CAPITAL GAINS TAXATION OF DAMAGES: A CHALLENGE FOR LITIGANTS AND THEIR ADVISERS

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Australia's adoption in 1986, of capital gains taxation (CGT), employed a broad concept of gain not confined to the simple case of a purchase and resale at profit. The imposition of capital gains taxation on damages appeared to be a consequence of the adoption of a very broad conception of what is to be considered as an asset. The subsequent reformulation of what is a CGT event continued the continued the philosophy of broad inclusion. This paper asks what should occur in the process of assessing damages , and how to protect the compensatory value of an award.

I ADOPTION OF A NEW TAX

A *Tax Net is Cast Wide*

In its own terms Part IIIA *Income Tax Assessment Act* 1936 (*ITAA* 1936) did not specify that the recovery of damages constituted a capital gain, but courts and commentators[1] inferred this result from the broad terms of ss 160M(6) and 160M(7) of the former Part IIIA *ITAA* 1936 and, (post-1998) Div 104. The use of the broad brush originally was seen as necessary to counter avoidance of income taxation by structuring transactions to endow a particular receipt with the character of capital. The draft white paper[2] that accompanied the introduction of the tax, expressed the underlying policy of extending the capital gains regime beyond profit flowing from acquisition and disposal of individual assets. The legislation meant to catch extraordinary gains and for this purpose construct ambulatory definitions and deeming provisions such as are encountered in (the former) ss 160M(6) and 160M(7). These sought to tax receipts which hitherto had escaped *income* taxation because of their *capital* nature.

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1 Chalmers and Evans 'Pain But No Gain? Capital Gains and Compensation Receipts' (1996) 70 *ALJ* 619; Krever, 'The Capital Gains Tax Consequences of Litigation' (1997) 71 *ALJ* 699; Pincus and White, 'Taxation of Compensatory Payments and Judgments' (2001) 75 *ALJ* 378.

2 Treasury, *Reform of the Australian Tax System* (Draft White Paper) (1985).

Liability to tax under the new CGT regime was activated by a ‘disposal’ of an ‘asset’, and in certain circumstances the acquisition cost was deemed to be zero. Gain in the sense of profit was not required. Parliament decided on broad characterisation, rather than delineating specific categories that attracted tax liability. The conclusion that damages and settlement payments fell to be regarded as capital gain is counter-intuitive. Chalmers and Evans asked: how can damages, meant to restore loss inflicted upon a plaintiff, be regarded as ‘gain’?

The conclusion that damages indeed are exigible arose from:

- The broad deeming provisions of ss 160M(6) and 160M(7);
- The express exemption of damages for personal injury, professional reputation and damage to one’s employment (an inverse *expressio unius* argument); and
- The existence of roll-over relief which allowed the tax payer to postpone liability for taxation.

The legislative mandate came from two extraordinarily broad subsections bristling with deeming provisions positing the creation of an asset that did not previously exist, through its very disposal. The concept may appeal to one who has grappled with quantum physics or enjoyed science fiction, but in substance is a legal fiction. True, *expressio unius* contains a suggestion of parliamentary intent, but of its own force does not impose a tax. At most, it may buttress the conclusion drawn from the general language of ss 160M(6) and 160M(7). The argument for damages being exigible, because of the existence of roll-over relief, is circular. Roll-over relief (however welcome), would be required only in the event that the verdict is exigible. Similarly, the fact that certain assets have been made exempt (eg, the principal place of residence of a tax payer, or ‘grandfathered’ pre-September 1985 assets) does not lead to the conclusion that that all things unprotected must fall to tax. In 1992 statutory amendments extended the reach of ss 160M(6) and (7), and the scope of the definition of ‘asset’ in s 160A, in response to the decision in *Hepples v FCT*.[3] The limitation implicit in the earlier definition were thrown into sharp relief in *Reuter v FCT*.[4] These amendments were overtaken by the complete re-writing of the CGT provisions in 1998.

3 (1991-2) 173 CLR 492

4 (1992) 111 ALR 716, especially 733-735. The taxpayer received $8m from Bond Media Ltd under a deed whereby the taxpayer the taxpayer covenanted not to take any action against Bond Media or any other person without Bond Media’s prior approval. Hill J found that the evidence disclosed the payment arose out of the engagement of the taxpayer as an adviser to Rothwells Ltd in the Fairfax takeover. The motive for the payment by Bond, was to avoid the risk that a payment by Rothwells may be set aside as a preference. Hill J held the by the taxpayer, was income under ordinary concepts. Invited to consider the alternative, that s 160M(7) rendered it a capital gain, Hill J said that the taxpayer had a personal chose-in-action in the form of a contract with Rothwells. This was insufficient to constitute an ‘asset’ under s 160A, as applying at the time of the transaction, (which focussed on proprietorial rights).

B *Scope of Language used Queried*

In *Carborundum Realty*[5] Harper J, when asked to increase damages to compensate for the successful plaintiff's liability to capital gains tax, went to the basic question whether CGT liability existed at all. He had found the defendant liable to pay damages to compensate for its negligence in inspecting and reporting upon certain rental properties. The plaintiff had suffered economic loss through having paid an excessive price and the judge assessed damage at $75 000. After the assessment had been made, the plaintiff sought to amend its pleading to claim a further amount of damage, in substance an indemnity against CGT. The Plaintiff tendered in evidence, a private ruling it had obtained, where the Deputy Commissioner expressed the view:

> Based upon the facts as presented, the damages awarded in favour of the [Plaintiff] are not considered to be income assessable under section 25 (1) or other income provisions of the Income Tax Assessment Act. The damages awarded are considered to be a capital gain assessed to the [Plaintiff] under Part IIIA of the Act.

His Honour rejected this conclusion, and labelled it 'remarkable', remarking on the absence of any reasons for the conclusion. He undertook his own analysis, and rejected the proposition that an award of damages gave rise to capital gain. While he was prepared to assume first, that the plaintiff's right to bring an action was an 'asset' in terms of s 160A (even in its original formulation), and secondly that there was a disposal of the asset by the plaintiff in terms of s 160M(3)(b), he considered that no gain resulted because no money or other consideration was paid or received. Pronouncement of judgment in itself was insufficient. The decision was not appealed, and has been cited with approval by Davies J in *Namol Pty Ltd v Baulderstone Pty Ltd.*[6] Strictly speaking Harper J was not determining the correctness of the assessment of tax, and the judgment would not of course bind the Commissioner of Taxation.

Invited to give the broad reading to s 160M(7), Harper J employed the classic cannon of tax construction[7] which requires that in order to construe a statute as imposing a tax, the intention to tax must be shown by clear and unambiguous language and cannot be inferred from ambiguous words. Here the comments of Deane J in *Hepples*[8] are particularly pertinent: the drafting of the legislation is

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5 *Carborundum Realty Pty Ltd v RAIA Archicentre Pty Ltd & Anor* (1993) 93 ATC 4418, 25 ATR 192.

6 *Namol Pty Ltd Anor v AW Baulderstone Pty Ltd & Ors* (1993) 119 ALR 187, 191. It should be noted that Davies J added 'That is not say that, in appropriate cases, awards of damages will not be the subject of capital gains tax. If an award reflects compensation for a gain that would have been made but for the wrongful act or default, then there is no reason in principle to regard the sum awarded or the payment thereof as having other than the same character as the gain had had … (*Zim Properties Ltd v Proctor* (1984) 58 TC 371)'.

7 *Brunton v Commissioner of Stamp Duties* [1913] Appeal Cases 747, 760; *Anderson v The Commissioner of Taxes* (Victoria) (1937) 57 CLR 233, 243 and *Hepples v FCT* (1991-1992) 173 CLR 492, 510-11 per Deane J.

8 (1991-1992) 173CLR 492, 510-511.

peculiarly within the domain of the taxing authorities, who are well aware of its inherent obscurity.

