Taxation and Personal Injury Awards: The Search for Workable Guidelines

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TAXATION AND PERSONAL INJURY AWARDS: THE SEARCH FOR WORKABLE GUIDELINES

The definition of gross income set forth in section 61(a) of the Internal Revenue Code (the "Code") includes all items not specifically excluded by statute.¹ Section 104(a)(2) of the Code excludes from this definition amounts received as damages for personal injuries.² Two issues have arisen with respect to this exclusion. The

¹ I.R.C. § 61(a) (1982 & Supp. IV 1986). Section 61(a) lists fifteen common items of gross income including compensation for services, rents, royalties, interest, alimony payments, and annuities. Id. The accompanying regulations state that gross income is not limited to those items enumerated in section 61 and list several additional miscellaneous items of gross income for purposes of illustration. See Treas. Reg. § 1.61-14(a) (as amended in 1965) (including, inter alia, punitive damages and illegal gain). Furthermore, the United States Supreme Court has held that the statutory language indicates that Congress intended to exert the full force of its taxing power. Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 429 (1955). Consequently, section 61(a) has been liberally construed "in recognition of the intention of Congress to tax all gains except those specifically exempted." Id. at 430.

² I.R.C. § 104(a)(2) (1982). The section provides:
(a) In general
   Except in the case of amounts attributable to (and not in excess of) deductions allowed under section 213 (relating to medical, etc., expenses) for any prior taxable year, gross income does not include—
   . . . .
   (2) the amount of any damages received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal injuries or sickness . . . .

Id. Damages are defined by the regulations as amounts 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." Treas. Reg. § 1.104-1(c) (as amended in 1970). The exemption extends to awards for nonphysical personal injuries including defamation. Hawkins v. Commissioner, 6 B.T.A. 1023, 1025 (1927). It does not, however, extend to amounts awarded to compensate damages arising from business injuries because such injuries have not been classified as personal injuries. See Roemer v. Commissioner, 716 F.2d 693, 699 (9th Cir. 1983). Historically, this exclusion also applied to wrongful death recoveries. See Ander-
first is whether the gross (before-tax) income rule or the net (after-tax) income rule should be applied when calculating damages. This issue arises because the exclusion from gross income extends to amounts received as compensation for lost earnings. A majority of jurisdictions apply the “gross income rule,” under which evidence of the amount of income tax that would have been paid by the plaintiff is excluded and lost earnings are calculated based on the plaintiff’s gross income. Under the minority rule, evidence of the income tax which would have been payable on lost earnings is admissible and lost earnings are then calculated based on after-tax income.

See v. United Air Lines, 183 F. Supp. 97, 97 & n.1 (S.D. Cal. 1960); Rev. Rul. 75-45, 1975-1 C.B. 47; Rev. Rul. 54-19, 1954-1 C.B. 179, 180. Recently, however, the Internal Revenue Service (“IRS”) reversed its prior position, holding that the proceeds of a claim under Alabama’s wrongful death statute were not excludable under section 104(a)(2). Rev. Rul. 84-108, 1984-2 C.B. 32, 34. Relying on Alabama case law which construed wrongful death damages as punitive, the IRS reasoned that the amount was not received on account of a personal injury. Id. However, one federal district court sitting in Alabama did not follow this ruling, stating that “Revenue Ruling 84-108 constitutes an unwarranted administrative amendment of the clear language of the Internal Revenue Code and cannot stand.” See Burford v. United States, 642 F. Supp. 635, 636 (N.D. Ala. 1986).

The exclusion from gross income of damages received for personal injuries does not apply to amounts received as reimbursement for medical expenses that the taxpayer has deducted on a prior year’s income tax return under section 213. I.R.C. § 104(a) (1982). An award which includes reimbursement for previously deducted medical expenses must be reported as income in the year it was received to the extent of the amount of the previous deduction. Treas. Reg. § 1.213-1(g)(1) (as amended in 1979); see Frolik, The Convergence of I.R.C. § 104(a)(2), Norfolk & Western Railway Co. v. Liefelt and Structured Tort Settlements: Tax Policy “Derailed,” 51 FORDHAM L. REV. 565, 568-69 (1983).

