Characterization of Wrongful Dismissal Awards for Income Tax

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The recent decision of the Federal Court of Appeal in *R.* v. *Atkins*,[1] confirming the decision of the Trial Division which had held damages awarded for wrongful dismissal to be non-taxable, has brought to the fore, here as in other areas of tax law, the difficult task involved in the characterization of receipts as income or capital. Here, as in the case of personal injury awards, taxpayers in receipt of damages for wrongful dismissal as well as governmental agencies at the judicial, legislative and administrative levels, face the task of determining the tax treatment of such awards.

It is important to clarify at the outset the two stages at which tax implications could have an impact on damages awarded for wrongful dismissal. In chronological sequence, a taxpayer (plaintiff) may face the issue of tax implications in the *preliminary* question as to whether a judicial tribunal should take account of the plaintiff's tax status in assessing the quantum of the judgment which a defendant would be required to pay. This aspect has been adequately discussed elsewhere,[2] and was the subject of discussion in the now famous *Jennings*[3] decision which decided that *no* deduction should be made for any notional tax liability factor. This article will examine the *subsequent* tax treatment of the judicial award or settlement, in the context of the taxpayer *vis-à-vis* the taxing authorities. This examination (including the problem of characterization) analyzes the concept of income, the theoretical and pragmatic premises underlying damage awards in this area, and the policy objectives of the tax structure,

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1 *R.* v. *Atkins* [1976] C.T.C. 497, 76 D.T.C. 6258 (F.C.A.); [1975] C.T.C. 377 (T.D.).

2 Dworkin, *Damages and Tax — A Comparative Survey* [1967] B.T.R. 315; Fleming, *Damages: Capital or Rent* [1969] 19 U.of T.L.J. 295; Sheppard, *The Tax Element in Compensation since The Queen* v. *Jennings and Cronsberry*, (1971) 19 Can.Tax J. 448; Bale, *British Transport Commission* v. *Gourley, Reconsidered* (1966) 44 Can.Bar Rev. 66.

3 *The Queen* v. *Jennings* (1966) 57 D.L.R. (2d) 644. See also *Gehrmann* v. *Lavoie* [S.C.C.] October 7, 1975 as yet unreported; *Ofstedahl* v. *Cam-Set Mechanical Contractors Ltd* [1974] 1 W.W.R. 329 (Alta C.A.).

with a view to suggesting an acceptable reconciliation of these various aspects. For reasons which will become clear, this article does not examine the alternative of whether damages for wrongful dismissal are, or should be, taxable on a capital gains basis.

1. Tax policy objectives and the concept of income

Before attempting to characterize wrongful dismissal awards for purposes of their tax treatment, it may serve some useful purpose to provide a theoretical framework of tax policy objectives and the foundation of the concept of income. These objectives include the equitable distribution of tax burdens among the class of taxpayers as a whole, and within that class equitable treatment of the taxpayers *inter se*, and the avoidance of undesirable distortions in the decision-making process of resource allocation. Further, economic and social policy considerations play an important role in containing or expanding aggregate demand in the battle against inflation and the desire to promote full employment. Hence, equity, neutrality, and economic and social policy, complemented by revenue collection, administrative efficiency and tax simplicity, all play, with varying degrees of impact, a role in the development of a tax structure.[4]

In evaluating the relative weight to be assigned to these various tax objectives, one may observe at the outset that revenue collection *per se*, assumes a secondary role. If revenue collection were viewed as a primary objective of tax policy, any government would have available several other alternatives which would be more efficient in the promotion of this objective. Thus, a government might commandeer resources, create money, or rely on property, sales or consumption taxes. Each of these alteruatives, while promoting administrative efficiency, would, however, generate adverse consequences. Commandeering resources would tend to be capricious; the creation of money would, if unaccompanied by a commensurate increase in national output, promote even greater inflation than that which exists at the present time; property, sales and consumption taxes if used as the *primary* source of revenue, would penalize a limited segment of the population or place an uneven burden on lower income levels who spend a proportionately larger percentage of income on consumption.

That these consequences are undesirable is self evident. Thus commencing with Adam Smith who stated that:

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[4] For an extensive discussion see *Report of the Royal Commission on Taxation*, Ottawa: Queen's Printer (1966-67), vol.2.

> The subjects of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their several abilities .... In the observation or neglect of this maxim consists the equality or inequality of taxation...[5]

down to the Carter Commission which observed that:

> ... if the government had to choose one method to the exclusion of all other methods, taxation would be preferable because it *can* be more equitable, *can* be less disruptive to the economy, and *can* give the government more effective control over the total demand for goods and services...[6]

equitable distribution of tax liabilities has been an important determinant in the organization of a tax structure. It is submitted here that equity should play a pre-eminent role within any tax structure, given that the very existence of any tax structure itself presupposes the need for revenue generation.