C *Acceptance of the Broad Scope*

In the light of subsequent decisions, the decision now is regarded as heretical. While *Carborundum* distinguished several first instance judgements that embraced the proposition that Part IIIA would apply to awards of damages[9]. This approach is regarded with approval. For example, in *CSR Ltd v Commissioner of Taxation,*[10] Gyles J accepted the submission that an un-dissected lump sum payment of $100 million received by the tax payer in settlement of litigation over the extent of indemnity under an insurance policy, while not exigible under the 'income' provisions of ss 25 or 26(j) *ITAA* 1936, was assessable as capital gain under Part IIIA. Significantly, the contrary was not even argued. The conclusion on the fundamental point whether damages are exigible, comes from a series of first instance decisions which have not been the subject of comprehensive appellate analysis.[11] Recently the NSW Court of Appeal, in *Inglebrae Coal Pty Ltd v NSW Coal Compensation Board & Anor,*[12] accepted that a compensation payment could be exigible. The case is discussed below, for its consideration of the impact of CGT. In 1995 the ATO published the influential 'Public Ruling' (Taxation Ruling, *TR 95/35*) exposing departmental thinking of the scope of the legislation. As will be seen, the categories enunciated in *TR 95/35*, while offering guidance to the taxpayer, are couched in terms that differ from current legislation. *TR* 95/35 seems more a policy document, although expressed as an exegesis of the provisions of Part III A, which were supplanted by extensive amendment in 1998.

D *1998 Re-Writing of CGT Provisions*

In 1998 the capital gains provisions were substantially recast in the interest of simplification. Liability to CGT arose upon the occurrence of a 'CGT event', with Division 104 *ITAA* 1997, containing eleven categories of such events. Statutory change renders the formal analysis of Part IIIA and close analysis of Part IIIA decisions, academic. Krever's 1997[13] contribution addressed the 'old' Act, with an eye to future development and an exposition of *TR 95/35*. The Tax Office continues to publish (and refer to[14]) *TR 95/35*. Pincus and White (2001)[15] writing in the

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9 *Rabelais Pty Ltd v Cameron* (1995) 95 ATC 4552; *Tuite v Exelby* (1992) 93 ATC 4293 (the award of damages was reversed on other grounds of appeal); *Provan v HCL Real Estate Ltd & Ors* (1992) 92 ATC 4664.

10 [2000] FCA 403 (31 March 2000).

11 The Full Court in *The Duke Group Ltd* (*in liq) v Pilmer* (1999) 73 SASR 64, 179-181, paras 553-564 considered that as it was possible that damages would be exigible, the conditional order for indemnity made by the trial judge was appropriate.

12 (2003) 58 NSWLR 362.

13 Ibid.

14 Eg, *Practice Statement Law Administration 2004/5 (GA) re GT treatment of an amount received by former GIO shareholders in settlement of a class action against GIO (Australia Holdings Ltd) its former Directors and advisers*, esp paras 14-19.

context of the posi-1998 CGT provisions, invoke much of the old learning and refer to the evergreen *TR95/35*. Detailed exploration of the pre-1998 legislative structure is no longer necessary, but the questioned posed initially in *Carborundum* still remains: do damages and settlements fall under any of the categories of Division 104? The re-written legislation, having adopted a simplified tabular exposition, it would hardly seem impossible to state explicitly that damages are exigible. However in default of a statutory exposition, tax payers and their advisers must grapple with the scope of the various categories of Div 104, read in the light of *TR*95/35. This ruling now seems to have become endowed with quasi statutory effect. Part legal analysis, part commentary on hypothetical illustrative examples and part policy document it is an important point of reference. The retention of *TR*95/35 suggests the ATO is focussed on underlying policy. It is hardly too much to ask that these matters be translated into explicit legislative provision.

TR 95/35 operates on the basis of characterisation of a transaction. In the former Part IIIA context, a suit for damages would be analysed as falling into one of three categories:

- Compensation in respect of an underlying asset (one would 'look through' the claim to see whether there was a disposal of some underlying asset;
- Alternatively, the right to bring a legal action is itself the asset;
- A deemed disposal founded upon the deeming provisions in the now repealed ss 160M(6) and 160M(7).

The classification of the litigation as relating to an 'underlying asset' or representing an asset in its own right, may lead to markedly different taxation outcomes. While the 'worked examples' in *TR95/35* display attractive practical solutions, the legislative basis for classification (and tax outcomes) is not readily apparent. The third category of deemed disposals is otiose post-1998, but it may 'translate' to some situations, which fall under Events C1 or C2 (below).

Classification under one or other heading may yield a different result, which of course begs the question of determining the legal principle upon which the characterisation is based. The exercise of formulating statutory rules should turn the law maker's gaze to what underlying policy aims of CGT. It may be one thing to impose a tax when an underlying asset is realised, another where that characterisation cannot easily apply.

At first blush the types of events that fall to be considered in the context of litigation (or settlement) are: Event A(1) (disposal of a CGT asset); Event C1 (loss or destruction of a CGT asset); Event C2 (Cancellation, surrender and similar endings), and Event D1 (creating contractual or other rights). One could image that more complex commercial disputes could in fact give rise to variance of these basic categories, with the need to trawl through the more specialised provisions be they in

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[15] Pincus and White, above n 1.

regard to the creation or a trust or the disposal of beneficial interests. One should not overlook the specific provision in Event H1 (Forfeiture of the deposit), which would routinely arise in conveyancing type disputes.

Obedient to the general rule enunciated in s 102-25 *ITAA* 1997 (that where one or more CGT event occurs, the one that applies is the one most specific to the tax payers situation), one still is faced with the task of finding the appropriate category for the fact situation, perhaps with some guidance from *TR95/35*.

II WHAT KIND OF DAMAGES ATTRACT CGT?

A *Commercial Litigation*

Generally speaking, what falls to CGT could be described generally as damages in commercial disputes. Not all awards are exigible as capital gains. As is discussed in greater detail below, damages at common law for personal injury escape both income and capital gains taxation. Even where an injured plaintiff recovers damages on account of loss of earning capacity, this possesses the character of capital and is not included in the assessable income of the plaintiff. An award that is entirely and purely of income character will be exigible as ordinary income,[16] and continues to be taxed under the income regime, and as is set out below, protected against CGT by s 118-20, as a means of avoiding double taxation. If the award is of a mixed, nature being composed of items of capital and items of an income nature, then the entire amount is treated as *capital*[17] for purposes of *income* taxation. With the advent of CGT, in the absence of specific sheltering provisions, CGT provisions govern the situation. Damages for personal injury were taken to be capital representing the loss of amenity and enjoyment of life and earning capacity.[18] Personal injury damages are sheltered from CGT by s 118-37(1).

B *CGT Shelter for Personal Injury, Occupational Injury etc: Section 118-37(1)*

Section 118-37(1) shelters from CGT a miscellany of compensation payments including:

(a) compensation for wrong or injury suffered in the taxpayer's occupation;
(b) compensation for any wrong injury or illness suffered by the taxpayer or the taxpayers relatives personally;
(c) gaming;
(d) certain agricultural support payments.

There are also exemptions in favour of compensation for persecution during World War II (s 118-37(4)).

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16 *Gill v Australian Wheat Board* [1980] 2 NSWLR 795.
17 *McLaurin v FCT* [1961] 104 CLR 381; *Allsop v FCT* (1965) 113 CLR 341.
18 *Atlas Tiles v Briers* (1978) 144 CLR 202.

The upshot is that damages outside the exempted area of personal injury and certain occupational wrongs may fall to CGT. The sheltering of 'injury in occupation' may not be entirely *effective*. Where a taxpayer receives compensation for say wrongful dismissal, there is still the question whether the payment answers the description of a payment made in consequence of the termination of employment which enlivens s 27 AH which is an extended 'income' taxation provision.

C *Relief from Double Taxation: Section 118-20*

Section 118-20 offers relief from CGT if a gain is subject to tax under concepts of ordinary income. To the extent that such a gain results in ordinary income tax, the gain from a CGT event is reduced. An award of damages which is pure income will be taxed under ordinary concepts, and no CGT liability arises. In case of awards of a mixed character, the capital nature of the award will prevent ordinary income tax from applying. In the absence of exemption, the award will fall to CGT.

