REPORTABLE

IN THE HIGH COURT OF SOUTH AFRICA
(WESTERN CAPE HIGH COURT, CAPE TOWN)

CASE NO: 20738/2008

In the matter between:

CANDICE BARCLAY Plaintiff

and

THE ROAD ACCIDENT FUND Defendant

SUPPLEMENTARY JUDGMENT
DELIVERED ON 1 DECEMBER 2011

BLIGNAULT J:

[1] On 21 July 2011 I delivered a judgment in this matter in which I dealt with the *quantum* of the damages to be awarded to plaintiff for the loss of earnings suffered by her. I did not quantify plaintiff's loss as I had been requested by the parties to make certain findings after which the *quantum* of the loss would be determined by the parties' actuaries.

[2] In para [24] of my judgment I listed the assumptions and findings to be taken into account by the actuaries. They read as follows:

> *"(1) Plaintiff is to be awarded a capital sum calculated on the basis of one hour's work per weekday, ie excluding Saturdays and Sundays, at the rate of R200,00 per day. This means that plaintiff's actual and expected monthly income is irrelevant.*
> *(2) Plaintiff is expected to retire at the age of 60.*
> *(3) Plaintiff is assumed to take a three week holiday per year during*

which she will not earn any income.

(4) The date of calculation is the date of this judgment, ie 20 July 2011.

(5) A globular contingency deduction of 30% should be applied.

(6) The mortality table, discount, interest and inflation rates used in Mr Munro's report dated 29 March 2011 are to be applied."

[3] In para [25] of the judgment I said the following:

"[25] If the parties are agreed on the result of the actuarial calculation it may be submitted to me to be made an order of court. If they are not agreed, the difference(s) between the parties could be explained and motivated in written argument for purposes of the judgment to be granted."

[4] The parties' respective actuaries thereafter prepared separate reports on the basis of my findings.

[5] There is a substantial difference between the calculation by plaintiff's actuary of the capital value of her loss of earnings and the calculation thereof by defendant's actuary. The difference is due to the fact that they departed from different premises. Plaintiff's actuary's approach is that the amount of the income tax that plaintiff would have paid on her lost earnings, should not be deducted in arriving at the amount to be awarded. Defendant's actuary, on the other hand, deducted income tax from plaintiff's loss of earnings in performing his calculation.

[6] The difference between the results of the two calculations is material and I

accordingly invited counsel to submit written argument on this issue.

[7] Mr H G McLachlan, counsel for plaintiff, submitted that the issue is *res iudicata.* According to his argument the findings and assumptions listed by me in para [24] of my judgment are final and exclusive. The list does not mention the question of the deductibility of plaintiff's income tax and the court has no power to supplement or correct its own judgment at this stage.

[8] Mr K F Allen, counsel for defendant, contended that the issue of the deductibility of income tax, is not *res iudicata* and that this court can and should determine the issue. He submitted that a deduction for plaintiff's income tax savings should be made in calculating the capital value of her loss of earnings.

[9] I propose to deal with the question of *res iudicata* first. In my view there are two reasons why Mr McLachlan's submission cannot succeed. The first reason is that I did not give any final order in respect of this issue. The question of the final quantification of plaintiff's claim was left open. The actuaries subsequently disagreed on the basis for this quantification. There is no reason why this issue should not be determined before a final order is given.

[10] It seems to me in any event that if my order on the question of the deductibility of plaintiff's income tax savings were to be regarded as a final decision, it would be subject to variation in terms of High Court Rule 42(1)(c) which reads as follows:

"42 Variation and Rescission of Orders

(1) The court may, in addition to any other powers it may have, mero motu or upon the application of any party affected, rescind or vary:

…......................

(c) an order or judgment granted as the result of a mistake common to the parties."

[11] In the present case there was a common mistake. Counsel on both sides were under the impression that the question of the deductibility of plaintiff's income tax savings was not a significant issue in the case. For that reason no argument was addressed to me on this issue at the hearing of the matter. Counsel erred in this regard. The issue has proved to be of considerable significance.

[12] I am accordingly of the view that the question whether income tax should be deducted from plaintiff's notional lost earnings has not yet been decided in this matter. I proceed to consider it.