The next step in implementation of the propounded concept of equity, is the search for an appropriate vehicle. The choice often made for this purpose is the allocation of the tax burden amongst taxpayers in accordance with their relative economic well being or taxpaying capacity. Economic well being and capacity in turn may be measured by "income", which reduces the immediate issue to one of appropriately defining that term. The basic requirement of that definition is given by the purpose to be served by the defined concept — that of providing a measure of the relative economic status or well being of the taxpayer. For this purpose, therefore, the definition should be comprehensive and, subject to the demands of pragmatic implementation, should include "the money value of the net accretion to economic power between two points in time ...".[7]

This accretion concept endorsed by Fisher as "a flow of benefits during a period of time ...",[8] and Marshall who observed "for scientific purposes, it would be best if the word 'income' when occurring alone should always mean total real income ...",[9] was viewed with favour by the Carter Commission in its formulation of a "comprehensive tax base". Simons, arguing that income is a good tax base, sought a definition of income which would provide the basis for most nearly equitable levies.[10] He stipulated the requirements of objectivity and quantifiability and defined the accretion concept as

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[5] Smith, *The Synthetic Wealth of Nations*, Graham (ed.) (1937), 282.
[6] *Supra*, note 4, 4.
[7] Haig, *The Concept of Income, The Federal Income Tax Act* (1920), 7.
[8] Fisher, *Elementary Principles of Economics* (1919), 34.
[9] Marshall, *Economics of Industry* (1893), 51.
[10] Simons, *Personal Income Taxation* (1938), 41.

the algebraic sum of consumption expenditures and the change in the taxpayer's net worth over a specified period of time.

Given this accretion concept of income, the task of implementation is viewed as one of maintaining the integrity of the concept without creating insuperable administrative difficulties. It is only against the backdrop of the conceptual definition of income, that administrative efficiency should assume significance. Thus, the doctrine of "realization" is *not* rationalized by the assertion that no income has been generated in any conceptual sense, but rather because of the difficulties involved in valuation without a market transaction, and the attendant problems of liquidity. Similarly, the choice of a calendar year as the yardstick in the computation of tax liability is premised on an artificial but convenient time horizon, regardless of whether the actual process of accretion accrues over a shorter or longer period. Again, the exclusion of imputed income is supported, not because of any rationale inherent in the definition of income, but rather in deference to problems of valuation and administration. Hence, it is submitted that each concession or detraction from the conceptual definition of income should be in response to a clearly articulated and countervailing objective of tax policy, after a considered determination that the specific benefit derived by departure from the concept of income clearly outweighs any corresponding sacrifice in the purity of the concept itself and the objective of equity in a tax structure. It is worthy of emphasis that the concept of income is an *economic* concept, which has been modified by accountants and lawyers to meet the demands of *specific* requirements of objectivity of market determination, convenience of tax administration, and the economic and social policy related to resource allocation.

2. Characterization of the award

Turning from the general theoretical framework of the concept of income and the objectives of tax policy to the specific task of characterization of wrongful dismissal awards, one should ask three questions:

(1) Does the recipient of a wrongful dismissal award improve his economic power or net worth, in a manner capable of objective measurement and quantification? If the answer is in the affirmative, then *prima facie* that *portion* of the award which contributes to the economic net worth of the taxpayer should be included in income for tax purposes, subject to two further questions.

(2) Is it justifiable to treat the damages received for wrongful dismissal in some special manner, owing to the existence of particular

circumstances surrounding such receipt which dictate its exclusion from income?

(3) What is the price to be paid by the tax structure in the event of exclusion of the damages for wrongful dismissal from income, and with what corresponding benefits?

Addressing the first question requires a brief overview of the basic objectives of damage awards for breach of contract, of which wrongful dismissal is merely a sub-set, in order that the specific issue may be placed in perspective.

