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Personal Injuries: Should Non-Taxability of Judgements Decrease Award

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PERSONAL INJURIES: SHOULD NON-TAXABILITY OF JUDGEMENTS DECREASE AWARD?

In a recent case[1] the Oklahoma Supreme Court decided that it was not error to have the jury compute an award for loss of earning capacity by an injured railway switchman based on his gross income, without regard to any income taxes which he would have had to pay on such income had he not been injured.[2] By this decision, the Oklahoma Supreme Court followed the great weight of authority refusing to allow income tax consequences to be considered in fixing awards in personal injury cases for future loss of earnings.[3] The reasons

[1] Missouri-Kan.-Tex. Ry. v. Miller, 486 P.2d 630 (Okla. 1971). This award was for $99,000, to a man with a permanent partial disability resulting from crushed feet. His life expectancy was 22.03 years, and his projected gross income for each of those years was $7,801.64.

[2] Such awards are not taxable under INT. REV. CODE of 1954, § 104(a)(2), which provides that gross income does not include "the amount of any damages received (whether by suit or agreement) on account of personal injuries or sickness." *See also* Treas. Reg. § 1.104-1(c) (1960).

[3] Stokes v. United States, 144 F.2d 82 (2d Cir. 1944); Culley v. Pennsylvania Ry., 244 F. Supp. 710 (D. Del. 1965); Jennings v. United States, 178 F. Supp. 516 (D. Md. 1959); Hall v. Chicago & N.W. Ry., 5 Ill. 2d 135, 125 N.E.2d 77 (1955); Spencer v. Martin K. Eby Constr. Co., 186 Kan. 345, 350 P.2d 18 (1960); Oddo v. Cardi, 218 A.2d 373 (R.I. 1966); Hoge v. Anderson, 106 S.E.2d 121 (Va. 1958); Behringer v. State Farm Mutual Auto Ins. Co., 6 Wis. 2d 595, 95 N.W.2d 249 (1959). *See also* Feldman, *Personal Injury Awards: Should Tax-Exempt Status Be Ignored?*, 7 ARIZ. L. REV. 272 (1966); Note, *Damages—Refusal to Instruct Jury to Calculate Loss of Earnings on the Basis of Net Income After Taxes*, 14 VAND. L. REV. 639 (1961). *Contra*, McWeeney v. New York, N.H. & H. R.R., 282 F.2d 34 (2d Cir. 1960), *cert. denied*, 364 U.S. 870 (1960); Moffa v. Perkins Trucking Co., 200 F. Supp. 183 (D. Conn. 1961); Meehan v. Central R.R., 181 F. Supp. 594 (S.D.N.Y. 1960); Grant v. Brooklyn, 41 Barb. 381 (N.Y. Sup. Ct. 1864); British Transp. Comm'n v. Gourley, [1956] A.C. 185 (1955).

given by the courts for such refusal can be divided into four general categories:

1. To allow deduction of income taxes from the plaintiff's recovery would deny the plaintiff the benefit of a tax-free award, thereby thwarting congressional intent;[4]
2. Determination of possible future income tax liability of the plaintiff is too conjectural;[5]
3. The matter of income tax liability is between the plaintiff and the government, and such matter is of no concern to the defendant, under the doctrine of *res inter alios acta;*[6]
4. The average juror would be confused by the complexity of computing the future tax liability of the plaintiff.[7]

These reasons are analyzed below to determine whether or not the majority rule is the best rule.

CONGRESSIONAL INTENT

Congress has always had the power to lay and collect taxes,[8] but could not tax incomes without apportionment among the several states[9] until the ratification of the 16th

[4] Hall v. Chicago & N.W. Ry., 5 Ill. 2d 135, 125 N.E.2d 77 (1955).
[5] Stokes v. United States, 144 F.2d 82 (2d Cir. 1944).
[6] This idea first appeared in the English courts, in the cases of Jordan v. Limmer & Trinidad Lake Asphalt Co., [1946] K.B. 356, and Billingham v. Hughes, [1949] 1 K.B. 643. These English cases were later overruled by British Transp. Comm'n v. Gourley, [1956] A.C. 185 (1955), but not before the idea was picked up by the American courts in the following cases: Hall v. Chicago & N.W. Ry., 5 Ill. 2d 135, 125 N.E.2d 77 (1955), and Missouri-Kan.-Tex. Ry. v. McFerrin, 291 S.W.2d 931 (Tex. 1956).
[7] McWeeney v. New York, N.H. & H. R.R., 282 F.2d 34 (2d Cir. 1960), *cert. denied,* 364 U.S. 870 (1960).
[8] Kerbaugh-Empire Co. v. Bowers, 300 F. 938 (S.D.N.Y. 1924), *aff'd,* 271 U.S. 170 (1924).
[9] Pollock v. Farmers' Loan & Trust Co., 157 U.S. 429 (1895) (declaring the Income Tax Act of 1894 unconstitutional).