[13] The question whether income tax on a claimant's notional earnings should be deducted in the quantification of his loss of earnings or earning capacity, has on various occasions received judicial attention, both here and in comparable foreign jurisdictions. A landmark decision is that of the House of Lords in *British Transport Commission v Gourley* [1955] 3 All ER 796 (HL)

where such income tax was deducted. This judgment has been applied in South Africa on a number of occasions. Mr Allen referred in his argument to some of these cases, namely *Pitt v Economic Insurance Co Ltd* 1957 (3) SA 284 (D); *Gillbanks v Sigournay* 1959 (2) SA 11 (N) and *Snyders v Groenewald* 1966 (3) SA 785 (C). In *R v Jennings et al* [1966] SCR 532, on the other hand, the Canadian Supreme Court declined to follow the *Gourley* judgment and held that the income tax which the plaintiff would have had to pay on future earnings should not be taken into account. In *Cullen v Trappel* [1980] HCA 10; (1980) 146 CLR 1 (1 May 1980), however, the High Court of Australia followed the *Gourley* judgment and deducted the income tax that the plaintiff would have had to pay on her future earnings.

[14] In my view the starting point of the enquiry is a set of principles which are not controversial. The first is the trite statement that receipts of a capital nature are not subject to income tax whilst income is. In terms of section 1 of the Income Tax Act 58 of 1962 receipts and accruals *of a capital nature* are excluded from the definition of *gross income.* There may of course be exceptional cases where extraordinary tax legislation is applicable but that is not the position in the present case.

[15] The second principle is that the claim which is sometimes loosely described as one for the loss of earnings (as in my judgment in the present case), is in truth a claim for the loss of the claimant's earning capacity which is

an asset in his estate. See *Rudman v Road Accident Fund* 2003 (2) SA 234 (SCA) para [10]:

> *"[10] ... on the facts of this case the nature of the loss ... is his diminished earning capacity. In Santam Versekerings-maatskappy Bpk v Byleveldt 1973 (2) SA 146 (A) Rumpff JA states the principle in the following terms, at 150B - D:*
>
> > *'In 'n saak soos die onderhawige word daar namens die benadeelde skadevergoeding geeis en skade beteken die verskil tussen die vermoensposisie van die benadeelde voor die onregmatige daad en daarna.'*
>
> *The same learned Judge of Appeal again dealt with the principle in Dippenaar v Shield Insurance Co Ltd 1979 (2) SA 904 (A). He says at917B-D:*
>
> > *'The capacity to earn money is considered to be part of a person's estate and the loss or impairment of that capacity constitutes a loss, if such loss diminishes the estate.'"*

[16] The third principle is that an amount paid by way of damages takes on, in the hands of the recipient, the character of the loss in respect of which it is being paid. If the payment is made in respect of a loss of a capital nature, the receipt is also of a capital nature. If the payment is made in respect of a loss of income, the receipt is of a revenue nature. This principle is sometimes expressed by asking whether the damages fill a hole in the taxpayer's capital

or a hole in his income. See *Bourke's Estate v Commissioner for Inland Revenue* 1991 (1) SA 661 (A) at 671J-672A; *Taeuber & Corssen (Pty) Ltd v Secretary for Inland Revenue* 1975 (3) SA 649 (A).

[17] The fourth principle is that an award of damages for the loss of a claimant's earning capacity is intended to place him in the financial position he would have been in had not been for the delict. It is not necessary, but in general preferable, to quantify the award by way of an actuarial calculation. See *Southern Insurance Association Ltd v Bailey NO* 1984 (1) SA 98 (A) at 113H - 114F. The object of such a calculation is to arrive at a lump sum that would allow the claimant to enjoy the financial benefits equal to the *quantum* of the earnings lost by him.

[18] The typical actuarial method (used in this case by both actuaries) takes place in two stages. In the first stage the notional income that the claimant would have earned over the relevant period, is computed. In the second stage this amount is capitalised at a net discount rate which takes into account the rate at which the claimant is assumed to invest the lump sum to be awarded to him and the likely future inflation rate.