III THE LITIGANT'S DILEMMA

The focus of this paper is not the existence of tax liability, but how to protect the value of damages. Whatever the attractions of the robust protest in *Carborundum* against the imposition of tax liability through oblique generalisation, a litigant is confronted by a variety of descriptions of CGT events which could encompass the conclusion of litigation. Certainly there is no mention of obtaining a verdict, which invites the kind of analysis considered above. However a negotiated *settlement* quite easily fits a number of these descriptions. (And one might ask whether in principle there should be a difference, although of course one cannot construe statutory provisions simply in terms of economic equivalence.)

The preponderance of authority and academic commentary indicates damages are capable of giving rise to a CGT event.[19] Settlements of litigated claims are more readily seen as giving rise to a CGT event. Commentators however tend to be guarded, reflect on the inherent uncertainty of classification,[20] remark on the unlikelihood that clarification and guidance will come from the legislature,[21] or like the present writer plead for legislative guidance. Krever suggested that the ultimate answer will be found in judicial precedent and doctrine, but to date little has arisen.
The litigant confronts a twofold problem

- To anticipate the possibility of having to pay tax on all or part of the fruits of litigation and to ensure so far as is possible that the ultimate damages reflect the litigants enhanced liability;
- To determine the question of tax liability.

19 Eg, Chalmers and Evans, above n 1; Krever, above n 1; Pincus and White, above n 1; Woellner *et al*, *Australian Taxation Law* (2004) 488, and cases at notes 7, 8 and 9 (above).
20 Pincus and White, above n 1, 390.
21 Krever, above n 1, 712.

The second question is logically anterior, in the sense that if there is no liability there is no need to seek any kind of indemnity. But in the practical course of litigation, the pressure of litigation may require the assertion of a claim before there is any reflection or indeed specialised advice on this issue.[22] The plaintiff's lawyer may not have the ultimate carriage of tax matters. A defendant might dispute that the verdict is exigible to minimise the payout. A litigant may not be as prepared, as for example, was the plaintiff in *Carborundum,* who had obtained a private ruling. That private ruling there of course did not bind the Court, but could bind the Commissioner as regard the taxpayer. Harper J's rejection did not bind the Commissioner. *Carborundum* illustrates the peril of falling between the two stools, or as Harper J expressed it, as being caught between Scylla and Charybdis.

Ideally, to preserve its compensatory effect of the award would be 'grossed-up' to an amount which, when taxed at the rate appropriate to the particular plaintiff, would still return to the plaintiff full compensation. In terms of arithmetic, it is insufficient simply to add back the tax, as the composite amount would still be insufficient: there would be CGT on the added portion.[23]

An additional source of complication flows from the variety of litigious disputes that may give rise to CGT. Unlike the familiar examples of common law actions for personal injury with the focus on compensation in the form of returning the plaintiff to her or his pre-accident financial position, CGT potentially concerns all litigious claims (except those excluded from the net). Common law personal injury decisions have focussed on the need to maintain the real value of compensation against the incidence *inter alia* of income taxation. This provides a guide as to what to do with CGT in some cases.

Other factors that shape the award where the remedy sought consists of disgorgement, tracing, imposition of trusts, equitable compensation, account of profits, or exemplary awards. In some cases it may be difficult to draw a direct analogy with the personal injury compensation. If factors beyond the loss suffered by the plaintiff shape the award, the case for simple grossing-up may be less compelling. For example the fact that litigation is couched in terms of seeking equitable relief might indicate different principles of quantification, be it because of

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22 In at least 3 cases, *Carborundum Realty Pty Ltd V RAIA Archicentre Pty Ltd & Anor* (1993) 93 ATC 4418, *Namol Pty Ltd v AW Baulderstone Pty Ltd & Ors* (1993) 119 ALR 187, and *Osric Investments Ltd v Woburn Downs Pastoral Pty Ltd* [2001] FCA 1403, the application for indemnity arose late in the course of the litigation, giving rise to comment by the court. The lateness of the application may well impinge upon the ability of the opponent to meet the application and disincline the court from acceding to the application. The cases are considered in greater detail.

23 Assume that you first established the quantum of compensatory damages as C. A simplified formula to gross up the verdict, so that the plaintiff receives C after payment of GST is :

$$\text{Verdict} = C \times \frac{1}{1 - (\text{CGT rate})\%}$$

The 'CGT' rate depends on the taxpayer's marginal tax rate which in turn depends on the taxpayer's status (individual or corporation), and in the case of an individual the applicable marginal rate in light of any other income.

different rules as to causation or remoteness, or whether concepts such as contributory negligence would apply.[24] The mixture of potential claims prompts attempt s at novel claims for relief. For example, in *Namol Pty Ltd* (considered in greater detail below) Davies J expressed the view that there was no reason in principle to gross-up the portion of an award representing exemplary damages. If the object is to punish or express disapproval, the exemplary portion is not serving the function of restoring the plaintiff to her or his *ex ante* position.

The type of remedy is significant. The common law paradigm is the once-and-for-all award.[25] Below several cases are considered, which depart from this paradigm. Is this departure always possible? Equity is capable of granting relief on conditions, a notion foreign to common law. In this context one sees the potential rehearsing much of the learning on the limits of fusion of law and equity.[26] It is tolerably clear that the party seeking the indemnity bears the burden of proof, in terms of the legal exposure and in terms of causation and non-remoteness. In other words it must demonstrate the reason for visiting its tax liability on the defendant.[27] The form of relief itself may preclude any compensatory adjustment.[28]

A survey of reported decisions over the last dozen years reveals markedly disparate approach to the question of whether the liability to CGT should be reflected in damages. In part this may be due to the fact that the claim for compensation is simply one part of a major dispute, where primary focus of attention is the existence of liability and perhaps the establishment of the major heads of claim. It may be that CGT is perceived as a secondary issue, in some cases clearly an afterthought, not fully formulated until late in the proceedings. Perhaps there still is an element of novelty or unfamiliarity, perhaps even tinged with the suspicion that an enhanced award may not necessarily result in the payment of tax. The outstanding issue in the arena of quantification of compensation is whether any general principles guide the courts in factoring into damages the loss through taxation which the successful Plaintiff is to incur. In grappling with these problems courts have applied, unusual remedial measures such as contingent orders in respect of further costs of litigation with the ATO, conditional orders for recouping the CGT if it is not in fact levied,

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24 See for example, the divergence of views in *Pilmer and Ors v Duke Group Ltd (in liq)* (2001) 207 CLR 165, between McHugh, Gummow, Hayne and Callinan JJ (201-203), and Kirby J (228-232).

25 A formulation of fundamental principles of common law personal injury damages is provided in the joint judgment of Gibbs CJ and Wilson J in *Todorovic v Waller* (1981) 150 CLR 402, 409.

26 See generally Professor Andrew Burrows 'Remedial Coherence and Punitive Damages in Equity' (Paper presented at the Conference on Fusion: The interaction of common law and equity, Sydney, 16-18 December 2004). Burrows reviews the operation of different principles for relief from the perspective of functionality and utility, with the focus of a critique of the Court of Appeal's decision in *Harris v Digital Pulse Pty Ltd* (2003) 56 NSWLR 298 which overturned an award of exemplary damages for breach of fiduciary duty. Edited papers are to be published in the proposed Degeling and Edelman (eds), *Equity in Commercial Law* (2005).

27 Eg, *Fedorovitch v St Aubins Pty Ltd* [1999] NSWSC 506, paras 57 and 58.

28 *Fedorovitch v St Aubins Pty Ltd (No 2)* (1999) 17 ACLC 1,558, 1,562, paras 35-37.

and a postponement of the determination of part of the damage (the GST amount) pending the levying of tax.

As will be seen, where damages have been adjusted, there was a departure from the common law paradigm of a once-and-for-all award. Two cases involved the imposition of conditions which ordinarily would not occur at common law.

