

Taking the Taxation Effect into Account in the Assessment of Damages

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The Problem

Compensation receipts assume the character of things that they replace (*Commissioner of Taxation (NSW) v Meeks* (1915) 19 CLR 568 at 580 per Griffith CJ). Consequently, in personal injuries and wrongful dismissal cases, where compensation is paid for lost earnings the compensation received is on income account and, therefore, it is taxable. In such cases, where the loss and the compensation amounts are both taxable, there is no difficulty in calculating quantum – the amount required to return the plaintiff to his or her pre-loss position is the gross pre-tax sum that he or she did not receive and there is no reason why that should be reduced by a notional taxation element (*Gill v Australian Wheat Board* [1980] NSWLR 795 at 797).

On the other hand, where the loss would have been taxable but the compensation receipt is not (as will be the case with compensation for loss of future earning capacity) there is a question as to the proper basis upon which quantum should be calculated. An uncritical consideration of the ‘compensation principle’ articulated by Lord Blackburn in *Livingstone v Rawyards Coal Co* (1880) 5 App Cas 25 (at 29), where he said, ‘where any injury is to be compensated by damages, in settling the sum of money to be given as reparation of damages you should as nearly as possible get at that 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 if he had not sustained the wrong for which he is now getting his compensation or reparation’, might lead one to the conclusion that the proper amount would be that part of the plaintiff’s earnings which he or she was able to retain (ie his or her after-tax earnings) – and that is indeed how the question of quantum is now generally resolved. However, there are a number of issues which affect the validity of that calculation and it is those which will be considered in this paper.

The History

In 1955 the House of Lords held in *British Transport Commission v Gourley* [1956] AC 185 that, in personal injuries actions, the amount awarded for loss of earning capacity was to be calculated on an assessment of likely future earnings – and on a ‘net of tax’ basis. This was principally because those damages were not themselves taxable. The underlying principle was that of compensation - the amount awarded should put plaintiffs in the same position as they would have been in if they had not sustained the injuries (at 197). If plaintiffs were awarded the pre-tax amount of the earnings foregone and was not then subject to tax on it, they would be over-compensated. Three of their Lordships noted that the same principles would apply in wrongful dismissal actions. This, though obiter, was later accepted as correct.

The *Gourley* decision departed radically from earlier UK decisions (commencing with *Fairholme v Firth & Brown Ltd* (1933) 149 LT 332 in which it had been held that, in assessing damages in such cases, no regard should be had to the effect of taxation on the amount lost – because, either, the

servant's taxation liability was '*res inter alios acta*' - something between others - (per du Pareq J at 333) or, alternatively, because the incidence of taxation on the award was 'too remote' to be properly taken into account in the assessment of the plaintiff's damages.

Fairholme v Firth & Brown Ltd was subsequently followed in *Jordan v Limmer & Trinidad Lake Asphalt Co Ltd* [1946] KB 356, *Blackwood v Andre* 1947 SC 333, *Billingham v Hughes* [1949] 1 KB 643 and, in Australia, by *Davies v Adelaide Chemical and Fertilizer Co Ltd* [1947] SASR 67. A similar finding was reached in *W Rought Ltd v West Suffolk County Council* [1955] 2 QB 338, which unlike the other cases, involved compensation for lost profit as the result of an interruption of manufacturing operations (though this decision was overturned on appeal following *Gourley's* case: see *West Suffolk County Council v W Rought Ltd* [1957] AC 403).

The only dissenting view during this period was in *M'Daid v Clyde Navigation Trustees* 1946 SC 462 in which Lord Sorn held that damages awarded for personal injury should be calculated on a 'net of tax' basis – but that decision seems to have been decided without consideration of the contrary views in *Fairholme v Firth & Brown Ltd* and it was, later, expressly disapproved by Lord Keith in *Blackwood v Andre* 1947 SC 333 (at 333-334).