[19] The effect of income tax plays a role in both stages. In the first stage the question is whether income tax should be deducted in the calculation of the claimant's gross notional earnings over the relevant period. The question in the second stage is whether income tax should be taken into account in the quantification of the net discount rate. The deduction of income tax in the

calculation of the claimant's gross notional earnings would, *ceteris paribus,* diminish the lump sum to be awarded to the claimant. The deduction of income tax from the income that the claimant is assumed to receive from his investment of the lump sum, would result in the employment of a lower net discount rate. A lower discount rate would, *ceteris paribus,* increase the lump sum to be awarded to the claimant.

[20] It follows that it would in principle be unfair to the claimant if income tax is deducted from his gross notional earnings and a pre-tax investment rate is used in calculating the net discount rate. That would in effect amount to the double taxation of the claimant to the benefit of the defendant. By the same logic it would in principle unduly favour the claimant if income tax is not deducted from his notional earnings in the first stage of the calculation but then deducted in the second stage to arrive at an after-tax net discount rate.

[21] The question of principle that arises for determination is which calculation is to be applied. Should one deduct income tax in calculating the claimant's gross notional earnings and deduct it again in calculating the net discount rate or should one ignore income tax in both stages of the calculation? Before dealing with this question it would be useful to consider first the various judgments referred to above.

[22] In the *Gourley* case the plaintiff claimed damages from the defendant for what was described as a loss of earnings. The court deducted the plaintiff's income tax savings in calculating the *quantum* of the damages awarded to

him. It is important, however, to note that the court treated the plaintiff's loss as a loss of income. One must further have regard to the legislative context in the *Gourley* judgment. The plaintiff found himself in a situation where, due to the particular provisions of the English tax legislation, his lost income would have been subject to income tax but the damages themselves were not taxable.

[23] The import of the *Gourley* judgment in its particular context is described in McGregor on Damages 17th edition para 14-002 as follows:

> *"The presence of two factors was necessary to set the stage for the problem which was posed for their Lordships' decision in Gourley's case: (1) the sums for the loss of which the damages awarded constitute compensation would have been subject to tax; and (2) the damages awarded to the claimant would not themselves be subject to tax. For there cannot be any reason for taking tax into account in calculating damages given in compensation for a loss which would never itself have been taxed: this would let in a taxation where no taxation would have been, which would be unfair to the claimant. Equally there cannot be any reason for taking tax into account in calculating the damages if the damages themselves will then be taxed in the same manner as the loss compensated would have been taxed: this would result in a double taxation, equally unfair to the claimant."*

[24] In *Pitt v Economic Insurance Co Ltd* 1957 (3) SA 284 (D), at 287A-C, the *Gourly* judgment was followed, without any apparent consideration of its particular legislative context. The court (Holmes J) did however point out that the incidence of taxation in relation to interest obtainable on the court's award, should also borne in mind.

[25] In *Gillbanks v Sigournay* 1959 (2) SA 11 (N) the reasoning of the learned judge (Henochsberg J) is not very clear. He pointed out, at 18F, that the award in the *Gourley* judgment was not subject to income tax and he referred, at 18H, to a statement in Silke South African Income Tax 33 that damages received for personal injury are an accrual of a capital nature and are not taxable. The learned judge nevertheless took the plaintiff's notional tax savings into account, albeit as part of an all encompassing contingency and not quantified as a separate item.

[26] The matter went on appeal. It is reported as *Sigournay v Gillbanks* 1960 (2) SA 552 (A). Schreiner JA, delivering the majority judgment. He confirmed, at 568FG, that if income tax were to be deducted from the plaintiff's gross earnings, then the tax that would have been payable on the interest that would have accrued from the investment of the amount of the award, must also be taken into account.

[27] In *Snyders v Groenewald* 1966 (3) SA 785 (C) van Winsen J followed the judgments in *Pitt v Economic Insurance Co Ltd supra* and *Sigournay v Gillbanks supra* in coming to the conclusion that it would be correct to deduct the plaintiff's income tax savings. One must assume that he also recognized that income tax payable on the award must also be taken into account.