Amendment to the Constitution on February 25, 1913.[10] In early decisions involving awards for personal injuries the Commissioner of Internal Revenue could not decide whether such awards were income, and thus taxable, or "capital", and not taxable.[11] In 1918 Congress made amounts received by suit or agreement on account of personal injuries non-taxable, excluding them from gross income.[12] This bill was passed in order to remove any doubt as to whether these amounts were includable in gross income.[13] It is quite possible that Congress never intended to confer any special benefit upon this type of plaintiff, merely desiring that, once the jury had properly computed the award (with deductions for income tax), the plaintiff would be protected against effective double taxation should the Commissioner later determine that such awards were taxable.[14] The only evidence found by this author tending to show a legislative intent to confer an award free from tax considerations to victims of personal injuries was in the opinions of various courts.[15]

[10] U.S. CONST. amend XVI, which states: "The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration."

[11] The Commissioner at first thought that these awards were taxable, likening them to insurance proceeds. However, a short time later, after the Attorney General had advised the Treasury Department that insurance proceeds were "capital", 31 OP. ATT'Y GEN. 304, 308 (1918), the Commissioner reversed his position, and held that insurance proceeds and personal injury awards or settlements were not taxable, 20 TREAS. DEC. INT. REV. 457 (1918).

[12] Revenue Act of 1918, ch. 18, § 213(b) (6), 40 Stat. 1066. The present statute is found at note 2.

[13] H.R. REP. No. 767, 65th Cong., 2d Sess. 9-10 (1919).

[14] Nordstrom, *Income Taxes & Personal Injury Awards*, 19 OHIO ST. L.J. 212 (1958).

[15] Hall v. Chicago & N.W. Ry., 5 Ill. 2d 135, 125 N.E.2d 77 (1955); Dixie Feed & Seed Co. v. Byrd, 52 Tenn. App. 619, 376 S.W.2d 745 (Ct. App. 1963), *appeal dismissed*, 379 U.S. 15 (1964).

FUTURE TAX LIABILITY TOO CONJECTURAL

It has been argued that the computation of one's income tax depends upon such a myriad of facts that it would be extremely difficult to pinpoint with any accuracy the amount of tax which the plaintiff might have incurred on earnings he would have received had he not been injured.[16] Among the factors which serve to greatly alter a taxpayer's liability for income tax are the number of dependents claimed, which may change with time,[17] the amount of charitable contributions, the marital status of the taxpayer,[18] additional deductions at age 65[19] and changes which Congress may make in tax legislation.[20] While all of these things may serve to make a plaintiff's future tax liability less certain, the jury has been called upon to determine many facts which are at least as uncertain, for in determining the amount of an award for loss of future earnings the jury may consider the plaintiff's life expectancy,[21] the effect of injuries on his future earning capacity,[22] the present value of the award,[23] inflation,[24] and the capacity for

[16] Texas & N.O. Ry. v. Pool, 263 S.W.2d 582, 591 (Tex. Civ. App. 1953), *overruled as to form of jury instruction,* Missouri-Kan.-Tex. Ry. v. McFerrin, 291 S.W.2d 931 (Tex. 1956).

[17] *Id.*

[18] *Id.*

[19] Southern Pac. Co. v. Guthrie, 180 F.2d 295 (9th Cir. 1950), *cert. denied,* 341 U.S. 904 (1951), *aff'd on rehearing,* 186 F.2d 926 (1951).

[20] Texas & N.O. Ry. v. Pool, 263 S.W.2d 583 (Tex. Civ. App. 1953), *overruled as to form of jury instruction,* Missouri-Kan.-Tex. Ry. v. McFerrin, 291 S.W.2d 931 (Tex. 1956).

[21] Cole v. Chicago, St. P., M. & O. Ry., 59 F. Supp. 443 (D. Minn. 1945).