The underlying principle of the theory of damages in breach of contract actions has been explicitly enunciated on numerous occasions. Nearly a century ago Lord Blackburn articulated the principle in a classic statement; damages should represent "that sum of money which will put the party who has been injured, or who has suffered, in the same position as he would have been in if he had not sustained the wrong for which he is now getting his compensation or reparation".[11] Specifically, in contract actions the successful plaintiff is entitled to be placed, so far as money can do it, in the position he would have occupied *had the contract been performed*, or had his rights been observed. These sentiments have withstood the test of time in various formulations. Thus, Viscount Dunedin stated that "the Common law says that the damages due either for breach of contract or for tort are damages which, so far as money can compensate, will give the injured party reparation for the wrongful act . . .".[12]

This doctrine of compensation in contract damages has been carried forth as entitling the successful plaintiff to the economic "value" of the bargain or his expectational interest. In determining the factual benefit implicit in the "expectation interest" the courts take into account the certainty or uncertainty of the benefit.

Turning from the general theoretical premise of damages in contract to the specific action for wrongful dismissal, one observes a consistency of approach in articulation of the principle. The *prima*

[11] *Livingstone* v. *Rawyards Coal Co.* (1880) 5 App.Cas. 25, 39. See Street, *Principles of the Law of Damages* (1962), 3; Blain J. in *Yetton* v. *Eastwoods Froy Ltd* [1967] 1 W.L.R. 104, 115; Ogus, *The Law of Damages* (1973), 17-21, 283-8.

[12] *Admiralty Commissioners* v. *S.S. Susquehanna* [1926] A.C. 655, 661. See also *Victoria Laundry* v. *Newman* [1949] 2 K.B. 528, 539 (C.A.) *per* Asquith L.J.; *Robinson* v. *Harman* (1848) 1 Ex. 850, 855; 154 Eng.Rep. 363, 365 *per* Parke B. *Czarnikow* v. *Koufos* [1969] 1 A.C. 350, 400 *per* Lord Morris; *British Westinghouse Co.* v. *Underground Ry Co.* [1912] A.C. 673, 689 *per* Viscount Haldane L.C.

facie measure of damages is the contract price, which is all the plaintiff need show. As McGregor suggests, the measure of damages for wrongful dismissal "is *prima facie* the amount that the plaintiff would have earned *had the employment continued* according to contract subject to a deduction in respect of any amount accruing from any other employment which the plaintiff, in minimizing damages, either had obtained or should reasonably have obtained".[13]

The central element in determination of quantum in wrongful dismissal suits revolves around the question: what would the plaintiff have "earned"? The structural heads under which the quantum is computed may, in the case of wrongful dismissal, be identified from judicial decisions. Hence, it is clear that the salary or wages which the defendant had agreed to pay for the services of the plaintiff would be included in determination of the factual benefit implicit in the "expectation interest". In so doing, the courts take into account the certainty or uncertainty of the benefit. This rule is qualified, however, in that where the realization of a benefit is dependent on the discretion of the defendant promisor, then the plaintiff promisee is entitled to no more than the defendant was *legally bound* to do or convey.[14]

Specifically, where contracts are terminable on notice, damages for lost earnings are restricted to those which would have been payable *during the period of notice.*[15] It is dubious whether a breach of contract of employment will ever give rise to an award of nonpecuniary damages as part of the expectation interest. Thus, in *Peso Silver Mines Ltd* v. *Cropper*,[16] the damages award was reduced from $10,000 to $6,500 to reflect salary only, whereas the Trial Judge had added $3,500 for loss of reputation in the mining community. Cartwright J. observed in this context that "the claim being founded on breach of contract the damages cannot be increased by reason of the circumstances of dismissal whether in respect of the respondent's wounded feelings or the prejudicial effect upon his reputation and chances of finding other employment".[17]

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[13] *McGregor on Damages* 13th ed. (1972), 594 (italics added).

[14] Ogus, *supra*, note 11, 310.

[15] *British Guiana Credit Corporation* v. *Da Silva* [1965] 1 W.L.R. 248, 259-60.

[16] [1966] S.C.R. 673; (1966) 56 D.L.R. (2d) 117 (B.C. C.A.).

[17] *Ibid.*, 684. The decision in *Jarvis* v. *Swans Tours Ltd* [1973] 1 All E.R. 71 may reasonably be limited to fact situations *other than* employment contracts; in that decision the award was increased from £31 to £125 for "loss of entertainment and enjoyment" from being put in inferior facilities on vacation.
In a similar vein, compensation for injury to feelings was denied in *Addis* v. *Gramophone Company Ltd* [1909] A.C. 488, 492-493, 501, 504.
So also in *British Guiana Credit Corporation* v. *Da Silva* [1965] 1 W.L.R.

