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TAX FACTORS IN PERSONAL INJURY AND FATAL ACCIDENT CASES: A PLEA FOR REFORM

By VERN KRISHNA*

I. INTRODUCTION

Four decisions¹ handed down by the Supreme Court of Canada in January, 1978 provide definitive, though troublesome, statements on the appropriate consideration to be given to tax factors in the determination of quantum in personal injury and fatal accident cases. Quite apart from their authoritative exposition of the applicable principles in both personal injury and fatal accident cases, the decisions are important in at least two other respects. First, the Court reversed its previous position on the appropriate consideration of tax factors in the determination of awards in fatal accident cases.² Secondly, the Court approved a particular method of computation in fatal accident cases.³ While the decisions are important for their exposition of principles, they create difficulties in their application to well-established principles of damage computation. At the same time, they adversely affect certain fundamental rights of taxpayers to plan their own affairs to maximum advantage.

II. THE TAX FACTOR IN PERSONAL INJURY CASES

Of the group of four decisions handed down by the Supreme Court of Canada, three involved personal injuries⁴ and consideration of tax factors in determining the quantum of the award was present in all three. The Court, following its earlier decision in *The Queen v. Jennings*,⁵ decided that a judicial tribunal should not take into consideration tax factors in determining the quantum of an award in personal injury cases. This position contrasts with the Court's position, discussed hereinafter, in fatal accident situations.

In order to place the issue and the decision in perspective, it is necessary to examine, as indeed the Court did, the underlying rationale in the determination of a damage award in personal injury cases. At the outset, the Court

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¹ *Andrews v. Grand & Toy Alberta Ltd.*, [1978] 2 S.C.R. 229, 83 D.L.R. (3d) 452, 3 C.C.L.T. 225; *Thornton v. Bd. of School Trustees of School Dist. No. 57 (Prince George)*, [1978] 2 S.C.R. 267, 83 D.L.R. (3d) 480, 3 C.C.L.T. 257; *Arnold v. Teno*, [1978] 2 S.C.R. 287, 83 D.L.R. (3d) 609, 3 C.C.L.T. 272; *Keizer v. Hanna*, [1978] 2 S.C.R. 342, 82 D.L.R. (3d) 449, 3 C.C.L.T. 316.

² *Keizer v. Hanna*, *supra* note 1, *rev'g Gehrman v. Lavoie*, [1976] 2 S.C.R. 561, 59 D.L.R. (3d) 634, [1976] 1 W.W.R. 468.

³ *Keizer v. Hanna*, *supra* note 1, at 372 (S.C.R.), 468 (D.L.R.), 325 (C.C.L.T.).

⁴ *Andrews v. Grand & Toy Alberta Ltd.*, *supra* note 1; *Thornton v. Bd. of School Trustees of School Dist. No. 57 (Prince George)*, *supra* note 1; *Arnold v. Teno*, *supra* note 1.

⁵ [1966] S.C.R. 532, 57 D.L.R. (2d) 644, *aff'g* [1965] 2 O.R. 285 (C.A.).

accepted compensation of an injured plaintiff, i.e., monetary *restitutio in integrum*, as the underlying principle of the theory of damages in tort actions. Dickson J., speaking for a unanimous Court in *Andrews v. Grand & Toy Alberta Ltd.*,⁶ accepted this principle when he quoted, with approval, Viscount Dunedin in *The Susquehanna*:

. . . the common law says that the damages due either for breach of contract or for tort are damages which, so far as money can compensate, will give the injured party reparation for the wrongful act. . . .⁷

To the same effect, his Lordship accepted the principle, quoting *McGregor*,⁸ of "full compensation for the pecuniary loss" suffered by a plaintiff.

It is with respect to the application of this principle of "full compensation" that the Court, as it had done earlier in *Jennings*, asserted its conclusion that tax factors should not enter into the determination of quantum. This assertion is weak on two grounds. First, it does not conceptually accord with the theory of damages accepted by the Court in the same judgment; secondly, it fails to recognize the superficiality of the distinction, in this particular context, between the "capital asset" and "loss of earnings" approaches to compensation.