IV CLAIMS FOR ADJUSTMENT FOR CGT

A *Damages Adjusted*

1 *Provan v HCL Real Estate Ltd*

In one of the first reported cases *Provan v HCL Real Estate Limited & Ors*[29] a vendor of land sued his real estate agent alleging negligence, breach of contract and breach of fiduciary duty. The Court found for the plaintiff on all grounds, finding that the agent had (wrongly) informed the Plaintiff that there was only one interested buyer and had encouraged him to sell. Subsequent to exchange the Plaintiff discovered that there were in fact other parties interested in the purchase of the property. The Court held that had the property been put to auction a higher price would have been achieved. Damages were assessed at $955 450 being the difference between what was the likely price had the property been put to auction, and the actual price for which the property was sold by private treaty. The different causes of action did not in this case lead to any difference in quantification.

Rolfe J, drawing on the approach adopted by Rogers J in *Gill v Australian Wheat Board*[30] decided that as a matter of principle an indemnity against the incidence of tax should be provided for in the award. But in order to receive an indemnity, exposure to CGT must be shown as flowing from breach in the sense of *Hadley v Baxendale.*[31] His Honour was prepared to adopt a liberal view of the link between the liability to tax and natural consequences breach of contract. So far as negligence was concerned, the liability to CGT was reasonably foreseeable and could be viewed as causally related to the breach of duty in terms of the test in *March v E & M H Stramare Pty Ltd & Anor.*[32] His Honour also considered that this was a case where damages for breach of fiduciary duty were justified. Although not explicitly stated, it may be that the finding of entitlement to equitable damage would support the unusual order with regard to the costs of disputing tax liability.

The remedy in so far as CGT was concerned, was a declaration that if the Plaintiff is held liable to pay capital gains tax on the judgment. The decision gave 'in principle' indemnity, but did not resolve the dispute between Plaintiff and Defendants 'once and for all', as the issue whether damages are exigible, may yet

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29 (1992) 92 ATC 4644.
30 [1982] NSWLR 795.
31 (1854) 9 Ex Ch. 341; 156 ER 145.
32 (1990-1991) 171 CLR 506.

be litigated. There was a further order that if the Defendant acknowledged there was a proper defence to the Tax Commissioner's claim the Defendant was to pay the costs of the tax proceedings allowing both parties to dispute the matter with the revenue authorities. This addresses the *Carborundum* problem of falling between two schools, but in a manner which is potentially very costly to the Defendant. The transference of the cost of litigating CGT liability (which no longer financially troubles the Plaintiff) may seem fair to the Plaintiff, one might question whether this satisfies the traditional tests of remoteness in contract or in tort.

2 *Tuite v Exelby*

In *Tuite & Anor v Exelby & Ors*[33] arose out of an action on a restrictive agreement. The plaintiffs (the Tuites) purchased the shares in the company Wenmar Stockfeeds Pty Ltd, from the Exelbys. The company operated a stockfeed business and prior to the sale the Tuites and the Exelbys were the shareholders. The terms of the sale included a restraint on the vendors preventing them from being involved in the same kind of business for a period of two years. The defendants in fact did commence to operate a company in competition with Wenmar. Shepherdson J, found a breach of contract by the First and Second Defendants, and found that the value of the plaintiffs' shares had been reduced because of this. The Third Defendant was found to have wrongfully procured a breach of contract by the First and Second Defendants. His Honour also found a breach of fiduciary duty on the part of Directors.

Part of the damages was to pay an amount of $808 940 was on account of the reduction in the capital value of shares. As the shares were an 'asset' for the purposes of Section 160M(7)(a), the award of damages gave rise to a deemed disposal and thus liability to CGT under Part IIIA. The judge increased the award by $517 191 by way of a CGT indemnity. However this was accompanied by a requirement that the Plaintiff give an undertaking that in the event that Capital gains Tax was not assessed, or assessed in a lesser amount, the Plaintiff would refund the relevant amount to the Defendants. As remarked previously, the form of the orders does not sit easily with common law notions. Again the basis for this particular order may reside in the peculiar rights that enliven the jurisdiction of equity. If so, the case may provide limited guidance.

This decision is consistent with the 'once and for all' concept of damages, using an imperfect mechanism for preventing overcompensation. Perhaps an order might be fashioned utilising payment into court for payment out to the ATO as a means of securing the payment of tax, or the return of monies to the Defendant. This could be achieved by statute, at once providing a mechanism of general application not requiring enforcement *in personam* by proceedings for contempt, and obviating arcane arguments as to the jurisdiction of the Court to impose conditions. This is all the more a problem in courts of statutory jurisdiction, not invested with the powers

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33 (1992) 93 ATC 4293.

of the Supreme Court(s). Shepherdson J's decision was reversed on other grounds[34] but the CGT formulation was not disturbed.

3 *Rabelais v Cameron*

In *Rabelais Pty Ltd v Cameron*,[35] Hodgson J found for the Plaintiff who had sued in contract seeking damages for losses suffered for failure to complete a contract. The Plaintiff sought indemnity against Part IIIA tax, and his Honour decided that while in principle a CGT liability could arise (and implicitly decided that this liability was causally related to the breach, and was not too remote). He decided, however, that quantification of indemnity should be considered separately. No doubt this was to allow the matter to be determined by the ATO. While remarking it was desirable that all aspects of damages be disposed of in one hearing, because of the possibility of substantial loss, his Honour reserved leave to the Plaintiff to apply for additional damages on a separate occasion. This case uses a simple mechanism of reserving the successful plaintiff's position, but at the cost of compromising the norm of finality of litigation.

4 *Duke Group Ltd v Pilmer*[36]

A conditional order for indemnity adopted by the trial judge, who decided to follow *Provan*, was approved by the Full Court. The Full Court noted Mullighan J[37] had not embarked on a detailed examination of the then applicable Part IIIA, but concluded there was reasonable possibility that damages would prove exigible and made a conditional indemnity order against the possibility. Significantly, Mullighan J's gave common law damages, holding that the defendant firm of accountants had breached both their contractual and common law duties of care. He also found against there being any fiduciary relationship. (His honour also found the directors were in breach of their duties.) On the appeal the defendant argued against any indemnity on the basis of broad principle that tax liability could not arise, but raised no argument as to the order on the basis of want of jurisdiction, or difficulty of enforcement.[38] The Full Court briefly considered whether it was open to the judge to make the conditional order which on its face breaches the once-and-for-all rule, but concluded that it did not violate the underlying norm of finality of litigation.[39] The Full Court held the trial judge erred in the way he quantified damages and in his conclusion as to the absence of a fiduciary relationship. The Full Court held that the fiduciary duty arose, and had been breached. An appeal to the High Court[40] was upheld. The High Court remitted the assessment of damages in contract and

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34 *Pincus v White* (2001) 75 ALJ 378, 389 n 97, *Exelby v Tuite* (unreported) Appeal Number 273 of 1992, 28 November 1994.

35 (1995) 95 ATC 4552.

36 (1999) 73 SASR 64, 179-181, paras 553-564.

37 *The Duke Group Ltd v Pilmer* (1998) 16 ACLC 567.

38 (1999) 73 SASR 64, 179, para 555.

39 (1999) 73 SASR 64, 181, para 562.

40 *Pilmer and Ors v Duke Group Ltd (in liq) and Ors* (2001) 207 CLR 165.

negligence, to the Full Court. The majority also held that there was no relevant fiduciary duty owed. The question of CGT did not arise for consideration.

B *Refusal of CGT Adjustment*

1 *Namol Pty Ltd v Baulderstone Pty Ltd*

Carborandum has already been considered. There Harper J declined to award any indemnity on the ground that no primary liability to pay CGT arose. In a case decided subsequently, *Namol Pty Ltd & Anor v A W Baulderstone Pty Ltd & Ors*,[41] Davies J assessed damages for breach of copyright, at $500 000, consisting of $350 000 as representing the compensating damages and $150 000 as additional damages for aggravated breach pursuit to Section 115(4) of the *Copyright Act* 1968 (Cth). He expressly found that s 160M(1), s 160M(3) and s 160M(7) did not apply, approving of Harper J's analysis in *Carborundum*, saying:

> It is foreign to the context and purpose of the capital gains provisions to regard them as applying to the ordinary circumstances of compensation for loss brought about by the act or default of another person.[42]

Davies J expressed three reasons for refusing to make any allowance for CGT[43]

1. The $350 000 compensatory damages were calculated by reference to profits from the exploitation of the copyright, and in assessing the amount he made no allowance for income tax on the profits which Namol would have earned from carrying on the contract.