It is important, for the purpose of characterization of the damage award, to bear in mind that damages for wrongful dismissal at common law are *in lieu of notice,* and that the plaintiff cannot insist on being employed by the employer.[18] The essence of the award then is the "*salary and other income* which he [*i.e.* the plaintiff] *would* have earned ... less any amounts actually earned by him [*i.e.* the plaintiff] during the period".[19] Hence, in *Harte* v. *Amfab Products Ltd,*[20] where an employee had been abruptly discharged, the Court found that "the proper notice the plaintiff should have received upon termination of employment was one year. The *maximum* award of damages to which he would therefore be entitled is one year's *salary* less any deductions that should reasonably be made for mitigation". The same principle was followed in *Carter* v. *Bell & Sons,*[21] where the Court implied, as a term in the contract of hiring, an obligation to give reasonable notice of an intention to terminate the employment. So also in *Bardal* v. *The Globe & Mail Ltd*[21a] where the Court observed that "the contractual obligation is to give reasonable notice and to continue the servant in his employment".

Apart from the obvious inclusion of salary, the court may include other forms of earnings where the circumstances warrant such an inclusion. Hence, in *Lindsay* v. *Queens Hotel Co.,*[22] Bray J. in assessing the damages for wrongful dismissal of a domestic servant was willing to include the value of board and lodging, and included these benefits as a component of "the actual pecuniary loss which has been sustained ...". So also in *Addis* v. *Gramophone Company Ltd,* Lord Loreburn L.C. included the value of commissions stating that:

> ... it signifies nothing ... whether the claim is to be treated as for wrongful dismissal or not. In any case there was a breach of contract ... and the damages are exactly the same in either view. They are, in my opinion, the salary to which the plaintiff was entitled for the six months ... together with the commission which the jury think he would have earned ...[23]

248, the Privy Council refused, in an action for wrongful dismissal, to allow damages under the head of "humiliation, embarrassment and loss of reputation". See Lord Donovan at 259 D-E.

[18] Freedland, *The Contract of Employment* (1976), 250-252.

[19] *Wells* v. *Mack Maritime Ltd* [1975] S.H. No. 04567 N.S.S.C. Trial Div. *per* Cowan C.J.T.D. at p.10.

[20] (1970) 73 W.W.R. 561 (B.C.S.C.) (italics added).

[21] [1936] 2 D.L.R. 438, 439; [1936] O.R. 290, 297.

[21a] (1960) 24 D.L.R. (2d) 140, 143.

[22] [1919] 1 K.B. 212-213.

[23] [1909] A.C. 488, 490.

Similarly, tips and commissions were included in the determination of quantum, where it was clearly within the contemplation of the parties that the plaintiff would receive the tips.[24] In other situations, the value of luncheon vouchers,[25] pension schemes,[26] and piece-work[27] have been included in the assessment of damages. At the same time, unemployment insurance receipts may be deducted and justified on the basis that the employer has contributed to the fund.[28]

Given the general enunciations above of the process of quantum determination in actions for wrongful dismissal, the issue presented here is whether the damage award received by a plaintiff in an action for wrongful dismissal should be treated as income for purposes of the *Income Tax Act*[28a] and therefore taxed, or as a capital receipt thereby escaping taxation. Both views have received approval in the past three years. In *Quance* v. *The Queen*,[29] the taxpayer was wrongfully dismissed from his employment. At the outset the employer offered six and one-half months salary, whereas the taxpayer demanded one year's salary in lieu of notice. Eventually the employer offered nine and one-half months salary in lieu of notice, which the taxpayer did *not* agree to. The taxpayer consulted his lawyers, but his demands went unheeded. Despite all protestations, the employer continued to make semi-monthly payments to the plaintiff. In subsequent litigation with the Minister of National Revenue (MNR), the Federal Court of Canada, Trial Division held that the amounts received by the taxpayer were taxable as an income receipt, since the money received by the plaintiff was in satisfaction of a contractual obligation, and that "obligation was to give the plaintiff *reasonable notice* of the termination of his employment and upon failing to do so to pay him, *in lieu thereof*, the salary that would have been earned during the period of notice"[30] (emphasis added). In adopting this approach Cattanach J. followed an "in lieu" theory of income and successfully harmonized the tax treatment of the award with the conceptual and pragmatic purpose of the award itself. He analyzed that damages "for dismissal without notice are to replace the income he was deprived of *by not being given reasonable notice*

[24] *Manubens* v. *Leon* [1919] 1 K.B. 208, 211.

[25] *McGrath* v. *De Soissons* (1962) 112 L.J. 60.

[26] *Bold* v. *Brough, Nicholson & Hall* [1964] 1 W.L.R. 201.

[27] *Devonald* v. *Rosser* [1906] 2 K.B. 728; *Bauman* v. *Hulton Press* [1952] 2 All E.R. 1121.

