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THE JURY, TORT DAMAGES AWARDS, AND FEDERAL INCOME TAXES

A fact of considerable importance to today's defense attorneys in personal injury actions is that damages[1] awards in tort actions are tax-free. "[G]ross income does not include . . . the amount of any damages received (whether by suit or agreement) on account of personal injuries. . . ."[2] More specifically, "The term 'damages received (whether by suit or agreement)' means an amount received . . . through prosecution of a legal suit or action based upon tort or tort type rights, or through a settlement agreement entered into in lieu of such prosecution."[3] In enacting this portion of the Internal Revenue Code Congress evidently viewed tort damages awards as a return of capital which results in no gain to the successful plaintiff, and thus ought not to be taxed to him.[4] This is in keeping with the general compensatory theory underlying all such awards, that the plaintiff should be made whole.[5]

In light of the vast influence of income taxes in our society today, and with the reasonable expectation that this influence will continue and perhaps become even more pronounced in the future, this provision, Section 104 of the Internal Revenue Code, has caused defense lawyers to consider an additional element in their preparations of defenses in tort actions.[6] That element is the effect of taxes, or rather the lack of taxes, on the personal injury award.[7] Essentially income taxes have relevance in two areas which are significant in their effects on the size of damages awards: First, as a deduction from the plaintiff's gross income to arrive at net disposable income in determining both past and future loss of earnings; and second, in the form of a cautionary instruction

1. "Damage" means the loss or injury from which the claim is asserted; "damages" means the money given as compensation for the loss. McCORMICK, DAMAGES § 1 (1935).
2. INT. REV. CODE OF 1954, § 104(a)(2). In this connection also, it should be noted that most State income tax codes have like provisions.
3. Treas. Reg. § 1.104-1(c) (1956).
4. Starrels v. Commissioner, 304 F.2d 574 (9th Cir. 1962).
5. 4 RESTATEMENT, TORTS § 924 (1939).
6. Section 104 was newly enacted into the Code in 1954. Prior to that time taxes were not of such major importance in the American ecomony, and thus did not then attract the attention they are receiving presently.
7. See generally, 26 FORDHAM L. REV. 98 (1957); 69 HARV. L. REV. 1495 (1956); 10 SW. L.J. 80 (1956).

to the jury to prevent it from erroneously adding an amount to an otherwise adequate award which it mistakenly believes will be the plaintiff's tax liability.[8] These implications become clearer with an understanding of the present state of the law in this area.

In the majority of jurisdictions in this country the law is that the subject of income taxes shall not arise in any fashion in tort litigation.[9] The majority rule forbids argument, evidence, or instructions to the jury on the subject of income taxes as they pertain to personal injury actions.[10] The rule apparently originated in this country[11] in a Second Circuit opinion by Judge Frank in which he said: "We see no error in the refusal to make a deduction for income taxes in the estimate of libellant's expected earnings; such deductions are too conjectural."[12] The magic phrase "too conjectural" has been used frequently in those jurisdictions which follow

8. Nordstrom, *Income Taxes and Personal Injury Awards*, 19 OHIO ST. L.J. 212 (1958). Although this discussion is limited to loss of earnings, the same principles and arguments apply to damages for wrongful death and damages for pain and suffering, etc.