In Australia, the practice prior to the *Gourley* decision was the same as it had been in the UK – the tax effect was not taken into account in the assessment of damages. Thereafter, though, the *Gourley* decision was regularly followed by State courts when they were assessing damages for both personal injuries and wrongful dismissals. It was not, however, considered by the High Court until its decision in *Atlas Tiles Ltd v Briers* (1978) 144 CLR 202.

In that case the High Court held by a 3:2 majority that, contrary to what had been held in *Gourley*, damages calculations (in that case for wrongful dismissal) should not involve a deduction for the income tax that would have been payable on the amounts that were lost as a result of the injury or wrongful dismissal.

The majority gave a number of reasons for reaching this decision. First, there was the problem of valuing the loss. As Barwick CJ pointed out, the compensation principle is fundamental but 'it is for that of which the plaintiff has been deprived that the award of damages must compensate' and that what had to be kept in mind was that what was being compensated was loss of earning capacity and not loss of earnings (where the award would be taxable). He acknowledged that loss of earnings would be a consideration to be taken into account in arriving at a valuation of the loss, perhaps a major consideration but then went on to draw an analogy with loss of a rental property and said that the compensation paid would not simply be a factor of the lost rent that would have been earned from its continued use. This was his major argument and the one on which he finally decided that the incidence of tax on the amount lost was therefore too remote to be taken into account (see p 218): 'If ... the correct statement is that compensation is to be given for destroyed or reduced earning capacity and not for the non-receipt of earnings, the liability to pay tax on taxable income to which the product of the earning capacity would contribute is not relevant to the valuation of the earning capacity destroyed or diminished: or it may equally be said that the liability is remote in a legal sense'.

Second, there is the problem of calculation of the quantum of the reduction. If you take tax out of the award how do you calculate the reduction? Barwick CJ suggested two options. The first (which

seemed to him to accord with the compensation principle) was to look at how much the plaintiff's tax liability would be increased if the damages in their pre-tax form had been added to his or her taxable income and then take that amount away from the award (thus suggesting that the amount would be regarded as the 'last income' earned for the year and therefore would be regarded as 'taxable' at the plaintiff's highest marginal tax rate/s. The other alternative he suggested was that the tax be rateably spread over all elements of taxable income to provide some form of 'average'.

He therefore concluded that arriving at an appropriate figure was a near impossibility (noting that Lord Jowitt's solution in *Gourley's* case of arriving at one 'on broad lines' - even if that meant that the figure was 'rough and ready' - was not appropriate) and that if damages awards were to be reduced it would be better to leave it to the legislature to determine whether, and, if so, to what extent damages awards should be reduced by a taxation effect.

He also commented on the fact that one impact of reducing the damages awarded was that the wrongdoer was the real beneficiary – making it cheaper to injure a taxpayer than a non-taxpayer – and effectively denying the revenue the benefit of the tax that might otherwise have been paid.

Jacobs J took much the same view saying that the *Gourley* rule required too many exceptions to be workable and that therefore the pre-*Gourley* position was to be preferred. He noted that this objection did not apply to lost earnings pre-trial where both the amount of the loss and the tax payable on it could be calculated with precision, but that it did apply to the calculation of damages for loss of future earning capacity.

He also noted that the sole beneficiary of the rule would be the wrongdoer and that there were significant reasons for the law not to offer a financial inducement to wrongdoing.

Murphy J took the view that taking the notional tax liability into account was just one way in which damages in personal injury cases were underestimated (the other being not taking inflation into account) – and said that the difficulties of calculating a sum which would provide true compensation were so great that 'in general the calculation' is not attempted. He also raised the issue of the difference between calculating past lost earnings (which was relatively simple) versus future loss of earning capacity (which was not).

Of the minority Gibbs J accepted that precise calculation was problematic but said at 222 that 'there is nothing in *Gourley's case* that requires the court to proceed so mathematically'. He said that calculating damages often requires making an estimate and that should not preclude the compensation principle applying to prevent over-compensation – which would happen if tax was not taken into account.

On the question of benefit to the defendant by the reduction in damages payable he says that 'the question is what damages will compensate the plaintiff for his loss.