[28] *Parsons* v. *B.N.M. Laboratories* [1964] 1 Q.B. 95 (C.A.).

[28a] S.C. 1970-71-72, c.63.

[29] (1974) 74 D.T.C. 6210; [1974] C.T.C. 225.

[30] *Ibid.*, 6213 (italics added).

... [and] ... accordingly such an award is imbued with the quality of income...".[31] A consequence of this reasoning was that substance prevailed over form.

In contrast to the above approach is the decision of the Federal Court of Canada, Trial Division in *The Queen* v. *Atkins*.[32] Here the taxpayer was abruptly dismissed from his employment, without warning or explanation. Under threat of litigation, the taxpayer managed to secure a settlement of $18,000 and some fringe benefits and claimed the *entire* amount as tax-free damages. The Minister contended *inter alia*, that the money represented approximately 42 weeks salary, and 42 weeks being a reasonable period of notice, the sum involved was simply salary in lieu of notice.[33] Collier J. rejected the Minister's contentions that the sum represented either salary,[34] a benefit received by virtue of employment,[35] a retiring allowance[36] or a payment in satisfaction of an obligation contemplated in section 6(3)(b), and held the *entire amount* to be non-taxable.

In arriving at his conclusion Collier J. did not reject the *Quance* decision; rather the Court approved of the result in the earlier decision but distinguished it "on the particular facts".[37] The Court accepted that there had been a breach of contract, that the employer company had not given reasonable or any notice, that the taxpayer was entitled to damages for breach of contract, and that the general principles of damages for breach of contract applied to cases of wrongful dismissal.[38] In characterizing the nature of the damages as non-taxable, however, Collier J. was influenced by two considerations:

(1) The fact that damages for wrongful dismissal *may* include sums *other than* salary or wages, although salary or wages would provide one component element; here the Court recognized that older employees and executives might have difficulty in obtaining new employment "not because of lack of ability, but because of their age and the disturbances which might be caused to existing seniority stratas, and because of the difficulties of injecting new middle-aged (or older) persons into pension schemes".[39]

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31 *Ibid.*, (italics added).
32 [1975] C.T.C. 377; (1975) 75 D.T.C. 5263.
33 *Ibid.*, 383.
34 S.C. 1970-71-72, c.63, s.5(1).
35 *Ibid.*, s.6(1)(a).
36 *Ibid.*, s.56(1)(a)(ii).
37 [1975] C.T.C. 377, 387.
38 *Ibid.*, 384.
39 *Ibid.*, 386.

(2) The absence of evidence as to the ingredient sums which went into the computation of the $18,000 figure. In distinguishing the facts from the *Quance* case, the Court specifically mentioned that "[t]here is no evidence that the sum of $18,000 was intended by the employer or by the defendant to represent salary purely and simply, or that other factors deserving of compensation in damages were not included ...".[40] Collier J. rejected the suggested "strong inference" of the Minister that the employer intended to compensate only in respect of loss of salary:

> The evidence is silent. No reasonable inference can be drawn that the company and the defendant considered loss of salary as the sole matter for compensation. Further, it is impossible to say what portion of the $18,000 one, or either, party attributed to that aspect of the defendant's loss... there is ... no evidence as to what the $18,000 covers, nor any practical, realistic, or reasonable means of dissecting it to discover its components.[41]

In light of the reasoning of the Trial Court in the *Atkins* decision, (approved on appeal), several observations may be made. The first consideration that the award *may* contain elements other than salary, and may be influenced by the age of the plaintiff, is not sufficient rationale to metamorphose an income item into a capital receipt. The difficulty which an ex-employee may encounter in obtaining new employment by reason of age or other factors may well be accounted for in determining the period of reasonable notice required to terminate the employment, and thereby indirectly influence the quantum of the award or negotiated settlement. This was the approach adopted in *Bardal* v. *The Globe & Mail Ltd*,[42] where McRuer C.J.H.C. stated that the "reasonableness of the notice must be decided with reference to each particular case, having regard to the character of the employment, the length of service of the servant, the age of the servant and the availability of similar employment, having regard to the experience, training and qualifications of the servant". The second consideration that an award may contain elements other than salary should merely be directed towards the evidentiary burden of computation of the ingredient elements, which burden is usually borne by the *taxpayer*. That this task of dissection is not impossible for a taxing authority or tribunal may be evidenced by the fact that the Tax Review Board, in the *Atkins* case, had managed to arrive at two figures, *viz.* $12,000 as a taxable retiring allowance and $6,000 as a non-taxable receipt.[43]

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[40] *Ibid.*, 387.
[41] *Ibid.*, 388-389.
[42] (1960) 24 D.L.R. (2d) 140, 145; [1960] O.W.N. 253, 255.
[43] Unreported decision of the Tax Review Board.