The first weakness becomes evident if one examines the mode of computation (demonstrated with considerable clarity in the *Andrews* decision) adopted by the Court. First, the Court estimated the amount of future earnings that the plaintiff would have earned had he not been injured. Having estimated this at \$1,200 per month,⁹ the Court reduced this figure by 53 percent, which percentage represented an estimate of the future maintenance costs already included under a different head of damages, so as to avoid duplication or overcompensation.¹⁰ As a result of this reduction, the Court calculated the residue of the prospective earnings, net of maintenance costs included elsewhere, to be \$564 per month (47% x \$1,200). Secondly, with the assistance of actuarial evidence, the Court estimated the remaining working life of the plaintiff to be 30.81 years.¹¹ Thirdly, the Court estimated the appropriate discount rate to be applied, in order to reduce the earnings to their present value, at 7 percent.¹² This reduction of estimated future earnings to their

⁶ *Supra* note 1, at 240 (S.C.R.), 461 (D.L.R.), 234 (C.C.L.T.).

⁷ [1926] A.C. 655 at 661, [1926] All E.R. Rep. 124 at 127, 95 L.J.P. 128 at 130, 135 L.T. 456 at 458, 42 T.L.R. 639 at 641, 17 Asp. M.L.C. 81 at 83, 33 Com. Cas. 1 at 7 (H.L.), cited with approval in *H. West & Son Ltd. v. Shephard*, [1964] A.C. 326 at 345, [1963] 2 W.L.R. 1359 at 1368, [1963] 2 All E.R. 625 at 631 (H.L.). To the same effect, see *Livingstone v. Rawyards Coal Co.* (1880), 5 App. Cas. 25, 28 W.R. 357, 44 J.P. 392, 42 L.T. 334 (H.L.).

⁸ H. McGregor, *McGregor on Damages* (13th ed. London: Sweet & Maxwell, 1972) at 738 (para. 1097), quoted by Dickson J. in *Andrews v. Grand & Toy Alberta Ltd.*, *supra* note 1, at 241 (S.C.R.), 461 (D.L.R.), 234 (C.C.L.T.). To the same effect, see D. Kemp and M. Kemp, *The Quantum of Damages in Personal Injury and Fatal Accident Claims* (3d ed. London: Sweet & Maxwell, 1967) at 4.

⁹ *Andrews v. Grand & Toy Alberta Ltd.*, *supra* note 1, at 252 (S.C.R.), 469 (D.L.R.) 244 (C.C.L.T.).

¹⁰ *Id.* at 254 (S.C.R.), 471 (D.L.R.), 245-46 (C.C.L.T.).

¹¹ *Id.* at 252 (S.C.R.), 470 (D.L.R.), 244 (C.C.L.T.).

¹² *Id.* at 259 (S.C.R.), 474 (D.L.R.), 249-50 (C.C.L.T.).

present value was made in consideration of the plaintiff receiving a lump sum of money earlier than he would have had he actually worked and been paid periodically over his estimated remaining working life of 30.81 years. Finally, the Court reduced the net present value of the amount determined by a factor of 20 percent to allow for contingencies in the plaintiff's career and earnings.¹³

To this point, the method of computation accords with the principle of full and fair compensation of the plaintiff. Hence, earnings, working life, discount factors, and contingencies are all accounted for on the principle that the plaintiff should be financially restored to his pre-injury status. Applying these factors on the basis of an "exhausting fund principle,"¹⁴ the Court determined that an award of \$69,981 would compensate the plaintiff for his prospective loss of gross earnings.¹⁵ The question remains, of course, whether an injured plaintiff should be compensated for his prospective earnings on a gross or net income basis. Conceptually, the Court failed to recognize that an award of damages computed on the basis of gross income (in this instance \$564 per month) would overcompensate the plaintiff. Stated another way, would a plaintiff who had not been injured by the tortfeasor be entitled to take home \$564 per month, or some lesser sum?

The second weakness, which highlights the first, is the Court's reasons for calculating the award without reference to any tax considerations. Thus, Dickson J. began the computation described above by asserting his conclusion: "It is not loss of earnings but, rather, loss of earning capacity for which compensation must be made,"¹⁶ citing the decision in *Jennings*, in which case the Supreme Court made a similar assertion. It is difficult to reconcile this assertion with either the principle of compensation underlying quantum determination or the process of calculation set out in the judgment of Dickson J.