Stephen J noted at 231 that the two objections to *Gourley's Case* were that: (1) 'the incidence of income tax is too remote or is *res inter alios acta*' and (2) 'that if either party is to benefit from the transmutation of taxable earnings into tax-free damages it should be the innocent plaintiff rather than the unworthy wrongdoer'.

Regarding objection (1) he said that remoteness was 'inappropriate as a reason for inflating damages by excluding from consideration factors tending to reduce the measure of the plaintiff's loss.... [and that] ... Res inter alios acta is little more apposite. It is often employed, albeit inaccurately, to justify benefits which a plaintiff may derive from third parties being excluded from consideration... [but] ... the decision whether or not the incidence of income tax is to be taken into account is essentially concerned with the aim of compensating the plaintiff and with matters of policy in achieving that aim'. He then went on to say that *Gourley* was right because take home pay is 'the true measure of the wage-earner's reward' so there was 'no error in the policy decision so made'.

He similarly dismissed the benefit argument saying that it 'is to lose sight of the fact that the prime purpose of damages is that of compensating the injured party, no more and no less. It introduces instead a notion suitable only to some punitive theory of damages and seeks to convert awards of damages into vehicles for the **distribution of tax savings**. It also ignores reality in supposing that the financial interests of defendants in the great bulk of personal injuries cases are other than those of the premium paying community at large'. Stephen J then went on to say, also on 232, that 'any abandonment of the now conventional post-*Gourley* basis for the assessment of financial loss due to impaired earning capacity would dramatically increase the general level of awards of damages, calling for a far-reaching and temporarily disruptive re-evaluation of the present basis **whereby loss has come to be distributed, by means of insurance**, throughout the community'.

[The tax savings issue is no doubt a valid point – though could be remedied by making such awards taxable; though then you have the issue of the rate at which they should be taxed – given that the receipt would be entirely in a single tax year and would therefore be fully taxable in that year absent some form of averaging provision similar to that which used to apply to capital gains under the old Part IIIA. The insurance point is a valid policy consideration – though it should be one for government to take into account in deciding on whether such awards should be taxable].

Regarding calculation of quantum he rejected the 'simple and blunt' model and said at 233 that 'special factors' could be taken into account – such as the higher rates that would apply to increased remuneration in the future, other sources of income, changes to allowable deductions etc – as well as possible inflation etc. However, he then went on, effectively, to ignore any consideration of how that might occur by saying that 'these are matters for another day and for a case that squarely raises the issue'. This however also ignored the fact that the High Court had previously, and specifically, rejected the use of inflation estimates in calculating quantum in *O'Brien v McKean* (1968) 118 CLR 540.

Stephen J also emphasized the fact that calculating loss on the basis of anticipated future earnings was at best an informed estimate so getting precise accuracy for an ancillary factor such as tax was 'obviously illusory' and that making a 'broad estimate' was sufficient for the purpose of calculating damages – thereby specifically endorsing and adopting Lord Jowitt's comments in *Gourley*.

Cullen v Trappell

Interestingly, the decision in *Atlas Tiles v Briers* stood for less than 18 months. The case overturning it was *Cullen v Trappell* (1980) 146 CLR 1 in which special leave to appeal from a decision of the NSW Court of Appeal (applying the *Atlas Tiles* decision) was granted specifically to allow the High Court to reconsider its earlier decision. In a 4:3 decision the majority (Gibbs, Stephen, Mason and Wilson JJ)

refused to follow *Atlas Tiles*, applied *British Transport Commission v Gourley* and held that, when assessing damages for personal injury, the court should take into account the income tax that the plaintiff would have had to pay on the earnings of which he or she had been deprived as a result of the injury/dismissal.

The reasoning adopted was essentially the same as the minority (Gibbs and Stephen JJ) had applied in *Atlas Tiles*. In brief it was that (1) damages are compensatory in nature and should not be calculated on the norm that 'the wrongdoer should pay' (ie there should be no punitive element involved in either intent or result); and (2) (pragmatically) in nearly all cases any tax benefit does not attach to the wrongdoer but, because of insurance, to the public generally.