[22] Missouri-Kan.-Tex. Ry. v. Edwards, 361 P.2d 459 (Okla. 1961).

[23] Alabama G.S. Ry. v. Carroll, 84 F. 772 (5th Cir. 1898); Coffman v. St. Louis-S.F. Ry., 378 S.W2d 583 (Mo. 1964); Galveston, H. & S.A. Ry. v. Paschall, 92 S.W. 446 (Tex. Civ. App. 1906).

[24] 27 states have allowed the decreased value of the dollar to be considered by the jury in making an award for per-

employment for the rest of the plaintiff's life span.[25] It is of interest that the definite trend in wrongful death actions, which are subject to many of the same considerations as personal injury actions as to the computation of loss of future earnings, seems to be toward allowing a deduction from the deceased's gross income of income taxes which would have been paid had the deceased lived and earned this income.[26]

> Assuredly, the incidence of future income taxes is no more "guess work" and no more difficult of exact calculation than possible future advancement, wage increases and inflation, all matters to be taken into account in calculating future income. Nor is it to be forgotten that mathematical precision in fixing damages is not demanded . . . . Unless such damages take income taxes into consideration, the beneficiaries will

sonal injuries. *E.g.,* Jakubec v. Southern Bus Lines, 31 So. 2d 282 (La. Ct. App. 1947); Kelly v. Neff, 14 So. 2d 657 (La. Ct. App. 1943).

[25] Philadelphia v. Philadelphia Transp. Co., 400 Pa. 315, 162 A.2d 222 (1960).

[26] Hartz v. United States, 415 F.2d 259 (5th Cir. 1969); Cox v. Northwest Airlines, Inc., 379 F.2d 893 (7th Cir. 1967), *cert. denied,* 389 U.S. 1044 (1969); United States v. Sommers, 351 F.2d 354 (10th Cir. 1965); Brooks v. United States, 273 F. Supp. 619 (D. S.C. 1967); Anderson v. United Air Lines, Inc., 183 F. Supp. 97 (S.D. Cal. 1960); De Vito v. United Air Lines, Inc., 98 F. Supp. 88 (E.D.N.Y. 1951); Floyd v. Fruit Indus., 144 Conn. 659, 136 A.2d 918 (1957); Magnolia Petroleum Co. v. Sutton, 208 Okla. 388, 257 P.2d 307 (1953). *Contra,* New York Cent. Ry. v. Delich, 252 F.2d 522 (6th Cir. 1958); Allendorf v. Elgin, J. & E. Ry., 8 Ill. 2d 164, 133 N.E.2d 288 (1956), *cert. denied,* 352 U.S. 833 (1956), *rehearing denied,* 352 U.S. 937 (1957); Wawryszyn v. Illinois Cent. Ry., 10 Ill. App. 2d 394, 135 N.E.2d 154 (App. Ct. 1956); Bergfeld v. New York, C. & St. L. Ry., 103 Ohio App. 87, 3 Ohio Ops. 2d 167, 144 N.E.2d 483 (Ct. App. 1956); Smith v. Pennsylvania Ry., 47 Ohio Ops. 49, 59 Ohio L. Abs. 282, 99 N.E.2d 501 (Ct. App. 1950). The tax status of wrongful death awards is similar to personal injury awards. Rev. Rul. 54-19, 1954-1 CUM. BUL. 179.

accordingly be receiving more than they would have had the deceased lived.[27]

RES INTER ALIOS ACTA DOCTRINE

This doctrine first appeared in English cases dealing with the computation of damages for lost future earnings,[28] setting down the rule that income tax liability is strictly between the plaintiff and the government, and is of no concern to the defendant. "If, by reason of having received these wages, he is compelled to pay a certain amount for income tax, that is a matter between him and the Crown."[29] Although this doctrine has been picked up by several courts,[30] it has drawn sharp criticism from opponents of the collateral source rule, to which it bears a close resemblance.[31] These critics argue that the primary purpose of damages is to restore the plaintiff to his former position,[32] not to punish the defendant.[33] The defendant should not be forced into placing the plaintiff in a better position than he would have been but for the injury, which is the result when the defendant must compensate the plaintiff for lost gross earnings when all the plaintiff would have received was his net earnings after taxes had the plaintiff not been injured. In the case of a plaintiff in a high

[27] Brooks v. United States, 273 F. Supp. 619, 629 (D. S.C. 1967) (a wrongful death action).