The fallacy of this assertion is revealed by answering the question posed by the Court itself: "A capital asset has been lost: what was its value?"¹⁷ The difficulty arises from the nature of the computational process inherent in the determination of capacity; the process itself reveals the superficiality, and inappropriateness, of the distinction made by the Court between "capacity" and "earnings." To determine the value of the capital asset, the Court immediately embarked upon the calculation described above; the first step was the calculation of the plaintiff's estimated future earnings, which the Court established at \$564 per month. In this case, the damage award of \$69,981 was calculated by discounting the plaintiff's estimated monthly wage rate, for a given number of years, at a selected discount rate. This lump sum award was

¹³ *Id.* at 254 (S.C.R.), 470 (D.L.R.), 245 (C.C.L.T.).

¹⁴ The "exhausting fund principle" requires that the present value calculation should provide for a self-extinguishing fund. As Dickson J. Stated: "To allow a residual capital amount would be to over-compensate the injured person by creating an estate for him." *Id.* at 260 (S.C.R.), 475 (D.L.R.), 251 (C.C.L.T.). The "exhausting fund principle" was also applied in *Thornton v. Bd. of School Trustees of School Dist. No. 57 (Prince George)*, *supra* note 1, at 274 (S.C.R.), 483 (D.L.R.), 261 (C.C.L.T.).

¹⁵ *Andrews v. Grand & Toy Alberta Ltd.*, *supra* note 1, at 266 (S.C.R.), 479 (D.L.R.), 255 (C.C.L.T.).

¹⁶ *Id.* at 251 (S.C.R.), 469 (D.L.R.), 243 (C.C.L.T.).

¹⁷ *Id.*

intended to compensate the plaintiff under the head of "prospective loss of earnings." In this context, "capacity" represents nothing more than the capitalized value of estimated future cash flows; this "capital asset" is nothing other than the substitution of discounted future earnings.

The Court would normally require an individual earning \$564 per month for 30.81 years to pay tax on his earnings. Yet, that same individual, if injured, receiving \$564 per month for 30.81 years, discounted by 7 percent to allow for early payment, is considered to receive a non-taxable capital receipt! Since the capitalized value of estimated future earnings is premised on the principle of *restitutio in integrum*, this principle of compensation should have been extended to the characterization of the damage award itself. Thus, a sum of money substituted for initially taxable earnings should, barring compelling reasons, remain liable to tax.

Given its reservations on the use of lump sum awards, the Court's characterization of the award as a "capital asset" is particularly incongruous. Although Dickson J. did not detail any particular alternative, he clearly favoured periodic payments in lieu of lump sum awards.¹⁸ His Lordship did not refer to (as, indeed, there was no need to do so) the possible consequences if the damage award had been ordered payable on a periodic basis. Should such periodic payments, received over a lifetime, be awarded on a non-taxable basis as compensation for "capacity"? Or would the Court have considered such periodic payments to be taxable? If damage payments payable on a periodic basis were subject to tax, would the reason be because they are substituted for earnings? Would such periodic payments no longer be considered as compensation for impaired capacity?

An example illustrating the difficulty inherent in the Court's approach may serve to indicate the superficiality of the attempted distinction between "capacity" and "earnings." Assume (ignoring the aspect of the "exhausting fund principle," which addresses a different issue) that a plaintiff earning \$10,000 per year is injured for a period of three years. Once liability has been determined, it is decided to compensate the plaintiff for his lost earnings. Two alternatives are available. First, the plaintiff may be awarded a lump sum discounted, in this illustration, at 7 percent. If this alternative is adopted, the plaintiff would receive \$26,243 (the present value of an annuity of \$10,000 payable over three years). The difference of \$3,757 (\$30,000 minus \$26,243) represents the discount for payment earlier than the time the money would have been earned had the plaintiff worked. This amount of \$26,243 would not, following the reasoning in *Andrews*, be reduced to take account of any potential tax liability.