   > As Namol would have been subject to income tax on any income derived from that sub contract, and as its financial returns from the use of the plans would have been reflected in that income, and thus subject to income tax, it is not inconsistent with the award for compensation to accept that Namol should pay capital gains tax upon that $350 000. The overall result of the different basis of taxation would not be the same, but there is no material before the court which would enable any precise quantification of the different liabilities to be made. Thus, in *Pennine Raceway Ltd v Kirklees Metropolitan Council* (2),[44] it was held that, although there was no certainty in that case as to the type of tax that would be levied, whether capital gains tax or income tax, it was not necessary for the court to decide such a matter in the assessment of damages.

2. As regard the $150 000 award for aggravated default, this was not an element of compensatory damages but punitive damages. It was imposed to reflect the Court's view of the seriousness of the conduct, rather than to satisfy any loss

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41 (1993) 119 ALR 187.
42 (1993) 119 ALR 187, 190.
43 (1993) 119 ALR 187, 191-2.
44 [1989] STC 122.

by Namol. His Honour saw no injustice in the successful Plaintiff receiving less than awarded punitive damages.

3. For similar reasons his Honour did not see it necessary to augment the amount of interest awarded, on the ground that had the interest been received as a cash flow, it would have been income but when agglomerated in damages it would acquire a capital flavour, relying on *McLaurin v FCT,*[45] and anticipating the full court's decision in *Whitaker v FCT.*[46]

Calculation of economic loss on the basis of loss of gross revenue does raise the possibility of overcompensation and associated issues debated in *British Transport Commission v Gourley*[47] and *Cullen v Trappell,*[48] Davies J did not state he was departing from these authorities in search of a technique for compensatory adjustment. Indeed as he had made the prior finding that damages were not exigible, it is difficult to see why adjustment was called for. In any event Davies J did not express a general principle for overcoming the problem of CGT allowance. His remarks do contain the genesis of a rationale for declining to make any CGT adjustment, which was referred by Santow JA in *Inglebrae Coal Pty Ltd v NSW Coal Compensation Board & Anor.*[49] The appeal to the Full Court (comprised of Burchett, Gummow and O'Loughlin JJ), *Bailey v Namol Pty Ltd,*[50] was dismissed. The Full Court did not deal either with the question of the basis of quantification (gross v net income) or with the refusal of CGT indemnity. Although Davies J did not expressly set out to compensate for CGT (indeed liability to the tax, in his view, did not arise), it may be that the judgment points to an imperfect method of adjustment for CGT. The verdict is effectively increased by calculating loss of earning capacity based on *gross* income.

This certainly was the thinking in the English Court of Appeal in *Pennine Raceway Ltd*, to which Davies J referred. There the Appellant, Pennine Raceway Ltd, had become entitled to compensation for the destruction of its business of drag race promoter when the local authority revoked the licence which had enabled the operation of a raceway on a disused airfield. The compensation had regard to the loss of profits and other costs incurred by the taxpayer. When the Revenue decided to levy the taxpayer under s 20(1) Capital Gains Tax 1979 (UK), the Appellant appealed against the assessment of compensation. The Court of Appeal accepted the company's argument that it was liable to either income or capital gains tax. The court did not determine what *kind* of tax would apply, although Croom-Johnson LJ for one, inclined to the view the award was capital. For this reason the court decided that the basis of calculation was to be *gross* revenue. Croom-Johnson and Ralph

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45 (1961) 104 CLR 381.
46 (1998) 82 FCR 261.
47 [1956] AC 185.
48 *Cullen v Trappell* (1980) 146 CLR 1.
49 (2003) 58 NSWLR 362, 385.
50 (1994) 125 ALR 228.

Gibson LJJ each suggested[51] that the principle in *British Transport Commission v Gourley*[52] (under which damages for personal injury were calculated on the basis of after-tax earning), operated only where those damages would not bear tax in the hands of the recipient. While the proposition intuitively is appealing, it is not a correct statement of the reasoning in *Gourley*. This is considered in more detail below. There is a fine irony in *Pennine Raceway Ltd* adopting gross revenue a technique of adjustment, and *Namol* declining an adjustment, but utilising gross revenue as the basis of calculation.

There were two procedural aspects which may have affected the outcome in *Namol*. The application for CGT indemnity arose late in the proceedings apparently without any elaborate opinion evidence. First, Davies J expressed the 'firm' view that if capital gains tax is to be taken into account there should be at least an opinion of an experienced tax practitioner as to the likely tax consequences of the judgment and as to the basis on which such opinion is held. One might observe, that while a court would be assisted by submissions from an expert on tax, the 'likely tax consequences' are a matter of application of legal principle, which however difficult and obscure, remain in the province of the court. Indeed in *Carborundum*, a decision expressly approved by Davies J, the court had no difficulty in rejecting the private ruling as wrong in law. Even with the abolition of the common law rule that evidence may not be adduced on the 'ultimate issue' to be determined by the court (eg, *Evidence Act* (NSW) s 80 and *Evidence Act* (Cth) s 80), it is hard to see what the expert is to do apart from stating his or her legal opinion. The expert must expose the theoretical basis of any conclusion the empirical enquiries or assumptions made in arriving at a conclusion.[53] Doubtless the application of tax law is technical and difficult. But at the bottom it requires a quintessentially legal decision. The plaintiff must prove entitlement to a particular head of damage, but then it becomes a matter of application of (then) Part IIIA or, (now) Division 104 *ITAA* 1997, and no further 'factual' issue remains to be determined.

Secondly, the other reason for rejecting CGT indemnity, was that the application was made at the end of the case. This is a matter of case management. There is a real concern that the opposing party is able to meet the case. The appropriate remedy may be in costs, for example of adjournment. It is difficult to elevate a matter of case management into a principle of disentitlement. Moreover, if the court is prepared to depart from the notion of a once-and-for-all monetary award (for example by awarding $*x*, and granting a declaration that the plaintiff is entitled to an indemnity if CGT is assessed), then issues as to whether the award is exigible, and its quantification, do not arise for immediate decision.

The notion that difficulty of application of a taxing statute may be a reason for declining to adjust the quantum of damage, once found favour with Barwick CJ in

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51 [1989] STC 122, 125 per Croom-Johnson LJ, and 127 per Ralph Gibson LJ.
52 [1956] AC 185.
53 *Makita (Australia) Pty Ltd v Sproules* (2001) 52 NSWLR 705, 745 per Heydon JA.

Atlas Tiles v Briers[54] (where his Honour relied on the difficulty in precisely calculating the incidence and quantum of tax as one reason for refusing to follow *British Transport Commission v Gourley*[55]). The analogy however is not entirely precise. In the *Atlas Tiles* situation regard would have to be had to the individual tax circumstances of the Plaintiff to see the factors which may affect the quantum of tax payable. This would require the consideration of evidence of the individual financial circumstance and the interplay of financial affairs and tax rates. An accountant or some other expert may well be able to organise the financial information and prepare a report which would assist the Courts. The problem confronting the Court in *Namol* was not one of minute factual detail but one of *concept* and *characterisation.* There is no reason in principle to refuse to consider appropriate evidence as to individual tax liability, or to baulk at embarking upon the appropriate calculation. The upshot is that *Namol* stands as authority against making any allowance for CGT, but for reasons that may have been peculiar to its factual matrix.