[28] In *R v Jennings et al supra* the Supreme Court of Canada dealt pertinently with the question whether a reduction should be made in the calculation of the damages for the future loss of earnings claimed by the plaintiff. Judson J delivered the unanimous judgment of the court on this

aspect of the case. He emphasised that the plaintiff is compensated for the loss of his earning capacity which is a capital asset and not for a loss of earnings as such. The thrust of his reasoning is contained in the following passage, at 545-546, which I quote in full:

> *"The plaintiff has been deprived of his capacity to earn income. It is the value of that capital asset which has to be assessed. In making that determination it is proper and necessary to estimate the future income earning capacity of the plaintiff, that is, his ability to produce dollar income, if he had not been injured. This estimate must be made in relation to his net income, account being taken of expenditures necessary to earn the income. But income tax is not an element of cost in earning income. It is a disposition of a portion of the earned income required by law. Consequently, the fact that the plaintiff would have been subject to tax on future income, had he been able to earn it, and that he is not required to pay tax upon the award of damages for his loss of capacity to earn income does not mean that he is over-compensated if the award is not reduced by an amount equivalent to the tax. It merely reflects the fact that the state has not elected to demand payment of tax upon that kind of a receipt of money. It is not open to the defendant to complain about this consequence of tax policy and the courts should not transfer this benefit to the defendant or his insurance company."*

[29] In *Cullen v Trappel supra* Gibbs J delivered the principal majority judgment. He repeated the reasons which he had given in *Atlas Tiles Ltd v Briers* [1978] HCA 37; (1978) 144 CLR 202 (14 December 1978) where he delivered a minority judgment. The latter was also a decision of the High Court of Australia but it was overruled by a differently constituted court in *Cullen v Trappel supra.* Gibbs J followed the *Gourley* judgment and held that the

plaintiff's income tax should be deducted from his gross notional earnings. He approached the *Gourley* judgment on the basis that it would have required the strongest reasons to justify the court in refusing to follow a decision of the House of Lords that has provided the basis upon which damages had been assessed in Australia for the previous twenty years.

[30] In *Atlas Tiles Ltd v Briers supra* Barwick CJ delivered the majority judgment. He emphasised that a claimant's earning capacity is a capital asset which, like other capital assets, is capable by its use or employment of producing income. In para 18 of the judgment he said the following:

> *"18. But the plaintiff has not in a relevant sense lost the earnings either in the period before verdict or the future thereafter: he has lost the capacity to earn perhaps the equivalent of his current earnings or perhaps more or less according to the reasonable expectations of the employment of his earning capacity. If the award of damages for such an injury destroying or diminishing his earning capacity were merely a matter of replacing those earnings, the amount of the award would be taxable: but it is not, for the reason that the award is for a capital loss, however much the amount of the award is quantified by a consideration of what the use or employment of that capacity might be expected to produce. In other words, the assessment of damages for loss of earning capacity is in truth an exercise in valuation. It is quite true to say that what that capacity may reasonably be expected to produce is a factor, indeed a major factor, in the process of valuation."*

It may be noted that Barwick CJ reiterated these reasons for his approach in *Cullen v Trappel supra* but in that case he was in the minority.

[31] For the sake of completeness I may mention that there are two other judgments of the South African Supreme Court of Appeal (as it is now called) in which the question of the effect of taxation on the calculation of damages was considered. In *Whitfield v Phillips* 1978 (3) SA 465 (A) the plaintiff claimed damages for loss of income by reason of a breach of contract and in *Omega Africa Plastics (Pty) Ltd v Swisstool Manufacturing Co (Pty) Ltd* 1978 (3) SA 465 (A) the plaintiff was awarded damages for the infringement by the defendant of its registered design. The courts in both instances rejected the defendants' contention that the plaintiff would be overcompensated as the damages in its hands would be a capital accrual and therefore not taxable. The basis of both decisions is that the damages would have been taxable in the hands of the plaintiff as income. These two decisions are accordingly distinguishable from the typical claim for damages for a loss of earning capacity.