The second alternative would be to adopt a method of compensation involving periodic payments. The plaintiff might receive \$10,000 per year for three years; in this situation no discount would be required to compensate for early payment. In lieu of his normal earnings, the plaintiff would receive \$10,000 each year from the tortfeasor. Should this amount of \$10,000, received annually, be considered tax exempt on the basis that it represents

¹⁸ *Id.* at 236 (S.C.R.), 458 (D.L.R.), 230 (C.C.L.T.).

compensation for capacity? If the award is considered tax exempt, would not the payment of \$30,000 overcompensate the plaintiff for the injuries suffered? If, in contrast, periodic payments were considered as compensation for loss of earnings, they would be subject to taxation. This would result in inconsistent treatment between lump-sum and periodic-payment damage awards. Again, assume that the tortfeasor wanted to prepay his liability at an appropriate, and agreed upon, discount. Would the discounted capital sum become non-taxable, while the non-discounted periodic payments remained taxable?

These difficulties stem from the effort to artificially characterize "loss of earnings" and "impaired capacity" in two distinct, and conceptually different, ways. The fallacy of the distinction, and the resulting sacrifice in the underlying principle of compensation, is illustrated in the following example. Assume that X, an employee, earns \$1,200 per month, and expends 53 percent of his take home pay on his own maintenance. His financial position, assuming the minimum of tax deductions, is as follows:¹⁹

Earnings (\$1,200 per month x 12)		\$14,400
Earnings Included in Income		\$14,400
Less: Basic Personal Deduction	\$2,270	
Standard Medical Deduction	100	
Employment Expense Deduction	250	
	\$2,620	(\$2,620)
Taxable Income		\$11,780
Less: Federal and Provincial Income Tax on Taxable Income		(3,510)
Disposable Income		10,890
Less: Self-maintenance (53% of Disposable Income)		(5,772)
Net Residue		5,118

If X is injured for a period of one year, he would, using Dickson J.'s reasoning in the *Andrews* decision, receive a net residue of \$6,768,²⁰ or \$1,650 in excess of his pre-injury net residual earnings.

It is this result of overcompensation that leads one to question the Supreme Court's reasons. The cases are rightly decided, however, in that a personal injury award should not be reduced for tax factors in a tort forum. To this extent, the Supreme Court's rejection of the reasoning in *British Transport Commission v. Gourley*²¹ is to be applauded. The disadvantages, and the inappropriateness, of the *Gourley* line of reasoning, which were clearly summarized in the speech of Lord Keith before the House of Lords,²² include, *inter alia*, the difficulty of accounting for other income, e.g., investment income, the impact of foreign taxes, changing tax circumstances, and, above all, the denial of the opportunity to plan one's affairs for maximum tax ad-

¹⁹ Using rates and deductions applicable in 1977.

²⁰ (\$1,200 per month x twelve months) less 53 percent for self-maintenance.

²¹ [1956] A.C. 185, [1956] 2 W.L.R. 41, [1955] 3 All E.R. 796, [1955] 2 Lloyd's Rep. 475, 34 A.T.C. 305, 49 R. & I.T. 11, [1955] T.R. 303 (H.L.).

²² *Id.* at 216-18 (A.C.), 59-61 (W.L.R.), 810-12 (All E.R.), 487-88 (Lloyd's Rep.), 315-16 (A.T.C.), 313-14 (T.R.).

vantage. Lord Keith accurately summarized the disadvantages of calculating damages on an after-tax basis:

. . . to fix them on the basis of existing taxation without any knowledge of what the future commitments and obligations and personal status of the injured person will be, or would have been, seems to me to be unreal. . . .²³

These dissenting reasons were accepted by the Supreme Court of Canada in *Jennings*, Judson J. stating: "I would, however, put my rejection upon broader grounds. I agree with the dissenting opinion of Lord Keith in the *Gourley* case. . . ."²⁴ These reasons are, it is submitted, sufficiently compelling to warrant exclusion of tax factors in the determination of quantum in a tort forum.