9. *Refusing to allow evidence of income tax:* Briggs v. Chicago Great W. Ry., 248 Minn. 418, 80 N.W.2d 625 (1957) (dictum); Hall v. Chicago & N.W. Ry., 5 Ill. 2d 135, 125 N.E.2d 77 (1955); Leming v. Oilfields Trucking Co., 44 Cal.2d 343, 282 P.2d 23 (1955) (dictum); Texas & N.O.R.R. v. Pool, 263 S.W.2d 582 (Tex. Civ. App. 1953); Pfister v. City of Cleveland, 96 Ohio App. 185, 113 N.E.2d 366 (1953) (dictum); Dempsey v. Thompson, 363 Mo. 339, 251 S.W.2d 42 (1952); Smith v. Pennsylvania R.R., 59 Ohio L. Abs. 282, 99 N.E.2d 501 (1950); Stokes v. United States, 144 F.2d 82 (2d Cir. 1944); Combs v. Chicago, St. P., M. & O. Ry., 135 F. Supp. 750 (N.D. Iowa 1955) (dictum); Runnels v. City of Douglas, 124 F. Supp. 657 (D. Alaska 1954); O'Donnell v. Great No. Ry., 109 F. Supp. 590 (N.D. Cal. 1951); Chicago & N.W. Ry. v. Curl, 178 F.2d 497 (8th Cir. 1949).
Allowing such evidence to be introduced: British Transport Comm'n. v. Gourley, [1956] A.C. 185 (1955); Southern Pac. Co. v. Guthrie, 180 F.2d 295 (9th Cir. 1949); Armentrout v. Virginian Ry., 72 F. Supp. 997 (S.D.W. Va. 1947), *rev'd* 166 F.2d 400 (4th Cir. 1948).
Refusing to allow instruction: Briggs v. Great W. Ry., 248 Minn. 418, 80 N.W.2d 625 (1957); Missouri-Kansas-Texas R.R. v. McFerrin, 291 S.W.2d 931 (Tex. 1956); Maus v. The New York, Chicago & St. Louis R.R., 165 Ohio St. 281, 135 N.E.2d 253 (1956); Highshew v. Kushto, 235 Ind. 505, 134 N.E.2d 555 (1956); Mitchell v. Emblade, 80 Ariz. 398, 298 P.2d 1034 (1956); Atlantic Coast Line R.R. v. Brown, 93 Ga. App. 805, 92 S.E.2d 874 (1956); Atherley v. MacDonald, Young & Nelson, Inc., 142 Cal. App. 2d 575, 298 P.2d 700 (1956); Hall v. Chicago & No. W. Ry., 5 Ill. 2d 135, 125 N.E.2d 77 (1955); Combs v. Chicago, St. P., M. & O. Ry., 135 F. Supp. 750 (N.D.W.D. Iowa 1955).
Allowing the instruction: Dempsey v. Thompson, 363 Mo. 339, 251 S.W.2d 42 (1952).
Taken from Nordstrom, *supra* note 8.

10. See the summary of cases and articles in Meehan v. Central R.R., 181 F. Supp. 594, 614 (2d Cir. 1960).

11. *But cf.* an earlier English decision, Fairholme v. Firth & Brown, Ltd., 49 T.L.R. 470 (1933).

12. Stokes v. United States, 144 F.2d 82, 87 (2d Cir. 1944).

the majority view, and it has been used to exclude the subject of taxes in the two areas mentioned above where it is most often sought to be introduced.[13] In a state court case decided the same year as the *Stokes case,* the Nebraska Supreme Court affirmed the refusal of a trial judge to instruct the jury concerning taxes when it requested information on the subject, saying: "We observe nothing in this which could have prejudiced either one of the parties."[14] This case formulated the "Nebraska rule" which, like the federal rule, holds that no mention of taxes is permissible in tort actions.

There are other arguments, of course, for excluding mention of taxes in the presence of the jury. Although Judge Frank's "too conjectural" holding seems the most prominent, two other rationales have been advanced. One is the feeling that the impact of federal taxes is a matter between the plaintiff and the taxing authorities. The defendant has no interest in whether or not a tax is levied.[15] The other is that to allow the introduction of such evidence would upset a well-established precedent.[16] Regardless of the persuasiveness of the rationales adopted in the majority holdings, the fears behind them are less nebulous. Some of the concrete reasons behind the majority view are that a consideration of taxes would permit the wrongdoer's escape of liability to high-bracket plaintiffs;[17] such a consideration would open courtroom doors to a parade of tax experts for both sides;[18] and future tax rates, exemptions, and permissive deductions are subject to such change that any estimate of future impact would be purely speculative.[19] The reasoning of the majority courts was perhaps best expressed in an Indiana decision in which the court said:

> 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

13. *E.g.*, Smith v. Pennsylvania R.R., 59 Ohio L. Abs. 282, 99 N.E.2d 501 (1950); Dempsey v. Thompson, 363 Mo. 399, 251 S.W.2d 42 (1952); Briggs v. Chicago Great W. Ry., 248 Minn. 418, 80 N.W.2d 625 (1957).
14. Creclius v. Gamble-Skogmo, Inc., 144 Neb. 394, 13 N.W.2d 627, 632 (1944).
15. *E.g.*, Hall v. Chicago & N.W. Ry., 5 Ill. 2d 135, 125 N.E.2d 77 (1955).
16. *E.g.*, O'Donnell v. Great No. Ry., 109 F. Supp. 590 (N.D. Cal. 1951).
17. O'Donnell v. Great No. Ry., 109 F. Supp. 590 (N.D. Cal. 1951).
18. *E.g.*, Schnedl v. Rich, 137 So. 2d 1 (Fla. App. 1962).
19. Burns, *A Compensation Award for Personal Injury or Wrongful Death is Tax-Exempt: Should We Tell the Jury?* 14 DE PAUL L. REV. 320, 322 (1965).

> 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.[20]

The minority courts on the other hand have held one of three ways: (1) the jury should be given evidence and argument on the plaintiff's existing tax liability;[21] (2) the jury should be instructed to disregard a consideration of taxes in computing the amount of the ultimate award;[22] or (3) both instructions and evidence should be allowed.[23] The admission of evidence is allowed on the undoubtedly realistic assumption that at the trial the plaintiff is going to introduce evidence of his gross earnings in computing loss of past and future earnings. If the jury accepts that calculation, it is feared the plaintiff will recover something which he has not lost, *i.e.,* the amount of his yearly income tax which would never have come into his hands. It is felt that the plaintiff should recover only his net disposable income or "take-home" pay, and not his gross income.[24] Secondly, an instruction is allowed in order to prevent the jury from "inflating" the award during the course of its deliberations because it does not know the law pertaining to the subject.[25] For example, it is feared that if the jury decides it wants to award the plaintiff $80,000 net, assuming it thinks he will incur about a 20 per cent tax liability on the award, it will award him $100,000 in its ignorance of Section 104. Finally, both evidence and an instruction are allowed because the problems are not mutually exclusive.[26] That is, the solution of one will not necessarily result in the solution of the other. Even though the plaintiff's loss of earnings are calculated on the basis of net income, the jury might still "inflate" the award

20. Highshew v. Kushto, 235 Ind. 505, 134 N.E.2d 555 (1956).
21. *E.g.*, British Transport Commission v. Bourley, [1956] A.C. 185 (1955); Southern Pac. Co. v. Guthrie, 180 F.2d 295 (9th Cir. 1949); Armentrout v. Virginia Ry., 72 F. Supp. 997 (S.D.W.Va. 1947), *reversed*, 166 F.2d 400 (4th Cir. 1948).
22. *E.g.*, Dempsey v. Thompson, 363 Mo. 339, 251 S.W.2d 42 (1952).
23. *E.g.*, Anderson v. United Air Lines, 183 F. Supp. 97 (S.D. Cal 1960).
24. The courts evidence confusion as to what "earnings" actually means in relation to taxes. There are three categories: (1) gross income; (2) adjusted gross income, *i.e.*, income after deductions but before taxes, and; (3) net income, *i.e.*, "take-home" pay.
25. Dempsey v. Thompson, *supra* note 22.
26. Anderson v. United Air Lines, *supra* note 23.

as in the example above. Both are needed, then, to prevent the plaintiff from recovering more than he has actually lost.[27]

