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Backgrounder

LRC 134—Report on Taxation and the Assessment of Income-Related Damage Awards

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When a court makes an award of damages to an injured person to compensate for lost earnings, the damages are calculated and awarded as if that person's earnings attract no tax. This approach can lead to some anomalous results, including the overcompensation of injured parties. This report arose out of a Special Advisory Committee formed by the Commission to consider standardized assumptions relating to the calculation of tax gross-ups and management fees. While this fell outside of their purview, the Committee noted the issue and this report discusses it.

The principle that compensation for damages should not be taxed comes from a 1966 decision of the Supreme Court of Canada, *R. v. Jennings*. This reflects a theory that the injured party is to be compensated for a loss of income-earning capacity rather than the loss of income itself. In many cases this theory leads to overcompensation of parties, which, in turn, may effectively be passed on to others through increases in insurance premiums.

The report identifies potential problems with the current approach in Canada. The treatment of damage assessment in personal injury cases and fatal accident cases is unjustifiably inconsistent, and our approach is out of sync with practices in England, New Zealand, and Australia. The approach also overcompensates a significant number of plaintiffs, and is inconsistent with both financial theory and the way judges assess losses. The Commission notes that the Supreme Court of Canada has had opportunities to reconsider *Jennings*, but has chosen not to do so—making legislative amendment the proper method of reform.

The Commission recommends that a provision be added to the *Law and Equity Act* to rationalize the calculation of damages in respect of lost earnings, and in effect overrule *R. v. Jennings*. The report recommends that when calculating future income loss judges should do a present value calculation based on the plaintiff's projected net income stream, and then "gross-up" the amount to compensate for the impact of taxes on the award. The report also discusses how this amendment to the *Law and Equity Act* would operate with the guidelines that the Special Advisory Committee had envisioned (see LRC Report 133, *Re-*

port on Standardized Assumptions for Calculating Income Tax Gross-Up and Management Fees in Assessing Damages). The report includes an appendix with those recommendations.

Further Developments

The report's recommendations have not been implemented.