Does it matter that the Supreme Court may have arrived at the right conclusion for the wrong reasons? Perhaps. The difficulty with resting the Court's decision on the artificial distinction between compensation for capacity versus loss of earnings is the impact of this reasoning on subsequent litigation in a tax forum. Since the Supreme Court is the ultimate arbiter of appeals in income tax matters, it is reasonable to anticipate considerable deference to its reasons, albeit reasons given in a different forum. The danger of excessive reliance on broad reasons is exemplified by *Cirella v. The Queen*.²⁵ In that case, the taxpayer received \$14,500 as special damages to the date of trial; the trial judge concluded that the award did not constitute income within the meaning of section 3 of the *Income Tax Act*.²⁶ Thurlow A.C.J. reached his conclusion relying on the reasoning enunciated in *Jennings*, stating ". . . I am of the opinion that these damages are not of an income character . . . but merely indicate the method by which a portion of the total award, which is of a capital rather than an income nature, was calculated."²⁷ Thus, rather than accepting Judson J.'s "broader grounds" for accepting Lord Keith's dissent, the Federal Court preferred the capital-income dichotomy. Given that the tax forum was the appropriate forum to determine the question of taxability, the Federal Court applied the wrong reasons in the right forum. This result is understandable in light of the definitive tone of the Supreme Court's reasons.

III. THE TAX FACTOR IN FATAL ACCIDENT CASES

The fourth case of the group of four, *Keizer v. Hanna*,²⁸ arose as an action brought under a fatal accident statute,²⁹ and involved the same issue on the tax aspects: does the impact of income tax have to be taken into account in assessing a damages award? Dickson J. approved the principle that the proper method of calculating the amount of a damage award in a fatal

²³ *Id.* at 218 (A.C.), 61 (W.L.R.), 811 (All E.R.), 488 (Lloyd's Rep.), 316 (A.T.C.), 314 (T.R.).

²⁴ *The Queen v. Jennings*, *supra* note 5, at 544 (S.C.R.), 655 (D.L.R.).

²⁵ [1978] C.T.C. 1, [1977] D.T.C. 5442, 4 C.C.L.T. 66 (F.C.-T.D.).

²⁶ R.S.C. 1970, c. 148, as am. by R.S.C. 1970-71-72, c. 63.

²⁷ *Cirella v. The Queen*, *supra* note 25, at 5 (C.T.C.), 5445 (D.T.C.), 73-74 (C.C.L.T.).

²⁸ *Supra* note 1.

²⁹ *The Fatal Accidents Act*, R.S.O. 1970, c. 164.

accident case is “. . . similar to that used in calculating the amount of an award for loss of future earnings, or for future care, in cases of serious personal injury. In each, the court is faced with the task of determining the present value of a lump sum which, if invested, would provide payments of the appropriate size over a given number of years in the future, extinguishing the fund in the process.”³⁰

The Court went further, however, and approved, in estimating future earnings of the deceased, a deduction for potential income tax liability.³¹ Two aspects of this decision are important. First, in approving the principle of deduction for potential tax liabilities, the Court reversed its earlier decision in *Gehrmann v. Lavoie*,³² which had applied the reasons enunciated in *Jennings*.³³ In *Gehrmann*, de Grandpré J. had reserved consideration of the tax issue until a suitable case presented itself.³⁴ In *Keizer*, de Grandpré J., presented with a suitable case, (concurring with by other members of the Court) decided in favour of reducing damage awards for tax liabilities.

Second, the *Keizer* case represents a shift in emphasis from the capacity theory back to the underlying principle of compensation. De Grandpré J. adopted the earlier reasoning of Addy J. in *May v. Municipality of Metropolitan Toronto*³⁵ that the widow is not entitled to anything more than the net income from her husband: “It is obvious that the widow at no time was entitled to the income and at no time was she ever able to receive or could she count on receiving either as a right or as a gratuitous payment anything more than the net income of the deceased after deducting income tax. . . .”³⁶ In this view he was supported by Dickson J., who was prepared to distinguish fatal accident and personal injury cases on the basis that, under the former, awards are intended to compensate dependents for the loss of support payments made by the deceased, and such support payments “. . . could only come out of take-home pay. . . .”³⁷

This shift in emphasis from the capacity theory used in personal injury cases to the concept of compensation in fatal accident situations presents a

³⁰ *Keizer v. Hanna*, *supra* note 1, at 352 (S.C.R.), 462 (D.L.R.), 342 (C.C.L.T.). Laskin C.J.C. and Martland, Ritchie, Pigeon and Beetz JJ. concurred with Dickson J.; Spence J. wrote a separate judgment concurring in the result; de Grandpré J. (Judson J. concurring) dissented.