They specifically rejected the argument that following *Gourley's Case* would lead to unacceptable difficulty and complication in the assessment of damages but said that even if that were the case 'there is no reason for departing from the fundamental principle on which that decision rests': (per Gibbs J at 17. (He had earlier noted that: 'The method now usually adopted in assessing damages for economic loss to be suffered in the future is first to estimate what the loss will be, and over what period it is likely to occur, and then to estimate what sum, if paid **at the date of judgment**, would compensate the plaintiff for that future loss. This is usually done by applying actuarial tables which show the present value of as future loss, once an appropriate rate of interest has been applied' (though it is clear that Gibbs J's calculation produced the plaintiff's current after tax loss of \$66 a week – without consideration of pay rises or the effect of inflation).

Of the minority Barwick CJ adhered to the views he expressed in *Atlas Tiles* and emphasized again that, in his view, *Gourley* wrongly confused replacement of the capacity to earn with replacement of the wages that might be expected to have been earned – while again acknowledging that the lost wages would be an element in the calculation – saying (at 8) that 'To attempt to assess damages on the basis of the benefit which the recipient of salary or wages derives from its receipt, is to my mind to introduce remote and irrelevant considerations'.

He also then went on to illustrate that point by giving, as an illustration, the impact that other outgoings– including travel and clothes required for work and other requirements of the employer – can have on disposable income and said that they 'may significantly affect the benefit derived from the receipt of salary or wages'.

He also said that there are other matters that could affect the plaintiff's tax liability, such as available rebates (and, presumably, things such as deductible losses from other endeavours etc) which make arriving at an accurate assessment impossible, because: 'No doubt, if *Gourley's Case* were accepted, due allowance could be made for those deductions to which the employee is presently entitled, but not for those to which he might become entitled in the future.' He then went on to say that tax rates are not stable either.

Murphy J, at 27, criticised the trial judge's assessment of damages because (1) they assumed that the plaintiff's earnings would remain constant over the ensuing 25 years of his working life; (2) they ignored the probable increases in real wages reflected throughout the Australian community (and he noted that these had averaged about 3% per year over the 25 years before the trial) and (3) they ignored increases due to normal age progression and promotion. They also reduced the plaintiff's likely available 30 years of working life to 25 years to 'allow for adverse contingencies'. Also 'the

injustice is compounded when the notional wage loss is discounted by 6 percent.' 'That discount rate is a reflection of inflation. To ignore the provable effects of inflation on future earnings or expenses while taking it into account by adopting inflated interest rates when assessing the present value of those earnings or expenses is clearly an injustice to injured plaintiffs'.

In a similar vein Aickin J at 30-1 said, about applying the *Gourley* principle: 'If... the general rule continues to be that no account is to be taken of increases in wages or other income due to promotion, changes in awards due to 'indexation' or 'work value' or other matters in estimating loss of earning capacity, this practice, though realistic is anomalous.'

At 32 he went on to describe the process for determining damages saying 'The process now used is primarily to take a plaintiff's weekly or other periodic wage or salary as at the date of hearing, and to subtract from it in the case of partial incapacity the weekly amount which he is able to earn at the date of hearing. The next step is to calculate the total sum which would be received if that figure represented actual earnings for the balance of the working life of the plaintiff. From the total figure so calculated a reduction is made for what were originally called contingencies but which are now usually referred to as 'the vicissitudes of life' and then a chosen discount rate is applied in order to calculate from the appropriate tables the present value of that series of periodical payments'.

He also said at 33: 'To make as a matter of course an adjustment for unfavourable contingencies which may operate to reduce the estimate for the future, rather than to advert to both favourable and unfavourable contingencies is a departure from logic. However it is not customary to make allowance for the prospect of promotion to a more highly paid position, whether as a result of obtaining higher qualifications by reason of experience or training ... and thereby obtaining new skills' etc'.