2 *Joondalup Gate Pty Ltd*[56]

This case arose out of a compulsory acquisition, and subsequent claim for compensation under *Land Acquisitions and Public Works Act* 1902 (WA). The Compensation Court (Parker J with RJ Priest and PL Solomon, Assessors) accepted that such acquisition constituted a disposal of (part) of an asset under *ITAA* 1936 s 160R and that the asset was acquired and disposed after 20 September 1985 (s 160L(1)). In refusing the landowner's claim for CGT indemnity, the court found that the claim for increased compensation on account of tax, was not readily accommodated under the relevant provision (s 63) governing the awarding of compensation. The Court decided the claimant proposed to develop the land for rental or from deriving capital gain from sale. Income from the subject portion of the land would be liable to income taxation, and any sale of land or part thereof would have been subject to CGT. The court concluded:

> This persuades us to the view that it would be unjustified in principle and inappropriate in fact to include in the compensation award an amount in respect of any potential liability for capital gains tax arising by virtue of this compulsory taking.[57]

This must be correct in principle, as there is no new exposure to liability created by resumption: this event merely brings forward in time an expected liability. The court also commented on the 'impossibility' of quantification as because *inter alia* of the need to have regard to the taxpayer's individual circumstances. With respect this cannot be a principle of disentitlement, and all that it points to is either an

[54] (1978) 144 CLR 202.
[55] [1956] AC 185.
[56] *Joondalup Gate Pty Ltd v Minister of Lands as Delegate of the Minister of Works* (1996) 33 ATR 327.
[57] (1996) 33 ATR 327, 330.

evidentiary deficiency. In other cases courts have attempted adjournment or orders on terms.

3 *Osric Investments*

In *Osric Investments Pty Ltd*[58] Drummond J refused to allow any increase in damages choosing to follow Davies J's judgment in *Namol*, but noting the conflicting state of authorities.[59] He also referred to the difficulty in making an assessment and pointing to the evidentiary onus on the plaintiff. This is a case where the application was made late in the proceedings. Drummond was not disposed to follow the two stage procedure of an 'in principle' declaration with liberty to lead evidence on taxation issues on a subsequent occasion,[60] but referring to *Duke Group Ltd v Pilmer*, where the South Australian Full Court adopted this approach.[61]

4 *Inglebrae Coal*

The effect of CGT was again considered in *Inglebrae Coal*[62] which arose in the context of a special statutory regime devised to enable the State to compulsorily acquire coal and to pay compensation. Adjustment was made, pursuant to the statutory regime, so the case cannot be classed simply as a denial, but the general discussion questioned whether there is a general principle requiring adjustment. The relevant regulations permitted compensation to be increase in certain defined circumstances. The Appellant had been assessed as liable to $2.105m CGT on the statutory compensation for compulsory acquisition, and sought additional compensation in terms of Clause 7(1A) of the '1997 arrangements'. This permitted additional compensation 'on account of consequential pecuniary loss directly attributable to the discharge of an estate or interest created before the commencement of the order'.[63] The Appellant had acquired fee simple in a coal title

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58 *Osric Investments Pty Ltd v Woburn Downs Pastoral Pty Ltd* [2001] FCA 1402 (3/10/01) including corrigendum dated 10/10/01; 20 ACLC 1; 48 ATR 184.

59 [2001] FCA 1402 para 196.

60 [2001] FCA 1402.

61 *Duke Group Ltd v Pilmer* (1999) 73 SASR 64, 179-181, paras 559-562.

62 *Inglebrae Coal Pty Ltd v NSW Coal Compensation Board & Anor* (2003) 58 NSWLR 362.

63 The terms of the relevant sub-clause 7(1A) are: 'cl 7(1)(A) A person other than the Crown or instrumentality or agency of the Crown, who claims to have sustained a consequential loss that is attributable to the operation of s 5A of the acquisition is eligible to apply for compensation under this Part but only if the consequential loss is a pecuniary loss that is directly attributable to the discharge by virtue of the operation of that section or any trust, lease, licence, obligation, estate interest or contract established, granted, incurred, created or entered into before the commencement of the Order.' In 1981 Parliament passed the *Coal Acquisition Act* 1981 (CAA) which vested coal in the crown. Pursuant to s 8 of the Act the Governor made coal acquisition (Compensation) arrangements 1985 (1985 Arrangements) which was effectively a piece of subordinate legislation which provided a compensation regime for coal owners. In 1990 Parliament passed *Coal Ownership (Restitution) Act* 1990 which enabled claimants to seek restoration of ownership of coal subject to refunding of compensation. In 1997 amendments to CAA inserted s 5A which permitted compulsory acquisition, with

in 1995 for $1 147 000. The Crown had compulsorily acquired the coal under s 5A of CAA, and in due course the Appellant was awarded compensation of $9 500 100 for this coal. The re-acquisition occurred when the applicable CGT legislation was Part IIIA *ITAA* 1936. By virtue of s 160 M there was a 'disposal' upon compulsory acquisition. It was common ground that the Capital Gain was $4 480 431. The Appellant was assessed as liable to CGT in the sum of $2 105 804.

Under the 1997 arrangements the appellant could effectively seek further compensation from the New South Wales Coal Compensation Board provided it could establish the CGT liability was a pecuniary loss directly attributable to the discharge by virtue of the operation of s 5A of any estate or interest created before the commencement of the Order, in terms of clause 7.

The Board declined the Application, whereupon the Appellant appealed to the Compensation Review Tribunal which made an 'in principle' decision in the Appellant's favour. The Tribunal's decision was then the subject of an application for prerogative relief to the Supreme Court, which at first instance held that CGT liability was not a 'consequential loss' within the meaning of clause 7. The Appellant then appealed to the Court of Appeal which unanimously reversed the decision, holding that the liability to CGT was a consequential loss which was directly attributable to the operation of s 5A.

Because this was a unique statutory system of compensation, it may seem that the disposal of the appeal would not give rise to broader issues of quantification of compensation. Mason P and Santow JA each considered broader principles of compensation, with a focus on the concept of *causation*. At first instance the Master held the loss arose because of the operation of the tax law. The Court of Appeal attributed the loss to the discharge of the Appellant's interest in the coal, by virtue of s 5A CAA. The CGT liability would not have arisen but for the operation of s 5A CAA.[64] The Court considered other instances of compulsory acquisition, to examine when an acquisitions gives rise to loss. Santow JA considered the situation of land resumption and whether in the ordinary course an investor in land should be entitled to special compensation for that *acquisition* resulting in the of incurring of tax liability. His Honour was of the view that where an investor acquired property which was to be disposed of at some future time (with the prospect of CGT), the resumption simply would bring forward the time at which tax was imposed, rather than expose the investor to the unforseen liability to tax. Adopting the reasoning in *Joondalup Gate v The Minister for Lands,*[65] there was no need to compensate this investor further. By comparison, in *Inglebrae* acquisition deprived the coal owner of the ability to enjoy a revenue flow of royalties from owning the coal until it was mined out.[66] The Appellant was exposed a completely different liability to that

compensatory arrangements in the Coal Acquisition (Re-Acquisition) Order 1997, the '1997 Arrangements'.

64 (2003) 58 NSWLR 362, 379 per Mason P, 387 per Santow JA.

65 (1996) 33 ATR 327, 330; see also *Harris v Welsh Development Agency* [1999] 3 EGLR 207.

66 (2003) 58 NSWLR 362, 380 per Mason P, 387 per Santow JA.

which would be experienced as recipient of revenue flow from royalties. This was not the situation where liability to CGT simply came forward in time.

5 *Fedorovitch v St Aubins Pty Ltd (No 2)*[67]

Here the successful plaintiff in a company oppression suit sought an increase in the price to be paid for its shares, on account of CGT, in the compulsory buyout which was ordered by the court. Young CJ in Eq considered it inappropriate to include compensation under the guise of valuation of shares, although the terms of s 246AA(2)(e) of the Corporations Law did give the court an absolute discretion to set the purchase price. A further (and perhaps more compelling reason), was that the shares (in a home unit company, effectively the means of holding a company title flat) were an investment, and may well be sold in the future thereby attracting CGT. Cases previously considered would suggest there is no basis for increasing compensation, although his Honour suggested somewhat enigmatically, that if he relied on the latter reason he might have awarded part of the CGT. The second ground was referred to in *Inglebrae*.

V PRESERVATION OF THE REAL VALUE OF DAMAGES

A *Experience with the Effect of Income Taxation on Damages*

Part 5 asks whether there are lessons from common law damages cases which arose largely, but not exclusively in the realm of personal injury. In pre-CGT times courts awarding compensatory damages at common law have had to wrestle with the adequacy of damages as compensation, if those damages were to be the subject of tax. The principle adopted was to adjust awards to overcome any fiscal effects, to provide full restitutionary compensation and achieve a just result between plaintiff and defendant. The following cases do not of course deal with CGT, but do illustrate the principle of striving for full restitution.