³¹ *Id.* at 347 (S.C.R.), 459 (D.L.R.), 338 (C.C.L.T.). de Grandpré J.'s dissent goes to a different issue. A majority of the Supreme Court adopted de Grandpré J.'s reasons on the tax issue: “I have concluded, upon reading the reasons for judgment to which I have referred, and upon further reflection, that de Grandpré J. is correct in law and that the impact of income tax should be taken into account in assessing a damage award under *The Fatal Accidents Act.* . . .” *Id.* at 347 (S.C.R.), 459 (D.L.R.), 338 (C.C.L.T.) *per* Dickson J.

³² *Supra* note 2.

³³ *Id.* at 566-67 (S.C.R.), 638 (D.L.R.), 472 (W.W.R.).

³⁴ *Id.* at 568 (S.C.R.), 640 (D.L.R.), 474 (W.W.R.).

³⁵ [1969] 1 O.R. 419, 2 D.L.R. (3d) 659 (H.C.).

³⁶ *Id.* at 422 (O.R.), 662 (D.L.R.), quoted by de Grandpré J. in *Keizer v. Hanna*, *supra* note 1, at 368-69 (S.C.R.), 465 (D.L.R.), 322 (C.C.L.T.).

³⁷ *Andrews v. Grand & Toy Alberta Ltd.*, *supra* note 1, at 259 (S.C.R.), 474 (D.L.R.), 250 (C.C.L.T.).

glaring inconsistency in the Court's reasoning. De Grandpré J., after referring to the unanimity of various text writers,³⁸ rested his reasons on the basis of the principle of compensation, stating:

It seems to me that what the widow and the child have lost in this case is the support payments made by the deceased, support payments which could only come out of funds left after deducting the cost of maintaining the husband, including the amount of tax payable on his income. I cannot see how this pecuniary loss could be evaluated on any other basis than the take-home pay, that is, the net pay after deductions on many items, including income tax.³⁹

His Lordship went further, however, and specifically rejected the capacity theory as regards fatal accident cases: "I cannot consider that the deceased here was a capital asset."⁴⁰

This emphasis on the compensation principle of damage awards is to be preferred over the capacity theory. It does, however, make it difficult to reconcile the Court's position in personal injury and fatal accident cases. It remains unclear whether the distinction is supported on the basis that the plaintiff is the injured party in one action and only a dependent in the other, or that the recipient of the award is not entitled to anything more than net income. The first distinction is merely premised on form over substance. The second distinction ignores the fundamental premise that the deceased himself would not have been entitled to anything more than net income.

While the reasoning in *Keizer*, based on the compensation principle, is to be preferred over the reasoning in the personal injury cases, it does, nevertheless, leave matters in an unsatisfactory state. As indicated earlier, the uncertainty and complexity inherent in the estimation of tax liability, and the denial of opportunity to the plaintiff to plan his affairs, suggest that considerations of tax should be left to a subsequent forum. This would permit the plaintiff to plan his tax affairs to maximum advantage. Further, had the Supreme Court clearly indicated that it chose to ignore the tax issue on the basis that the forum was inappropriate, it would not inhibit a subsequent tax court, which is the appropriate forum, from accounting for the tax liability. In light of these limitations, *Keizer* represents the right decision in the wrong forum.

IV. COMPUTATION OF TAX LIABILITY IN FATAL ACCIDENT CASES

Having stated the general principle that an award under a fatal accident statute must be computed on a net of tax basis, de Grandpré J. turned to the method of computation of the award. At this juncture a new issue entered into the computational process. While the damage award is to be computed on a net of tax basis, the Court was concerned that any interest earned on

³⁸ McGregor, *supra* note 8, at 296 (para. 407(b)); J. Fleming, *The Law of Torts* (4th ed. Sydney: The Law Book Co., 1971) at 586; H. Street, *The Law of Torts* (6th ed. London: Butterworths, 1976) at 414, referred to by de Grandpré J. in *Keizer v. Hanna*, *supra* note 1, at 369-70 (S.C.R.), 466 (D.L.R.), 323-24 (C.C.L.T.).

³⁹ *Keizer v. Hanna*, *supra* note 1, at 371 (S.C.R.), 467 (D.L.R.), 324-25 (C.C.L.T.).