In the Federal Court of Appeal, however, the Chief Justice (Pratte J. and MacKay D.J. concurring) went further and distinguished the situation where salary is paid as a benefit under the contract or in respect of the contractual relationship, from the situation where the damage award is *measured by reference to the salary*. While the former would be taxable under section 5(1) of the Act, the Court held the latter to be a non-taxable receipt.

As a footnote to the *Atkins* litigation it is interesting to observe that, whereas the Trial Division specifically decided that the payment was *not* a "retiring allowance"[43a] since the taxpayer was "fired", and the Minister did not advance or pursue the retiring allowance argument on appeal, on August 23, 1976 (three months after reasons for judgment were handed down in the appeal) Revenue Canada issued an Interpretation Bulletin[43b] adopting the position that a retiring allowance would *include* those situations where an employee is dismissed prior to the normal date of retirement. In light of the interval between the decision and issuance of the Bulletin, it is presumably the intention of Revenue Canada to restrict the application of the retiring allowance provision to those situations wherein the taxpayer accepts the monetary offer without threat of litigation, *etc.*, and does not intend to cover those situations in which such an amount would be construed as damages.

The major difficulty of decisions in the area of wrongful dismissal has been two diametrically opposed theories of the nature of the receipt. On the one hand, there are those who suggest that a wrongful dismissal award represents replacement of a loss of earning capacity. This group may be categorized as the "capital asset" school, which favours non-taxation of *any portion* of the damage award recovered by the plaintiff, on the premise that such awards compensate for a loss of capacity or a capital asset. *Brown* v. *M.N.R.*[44] illustrates this line of thought. In that case, the Board held the damages received by an ex-employee to be non-taxable, stating that the "amount of damages awarded is *not* an income receipt of the appellant equivalent to the income which he would have received had he been permitted to continue in his employment, *but is a capital receipt paid to him in respect of the destruction of*

43a [1975] C.T.C. 377, 391.

43b I.T. 337, "Retiring Allowances".

43c *Ibid.*, para.4.

44 (1952) 52 D.T.C. 9 (I.T.A.B.).

that right".[45] So also in *Garneau* v. *M.N.R.*[46] the Board, in finding the damages of a wrongfully dismissed physician to be non-taxable stated that the "capital of a profession is the right and privilege of exercising it. To derogate from that right and privilege would impair the capital it represents . . .".[47]

On the other hand, there are those who favour the view that such an award received by the dismissed employee represents, in part at least, a replacement of loss of earnings *per se* during the period of reasonable notice required from the employer. This latter school, epitomized by *Quance*, would argue that *at least* a portion of the plaintiff's damage award is granted "in lieu" of potential earnings lost during the period of notice required, and should be subject to tax.

Which of the above two theories is the more acceptable in the context of wrongful dismissal awards? The answer should surely depend and be formulated in the context of the theory and purpose of damage awards, with an eye on the nature of income and the pragmatic necessity of administering a tax system simply and equitably in light of the objectives of taxation. If the "capital asset" theory is accepted as the correct view, then it may be asked: What is the value of the capital asset that is being replaced? The response would call for valuation of a capital asset as being the equivalent of the present value of future cash flows which are being *compensated in lieu of notice*, at some specified rate of return. The fact that, in wrongful dismissal situations, the period of reasonable notice is usually short and rarely above one year does not detract from the principle, but serves merely to alleviate the practical problem of discounting. Thus, absence of discounting in the computational process of quantum determination becomes an "acceptable" error causing minimal distortion due to the brevity of the period involved. Hence, it becomes readily apparent that the cash flow which is the object being discounted (at least in theory) is the same cash flow which is given *in lieu* of reasonable notice.

The traditional analysis based on conceptual distinctions of the "capital asset" theory and the "in lieu" theory, useful as it is in tax law, can, however, only be carried so far. When one gets to the requirement, as an implicit assumption of the computation, that the plaintiff notionally erode his principal sum on a regular basis,

[45] *Ibid.*, 10 (italics added).

[46] (1968) 68 D.T.C. 132 (T.A.B.) See also Wheatcroft, *The Law of Income Tax, Surtax and Profits Tax* (1962), 1070-71.