[32] I revert to the question posed in para [21] above. Should one deduct income tax in calculating the claimant's gross notional earnings and deduct it again in determining the net discount rate to be applied or should one ignore income tax at both stages of the computation? It seems to me that recognition of the implications of the fact that the claimant's earning capacity is a capital

asset, leads one to the conclusion that income tax should not be deducted in the first stage of calculating the claimant's gross notional earnings. A claimant is not bound to employ his earning capacity in any particular manner. The fact that the *quantum* thereof is normally calculated with reference to the earnings which he would have earned over the period in question, does not change its nature as a capital asset. The claimant might, for example, have decided to utilise his earning capacity by starting and developing his own business. I respectfully agree in this regard with the views of Judson J in *R v Jennings supra* and Barwick CJ in *Atlas Tiles Ltd v Briers supra.* Support for it is also to be found in an article written as long ago as 1979 by H J O van Heerden (later Deputy Chief Justice) entitled *"Skadevergoeding en Belastingpligtigheid"* in *J C Noster: 'n Feesbundel* (essays in honour Prof J C de Wet, edited by J J Gauntlett) at p1. He approved of the approach of Judson J in *R v Jennings supra.*

[33] That brings me to the question of the proper approach to be adopted in the second stage of the determination, namely the manner of treating income tax in calculating the appropriate net discount rate. It follows from my earlier discussion that it would in principle be unfair to the defendant if an after-tax investment rate is used. There is no reason in principle, however, why the net discount rate should be calculated on the assumption that the claimant would invest the award in such a manner that the proceeds would be fully taxable His earning capacity, as an asset in his estate before the delict, was not limited to any particular form of utilisation. The utilisation of the compensation for his loss should similarly not be limited in any particular respect. The

claimant may elect to utilise his award by investing it or to purchase capital assets with it. If he decides to invest it, he would be able to choose between various investments possibilities, some of which may be tax-free.

[34] It remains to apply this approach to the facts of the present case. Plaintiff's actuary did not deduct income tax from plaintiff's gross notional earnings. He applied a net discount rate of 2,5% per year, based on an interest rate of 8% per year after all taxes and a future inflation rate of 5,4% per year. He calculated that the net present value of plaintiff's loss, after the deduction of 30% for contingencies (which had already been decided), amounted to R595 420,00.

[35] Defendant's actuary deducted income tax from plaintiff's gross notional earnings at a marginal tax rate of 35%. He applied a net discount rate of 2,5% per year, based on a net of tax rate of return of 8% per year and a future inflation rate of 5,4% per year. His valuation of the net present value of plaintiff's loss, after the deduction of 30% for contingencies, amounted to R383 173,00.

[36] It is apparent that the two actuaries did not differ in their calculation of the net discount rate. The difference between their results is mainly due to the fact that defendant's actuary deducted income tax from plaintiff's notional earnings whilst plaintiff's actuary did not.

[37] It follows from my earlier discussion that I do not agree in principle with the method used by either actuary. Plaintiff's actuary did not deduct income

tax from plaintiff's gross notional earnings but he apparently applied it in arriving at an after-tax investment rate. That method would favour plaintiff. Defendant's actuary deducted income tax from plaintiff's gross notional earnings which is in conflict with the method suggested by me. The use of an after-tax investment rate might compensate plaintiff to some extent but only if it is assumed that plaintiff would have invested her entire award in such a manner that all her income would be taxable.

[38] I am not in a position at present to determine what allowance should be made for the taxation of the income to be derived by plaintiff from her utilisation of the award. I do not have the requisite evidence before me. Evidence of actuarial practices would also be useful as it may, from a wider perspective, be cost effective to use standardised rates in this kind of cases.

[39] In this case, however, it would be unfair to the parties to subject them to another round of evidence and argument. I accordingly propose to award a sum which, on the evidence before me, I view as fair and reasonable compensation for plaintiff's partial loss of her earning capacity. I assume in this regard that plaintiff is likely to invest a substantial portion of the sum awarded to her in tax-free investments. On this basis I propose to award a sum of R500 000,00 to plaintiff.

[40] In the result, judgment is granted in favour of plaintiff for payment of the amount of R500 000,00.

A P BLIGNAULT