⁴⁰ *Id.* at 372 (S.C.R.), 467 (D.L.R.), 325 (C.C.L.T.).

the principal sum of the award would be taxable. Hence, true compensation of the dependent requires that the principal sum to be capitalized be increased by an amount for the potential tax liability on the interest to be earned.

While the Court did not, given the overall adequacy of the award in the particular case, undertake this adjustment for taxes on interest to be earned, it did in *dictum* approve a particular method of computation, specifically, the method adopted by the House of Lords in *Taylor v. O'Connor*.⁴¹ This method, detailed in the judgment of Lord Reid,⁴² requires, first, that the earnings of the deceased be reduced by the estimated tax liability on those earnings, to put the earnings on a net income basis; next, the earnings should be reduced by an amount estimated for the self-maintenance of the deceased, and any other contractual commitments of the deceased that would have reduced his disposable income; then, this residue is to be increased by the estimated tax liability on the interest to be earned; and finally, the resulting figure is to be capitalized, using the exhausting fund method, to determine the quantum of the award.

This method of computation is illustrated in the following example. Assume that the deceased's future earnings are estimated at \$25,000 per year; the deceased's tax liability on these earnings is estimated at \$8,000; partnership contractual commitments required the deceased to invest \$2,000 per year in the firm's working capital; it is estimated that the deceased expended \$5,000 on his own maintenance, \$8,000 on his dependents, and he saved \$2,000 per year. The sum to be capitalized to determine the quantum of the award would, following the decision in *Taylor v. O'Connor*, be computed as follows:

Estimated Gross Earnings, per year, of the Deceased	\$25,000
Less: Estimated tax payable per year	(8,000)
Estimated Net Income after Tax per year	\$17,000
Less: Amounts not available by reason of contractual commitments	(2,000)
Estimated Amount to take home	\$15,000
Less: Estimated expenses for self-maintenance	(5,000)
Estimated Amount Available Before Savings	\$10,000
Less: Estimated Savings by Deceased	(2,000)
Estimated Amount Available for Dependents	\$ 8,000

The decision in *Taylor v. O'Connor*, approved in the *dictum* of de Grandpré J.,⁴³ would require the \$8,000 to be increased by the potential tax liability on the interest to be earned, so as to restore the widow to the original financial position. Thus, the method requires an addition to the sum to be capitalized

⁴¹ [1971] A.C. 115, [1970] 2 W.L.R. 472, [1970] 1 All E.R. 365, 114 Sol. J. 132, 49 A.T.C. 37, [1970] T.R. 37 (H.L.).

⁴² *Id.* at 127-31 (A.C.), 474-78 (W.L.R.), 366-69 (All E.R.), 38-40 (A.T.C.), 37-40 (T.R.).

⁴³ *Keizer v. Hanna*, *supra* note 1, at 372-73 (S.C.R.), 468 (D.L.R.), 326 (C.C.L.T.).

in order to counteract the potential tax liability on future interest earnings. As Lord Reid put the matter: "This case is in a sense *British Transport Commission v. Gourley* in reverse . . .";⁴⁴ here the damages have to be increased.

While this process of computation may be appropriate in those jurisdictions that have followed the *Gourley* decision, it produces an inconsistent result in Canada. The Supreme Court of Canada, after having rejected the *Gourley* decision, which would reduce damage awards in personal injury cases by an estimated tax liability, has now approved in fatal accident cases a formula which applies *Gourley* in reverse to increase a damage award by the appropriate tax factor. By adopting this method, the Court indirectly inherits, despite its earlier rejection, all the difficulties and uncertainties inherent in *Gourley*, which difficulties it sought to avoid in *Jennings*. These difficulties become evident if one examines the technique of estimating the tax factor by which the award must be increased. As Lord Reid outlined the technique: "I have no means of knowing or even of estimating with any degree of accuracy by how much the damages in this case must be increased by reason of this factor. . . . I would expect—perhaps I should say guess—that by reason of this factor . . . the award should be increased by £500."⁴⁵

V. CONCLUSIONS

The Supreme Court's decisions, insofar as the impact of tax factors on the determination of quantum in personal injury and fatal accident cases is concerned, may be summarized as follows:

- (1) In personal injury cases, a Court should not take into account any tax considerations in computing the quantum of an award; this is because a capital asset, rather than loss of earnings, is being replaced.
- (2) In fatal accident cases, it is necessary to reduce the estimated earnings of the deceased by his potential tax liability. The purpose here is to compensate the dependent and to restore him to his financial position immediately prior to the deceased's death.
- (3) To restore the dependent, in a fatal accident case, to his financial position immediately prior to the deceased's death, it is necessary to increase the annual sum to be capitalized, in order to compensate the dependent for the potential tax liability on the interest to be earned.