[47] *Ibid.*, 136-37.

so that he is compensated and not enriched, the distinction between capital asset and loss of earnings becomes obscure. Ultimately the capital value of any property rights is the discounted present value of expected future cash flows emanating from that property. Thus, it is submitted that, shorn of all its verbal decorations, the traditional analysis of "capital asset" versus "in lieu" earnings is not sufficient to provide a satisfactory solution. For every asset may be viewed from two sides of the same coin. It may be conceived of as the capitalized value of future cash flows, and classified as a sum representing "capacity" or a "capital asset"; but this capital asset represents no more than the substitution of discounted future earnings. Hence, the two theories are essentially different sides of the *same equation.* Viewed in this light, inconsistent tax treatment of different sides of the same equation is premised on illusory and non-existent distinctions, and reduces to an exercise in semantics, with form prevailing over substance.

To escape from this tautological dilemma it is submitted that, insofar as the primary purpose of a wrongful dismissal damage award is compensation, pecuniary and other components represent substitutional sums of money premised on the principle of *restitutio in integrum.* The damage award is computed by calculating an amount in reference to the employee's salary, with this calculated amount being substituted for the salary. This same principle of substitution should be extended in the subsequent tax treatment of the receipt. Thus, substitutions for *initially* taxable components should remain taxable. This category may include, in the context of wrongful dismissal, salary, wages, gratuities,[48] or commissions,[49] or the value of board and lodging.[50] In a similar vein, substitutions for *initially* non-taxable components should continue to be excluded from taxation. This approach would be similar to that suggested by Diplock L.J., in the context of whether an award related to loss of prospective profits or a capital receipt from business. He stated the principle thus:

> Where, pursuant to a legal right, a trader receives from another person compensation for the trader's failure to receive a sum of money which, if it had been received, would have been credited to the amount of profits (if any) arising ... from the trade carried on by him ..., the compensation is to be treated for income tax purposes in the same way as that sum of money would have been treated if it had been received instead of the compensation.[51]

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[48] *Manubens* v. *Leon, supra,* note 24.

[49] S.C. 1970-71-72, c.63, s.5(1); *Addis* v. *Gramophone Company Limited* [1909] A.C. 488.

[50] S.C. 1970-71-72, c.63, s.6(1)(a); *Lindsay* v. *Queen's Hotel Co.* [1919] 1 K.B. 212.

[51] *London and Thames Oil Wharves Ltd* v. *Attwooll* [1967] 2 All E.R. 124, 134 (C.A.) leave to appeal denied.

The question then to be asked is: In substitution of what were the wrongful dismissal damages awarded? The response suggested in this paper is that the portion awarded to replace salary in lieu of notice and other taxable components should be characterized accordingly. Any portion awarded for non-taxable elements should similarly be substitutionally characterized and totally exempt from taxation.

On the basis of the preceding analysis, it is submitted that the response to the earlier questions, as to whether the recipient of a wrongful dismissal award improves his economic power or net worth in a manner capable of objective measurement and quantification, must be unequivocally affirmative. The improvement in net worth is capable of objective measurement by valuing the substitutional sum on which the damages are assessed. Based on this accretion test, the amounts received should *prima facie* be characterized as an income receipt. Of equal importance, however, and the central thrust of this paper, is the submission that given the structure of the *present* Act, the damages awarded to Mr Atkins should have been substitutionally characterized and the amount received, or a part thereof, treated as income under the *existing* Act.

The above recommended substitutional characterization, and the subsequent tax treatment in a manner similar to the treatment afforded the original elements, has several advantages at two levels, conceptual and policy. Conceptually, three advantages may be observed:

(1) This approach promotes the desired and oft-stated objective of compensation in the determination of damage awards.

(2) It enhances the conceptual purity of income theory and conforms to the accretion concept of wealth as enunciated earlier.

(3) It promotes the tax objective of equity by providing for similar treatment for similar items, and avoids tax preferences which are not founded on clearly articulated reasons.

Turning from the conceptual to the pragmatic, the suggested approach has a certain appeal:

(1) It gives effect to the substance of the transaction rather than the form of the negotiations and ultimate settlement documents. In the *Atkins* decision itself, the Court alluded to the fact that a clause of the termination document referred to "severance allowance" and not to "salary".[52] Thus, one author has suggested the avoidance of particular terminology such as "retiring allowance",

[52] *R.* v. *Atkins* [1975] C.T.C. 377, 387.

"severance" or "salary", which may tend to imbue the receipt with the colour of income.[63]

(2) It will tend to promote settlements and avoid unnecessary disputes or litigation. While some disputes and litigation are unavoidable given the usually hostile atmosphere surrounding a wrongful dismissal, the suggested approach should have the effect of confining such legal proceedings to "real" as opposed to "cosmetic" confrontations. The present uncertain and somewhat variable tax status of damages awards, dependent in part on the threat of litigation, may be highlighted from two decisions.