Defense attorneys and law journal authors have for some time argued in favor of the minority rule which would allow both evidence of taxes and an instruction concerning the implications of Section 104.[28] The majority rule, they feel, works an unjust result. First of all, they argue, evidence of the plaintiff's past tax liabilities should be admitted so that he doesn't recover his actual loss plus what would otherwise have gone to the government in the form of taxes had he been able to continue working.[29] This could be done, in the minority view, by cross-examining the plaintiff,[30] by cross-examining the actuary who testifies as to the present worth of future income,[31] or, most easily, by introducing in evidence the plaintiff's past tax returns obtained through the discovery procedure.[32] By introducing such evidence, it is said that the proper deduction to be made for taxes in computing lost past earnings could be calculated with certainty, and the tax burden which would have been encountered in the future could be calculated with as much certainty as the amount of future earnings itself.[33] This procedure is allowable in the minority view.[34]

Secondly, to prevent the jury from "inflating" the award because it erroneously thinks in its ignorance of the law, the award will be taxed, the authors and attorneys argue that an instruction on Section 104 is needed.[35] The usual form of instruction requested is as follows:

> You are instructed as a matter of law, that any award made to the plaintiff in this case is not income to the plaintiff within the meaning of the Federal Income Tax Law. Plaintiff is entitled to an award of

27. See, for example, 24 INS. COUNSEL J. 70 (1957).
28. See generally, 11 MIAMI L.Q. 304 (1957); 35 N.C.L. REV. 401 (1957); 4 U.C.L.A. L. REV. 636 (1957).
29. See, for example, DeParq & Wright, *Damages Under the Federal Employers' Liability Act*, 17 OHIO ST. L.J. 430 (1956).
30. Nordstrom, *supra* note 8. *Cf.*, Reeves v. Pennsylvania R.R., 80 F. Supp. 107 (D.D.C. 1948).
31. Nordstrom, *supra* note 8, at 219.
32. As to discovery, see FED. R. CIV. P. 34, 28 U.S.C. § 2072 (1964).
33. Nordstrom, *supra* note 8.
34. Armentrout v. Virginian Ry., 72 F. Supp. 997 (S.D.W. Va. 1947).
35. Burns, *supra* note 19.

> damages. You are to follow the instructions already given by this court in measuring those damages and in no event should you either add to or subtract from that award on account of Federal income taxes.[36]

And finally, dealing with the other majority arguments, the proponents of the minority view argue that although the subject of taxes may be conjectural, it is not "too conjectural."[37] They feel that many of the elements which go to make up the general damages award are conjectural. For instance, future earnings, they say, are conjectural to the extent that they determine the plaintiff would have made neither more nor less than he has made in the past. On the other hand, to assume that there would have been any change would be equally the product of conjecture.[38] Some courts, recognizing the former problem, have even allowed the plaintiff to show that he would actually have had more earnings in the future but for the fact that he was incapacitated.[39] It is also felt that the reduction of the plaintiff's award to present value to reflect the earning power of the plaintiff's money in the future is conjectural or speculative. The discount tables used in calculating the reduction to present value seem reliable enough, but they make no allowance for inflation and do not consider the dollar's future value.[40] The reduction of the lump sum award to present value is interesting in itself, as it anticipates the investment of the award by the plaintiff by which he will realize a return equal to the going rate of interest. The interest which he realizes on the investment is taxable to him as ordinary income,[41] and the plaintiff will want to show this fact at the trial if the subject of taxes is brought up.

The second argument, that the matter of taxes is between the plaintiff and the government,[42] is said to be of even less force. Although it is recognized that the income a man has is his own business and the exact amount of tax he pays on

36. Anderson v. United Air Lines, *supra* note 23.
37. Burns, *supra* note 19.
38. *Ibid.*
39. *E.g.*, Burlington Transp. Co. v. Stoltz, 191 F.2d 915 (10th Cir. 1951); Annot., 12 A.L.R.2d 611; Turrietta v. Wyche, 54 N.M. 5, 212 P.2d 1041 (1949).
40. Nordstrom, *supra* note 8, at 227.
41. INT. REV. CODE OF 1954, § 61.
42. Dempsey v. Thompson, *supra* note 22.

