TORTS—MEASURE OF DAMAGES—INCOME TAX DEDUCTIBLE FROM COMPENSATORY PAYMENTS—JUDGMENT TAXABLE—TAXATION PRACTICE—INCOME AND CAPITAL

In *British Transport Commission* v. *Gourley*[1] the House of Lords overruled *Billingham* v. *Hughes*[2] and held contrary to nearly all previously existing authority[3] that in assessing damages for loss of income the defendant's damages may be mitigated in accordance with the taxes which the plaintiff would normally have to pay on his income. The case raises aonther point which the House does not decide: are the compensatory payments made to the plaintiff taxable?

The plaintiff in the present case was a consulting engineer and the injuries received disabled him from carrying on in is normal professional capacity. The claim for loss of income embraced both actual and prospective losses and the House of Lords allowed the amount of tax payable to be considered with regard to both branches of the claim. The importance of the decision is clear in the light of the reduction made in the case itself; the damages were reduced by allowance of the taxation from £37,720 to £6,695, a decrease of more than £31,000.

Their Lordships treated the case as an appeal from *Billingham* v. *Hughes*. In the case, the Court of Appeal followed *Fairholme* v. *Firth and Brown Ltd.*[4] and held that taxes were not taken into consideration because they were "matter completely collateral and merely "*res inter alios acta*"[5]. In reaching this conclusion the Court of Appeal relied on three grounds:

(a) The incidence and and extent of the tax were matters between the Crown and the Plaintiff, they were of no concern to the Defendant.

(b) The income of the tax-payer is his to do as he pleases. The tax is not levied on the money received but is personal.

(c) The wrong-doer should not be permitted to benefit by virtue of the plaintiff's financial obligations.

The House of Lords however stated that to treat the existence of income tax as a "res inter alios actos" and therefore, too remote, is out of touch with reality. In his opinion (concurred in by Lords Radcliffe and Somerville) Lord Goddard states (at p. 206):

> The basic principle so far as loss of earnings and out-of-pocket expenses are concerned is that the injured person should be placed in the same financial position, as far as can be done by an award of money, as he would have been had the accident not happened. Hitherto the decisions . . . have treated the incidence of tax on a man's earnings as res inter alios acta. This expression in this context is, I think, misleading. A plaintiff may seek to increase or a defendent to

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[1] [1956] A.C. 185.

[2] [1949] 1 K.B. 643 (C.A.).

[3] The major exception was the Scottish decisions: *McDaid* v. *Clyde Navigation Trustees*, [1946] S.C. 462.

[4] (1933), 49, T.L.R. 470.

[5] Mayne on Damages (11th ed., 1946), p. 151.

decrease damages by items which are held too remote. The mere fact that the item arises as between the plaintiff and a third party would not seem to be the test. In a wrongful dismissal or personal injuries action the fact that the plaintiff has obtained remunerative employment with a third party is normally relevant, though it would fall within the words res inter alios acta. The question is whether the taxation is or is not too remote to be taken into account . . . . Tax is imposed by law . . . . the taxpayer must pay and, in my opinion, it cannot make any difference whether he receives the gross income and pays the tax later . . . or whether it is deducted before he receives it . . . .[6] In either case to say that a taxpayer has the benefit of his full income is, in my opinion, to be "out of touch with reality" . . . . Damages which have to be paid for personal injury are not punitive, still less are they a reward. They are simply compensation and this is true with regard to special damage as it is with general damage.

At page 202 Earl Jowitt states the general opinion of the House when he says:

My Lords, it is, if I may say so with the utmost respect, fallacious to consider the problem as though a benefit were being conferred upon a wrongdoer by allowing him to abate the damages for which we would otherwise be liable. The problem is rather for what damages is he liable? and if we apply the dominant rule, we should answer: 'He is liable for such damages as, by reason of his wrongdoing, the plaintiff has sustained.'

The problem of mitigation of damages by taking the taxation into account has been considered in three reported Ontario cases[7], all of which followed the previous English authorites and disallowed consideration of the taxation as being *res inter alios acta*. The forceful judgment of the House of Lords in the present case casts grave doubts upon the Canadian decisions and it is submitted that the logical decision of the House of Lords will be followed in Canadian jurisdictions.

The principles of *res inter alios acta* and unwillingness to benefit the wrongdoer have not been restricted to problems of tax deduction however but have been applied in many English cases with reference to mitigation of damages in general[8]. It remains to be seen what effect the decision will have on other cases involving consideration of damages. This writer does not intend to deal with the whole problem of remoteness of damage but it is submitted that decision under consideration will assist in the restriction of the use of such vague expressions as *res inter alios acta* in the assessment of damages generally. It would appear that the test for ascertaining damages can be restricted to compensation with the limitation of remoteness.