In *Larson* v. *M.N.R.*,[54] the taxpayer, who was a senior executive, was suddenly informed that he was being "let go", and was offered two months salary. The taxpayer claimed one year's salary ($20,000), threatened legal action and settled for $10,000. The Board decided that the award was not taxable and was influenced *inter alia* by the fact that the taxpayer did *not* accept the initial offer, stating that "[h]ad he accepted this proposition the amount so received might well be regarded as a retiring allowance in respect of loss of office or employment".[55] The opposite result was arrived at in *Alexander* v. *M.N.R.*,[56] where the taxpayer's resignation was demanded in return for $30,000. The Board held the amount to be a retiring allowance and therefore taxable because " the payment received by the appellant was not the result or the final outcome of threatened litigation or protracted negotiations in that direction, but nothing more than the first step towards the termination of an uncomfortable situation".[57]

Later the Board observed in the same decision that "[t]he appellant made no attempt to negotiate for a larger amount or to demand other concessions...".[58] These decisions would thereby suggest that the taxpayer may be well advised to have a good fight first, and not to relent too readily once the fight has commenced.

(3) It would avoid the present necessity for deliberate obfuscation both in the computation of the settlement amount and in the drafting of the settlement agreement. Thus, in the interest of tax minimization, there is at the present time a tendency to avoid

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[63] McDonald, "Wrongful Dismissal: Tortious Breach of Contract" in Law Society of Upper Canada, *Special Lectures* (1973), 477, 492.

[54] (1967) 67 D.T.C. 81 (T.A.B.).

[55] *Ibid.*, 83.

[56] *Alexander* v. *M.N.R.* (1971) 71 D.T.C. 664 (T.A.B.).

[57] *Ibid.*, 673.

[58] *Ibid.*

express reference to "salary" or the salary period or mode of payment, or any correlation between the amount paid as damages with the period of reasonable notice. That this self-inflicted obscurity is a response to the existing confusion with regard to the tax treatment of wrongful dismissal awards is understandable.

(4) Finally, the approach suggested in this article would remedy the peculiar and vulnerable position of the dismissed employee in any settlement negotiations. While an employer may deduct the damages payment as a business expense on the premise that the liability was incurred as part of the operations by which the taxpayer earned his income,[59] the employee in negotiations is placed, at least in part, in a disadvantaged position. If the employer, despite the ex-employees protestations, continues to pay the salary equivalent in regular amounts over the same salary period, *e.g.*, weekly, fortnightly or monthly, the ex-employee may find himself within the scope of the *Quance* decision and subject to tax. This negotiating leverage may well be used by an employer to induce the ex-employee to accept a settlement lower than that to which he might otherwise be entitled. While negotiation in the settlement of legal disputes is a function of numerous variables (including the talents and knowledge of the negotiator) this leverage would appear unwarranted, premised as it is on the mere form of payment without any conceptual foundation.

In contrast to the benefits of inclusion of such awards in income, the benefits of exclusion are minimal. It may be argued that exclusion from income promotes simplicity within the tax structure by dispensing with any necessity of allocation into taxable and non-taxable components. The price paid, however, for this simplicity may well be too high to warrant exclusion. Exclusion of damages would work against the taxation policy of equitable distribution of tax liabilities; at the same time it would have no corresponding beneficial impact on the social and economic criteria of the tax structure.

Conclusion

This paper has endeavoured to analyze, in a narrow context, the process of characterization of damage awards for tax purposes in situations of wrongful dismissal. While the topic of damages for wrongful dismissal may in itself be narrow, the task of characterization of receipts and disbursements is one which is of wider import

[59] Following the reasoning of Thorson J. in *Imperial Oil Ltd* v. *M.N.R.* [1948] 1 D.L.R. 305.

and familiar to those involved in legislative, judicial, administrative and advisory functions. It is to be hoped that this process of characterization will be conducted in the wider context of income theory and tax policy objectives and will be rationalized with other spheres of legal and economic activity. The distinguishing characteristics of the approach suggested in this article are its emphasis on equity as being a desirable and the primary objective of a taxation structure, and a broad inclusionary concept of income premised on a theory of substitutional characterization of receipts. Further, extending this reasoning, it is submitted that characterization of damages as a capital gain would merely blunt the thrust of the inequity inherent in preferential treatment, without conceptual reconciliation of the underlying problem.