that income is, in most instances, likewise his own business, it is felt that whether or not he does pay taxes is of public concern; and when he ceases to pay taxes the public has a legitimate interest in the manner and amount by which he is relieved of his burden.[43] Besides, it is argued, once the plaintiff has brought his action and has attempted to recover an amount based on his gross income, the matter is no longer one between the taxpayer and his government, but one between the plaintiff and the defendant. The government is now out of the picture because of the tax-exempt status of the plaintiff's recovery under Section 104 and the defendant is in the picture because he is being called upon to pay money which would otherwise have gone to the government.[44]

The final argument, that precedent would be upset to allow discussion of taxes, appeals only slightly to the minority. It is felt that there is ample precedent in the minority jurisdictions for those courts which can find none in their own, and that courts should not allow good precedent to make bad law.[45]

Although the minority view advocates have propounded some convincing arguments as to why the subject of taxes should be admitted in tort actions, the majority rule still appears to be adhered to,[46] and there appears to be no great movement by the courts to adopt the minority rule. Although the minority has met the arguments of the majority, there may be other arguments in favor of the majority rule which have been overlooked. One such possible argument is that evidence and instructions concerning taxes would simply complicate and prolong the already complicated and lengthy personal injury actions, and in the final analysis use of such evidence and instructions would neither add to the trial nor make an appreciable change in the jury's verdict. The basis of this argument might be that evidence and instructions are of relatively little significance to the jury, considering the manner in which it ultimately arrives at an award in a personal injury case.

43. Burns, *supra* note 19, at 320.
44. *Ibid.*
45. *E.g.*, Ray v. Tucson Medical Center, 72 Ariz. 22, 230 P.2d 220 (1951).
46. Nordstrom, *supra* note 8.

"It is a major characteristic of the jury's approach to damages that it does not concern itself with the damage components as an accountant might but searches for a single sum that is felt to be appropriate."[47] It is felt by some authorities that the jury, in spite of the law and the instructions of the courts, applies a system of comparative negligence in determining damages awards.[48] That is, if the plaintiff has been only slightly negligent, or not negligent at all, and the defendant has been more negligent than the plaintiff or grossly negligent, then the plaintiff recovers a relatively large lump sum award which is considered by the jury to be just and fair according to its notions of these concepts. If the situation is the converse, then the plaintiff recovers nominal damages or nothing at all.[49] In any event, it is felt that it is the single, final, lump sum amount which the jury decides upon, not based upon deliberations over small component sums, but based upon the jury's evaluation of how much in the overall the plaintiff should recover in light of what the defendant has done.[50] If this is true, then there may be no reason to further prolong tort litigation by arguing about evidence of taxes and instructions on the subject. Even though nothing is said by counsel or the court on the issues of taxes, the jury may consider them in some quantitative way; and it may allow them to influence the size of the final award, if they have any relevance in the jury's view. This is the so-called "silent instruction," and it occupies the same position in the trial that the subject of insurance occupies, *i.e.,* although nothing is said about it the jury, in its collective experience and knowledge, knows it is there and considers it for what it is worth. "Judges consign [damages questions] to juries with a minimum of guidance, occasionally observing loosely that there are no rules for assessing damages in personal

47. Kalven, *The Jury, The Law and the Personal Injury Damage Award,* 19 OHIO ST. L.J. 158, 161 (1958). The author bases his conclusions in heavy reliance on Professor Kalven's observations concerning how the jury operates in reaching a verdict in personal injury actions.

48. For a discussion of this view based on the long experience and careful observations of a trial judge, see ULMAN, A JUDGE TAKES THE STAND, 31, 33 (1933).

49. *Ibid.* For further judicial sanction of this view, see Galena & Chicago Union R.R. v. Jacobs, 20 Ill. 478 (1858).

