TAXATION OF DAMAGES, COSTS AND INTEREST (2)¹

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Tax and Damages

It all began with Gourley, a case we all know, decided in late 1955. Before then little or no attention had been paid to whether damages should be reduced on account of taxation, though well before that time the Revenue had interested itself with the question of whether damages themselves were taxable. For Gourley to apply it was said two conditions must be satisfied, two factors must be present. At their simplest these two can be stated as -

(1) the loss compensated by the damages would have been subject to tax

(2) the damages would not be subject to tax,

and I shall refer to them simply as factor (1) and factor (2).

(I should say here, in parenthesis, that I am dealing, as was Gourley, with tax on income, whether income tax or corporation tax, with which nearly all the cases deal. Capital gains tax, and the difficult Zim case, is dealt with by John Walters.) This then is what I shall call pure Gourley; the loss compensated would have been taxed, the compensation will not be. However, a modified form of Gourley has made its appearance, particularly
noticeable in the course of the last 10 years, which is of great importance, particularly in the fields which are of concern to practitioners at the Chancery Bar. This is where factor (2), as stated, is inapplicable because the damages will be taxed, but they will be taxed at a lesser rate than the loss compensated would have been taxed. Should Gourley still apply, albeit in modified form? I shall deal with modified Gourley in due course but for the moment mainstream Gourley is my concern. This after all is where the vast majority of cases lies.

Gourley was of course dealing with personal injury and the Chancery Bar does not concern itself with such cases. Indeed the Chancery Bar does not concern itself with most of the types of case where pure Gourley has been applied over the years. Thus apart from being applied in relation to loss of earnings of one who has been physically injured, the rule already existed in relation to loss of dependency in Fatal Accident Act claims (Zinovieff, 1954), has been proposed, at House of Lords level, for claims for profits lost through injured reputations in defamation cases (Lewis v. Daily Telegraph [1964] AC 234) and had a number of contract applications in claims for wrongful dismissal (Beach, 1956, Phipps, 1958, Shindler, 1960) before special rules were brought in by statute to tax the damages. About the only cases which might have trespassed on to Chancery soil have concerned not damages but statutory compensation - which also follows the Gourley rule - and Gourley was applied in two cases because the Revenue happily said that the compensation would not be taxable (West Suffolk County Council v. Rought...
The reason that, outside these fields, applications of pure Gourley do not tend to occur is that so often where the loss compensated would have been taxable the damages likewise will be taxable, and where the damages will not be taxable the loss compensated would not have been taxable: the two run in parallel. In the first case factor (2) is inapplicable, and the fact that factor (1) is present makes no difference; in the second case factor (1) is inapplicable, and the fact that factor (2) is present makes no difference. Let us look at these two situations separately.

The inapplicability of factor (1) can be dealt with briefly. That it is inapplicable is obvious in relation to many items of damages. This is true of all non-pecuniary losses, and it is true of all negative losses by way of expense. Only where there is a positive loss by way of a loss of assets or a loss of profits does the question of applicability or inapplicability arise, and the answer in short will be that factor (1) is inapplicable where the loss is of a capital item – it will be recalled that I am dealing only with tax on income and not on capital gains, and factor (1) will only be applicable where the loss is of income from trading, investment or employment. Thus in Hall v. Pearlberg [1956] 1 WLR 244, where the
defendant had taken unlawful possession of the claimant’s farm, which depreciated through the defendant’s bad husbandry, the damages representing diminished value were awarded in full.

The inapplicability of factor (2) is a more difficult matter. One reason for this is what is called the “source doctrine” – the rule that to constitute taxable income or profit the sum in question must be traceable to a source. Types of income are classified by reference to the source from which they come, and from this it has been held, in a variety of cases, that if the taxpayer has ceased to possess a source of income he could not be taxed upon delayed receipts from that source. This is why damages paid to a wrongfully dismissed employee were held not taxable – before statute intervened – because the source, which was the employment, had *ex hypothesi* gone before the damages were awarded. Some cases are reasonably straightforward, and I can cite a whole raft of authorities holding damages to be taxable, and therefore factor (2) inapplicable. For example, where in *Diamond v. Campbell Jones* [1961] Ch 22 a dealer in real estate bought a house from a seller who repudiated, damages for the lost profit were awarded without tax deduction as they would be liable to tax as part of the profits of the dealer’s business. But there are cases which are more difficult. *Deeny v. Gooda Walker* is one – an episode in the extensive litigation initiated by Lloyd’s Names against their managing and underwriting agents for subjecting their syndicates to excessive exposure to risk by failure to arrange reinsurance cover to protect them against losses. In this episode, the matter went as far as
the Lords on the question of whether the damages were subject to tax: [1996] 1 WLR 426, HL as John Walters explains. All I would add here, by way of postscript to this issue, is that very occasionally, as in a very recent case, pure Gourley falls to be applied where the damages were not to be taxable, not on any ground of principle, but simply because the defendant had become insolvent (Finley v. Connell Associates [2002] Lloyd’s Rep PN 62).