The *Gourley* case also raises a problem which must be solved before the decision can be made of any general application. In answering the question of damages paid for personal injuries under the heading of loss of income. would not themselves be taxed. If they would be subject to tax then the plaintiff would only be compensated by a full payment from which taxes could be deducted. In the present case, as in *Billingham* v. *Hughes,* counsel agreed that

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[6] The reference here is to *Jordan* v. *Limmer and Trinidad Lake Ashphalt Co. Ltd.* [1946] K.B. 356 where tax paid at the source and never actually received was not allowed to be deducted in assessment of damages.

[7] *Bowers* v. *Hollinger & Co. Ltd.,* [1946] O.R. 526; *Fine* v. *T.T.C.* [1945] O.W.N. 901; *Anderson* v. *International Waxes Ltd.,* [1951] O.W.N. 113. The cases are all trial decisions.

[8] For a good example see *Payne* v. *Railway Executive,* [1952] 1 K.B. 26 where a navy disability pension was not allowed to be taken into consideration. See also: *Tubb* v. *Lief and Gordon,* [1932] 3 W.W.R. 245 (Sask. C.A); *MacDonald* v. *Goderich,* [1949] 3 D.L.R. 788 (Ont. C.A.) where accumulated sick leave was held too remote to be taken into consideration in assessing damages. Recent cases, *Flaherty* v. *Hughes et. al.* (1952), 6 W.W.R. (N.S.) 289 and *Schaeffer* v. *Mish,* [1950] 2 W.W.R. 948, consider state insurance and show a trend towards allowing the wrongdoer a legitimate benefit .

the sum would not be taxable and the House made no authoritative pronouncement on the point." There is no reported case of assessment for Income Tax of damages paid for personal injuries under the heading of loss of income. This however is a gratuity on the part of the Income Tax Department in that the department has made it a policy not to assess taxes on personal injury damage payments. It would appear that the Defendant is not entitled to to allege past inactivity on the part of the Income Tax Department if the plaintiff is legally liable to taxation.[10]

The general rule as to whether or not compensatory payments are income in frequently stated in the terms of Lord Clyde in *Burma S.S. Co. Ltd* v. *C.I.R.*[11] where he states that in order to ascertain whether the damage payment is income or capital it is necessary to determine what deficiency the payment was intended to make up, a "hole" in capital, or a "hole" in income. As was stated in *Income Tax Case No. 6*:[12]

> Thus if damages were awarded as compensation for the destruction of property, it seemed to follow that such damage were an occurence of a Capital Nature. If, on the other hand, though awarded in a lump sum, they were given as compensation for loss of employment, as the right lost was one to income, so the compensation, though in a lump sum, was an accural of an income nature.

At first glance it would appear, therefore, that the payments received as compensation for loss of earnings actual and prospective are income payments and would be taxable under the Income Tax Act[13] which purports to levy a tax on income from all sources.

The general rule, however, is not alwavs easy to apply. It is frequently difficult to determine whether the payment was made in order to make up a deficiency in capital or income. This is particularly so when the payments are allegedly made for loss of income. In *Van Den Bergh's* v. *Clark*[14], Lord Macmillan in adopting the reaoning of Lord Buckmaster in *Glenboig Union Fireclay* v. *I.R.C.*[15] states, "But even if a payment is measured by annual receipts, it is not necessarily itself an item of income . . . 'There is no relation between the measure that is used for the purpose of calculating a particular result and the quality of the figure that is arrived at by means of the test'" The issue is perhaps more clearly pointed out in the judgment of Dixon and Evat JJ. in the

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[9] Although their Lordships purport to agree with counsel, no discussion of the subject is reported, nor is any authority cited.

[10] In *Maepa* v. *Ewaskiw* (1953), 10 W.W.R. (N.S.) 565, it was held that compassionate payment of wages by the employer are not to be taken into consideration in assessing damages. The principle should certainly extend to cases of possible gratuitous forgiving of liability.

[11] (1930), 16 T.C. 67.

[12] (1923), 1 S.A.T.C. 54, quoted in Gordon, Digest of Income Tax Cases of the British Commonwealth (1939), p. 204.

[13] R.S.C., 1952, c. 148.

[14] [1935] A.C. 431, at p. 442.

[15] [1922) S.C. (H.L.) 112, at p. 115.

High Court of Australia in *Commissioner of Taxes* v. *Phillips*,[16] where they state:

> It is true that to treat a sum of money as income because it is computed or measured by references to of loss of future income is an erroneous method of reasoning . . . . It is erroneous because, for example, the right to future income may be an asset of a capital nature and the sum measured by reference to the loss of the future income may be a capital payment to replace that right.

The problem in such cases is therefore one of ascertaining whether payment is one to replace the income lost or whether it is paid as compensation for the loss of the right to earn income or, or for the loss of the source itself.