50. See also PROSSER, COMPARATIVE NEGLIGENCE, SELECTED TOPICS ON THE LAW OF TORTS, 30-39 (1954).

injury cases."[51] Component instructions "would . . . in general . . . increase damages rather than . . . deflate them."[52]

That the jury may operate in this way has come as a shock to many, but observations indicate that over a period of time the results are fair.[53] Although judges may be expected to base their judgments, in trials in which the jury has been waived, according to the strict principles of applicable law, it has been shown that in the end the judges' judgments do not differ appreciably from the juries' verdicts in tort cases.[54] As long as the end product is the type of result which the public desires from our legal system, it would seem to be immaterial what procedure is followed in achieving such a result.

The landmark case in support of this thesis is *Borzea v. Anselmi,*[55] decided by Chief Justice Blume of the Wyoming Supreme Court in 1952. In the *Borzea* case the plaintiff was suing for loss of earnings resulting from total permanent disability caused by an automobile accident. At the trial the jury awarded the plaintiff $21,536.85 for loss of future earnings, and the defendant appealed contending that the court erred in failing to instruct the jury that any award for loss of future earnings should be reduced to present worth on the basis of statutory interest tables. Judge Blume, in his opinion, complied to the letter of the statute in calculating the plaintiff's loss of future earnings as reduced to present value and, in addition, deducted the plaintiff's *estimated future tax liability!* "And let us be as liberal to the appellants as we can and agree with them that since the withholding income tax of the Federal Government never gets into the hands of the workman, his actual wage was his 'take home' pay. . . ."[56] After following the complicated statutory tables requiring reduction to present worth, and after making a further deduction for taxes which the *defendant had not requested at the trial,* Judge Blume arrived at a figure of $23,286.86, which

51. Kalven, *supra* note 47, at 158-159. See particularly, Nordstrom, *supra* note 8, Burns *supra* note 19. The author drew much valuable source material from both articles.
52. Kalven, *supra* note 47, at 161.
53. Kalven, *supra* note 47; *Ulman, op. cit. supra* note 48.
54. Kalven, *supra* note 47.
55. Borzea v. Anselmi, 71 Wyo. 348, 258 P.2d 796 (1952).
56. *Id.* at 383, 258 P.2d at 808.

amount he would have awarded the plaintiff. Comparing the jury's verdict of $21,536.85 with Judge Blume's result of $23,286.86, it may be seen that the Judge would have given the plaintiff $1,750.01 *more* than the jury awarded him. As a result of this, the Judge said: "Taking all the facts and circumstances in this case into consideration, we are unable to say that the amount allowed is excessive."[57] It is fairly obvious that the jury proceeded in an entirely different manner than did the appellate Judge, because it had no instruction concerning the two items of income taxes and present worth; but its result was so close as to make the difference negligible. "So it is quite apparent that either by accident or design, they took the present worth of future earnings into consideration with the like effect as though a specific instruction on the subject had been given."[58] Whether or not the jury reached its figure "by accident or design," the Supreme Court was satisfied that the jury reached a just result and it affirmed the decision.

On the basis of the results of studies made concerning the mechanics of decision-making in the jury room, it may be that the silent instruction, which mentions nothing at all about the matter of taxes, will suffice in personal injury cases to achieve the desired result. The majority rule may be the better rule if the jury would decide the same way whether or not the subject of taxes is introduced into the trial, as it would make tort trials shorter, less complicated, and less expensive. "Damages even more that negligence itself is law written by the jury."[59] If the jury is presently writing good law, there may be no need to change it by court order. If the end product of the jury function in awarding damages is desirable and in line with public policy, perhaps we should not tamper with it. "[T]he law recognizes that the computing of damages involves a complex value judgment as well as a literal determination of fact."[60] Perhaps that complex value judgment may best be left to the jury which is able to work it out satisfactorily without the unnecessary burden of additional evidence and instructions.

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57. *Id.* at 385, 258 P.2d at 809.
58. *Id.* at 379, 258 P.2d at 807.
59. Kalven, *supra* note 47, at 159.
60. *Id.* at 161.