He also referred to the fact that inflation is not taken into account saying: 'The decision of this Court in *O'Brien v McKean* (1968) 118 CLR 540 excludes the effect of inflation from the calculation in so far as it relates to the period beyond the date of hearing'. As was said in that case at 545-6:

"... it is the loss of earning capacity which has occurred by reason of the accident which is to be the subject of compensation by an award of damages: *it is not a case of replacing the wages which would have been earned in the future by a sum of money which represents the present value of the total of such wages: see Arthur Robinson (Grafton) Pty Ltd v Carter*. That loss of earning capacity has already occurred and is either permanent or likely to continue for some estimable time. *The fair compensation for it is to be determined as a matter of judgment and not of calculation. But it is of course to be an informed judgment*. Though the damages as I have said are not to be a replacement of the future wages, part of the relevant information for the purpose of forming a judgment as to the fair and reasonable compensation is a broad estimate of what that earning capacity before its destruction or diminution was capable of producing during such time as it would have been likely to be gainfully exercised. In obtaining such a conspectus, the vicissitudes of life, as it has been said, must not be lost sight of." **(Emphasis added)**

This comment (which still represents the law) seems to say that you do not take probable actual future earnings into account in calculated damages for loss of earning capacity but you do still take estimated tax on those non-indexed amounts of earnings into account.

Aickin J then went on to say (at 34), 'All these aspects indicate what appears to me to be a tendency to be selective in the factors which may affect future earnings and therefore enter into the calculation of the value to be attributed to the loss of earning capacity. ... When one comes to consider the question of tax there will be many cases in which its estimation even at the rates prevailing at the date of the trial will present great difficulty'. He then goes on to discuss the various problems, as already covered by others.

After *Cullen v Trappell*

Since the decision in *Cullen v Trappell* the principle that it accepted has been consistently applied by Australian courts - but there are still issues that may prove problematic and which, arguably, have not been fully considered in the decisions to date and which result, as Murphy J noted in *Cullen v Trappell*, at 27, in an assessment of the loss of future earning capacity which is 'unrealistic'.

For example, in that case the plaintiff, a qualified print machinist, who was no longer able to work in that trade had the quantum of his loss of future earning capacity assessed at \$45,311. This was in 1980 when he still had an estimated 30 years of working life remaining. It was calculated by taking into account the then after-tax weekly earnings that a rotary printing press machinist would earn (\$170 per week), deducting the amount that he was able to earn in a sheltered workshop (\$104 per week) multiplying that by the 25 years of working life that was likely to remain to him (the 30 years of anticipated working life discounted for the effect of his injuries and the vicissitudes of life), the resulting figure then being further discounted by 6% - to account for the effects of inflation on the returns on investment of the capital sum. The assumption in the making of such awards is that the capital sum awarded, appropriately invested, would produce a return which, with the capital sum itself, would all be sufficient to replace the lost future earnings but would be exhausted at the end of the plaintiff's anticipated working life (ie it would allow him to draw \$66 per week for the whole of those 25 years – *not \$66 adjusted for inflation*). Given that Mr Trappell was expected to have 25 years of life to be funded from the award, the amount of \$45,311 was clearly inadequate to provide him with real replacement earnings – even assuming he continued to earn some income from the sheltered workshop or other similar employment.

The Unresolved Problems with the *Gourley* Solution

While it is clear that there is much to commend the *Gourley* solution in the context of the compensation principle, it is also clear that its application fails to take into account a number of issues which do affect the question of the adequacy of the quantum of the compensation awarded. Most of those issues were identified by Lord Keith in the *Gourley Case* itself or by Barwick CJ and Jacob, Murphy and Aickin JJ in *Atlas Tiles* and/or *Cullen v Trappell*. In brief they may be summarised as follows:

1. Determining What is Being Compensated?

As Barwick CJ pointed out in both *Atlas Tiles v Briers* and *Cullen v Trappell* it is difficult to escape the conclusion that the majority in *Gourley's Case* did not really draw a distinction between a loss of earning capacity and loss of the proceeds of the future exercise of that capacity. The two are clearly related but, equally clearly, they are not the same thing - and to value the former, effectively exclusively, by reference to the latter need not produce a just outcome. As all of the judges

acknowledge, there is an element of estimation in determining the quantum of damages in many cases but, arguably, it should first be clear what exactly is being compensated.