In *Renfrew Town Council* v. *I.R.C.*[17] Lord Clyde suggests that where damages are awarded in a personal injury case for the loss of income it is a question of circumstances whether these are capital or income *receipts*. If a man is permanently disabled the damages would appear to be a capital increment but if he is only temporarily disabled and loses professional income it would appear that the damages are revenue.[18]

In Canada the policy of the Income Tax authorities has been not to tax damages for personal injuries. However questions involving damages for wrongful dismissal, and those involving damages for loss of income arising from personal injury are, to a large extent, analagous.[19] In the case of *Du Cros* v. *Ryall*[20] where an award was paid in settlement of the taxpayer's claim for wrongful dismissal it was held that the payment was one of capital, it being a payment to compensate for the loss of the source of income, which had disappeared.

In *Henley* v. *Murray*[21] the English Court of Appeal held that the sum of £2,000 paid a director of a company in consideration of his retirement from office, was held not taxable income as it was made for the abrogation of the source of employment: the employee had surrendered his right to receive remuneration. In that case Jenkins L.J. stated:

> . . . the question in each case is whether, on the facts of the case, the lump sum paid is in the nature of remuneration or profits in respect of the office, or is in the nature of a sum paid in consideration of the surrender by the recipient of his right in respect of the office.

This reasoning has been followed in Canada in three recent decisions of the Tax Appeal Board: *Millman* v. *M.N.R.*[22], *Brown* v. *M.N.R.* , *and No. 261* v.

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[16] (1936), 55 C.L.R. 144, at p. 156. See also *I.R.C.* v. *Ballantine* (1924), 8 T.C. 595 where payment of interest as damages was held not to be interest as such, but merely "estimations" and interest in name only. As such is was held to be a capital payment and not assessable under the English taxing statue. See also, *Simpson* v. *Maurice* (1929), 14 T.C. 580 which held that interest on German reparation payments was only a method of calculating damages and not taxable.

[17] (1934), 19 T.C. 13, at p. 19.

[18] This test is approved in C.E.D. (2nd ed., 1954), vol. 10, at p. 274.

[19] In the *Gourley* case Lord Goddard, discussing damages, equates the two and says, at p. 120, "In this opinion I am dealing solely with damages in personal injury and wrongful dismissal cases."

[20] (1935), 19 T.C. 444.

[21] [1950] 1 All E.R. 908.

[22] (1951), 4 Tax A.B.C. 373.

[23] (1951), 5 Tax A.B.C. 279.

M.N.R.[24]. In summary: it would seem therefore that where a payment is made to pay in full an amount of wages which are to be paid under the terms of a contract, or where the payment is to replace a specific sum which has been lost due to an inability earn income over a specific period, then these sums are income, having been made to make up a deficiency in the recipent's income. However where there is a permanent loss of a right to earn or of a source of income, or of the ability to earn, this is a loss of capital and payments in compensation of such, though measured in terms of 'income' are in fact making up a deficiency in capital.

Applying these conclusions to the *Gourley* case, it is submitted that damages for actual loss of wages, those special damages, would be taxable. These damages are based on the exact amount of income that the injured party would have earned over that period. They are received as a "quid pro quo" for the income lost or as Lord Macmillan stated in *Van Den Bergh* v. *Clark*:[25]

> If the applicants were merely receiving in one sum down the aggregate of profit which they would otherwise have received over a series of years the lump sum might be regarded as of the same nature as the ingredients of which it was composed.

In such cases therefore, where the damages themselves are taxable, the tax position of the plaintiff should not be taken into consideration, for unless the full amount is paid, the plaintiff will not be "placed in the same finincial position, so far as can be doen by an award of money."[26]

In the case of general damages awarded for loss of prospective earnings, damages are not paid as a direct substitute for the plaintiff's future earnings.

As Lord Goddard states, at p. 208 of the *Gourley* case:

> I do not thing that 'restitutio in integrum' has any application to general damages. The plaintiff receives compensation and not restitution.

These earnings are unpredictable. It is payment assessed largely on the basis of what the plaintiff would likely earn but it is an indefinite sum, which shall go to compensate, for once and for all, the permanent loss the plaintiff has suffered in his ability and capacity to earn money.[27] This sum is therefore not taxable (for the above reasons) and it is submitted that for the reasons stated by the House of Lords in the *Gourley* case tax position of the plaintiff should be taken into consideration in mitigation of general damages for loss of income.[28]

—H. M. Beaumont,
Third Year Law.

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[24] (1955), 13 Tax A.B.C. 23.

[25] *Supra*, footnote 14.

[26] *Gourley*, *supra*, footnote 1, at p. 206.

[27] *Billingham* v. *Hughes*, *supra*, footnote 2, at p. 655 where Birkett L.J. says: "The loss which he has suffered is the power to earn fees from is patients in his general practice, and his right to receive those fees from his patients."

[28] Since the case note was written, Pilcher J., *Beach* v. *Read etc.*, [1956] 2 ALL E.R. 652 has applied the Gourley Case in assessing damages for wrongful dismissal. In that case after making a rough estimate of the plaintiffs probable income from all sources Pilcher J., proceeded to estimate the tax which would have been payable on the income of the plaintiff by virtue of his services which were the subject of the action, and deducted this amount accordingly from the damages awarded.