[28] Jordan v. Limmer & Trinidad Lake Asphalt Co., [1946] K.B. 356, and Billingham v. Hughes, [1949] 1 K.B. 643. These cases were overruled by British Transp. Comm'n v. Gourley, [1956] A.C. 185 (1955).

[29] Fine v. Toronto Transp. Comm'n, [1946] 1 D.L.R. 221, 223 (1945) (a Canadian case which followed *Jordan*, *supra* note 28).

[30] Atlantic Coast Line Ry. v. Brown, 93 Ga. App. 805, 92 S.E.2d 874 (Ct. App. 1956); Hall v. Chicago & N.W. Ry., 5 Ill. 2d 135, 125 N.E.2d 77 (1955); Missouri-Kan.-Tex. Ry. v. McFerrin, 291 S.W.2d 931 (Tex. Civ. App. 1956).

[31] Rowe, *Damages in Personal Injury Action—Compensatory or Jackpot?*, 57 ILL. B.J. 540 (1969).

[32] C. MCCORMICK, MCCORMICK ON DAMAGES ¶ 137 (1935).

[33] 77 HARV. L. REV. 741 (1964).

tax bracket, the disparity between net and gross earnings can be enormous.[34]

This difference between net and gross income in the case of the high bracket taxpayer has given rise to the McWeeney Rule,[35] which provides that income taxes are deducted from the plaintiff's award for loss of future earnings only where a substantial portion of his gross income would have gone for taxes had he not been injured. Under this rule, an income of $10,000 per year will not have income taxes deducted,[36] while an income of $16,000 per year will be subject to a 15% deduction for income taxes.[37] This rule was attacked in one law review article, in which the author said, "[T]o allow the size of the plaintiff's income to be the controlling factor would discriminate between plaintiffs on a basis having no relation to the amount of damages suffered and would not reduce the conjecturality as to future tax liability."[38] Such criticism would appear justified, for it seems that the courts are legislating their own sliding scale of taxes, determining at what point and by what percentage these awards are taxable. Would it not be better for them to apply the tax schedules already enacted by Congress?

[34] Le Roy v. Sabena Belgian World Airlines, 344 F.2d 266 (2d Cir. 1965). This was a wrongful death action in which it was determined that the deceased would have earned about $16,000 per year. The court allowed a 15% deduction for income taxes, as the amount of tax in this case was too large to be ignored.

[35] McWeeney v. New York, N.H. & H. R.R., 282 F.2d 34 (2d Cir. 1960), *cert. denied,* 364 U.S. 870 (1960).

[36] Montellier v. United States, 202 F. Supp. 384 (S.D.N.Y. 1962), *aff'd,* 315 F.2d 180 (2d Cir. 1963) (a wrongful death action).

[37] Le Roy v. Sabena Belgian World Airlines, 344 F.2d 266 (2d Cir. 1965), *cert. denied,* 382 U.S. 878 (1965).

[38] Note, *Damages—Refusal to Instruct Jury to Calculate Loss of Earnings on the Basis of Net Income After Taxes,* 14 VAND. L. REV. 639 (1961).

EVIDENCE WOULD COMPLICATE TRIAL

There is no doubt that our income tax laws are complicated, with taxable income often composed of income from many sources other than earnings. This fact has made courts wary of allowing any mention of income taxes to arise at trial.

> Inquiries at a trial into the incidents of taxation in damage suits of the character we have here, would open up broad and new matters not pertinent to the issues involved. Such subject matter would involve intricate instructions on tax and non-tax liabilities with all the regulations pertinent thereto. No court could, with any certainty, properly instruct a jury without a tax expert at its side.[39]

While it is true that income tax laws can be complicated, the tax returns of the great majority of Americans are based on income derived almost exclusively from earnings.[40] The average juror is quite familiar with the computation of income tax on this type of income, and can undoubtedly make a good estimate of the tax owed by determining the average number of dependents, exemptions and deductions which the usual plaintiff will have over his projected life span. It is contended that a jury can determine the amount of tax which the plaintiff would have paid on the income he would have earned but for the injury at least as accurately as they can determine the actual lifetime of the plaintiff, the permanency of plaintiff's injuries, the possible earnings of the disabled plaintiff, or the chances for advancement (and thus increased earnings) which the plaintiff had before injury, all of which are already considered by the jury in making an award for loss of future earnings.[41] In those cases where the plaintiff has income from many different sources the court will have to spend much more time hearing evidence determining the

[39] Highshew v. Kushto, 235 Ind. 505, 509, 134 N.E.2d 555, 556 (1956).

