AxiomForum

Loss calculations:

Grossing up damages for tax

Abstract

In this article Axiom looks at a taxation consideration that may arise in undertaking an assessment of damages.

In circumstances where an award of damages forms part of the assessable income of the successful plaintiff, it may be appropriate to gross-up the award for damages by the tax payable on those damages.

In calculating a gross-up for tax, it is necessary to ensure that the gross-up is performed correctly. The correct figure can be achieved adopting either:

- The present value of after-tax cash flows (discounted at an after-tax discount rate), grossed-up for tax; or
- The present value of pre-tax cash flows (discounted at an after-tax discount rate).

Discounting pre-tax cash flows at a pre-tax discount rate is not appropriate. Adopting this approach will generally arrive at an incorrect loss calculation.

The calculation of the present value of after-tax cash flows requires an after-tax discount rate.

Assessing pre-tax damages

Damages calculations often involve forecasting cash flows for a number of years. These forecast cash flows are discounted reflecting both the time value of money and the risk associated with achieving the forecast. The result of this calculation will be a present value of forecast future cash flows.

Where the forecast cash flows are expressed on an 'after-tax' basis, the discount rate that is applied in calculating the present value is an after tax discount rate.

In the event the Court awards damages, in circumstances where the award of damages will be included in the assessable income of the plaintiff it may be appropriate to add an amount for the tax payable on the award of damages. Making an allowance for the payment of tax (often referred to as a tax gross-up) ensures that the plaintiff is put into the position that it would have been in but for the conduct that gave rise to the award of damages. A gross-up for tax is calculated by dividing the present value of the cash flows by 1 minus the applicable tax rate.

Whilst it may be appealing to do so, it is not correct to simply calculate damages on a pre-tax basis (where a pre-tax discount rate is applied to pre-tax cash flows). This will yield an incorrect figure for pre-tax damages. Rather, as addressed, the preferred approach is to calculate damages on a after-tax basis (applying an after-tax discount rate to after-tax cash flows).

If the Court awards damages, consider whether they need to be 'grossed up' for tax.

Methods available for calculating pre-tax damages

In the following example we set out three methods for calculating damages after allowing for a gross-up for tax. The available methods are:

- Method 1: After-tax cash flows are discounted at an after-tax discount rate. The present value of these cash flows is grossed-up for tax (by dividing by 1 minus the tax rate);
- Method 2: Pre-tax cash flows are discounted at an after-tax discount rate; and
- Method 3: Pre-tax cash flows are discounted at a pre-tax discount rate.

The example assumes a tax rate of 30%, a pre-tax discount rate of 14.29% and an after-tax discount rate of 10%.

Cash flow	Year 1	Year 2	Year 3	Year 4	Year 5	Total
Before tax cash flow	$6.00	$7.00	$8.00	$9.00	$10.00	
Tax	$(1.80)	$(2.10)	$(2.40)	$(2.70)	$(3.00)	
After tax cash flow	**$4.20**	**$4.90**	**$5.60**	**$6.30**	**$7.00**	
Method 1						
Present value of after tax cash flows	$3.82	$4.05	$4.21	$4.30	$4.35	
After tax damages						$20.72
Pre tax damages						$29.61
Method 2						
Present value of pre tax cash flow	$5.45	$5.79	$6.01	$6.15	$6.21	
Pre tax damages						$29.61
Method 3						
Present value of pre tax cash flow	$5.25	$5.36	$5.36	$5.28	$5.13	
Pre tax damages						$26.37

As illustrated, this simple example illustrates that:

- Method 1: The present value of after-tax cash flows, discounted using an after-tax discount rate, is $20.72. Following the gross-up for tax, the figure is $29.61;

- Method 2: The present value of pre-tax cash flows, discounted using an after-tax discount rate, is $29.61; and

- Method 3: The present value of pre-tax cash flows, discounted using a pre-tax discount rate, is $26.37.

As the example shows, Method 1 and Method 2 calculate the same pre-tax damages amount and are both correct methods for calculating damages on a pre-tax basis.

Whilst they yield the same outcome, Axiom prefers Method 1 over Method 2 as Method 1:

- Steps out the calculation, showing the tax that is assumed to be payable in each year of the forecast period;
- Accommodates changes in tax rates over time; and
- Facilitates the recognition of any tax losses from prior years.

Method 3 is incorrect and should not be applied in the assessment of a pre-tax damages amount.

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