2. Calculation Problems

2.1 As Lord Keith, Barwick CJ and Murphy, Jacob and Aickin JJ have variously illustrated, the present calculation of damages for loss of future earning capacity does not take into account a range of **possible future occurrences** that might affect its proper valuation – even where it is based solely on an assessment of future earnings. They include:

- The possibility of increases in real wages over time;
- The possibility of increases due to normal age progression and promotion;
- The possibility of increases achieved by education and changing occupation;
- The possibility of future deductions and offsets (for, for example, future dependants);
- Lifestyle choices (in particular, the impact of salary sacrifice type decisions on both future taxable income and the consequent tax liability).

Despite comments by Gibbs and Stephen JJ (in particular) that there is nothing in *Gourley's Case* that requires courts 'to proceed so mechanically as to fail to take these possibilities into account' there is still a real question about how the courts would do that and what evidence of their probable future conduct plaintiffs would have to adduce to induce a court to depart from the formulaic calculation to which they refer in *Cullen v Trappell* (per Gibbs J at 12).

2.2 If courts can get around that problem, there is still the problem of how they calculate the **rate of tax** to be applied to determine the reduction that should be made. As Barwick CJ noted in *Atlas Tiles* at 206, do they assume that the income foregone (and therefore the compensation) would be taxed at the taxpayer's highest marginal rate or rates or do they adopt some other, perhaps average, rate determined by spreading the amount of tax rateably over all elements of taxable income – or do they effectively ignore the other income and reduce the award by the tax that would have been payable on the income foregone, on the assumption that it was the only income received by the taxpayer (this last option seems to have been impliedly discarded as a possibility by their Lordships in *Gourley's case*).

2.3 Given that damages awards do not take inflation into account (thereby necessitating the taxpayer making drawdowns over time of capital from which other income is currently derived) – how can the courts be certain that the rates now applicable to that taxpayer's total income will continue to be the rates at which his total income will be susceptible to tax – **even assuming** that the applicable tax rates will not change at all over the course of his or her notional remaining working life – and how is that taken into account in determining probable future taxation liability.

2.4 How do the courts assess likely future tax liability anyway given the probability of fluctuations in tax rates and other relevant variables? Gibbs J acknowledges in *Atlas Tiles* (at 222) that 'it is impossible to foresee future changes in the level of tax, or in the tax laws, or in the situation of the plaintiff himself which may affect the extent to which the lost earnings would have borne tax' but then effectively disregards it as a legitimate concern saying, 'the court is constantly required to endeavor to predict the course of events in the future, and it does not abdicate a necessary function for fear that its predictions may be falsified'. The question should be asked however whether, if

there is a risk of over-compensating a plaintiff or under-compensating him or her because of inherent uncertainties in the calculation methodology, might it not advance justice more to err on the side of possible over-compensation.

2.5 What allowance, if any, should the courts make for other not tax-related outgoings that affect after-tax disposable income. In *Cullen v Trappell* Barwick CJ instances outgoings for travel and clothes required for work and other employer requirements that 'may significantly affect the benefit derived from the receipt of salary or wages'. On the compensation principle, logically, these expenses, which will no longer be incurred, should also be deducted from the gross receipt to arrive at the plaintiff's true loss – but, at present, they are not, even though they could be calculated at least as accurately as likely future tax liability.