[40] F. LUNDBERG, THE RICH AND THE SUPER-RICH 8 *et seq.* (1968).

[41] Nordstrom, *supra* note 14, at 215 *et seq.*

amount of tax to be deducted, but the probabilities are against such cases arising very often.[42]

There is another factor which has arisen in cases involving future loss of earnings which bears some mention. "In the past few years the public press has carried many reports of large sums won on television quiz programs or in lotteries. . . . These accounts almost always point out what a very large percentage of the winnings must be paid to the government as income tax."[43] As a result, there exists a possibility that a jury may believe that the award would be taxable in the same manner as lotteries, etc., and would add an additional amount to the award for taxes which they erroneously believe would have to be paid. To counter this possibility the courts have instructed juries that the awards are not subject to state and federal taxes.[44]

This cautionary instruction has been criticized because it introduces into the trial the matter of income tax, which many courts feel is irrelevant.[45] While this author feels that it is relevant to introduce into a trial all of those factors necessary to arrive at a plaintiff's actual damage, the instruction that an award is non-taxable opens up a Pandora's box of possible erroneous applications of this information by a jury. The jury, once informed that the award is not taxable, might still make their computation on a net earnings basis and would, thus, negate the intended effect of the instruction. It would seem easier for the court, after it has decided that income taxes should not be considered in the fixing of the

[42] F. LUNDBERG, *supra* note 40, at 8 *et seq.*

[43] From the dissent of Chief Justice J. Edward Lumbard in McWeeney v. New York, N.H. & H. R.R., 282 F.2d 34, 41 (2d Cir. 1960), *cert. denied,* 364 U.S. 870 (1960).

[44] Dempsey v. Thompson, 251 S.W.2d 42 (Mo. 1952).

[45] McWeeney v. New York, N.H. & H. R.R., 282 F.2d 34 (2d Cir. 1960), *cert. denied,* 364 U.S. 870 (1960); Hall v. Chicago & N.W. Ry., 5 Ill. 2d 135, 125 N.E.2d 77 (1955); Chicago, R.I. & P. R.R. v. Kinsey, 372 P.2d 863 (Okla. 1962).

award for loss of future earnings, to exclude all mention of taxes at the trial.

CONCLUSION

"How can the jury properly get the right results if it has to work with the wrong facts?"[46] In a society where one is presumed to know the law, it seems ludicrous that we should try to hide from the jury the existence of such a pervasive subject as taxation. Would not justice be better served if the jury were allowed to consider all the factors entering into these awards? The following model is presented as an alternative to the present majority rule.

MODEL

The jury should be informed that the award for future loss of earnings is not taxable, and that they should not, therefore, reimburse the plaintiff for taxes he will not have to pay. The defendant, with the aid of discovery, should be able to compel the production of the income tax returns of the plaintiff for the past five years. The average amount of such taxes shall be presumed to be the highest amount of taxes which the plaintiff would have paid had he not been injured. The plaintiff may offer into evidence any factors which might make this tax less. Once computed, such tax should be deducted from the plaintiff's gross earnings to yield net earnings. Such net earnings should then be discounted to present value, with inflation and the taxability of any interest received from investment of the award being taken into consideration.

This model removes much of the conjecturality inherent in making awards for loss of earnings, as the plaintiff's tax is based on an average of his tax years. Admittedly, this model could not apply to minors or the unemployed, whose earning capacity would have to be determined. The jury, in determining such earning capacity, would have to make the

[46] Rowe, *supra* note 31, at 541.

appropriate deduction for income tax, which, as argued previously, they are quite capable of doing. This deduction of income taxes from the plaintiff's award cannot be against congressional intent, as none has been expressed. Absent evidence of a contrary intent, it would seem wise to follow the general rule of damages, and only restore to the plaintiff that which he has lost. Finally, although the courts may have occasional difficulty in instructing the jury on income tax law, "it is hard to believe that the English language is not broad enough and precise enough to make the jury understand the impact on personal injury awards of section 104 of the Internal Revenue Code of 1954."[47]

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[47] Nordstrom, *supra* note 14, at 212.