1 *Cullen v Trappell*[68]

As was observed, the High Court decided to follow *Gourley* in awarding damages for loss of income earning capacity calculated on the plaintiff's post tax income. This was to ensure that the damages would not exceed what the plaintiff would earn, were he not incapacitated. In so doing, the Court reversed its decision in *Atlas Tiles*.

Making adjustment for tax was implicit in *Cullen v Trappell*. The adoption of net after tax income as the true measure of the plaintiff's loss of income earning

[67] (1999) 17 ACLC 1558, especially 1562. There was an earlier judgment that did not fully canvass CGT issues, see [1999] NSWSC 506 especially paras 57 and 58.

[68] (1980) 146 CLR 1.

capacity necessitated the adjustment of damages to accommodate the incidence of tax. As Stephen J said in *Pennant Hills Restaurants*:

> It is once more upon net after tax loss of income that awards of damages for future economic loss are to be expressed. In addition, regard is to be had to the income tax notionally payable on the income which would be produced where the sum awarded in respect of future economic loss is to be invested.[69]

In other words the court awarding the portion of the lump sum was to allow for *notional* revenue flow which was also subject to *notional* tax. There was of course no income tax payable, as damages were capital. The damages came in the form not of annuity, but a once-and-for-all lump sum, arrived at with the assistance of actuarial tables. The pragmatic device adopted in *Todorovic v Waller*[70] was to choose to apply the actuarial table with 3% discount to allow for two separated considerations:

- To acknowledge the fact that the receipt of a lump sum enabled the Plaintiff to enjoy the entire award ahead of earning it over his/her projected working life; and
- To 'accommodate' the notional tax to which the notional income would be exposed.

The theoretical underpinning of *Cullen v Trappell* led to adjustments to broad adoption of the practice in common law personal injury cases, of isolating a net income amount as the basis of calculation, with future earning capacity reckoned on the appropriate multiplier from the 3% table. The 'future' was further discounted (usually by 15%) to allow for the possibility the plaintiff would survive the full period (usually the projected working life), in other words the plaintiff who died early would have been over-compensated!

B *Extension beyond Personal injury*

1 *Gill v Australian Wheat Board*

In *Gill v Australian Wheat Board*[71] Rogers J entered a verdict to compensate the Plaintiff for the loss of income. This was not a case where the damages constituted an undisected agglomeration of capital, in accordance with *McLaurin v FCT,*[72] *Allsop v FCT*[73] and *Commissioner of Taxation v Northumberland Development Co Pty Ltd.*[74] In *Gill* the award was purely a substitution for lost income, and was taxable as income. However the award of damages would fall in one year, while the

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69 (1981) 145 CLR 625, 661.
70 (1981) 150 CLR 402.
71 [1980] 2 NSWLR 795.
72 (1961) 104 CLR 381.
73 (1965) 113 CLR 341.
74 FCA (1995) 95 ATC 4483; 138 ALR 1105.

amounts of income which that award compensated arose over a five year span. The concentration of damages in one year would increase the amount of tax that the Plaintiff was obliged to pay. Rogers J proceeded to assess the quantum of compensation having regard to the majority decision in *Cullen v Trappell,*[75] and having calculated what would have been the compensatory award, His Honour increased that amount by an amount representing the enhanced tax liability.

2 *New South Wales Cancer Council v Sarfaty*

This approach was approved by Gleeson CJ and Handley JA in *New South Wales Cancer Council v Sarfaty.*[76] Dr Sarfaty had successfully sued the NSW Cancer Council for wrongful dismissal, and the trial judge had made an award of damages incorporating a component on account of income tax. While the Court of Appeal reduced damages (on other grounds) it endorsed the methodology of calculating earning loss by reference to the *Gourley* and *Cullen v Trappell* principle, but also of increasing the award if there was a loss on account of tax. (By the time *Sarfaty* came to be decided there had been two developments: first *Cullen v Trappell*[77] had effectively reversed *Atlas Tiles Ltd v Briers,*[78] which decided that the Plaintiff's damages for wrongful dismissal should be based on pre-tax earnings. The decision of the primary judge McInerney J[79] was that because the then applicable s 26(d) *ITAA* 1936 brought the tax only 5% of the payment in termination of employment, the proper measure of damage was the Plaintiff's gross remuneration. Secondly, by the time of the breach of contract in *Sarfaty,* s 26(d) had been overtaken by the post -1983 amendments to the *ITAA* 1936, in particular ss 27A-27J and ss 159S-159SY. The Plaintiff thus no longer had the statutory protection of s 26(d) which sheltered 95% of the termination payment, or the protection implicit in the *Altas Tiles* methodology. The majority effectively decided that McInerney J had erred. The thrust the reasoning in *Cullen v Trappell* was that damages should be assessed by reference to the net earnings to avoid an unjustified windfall to a plaintiff at the cost to the defendant. This however did not mean that no adjustment should be made on account of the incidence of tax. The court approved of such an adjustment.

3 *Fox v Wood*

The most instructive authority on the need to adjust damages for the incidence of tax to preserve their restitutive integrity is *Fox v Wood.*[80] The majority in *Sarfaty* relied upon this decision to reach their conclusion. A '*Fox v Wood* amount' now is a standard head of claim in common law actions brought by injured workers. Throughout Australia, Workers Compensation acts provide for 'no fault' insurance based benefits to be paid to injured workers. Typically there are provisions for a

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[75] (1980) 146 CLR 1.
[76] (1992) 28 NSWLR 68, 80.
[77] (1980) 146 CLR 1.
[78] (1978)144 CLR 202.
[79] *Briers v Atlas Tiles Ltd.* [1978] VR 151, 169.
[80] (1981) 148 CLR 438.

weekly income support, and payment of medical expenses. The weekly benefit of course partakes of the quality of income and bears tax under the PAYG (previously PAYE) system as a periodic payment. Workers Compensation legislation has a common formula: benefits which are paid are recoverable from any common law verdict. For this purpose the benefits are the gross amount of benefit which the employer is obliged to pay pursuant to the Workers Compensation legislation. When the Court comes to quantify damages, it is bound *Cullen v Trappell* and quantifies damage by reference to the after tax loss suffered by the plaintiff. In *Fox v Wood* the Plaintiff complained that because of the operation of the Workers Compensation 'payback' provision, he was recouping to the employer (or more accurately the insurer) the gross weekly benefit whereas he had only received the weekly benefit net of tax. To this extent, the employer was advantaged and in fact received a windfall.

The High Court agreed and determined that the amount of tax paid on Workers Compensation benefits should be added to the lump sum verdict. It might be noted that Workers Compensation legislation end workers compensation benefits, both weekly payments and medical expenses, upon the entry of a common law verdict. Accordingly quantification of the *Fox v Wood* component simply is a matter of totalling payments made prior to verdict. There can be no doubt that the common law verdict is given on account of loss of earning capacity and is therefore received on purely on capital account. It is respectfully submitted that the most compelling analysis for this proposition is contained in the general remarks of Barwick CJ in *Atlas Tiles,*[81] although the calculation is now based on net figures. Similarly, Gibbs J (as he then was) characterised personal injury damages as capital in *Groves v United Pacific Transport Pty Ltd,*[82] where he also expressed the view that the *Gourley's* principle would apply only in cases where the award of damages was not taxable.

C *Conditions Precedent to Gourley's Principle?*

Gibbs J's view is not without controversy. It is submitted there is nothing contained in *Gourley* which compels this view. The principle is founded upon a consideration of doing justice as between plaintiff and defendant and ensuring that the plaintiff does not recover a windfall. There is however almost an intuitive appeal in Gibbs J's concept, echoed in cases such as *Namol* and *Pennine Raceway* (considered above). Gibbs J repeated his view in *Atlas Tiles,*[83] saying there are two conditions to the application of *Gourley*: that the earnings be taxable in the hands of the tax payer as periodic payments, but the verdict be capital. His Honour also suggested that where (as was the case because of the incidents of tax through s 26(d), there was a tax to be levied upon a payment made in consequence of a termination of employment, the award should be adjusted on account of the tax.[84]

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81 (1978) 144 CLR 202, 209.
82 [1965] QDR 62.
83 (1978) 44 CLR 202, 224.
84 (1978) 144 CLR 202, 225-227.