A most interesting aspect of this whole subject, as the law has developed, has been to deal with the situation where the loss for which you are getting damages would have been taxable and the damages are also taxable but at a different, generally lower, level. Strictly speaking, factor (1) applies but factor (2) does not, and that should be an end of it. This was the approach originally taken. The first case was Praet v. Poland [1962] 1 Lloyds Rep 566, and it was unusual in two respects which in combination may have influenced the decision: the tax in question was foreign and the tax rates involved were very small. The loss in question was of insurance premiums which, if received, would have been subject to tax at a two per cent rate in Belgium. When however it appeared that the damages themselves would be subject to tax in Belgium, albeit at an amount well below the two per cent figure, that was held to be an end of the matter. “Once it is agreed . . . . that the damages awarded will be subject to tax, the court enquires no further”, said Mocatta J. Gourley did not apply. This decision was soon after approved by the Court of Appeal in Parsons v. B.N.M. Laboratories [1964] 1 QB 95, a decision which
has had much influence, and where the members of the Court of Appeal laid down in no uncertain terms that if the damages would be taxed, at whatever level, *Gourley* had no application. That this was the decision to cement the rule of no *Gourley* where there was to be some degree of tax on the damages, is somewhat ironic, as *Gourley* was in fact applied in that case. It involved wrongful dismissal and golden handshakes, and the Court held that, the first £5,000 of any payment being exempt from tax, *Gourley* must apply to a payment of only £1,200.

The courts soon moved away, in wrongful dismissal cases, from the *Parsons* view that *Gourley* could not apply where the damages were partly taxable. They did so the moment a case appeared where the damages awarded exceeded the £5,000 threshold. Otherwise there would have been a terrible disparity between cases where the award was just under and cases where it was just over £5,000. The cases which followed (*Stewart*, 1963, *Bold*, 1964, *Shove*, 1984) concerned themselves only with the method of working out the statutory tax on the damages, a task made horrendous by the infinitely complex formula imposed by the legislation, a formula which mercifully disappeared in 1988. But the developments were not thought necessarily to place in doubt the validity of the general rule applied in *Praet* and approved in *Parsons* – the wrongful dismissal cases could be regarded as exceptional because of the dividing line between damages below and damages above the exempt threshold – and what was said in both cases, especially *Parsons*, and in the
following wrongful dismissal cases continued to be extensively cited in the cases to which I shall now turn.

It would of course simplify the position if the courts could adopt the rough and ready assumption that the effects of taxation cancel out, but the facts of a particular case may make such an assumption entirely unjustified. The most obvious cause of tax on damages being lower than tax on loss is falling tax rates between the time of the loss and the time of the award. This was the position in *Amstrad plc v. Seagate Technology Incorporated*, 1998, a forwarding-looking decision, which, despite its importance, is ill-reported: all I know is 86 Building Law Reports 34 and [1998] Masons CLR Reports 1. Damages had been awarded for the loss of profits which would have been made from the sale in 1989 and 1990 of some 50,000 computers. The tax on the damages when received would be at a rate of 33 per cent. but the tax on the profits had they been received at the proper times would have been at rates of 34 and 35 percent. Judge Humphrey Lloyd held that the damages, as he put it, “should be adjusted to take into account the incidence of taxation”. In other words *Gourley* was applied to the difference between the tax rates which, although small as a matter of rates, was large as a matter of amount, making a difference of about £1 million to the claimants. Here was a sensible shift away from the *Praet* and *Parsons* approach; indeed the five reasons which Pearson L J had propounded in *Parsons* for the rule there approved are all neatly and fully answered in the extensive judgment. Logic and justice had triumphed over expediency and pragmatism.
But things went differently in *Deeny v. Gooda Walker*. While the principal question there was whether the damages were taxable, there was a second question, but at first instance only ([1995] STC 439), which was whether, if it were decided that the damages were taxable, there should still be taken into account the fact that the damages would be taxed at a lower rate than would have been the losses for which compensation was given. The reason for this was that many of the Names would have been able to set off losses on other income against tax at a higher rate than the rate applicable to the award at the date of recovery. Potter J was not prepared to depart from what he called the traditional approach of simply regarding the effects of taxation as cancelling out because of the complexity of examining the different tax positions of over 3,000 individuals, particularly when the whole approach to the case had been on a group syndicate basis. The case may therefore be considered somewhat special, but there is no doubt that here expediency and pragmatism won out over logic and justice. Moreover, if the *Amstrad* line is adopted, it should follow that, if the rates of tax have been increasing rather than reducing over the relevant years, so that the tax on the damages would be greater than that on the lost profits, the damages should be adjusted upwards. This would be *Gourley*, in truth modified *Gourley*, in reverse. It is true that in the *Tate & Lyle* case, dealt with below, Forbes J refused to adjust the damages upwards on account of the rate of corporation tax having risen between cause of action and judgment, but it was early days when *Tate & Lyle* was decided, and
in any event Forbes J was, as we shall see, being innovative enough.