The inconsistency of the Court's positions on the appropriate consideration of tax factors in personal injury and fatal accident cases is clear. The criticism of the decisions, however, goes further than mere inconsistency; both positions represent less than optimal solutions. Exclusion of tax considerations in the determination of personal injury awards may be justified on the basis that inclusion would deny the plaintiff an opportunity to plan his financial affairs. A decision, excluding tax factors from the computational process, premised on this narrow basis would not inhibit a subsequent tax

⁴⁴ *Taylor v. O'Connor*, *supra* note 41, at 129 (A.C.), 476 (W.L.R.), 368 (All E.R.), 39 (A.T.C.), 39 (T.R.).

⁴⁵ *Id.*

court from considering the characterization of the award. Instead, the effect of the Court's decisions in the personal injury cases is to overcompensate the plaintiff and, therefore, to undermine the fundamental principle of damages. In this respect, the decisions represent the right conclusions for the wrong reasons.

In contrast, the Court's decision to take into account the deceased's tax status in determining the quantum of an award in a fatal accident case promotes the principle of full and fair compensation. By reducing the damage award before the dependent is afforded the opportunity to plan her financial affairs to minimize her tax liability, however, the Court denies the dependent an opportunity that was available to the deceased himself. To that extent, the Court's decision arrives at the right conclusion in the wrong forum. Further, the *dictum* of the Court, approving a method of computation that involves increasing the award by the tax payable on interest to be earned, highlights an inconsistency in reasoning. While the Court rejects the *Gourley* decision, which would reduce a damage award to account for the plaintiff's tax liability, it is prepared to apply *Gourley* in reverse to increase the award for tax payable on interest to be earned.

The Supreme Court could have decided, as an alternative, to ignore all tax factors in the determination of damage awards in all tort actions. Had the Court adopted this approach, and stipulated as its reasons for ignoring tax factors the inappropriateness of a tort forum to resolve such issues, it would have left the wider question of taxability of the award to a tax forum. A tax court, unhampered by capacity compensation theories, could include the damage award in the plaintiff's income.

The effect of this suggested approach would be to award the plaintiff damages computed without reference to tax liabilities. Following the initial tort litigation, the routine tax process would include in the taxpayer's income that portion of the award that was substituted for future earnings. This might be supported on the basis that substitutions for initially taxable amounts should remain taxable. Thus, the substitution of damages for prospective loss of earnings, manifest in the method of computing quantum, should be extended to the subsequent characterization to include the award in income.

This combination, of initial exclusion of tax factors in determination of quantum and subsequent inclusion in income, has several advantages. First, it would promote compensation of the plaintiff and avoid the present process of overcompensation. Secondly, it would afford the plaintiff the same opportunity to tax-plan his affairs that is available to other taxpayers. Thirdly, while preventing the plaintiff from receiving a windfall, it would deny to the defendant any financial advantage accruing from the plaintiff's tax status. Fourthly, it would promote the concept of horizontal equity, i.e., the similar tax treatment of those in similar financial circumstances. Finally, it would reduce the costs, associated with the process of adducing expert tax evidence, of tort litigation.

While this list of advantages may appear compelling enough to stimulate judicial reform in this area, it would be unrealistic to expect too much. In light of the judicial development of the doctrine to date, judicial reform is a distant

possibility. The preferable approach would be to leave the area to legislative reform. When Dickson J. said that, "The subject of damages for personal injury is an area of the law which cries out for legislative reform . . . ;"⁴⁶ his attention was concentrated on concepts of fault and lump sum awards. His Lordship could, however, have included the appropriate treatment of tax factors in personal injury and fatal accident cases in his list of concerns requiring legislative reform.

⁴⁶ *Andrews v. Grand & Toy Alberta Ltd.*, *supra* note 1, at 236 (S.C.R.), 458 (D.L.R.), 230 (C.C.L.T.).