practically avoid the obligation to pay the Claimant by applying a 99% tax rate on the income received by the Claimant from the award, effectively only leaving the Claimant with compensation of 1% of the total award granted.

The Tribunal separately noted that any claim for tax indemnity from taxes that may need to be paid by Claimant upon the receipt of the award in other jurisdictions outside Venezuela would lack merit. The Tribunal explained that these claims would not be considered a "consequential loss arising from Venezuela's breach of the Treaty and does not engage Venezuela's liability".

B. Occidental Petroleum Corporation et. al v. Ecuador *(2012)*[25]

The Claimants calculated damages on an after-tax basis and requested that the tribunal order that the Respondent would not

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[24] *Rusoro Mining Limited v. The Bolivarian Republic of Venezuela* ICSID Case no. ARB(AF)/12/5, Award 844-855.

[25] *Occidental Petroleum Corporation et. al. v. The Republic of Ecuador* ICSID Case no. ARB/06/11, Award 850-853.

seek to collect taxes on an award received by the Claimants. If this condition would not be fulfilled, the Claimants suggested that damages would need to be calculated on a pre-tax basis. Lastly, the Claimants suggested that the award be paid directly to the U.S. parent company, rather than to its Ecuadorian subsidiary, as an award paid to the U.S. parent would not be subject to any Ecuadorian tax.

The Respondent argued that the Claimants' request was "irrelevant and speculative at best".

The Tribunal recognized that the damages calculation was prepared on an after-tax basis, but nevertheless agreed with the Respondent's argument that the Claimants' request for tax indemnity was "speculative and premature" and thereby denied the Claimants' request.

C. Eiser Infrastructure Limited et. al v. Spain *(2017)*[26]

The Claimants included a tax gross-up calculation in its calculation of economic damages. The gross-up was based on the assumption that an award would be taxable in Luxembourg (i.e. not in the Respondent's jurisdiction). The Claimants acknowledged that "we are unable to tell you exactly what will be taxable and therefore how [sic] the tax gross-up should be". Therefore, the Claimants suggested that the income tax gross-up amount could potentially be escrowed, or that it could be determined that additional compensation would be necessary in order to make the Claimants whole in the event of a future tax liability upon the receipt of an award.

The Respondent argued that the tax gross-up calculation should be denied for the following reasons: The Respondent should not be held responsible for taxes imposed by another State, an award would be tax-exempt in Luxembourg in any event, and that the claim for a tax gross-up was "overly speculative, uncertain and contingent".

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[26] *Eiser Infrastructure Limited et. al. v. Kingdom of Spain* ICSID Case no. ARB/13/36, Award 453-456.

The Tribunal denied the inclusion of the tax gross-up given that it **did not receive sufficient evidence to verify how much, if any, taxes would be owing** (emphasis added) by the Claimants upon the receipt of an award.

It would appear based on this decision that if the Tribunal concluded that it did receive sufficient evidence relating to the tax that would be payable upon the receipt of an award, that it would consider the inclusion of the income tax gross-up calculation as part of the total damages award.

D. Mobil Investments Canada Inc. et. al. v. Canada *(2012)*[27]

The Claimants argued that a damages award would be taxable at the parent company level in the U.S., and therefore to obtain Full Reparation, the total award would need to include an income tax gross up calculation in order to fully compensate them for their losses.

The Respondent argued that the Claimants' loss calculation related to their Canadian enterprises, and not the U.S. parent companies, and therefore it was unclear why the total award would revert back to the U.S. parent and become taxable in the U.S. The Respondent also argued that under NAFTA, damages would be awarded to the "enterprise" that suffered the damages (i.e. the Canadian subsidiary), and not to the investor (i.e. the U.S. parent company).

The Tribunal denied the Claimants' request for an income tax gross-up and stated that the **Claimants did not provide sufficient evidence as to why the compensation could not remain with the Canadian enterprise, why an award of damages would be taxable to the Claimant in the U.S**. (emphasis added), what the tax rate would be, and why the income tax gross-up would be a necessary part of any resulting compensation.

[27] *Mobil Investments Canada Inc. et. al. v. Canada*, ICSID Case no. ARB(AF)/07/4, Decision on Liability and on Principles of Quantum 482 to 485.

E. Corn Products International, Inc. v. Mexico *(2010)*[28]

After the Tribunal issued its award, the Claimant, a U.S. company, discovered that the award may be subject to taxation by the Mexican government. The Claimant thereby argued that if the award would be taxed by the Mexican government, this would amount to double-taxation, given that the compensation was calculated on an after-tax basis, and was therefore already reduced for tax that would have been payable to the Mexican government on the counterfactual cash flows.

The Tribunal accepted the Claimant's argument and issued a correction of the award whereby it clarified that the award shall be paid to the U.S. parent company, rather than the Claimant's wholly owned Mexican subsidiary, in order to shield the award from any additional taxation in Mexico.

It is unclear whether the award would have been subject to further taxation in the U.S., and if or how this additional taxation was considered by the Tribunal in its assessment of potential double taxation.

F. Conclusion - Examples from International Arbitration Awards

As seen in the above examples, the issue of double taxation has been addressed in different ways by various Tribunals. While some Tribunals have recognized the nature of the issue and devised ways to avoid some or all of the double taxation that would result upon the receipt of an award, others have rejected requests for the inclusion of an income-tax gross-up, or a tax indemnity clause on account of this issue. Each case undoubtedly contains unique factors such as different tax jurisdictions and different treaties, and these factors likely contribute to the variability in the way this issue has been dealt with in each case.

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[28] IA Reporter "Corn Products asks tribunal to correct award so as to take account of likely taxation of award in Mexico" October 14, 2009; and, IA Reported "ICSID Tribunal corrects award so that it will be shielded from taxation". April 9, 2010.

IV. CONCLUSION

There are several ways that the issue of double taxation on international arbitration awards can be addressed, and the approach ultimately taken would depend on the specific circumstances and the complexity of the case, as well as the availability of reliable information. This issue has been raised in several recent international arbitration cases, and there has been variability in how the issue has been decided upon by the Tribunal in each case. Notwithstanding the limitations with each of the approaches outlined above, ignoring the issue of double taxation altogether can result in a material under-compensation or over-compensation for the Claimant, which would be inconsistent with the principle of Full Reparation.