Something needs to be said on the burden of proof. Does the claimant have to prove that factor (1) is not present or the defendant prove that it is? Similarly, does the claimant have to prove that factor (2) is not present or the defendant prove that it is? There was for long little clarity on this, but eventually the Court of Appeal in *Stoke-on-Trent City Council v. Wood Mitchell* [1980] 1 WLR 254 held that it was the defendant’s onus to show that factor (2) is satisfied, so that his failure to do so ousts the *Gourley* rule. It must be “clear beyond a peradventure” that the damages are not to be taxable in the claimant’s hands; otherwise the dangers of double taxation are too great. Indeed it is of some concern that the courts do not always get the position right. Thus in *Pennine* (above) the compensation was held to be payable net of tax on the basis that it would not be taxable in the claimant company’s hands, and, after the time of appealing this decision had run out, the Revenue turned round and demanded tax. Fortunately, faced with this double taxation the claimant company was able to obtain an extension of time for requiring a case to be stated and the decision was changed. But none of this would have happened if the onus had firmly been on the defendant to show that factor (2) applied. These considerations suggest that it may be wise in some cases to try to join the Revenue. It was said by the Court of Appeal in *Deeny* that they had been told that it was the first time that the Revenue had been joined by consent to argue the tax issue before the trial judge (Potter J) in
relation to a dispute over damages, not being a tax appeal ([1996] LRLR 109, CA, at 111, col.1). As for factor (1) there is likely to be far less difficulty with proof, but I would think that the onus should be also on the defendant here. There seems little point in splitting the onus between the two factors, and in any event it might be said that there should be no issue of taxation until a defendant raises it.

A few points should be made on the calculation of the tax. (1) The first is that the Lords made it plain in Gourley itself that mathematical exactness and accuracy are not necessary. “An estimate”, said Earl Jowitt there, “will be none the worse if its formed on broad lines.” This has continued to be the accepted position. (2) The assessment of tax liability falls to be based upon present rates of tax and present rates of reliefs and allowances, of course taking into account any changes that have occurred between cause of action and judgment. In Daniel v. Jones [1961] 1 WLR 1103, a fatal case, the Court of Appeal properly took into account the substantial tax reliefs on earned income proposed in the Budget of the day though there was no certainty at the time of judgment that the proposals would become law. In Amstrad Judge Humphrey Lloyd went further and, in the context of ascertaining the tax not on the lost profits or earnings but on the damages, ordered that no judgment should be entered until after it was known whether the imminent Budget statement brought in a change in the rate of corporation tax. In Beach v. Reed Corrugated Cases [1956] 1 WLR 807 the Court accepted evidence that the claimant intended to take steps in the
near future to minimise his tax exposure. (3) Though there have been varying decisions, it is clearly correct that the sum to which the \textit{Gourley} rule is to be applied is to be regarded as the top slice of an individual claimant’s income.

Finally, let me say something about the impact of tax not on the damages themselves but on the interest awarded upon the damages, a development stemming from the innovative and important decision in \textit{Tate & Lyle Food and Distribution v. Greater London Council} [1982] 1 WLR 149 at first instance. Dredging costs necessitated by the defendant’s nuisance were deducted by the claimants for a number of years in arriving at their trading profits for corporation tax purposes; subsequently these costs were recovered as damages and interest was claimed in the usual way. Forbes J held that the claimants must bring into the interest computation the amount of corporation tax that they had saved over the years until tax became payable on the costs when received as damages. Now \textit{Tate & Lyle} has been applied by Philips J in a further episode of the \textit{Deeny v Gooda Walker} saga. Just as Potter J was asked to reduce the damages because the tax on the damages would be less than the tax on the losses compensated ([1995] STC 439), Philips J was asked similarly to refuse to reduce the interest he would award by ignoring the tax element ([1996] LRLR 168). What applied to tax, it was argued, should apply equally to interest. This argument was happily not accepted by Philips J, despite having been cogently advanced by our most learned Chairman of this evening. He distinguished between loss of use of money
and loss of cash flow. The fact that you shared the damages money with the Revenue and would have similarly shared the money had you received it in the normal way was one thing, but the suggestion that you should be entitled to interest on the part that you would have shared with the Revenue was another. Moreover, there is a Court of Appeal decision in *O’Sullivan v. Management Agency and Music* [1985] QB 428 which is supportive of Philips J’s approach (though he did not think so). And further Philips J was unprepared to accept the pragmatic argument that exceedingly complex calculations would be required to ascertain the effect that taxation would have on the cashflow of, again, over 3,000 claimants. If the Court proceeded on the artificial basis that the claimants had been deprived of the whole of their damages, this would provide them with a large unjustified windfall at the defendants’ expense. Detailed investigations of the claimants’ tax positions could nonetheless be avoided, and in the result interest on only 75 per cent of the damages to which the group claimants had been held entitled was awarded. This is interestingly to be contrasted with Potter J’s decision on the main tax issue. How far defendants have taken advantage of Philips J’s wise decision over the last eight years it would be interesting to know.

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1 From a paper contributed by the author to a seminar of the Chancery Bar Association, chaired by Park J, on 24th February 2003.
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