3. Not Taking Inflation into Account

As Aickin J noted in *Cullen v Trappell*, as a consequence of the High Court's decision in *O'Brien v McKean*, the effect of inflation is excluded from the calculation of damages beyond the date of hearing. As damages for loss of future earning capacity under the *Gourley* principle are calculated on the basis of likely future earnings this produces an unrealistic representation of the true quantum of the loss (especially when that figure is itself reduced by a discount factor to take account of the effect of inflation). If a notional taxation factor built on assumptions as to future tax laws and the plaintiff's own taxation circumstances can be estimated and applied to reduce awards it seems inconsistent that similar assumptions about wage levels based on historic data cannot be made to give a better estimate of probable loss – and to ensure that the aim of providing damages which, together with the return on their investment will provide a true replacement of loss over what would have been the plaintiff's remaining working life. Given the decision in *O'Brien v McKean* (1968) 118 CLR 540, that would however require legislative action.

4. Benefitting the Wrongdoer

It would seem that an inescapable consequence of applying the compensation principle is that the wrongdoer will, in most cases, receive a benefit in that the damages payable for the consequences of the wrongful act will be reduced below what they would ordinarily have been. The judges were divided on the relevance of this question with some concerned at the injustice of providing that 'incentive' while the majority thought that the compensation principle, as the 'dominant rule', was fundamental and that the benefit to the wrongdoer was not a relevant consideration. More pragmatically they acknowledged the insurance effect and the impact that increasing awards to remove the benefit would have on premiums.

Realistically the only way in which benefit to the wrongdoer can be fully removed while still adhering to the compensation principle would be to assess damages based on pre-tax earnings and then make the award itself taxable. This is not without its difficulties – including, not least, the problem of the rate at which such awards should be taxed to ensure that the revenue did not receive a windfall at the expense of the plaintiff (perhaps the rate could be legislatively set at the taxpayer's average rate of tax for, say, the three years prior to the injury - after excluding abnormal items, as is currently done for the calculation of primary producers' income for averaging purposes).

This would, of course, increase both payments and insurance costs but one benefit might be to provide a revenue stream to cover the costs of disability and similar social security payments to plaintiffs whose awards end up being insufficient to fund their expenses through to the end of their notional working life. Either way there are a number of policy considerations which government would need to take into account in deciding whether legislative intervention to alter the present situation was justified.

Other Problems

There are at least two other possible problems with the *Gourley* solution: what happens if the damages awarded are themselves taxable – but at a lower rate? And what happens where the taxation situation with the damages is unclear?

The ‘Lower Rate of Tax’ Problem

Atlas Tiles v Briers involved a wrongful dismissal action where only 5% of the damages had been taxable under s 26(d). Gibbs J’s view was that notional tax should be deducted because the entire damages would not be taxable – only 5% of them. He noted, however, that, provided the whole award was taxable – even if at a lower rate - the pre-tax figure could be used as the basis of damages (apparently because of complexity).

On the other hand, in *NSW Cancer Council v Sarfaty* (1992) 28 NSWLR 68, it was held that where damages that have been assessed on the basis of after-tax salary are themselves taxable – albeit at a concessional rate, the appropriate course of action is not to award pre-tax damages but to increase the award by the amount of the taxation liability to compensate the plaintiff for the tax payable on the damages. Presumably, this solution could also apply to *McLaurin v FCT* type situations where the award/settlement amount is an undissected lump sum (see also Taxation Ruling TR 95/35).

It also seems to accord with the ‘*Gourley* in reverse’ principle.

The ‘*Gourley* in reverse’ principle applies, in particular, in relation to the interest which it is assumed will be earned by a plaintiff when the capital sum awarded as compensation is invested to produce income to augment the capital and to provide an income stream for the balance of the plaintiff’s notional working life. Because that interest is itself subject to tax it will fall short of what is needed to properly compensate the plaintiff unless it is ‘grossed up’ by the amount of tax. (An actuarial example of the gross up required – at the then applicable rates of tax and available interest rates - can be found at (1966) 40 ALJ at 135-137).