Stephen J (who with Gibbs J was in dissent in *Atlas Tiles*) analysed the supposed conditions precedent to the operation of *Gourley's* case and found that they did not form part of the reasoning of the Court. He characterised them as 'working rules judicially deducted from the decision',[85] saying:

> In my view it is not these so called conditions precedent but, rather, a judicious blend of principle and expediency that must determine when and the assessment of damages, the incidence of taxation is to be taken into account by the application of the principle in *Gourley's* case. In that blend the principle in question is that damages should be no more than compensatory, the expediency is concerned with the degree of added complexity which attainment of that principle may involve, it is easy to imagine a particular taxing provision the effect of which, if not taken into account in the process of assessment, will nevertheless have but little effect upon the attainment of the desired goal of just compensation. In such a case the added complexity involved in taking tax into account may outweigh the relatively slight gain in fairness of compensation.

His Honour went on to point out that the then s 26(d) was not a taxing provision (although it did include in the Plaintiff's tax a 5% of the termination payment) its effect was to protect the balance of the compensation. The refusal to apply *Goulay* conferred a windfall at the expense of the Defendant.

1 *Daniels v Anderson*

In *Daniels v Anderson*[86] Clarke JA and Sheller JA approved the methodology of Rogers J in *Gill v Australian Wheat Board.*[87] Curiously while their Honours noted the various formulations as to whether or not there were two pre-conditions to *Goulay*, and noted Rogers J's adoption of Stephen J's position on this matter in *Atlas Tiles*, they nevertheless included an echo of the 'pre-conditions' in their summary of the applicable propositions[88] where they summarised the rules and say inter alia

> 1. If an award is made for loss of earning capacity and the verdict is not taxable it is appropriate to assess the amount of verdict by reference to the nett earnings after tax.
>
> 2. In making such an assessment and using tables that determine the present value of future economic loss regard should be had to notional tax on the income assumed to be derived from the amount awarded for the future economic loss.
>
> 3. If the comparison between taxable receipts for which damages are recoverable and the taxability of the compensatory verdict are so uncertain and depend on such imponderables as a degree to which a Plaintiff can for example carry

85 (1978) 144 CLR 202, 236.
86 (1995) 37 NSWLR 438.
87 [1980] 2 NSWLR 795, *Daniels v Anderson* (1995) 37 NSWLR 438, 585
88 (1995) 37 NSWLR 438, 585D.

forward losses for previous years the appropriate course is to ignore taxation considerations.

4. If on the hand it is unjust not to take account of identifiable and quantifiable taxation impacts both on the loss receipts and the compensatory damages then these may be taken into account in assessing damages.

The majority however refuse to make adjustments to the damages awarded on account of changes in the tax rate, and specifically the rates operating at the time that AWA claimed, obtained and used tax deductions in respect of losses, and the current rates of tax. This called for a complex set of calculations and Rogers J had directed that the experts of the respective parties confer for the purpose of exploring the possibility of agreement, failing that further orders would be made in order to effect such adjustments. The majority decided that

> Even if a judicious blend of principle and expediency should determine the account to be taken of the impact of tax, in our opinion such an adjustment cannot be supported in the present case.[89]

The general thrust of authority supports the adjustment of compensation to offset the expected loss due to income tax. In principle the court in fixing compensation is expected to take into account the incidence of income taxation, even if this cannot be done with precision, to effect justice between plaintiff and defendant.

VI Conclusions

It is difficult to extract a set of consistent principles to guide litigants.

Where courts have dealt with the interaction of *income* tax and damages, they dealt with enhanced liability to tax by augmenting damages in the interest of granting just compensation. There is no reason in principle to confine this to income tax. The guiding principle would seem to examine the defendant's conduct to see whether it is the true cause of the plaintiff's CGT liability

1. Whenever confronted with CGT liability the litigant must distinguish between the situation where the conduct of the defendant creates the liability to pay CGT, from that where the liability CGT is simply brought forward. (eg, compulsory acquisition of property would in any case have been disposed of at a gain).

2. There is a fundamental question of whether the defendant's conduct caused the exposure to CGT (eg *Inglebrae*). Once this is established affirmatively, there is no reason to 'uncouple' CGT from damages in the name of remoteness. There may be other reasons for denying adjustment.

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89 (1995) 37 NSWLR 438, 586A.

3. Common law cases focussed on restoring the plaintiff to her or his *ex ante* position. The case for augmenting verdicts other than straightforward compensation awards, for example awards in the nature of exemplary damages, is less compelling (as observed by Davies J in *Namol*). Similar considerations may apply in remedies that do not wholly focus on restoring the plaintiff to a particular financial position, eg disgorgement or gains-based remedies such as constructive trusts.

4. The thrust of decisions in common law cases was to restore income-earning capacity measured by post-tax income. The suggestion that this depended upon the non-taxable 'capital' nature of the award was not necessary to the decision in *Gouley* or *Cullen v Trappell.* It would require the wholesale recasting of principle (Stephen J's 'judicious blend or principle and expediency'), if the basis of calculation of economic capacity were to move from after-tax earnings, to say gross earnings.

5. The only reason for revisiting the formulation of principle would be to formulate an approach for recognition of CGT. This occurred in *Pennine Raceway* where economic loss was calculated on gross figures with no additional element for any possible capital tax, as the court was satisfied that the taxpayer was exposed to some sort of tax liability, but not persuaded that it was a tax on capital or income. Davies J used a pre-tax technique in *Namol*, all the while disavowing any need to adjust and any principle that an indemnity be provided.

6. The use of conditional awards, or the some variant of 'wait and see' award, offers an imperfect compromise between disposing of the principal dispute between the parties, and leaving open the assessment of tax. It must be said frankly that courts are reluctant to entertain the assessment of tax, but it is wrong to attempt to avoid this task by imposing any forensic burden on the plaintiff beyond the requirement of establishing entitlement to a particular head of damage.

7. Conditional orders or awards are an attempt to ensure that the plaintiff is not given a windfall and that the CGT amount is paid to the revenue authorities. The common law had no concern how the successful plaintiff spent her or his verdict. Conditional orders not only protect the defendant, but effectively hypothecate part of the award to the revenue. There is the yet unresolved question whether this type of order is possible at common law.[90] When regard is had to the variety of courts and tribunals that set damages, it is probable that the only path to consistency of outcome is statutory. This is all the more when one reflects on the myriad of procedural rules and statutes involved.

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[90] See *The Duke Group Ltd (in liq) v Pilmer* (1999) 73 SASR 64 , also generally, see A Burrows 'We Do this at Common Law But That in Equity' (2002) 22 *Ox Jo LS* 1.

8. There is a great deal of appeal in the use of the declaratory order, such as in *Rabelais v Cameron*. Declaratory relief may be one instrument to sidestep arcane jurisdictional controversy. Declaration usually is confined to superior courts, but claims for indemnity will arise in all courts and tribunals including those not expressly vested with 'equity' jurisdiction.

9. Notwithstanding the appeal of the *Rabelais*, the court may be reluctant to accede to the request. In common law based claims the plaintiff may be well advised to seek, or initially seek, once-and-for-all award, and to this end be prepared to submit a detailed analysis of the breakdown of figures. It may be a matter of taste whether there is tendered an 'expert's report', or perhaps an opinion from counsel familiar with the intricacies of tax. The claim for indemnity should be pleaded or sufficiently raised so as not to impede the progress of the matter. It is a matter for law reform to fashion rules for payment of a portion of the award into court for payment out to the revenue, or even allowing the revenue authority standing to argue whether the award is exigible. In the absence of this, a litigant should have thoroughly researched report or opinion to support its submissions.

10. This paper is not complete without a plea for the fundamental reform of the taxing statute to express precisely what damages are exigible. It is not too late to ask why are damages to be subjected to taxation as 'gains' when in truth the taxpayer has sustained loss, and what is the policy rationale to subject all awards equally?