Recent examples can be found in *Tomasetti v Brailey* (2012) 274 FLR 248 (where damages for negligent financial advice were not awarded but the court noted that, if they had been, they would have been an assessable recoupment, and *Jamieson v Westpac* (2014) 283 FLR 286 – where damages were being sought for interest payments to a bank that had been claimed as a deduction. The bank argued that the damages should be limited to the after tax loss (ie that they should be reduced by the amount of the tax benefit that the plaintiffs had received because of the deduction. In both cases it was noted that:

- Where damages awarded for a loss are themselves taxable they have to be ‘grossed up’ to take into account the tax that would be payable – so the award would actually compensate the losses sustained

What Happens when the Taxation Consequences are Unclear?

The problem was well illustrated in *Davinski Nominees Pty Ltd v I & A Bowler Pty Ltd* [2011] VSC 220. In that case a shopping centre tenant was served with a notice to vacate. After some argument it agreed to leave on the plaintiff's undertaking to pay just compensation. The question of compensation was taken before VCAT which determined a figure on a pre-tax basis. That was disputed. The defendants argued that they were being compensated for lost income so the compensation they received would be taxable - so the *Gourley* principle did not apply and there should not be any reduction. The plaintiffs argued that any tax liability on the payment would be on capital account, that CGT not income tax would be payable - so the defendants should only get an amount equal to the net earnings they lost plus an amount equal to the CGT payable on the award (effectively the *Gourley* in reverse amount).

In reaching its decision the Victorian Supreme Court looked in particular at the judgment of Clark and Sheller JJA in *Daniels v Anderson* (1995) 37 NSWLR 438. Their Honours had noted that, where the taxability of compensation is so uncertain and dependent on imponderables, the appropriate course is to ignore the taxation considerations. Consequently, taxation is taken into account - *provided* there is a 'sufficient degree of certainty relating to the nature and quantification of the tax liability'.

In *Davinski Nominees* the end result was that the uncertainty over the ultimate tax treatment of the compensation led the court *not* to reduce the damages award - at all.

Possible Solutions

There is no easy solution to the *Gourley* problem. The uncertainties involved in arriving at an accurate valuation of loss of future earning capacity mean that awards will be, at best, an estimate not of that loss but of the probable proceeds of that loss - which, even then will be informed not by fact but by assumptions about future behaviour - by both the plaintiff and government.

Many of those difficulties concerning future behaviour would still remain if the loss was valued on the basis of pre-tax loss - but at least the uncertainties about the effect of the future structure of the tax system would be removed.

How then though to apply the compensation principle but in a way that ensures, as far as possible, the amount awarded approximates reality? The *Gourley* in reverse principle goes some way to achieving that outcome - but it too relies on a number of assumptions about the future - in relation to both financial markets and the taxation regime.

Legislating to require courts to take inflation into account when calculating loss of future earning capacity would seem to accord with the thinking underlying the '*Gourley* in reverse' principle and would also produce a more realistic estimate of probable lifetime loss (especially if calculated on a post-tax basis).

Reforming the compensation system to remove lump sum awards, at least for loss of future earning capacity, and replace them by indexed annuities would also assist. The annuities, as taxable receipts, would approximate the lost income and would be taxed on essentially the same basis with essentially the same after-tax outcome (they should vary only to the extent of work related deductions, which would no longer be applicable, and the other non-deductible but work related outgoings to which Barwick CJ referred in *Cullen v Trappell*). This need not mean that defendants

would thereby incur an ongoing financial and administrative burden. They could be required to pay a lump sum still – to an annuity provider - based on a calculation such as superannuation funds and other annuity providers routinely undertake.

A move to payment of annuities that would approximate pre-tax income would also remove the 'benefit to the wrongdoer' problem and ensure that the revenue was not adversely affected – as is the case now.

This would of course increase awards and have an impact on insurance premiums and the insuring public but it might also reduce the reliance by plaintiffs, later in life, on social security payments to augment their depleting capital pool. In both respects there are policy issues which government will need to consider.

At the end of the day perhaps the one guiding principle should be 'compensation for actual loss' but ensuring that awards err on the side of the plaintiff in cases of uncertainty.