See v. Humble Oil & Ref. Co., 443 F.2d 1245, 1249-50 (3d Cir.), cert. denied, 404 U.S. 883 (1971); see also Klawonn v. Mitchell, 105 Ill. 2d 450, 453, 475 N.E.2d 857, 858 (1985) (exemption applies to compensation for losses of both past and future wages despite fact that wages would have been taxed had victim not been injured); Rev. Rul. 85-97, 1985-2 C.B. 50 (entire amount received as settlement of personal injury suit, including amount allocable to loss of wages, is excludable from gross income). The IRS, however, has not been consistent in its application of the exemption for damages received on account of lost earnings due to personal injury or sickness. See Jaeger, Owens & Fields, Taxability of Damages—An Analysis of the Current IRS Position, 18 TAX ADVISER 432, 432 (1987).

See Johnson v. Manhattan & Bronx Surface Transit Operating Auth., 71 N.Y.2d 198, 206, 519 N.E.2d 326, 330, 524 N.Y.S.2d 415, 419 (1988). The primary rationale given by courts applying the gross income rule is that future income tax laws are too speculative to allow prediction of a person’s future income taxes. See, e.g., Flannery v. United States, 297 S.E.2d 433, 440 (W. Va. 1982), cert. denied, 467 U.S. 1226 (1984); Reeves v. Louisiana & Ark. Ry., 304 So. 2d 370, 377 (La. Ct. App.), cert. denied, 305 So. 2d 125 (La. 1974); see also infra notes 49-52 and accompanying text (discussing factors that must be predicted). Courts also suggest that Congressional intent to confer a humanitarian benefit upon tort victims is frustrated if only the tortfeasor may reap the benefit of the tax savings. See Lumber Terminals, Inc. v. Nowakowski, 36 Md. App. 82, 98, 373 A.2d 282, 292 (1977); see also infra notes 71-76 and accompanying text (discussing confusion in various state courts as to proper situations in which to apply gross income rule).
The second issue arising with respect to section 104(a)(2) is whether or not the jury should be instructed that damage awards are not subject to federal income tax. Here, too, there has been disagreement among the courts. The traditional approach has been to disallow an instruction that damage awards are tax exempt. However, an increasing number of courts have held that the instruction is discretionary with the trial judge, while others have even held that the instruction is mandatory.

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6 See Frolik, supra note 2, at 583. Initially, this issue arose when defendants began requesting an instruction that the award was exempt from income tax on the theory that juries ignorant of section 104(a)(2) would assume the award was taxable and possibly increase the award to compensate the victim for those taxes. See Nordstrom, Income Taxes and Personal Injury Awards, 19 OHIO ST. L.J. 212, 213 (1958); Note, Damages—The Role of Income Tax Exemption in Actions for Personal Injuries—Dempsey v. Thompson, 251 S.W.2d 42 (Mo. 1952), 32 TEX. L. REV. 108, 110-11 (1953); see also Comment, Income Taxation and the Calculation of Tort Damage Awards: The Ramifications of Norfolk and Western Railway v. Liepelt, 38 WASH. & LEE L. REV. 289, 292, 294 (1981) (court extended latitude by allowing evidence relating to taxes in jury instruction).


8 See, e.g., Bach v. Penn Cent. Transp. Co., 502 F.2d 1117, 1123 (6th Cir. 1974) (not reversible error in personal injury action to advise jury that award will not be subject to federal income tax); Nichols v. Marshall, 486 F.2d 791, 794 (10th Cir. 1973) (same); Anderson v. United Air Lines, 183 F. Supp. 97, 97-98 (S.D. Cal. 1960) (within discretion of trial judge to include instruction explaining tax consequences); Yukon Equip., Inc. v. Gordon, 660 P.2d 428, 433-34 (Alaska 1983) (instruction properly denied absent showing that juries in general increase recoveries in amount of taxes or that particular court increased verdict by amount of taxes); Fox v. Pacific Southwest Airlines, 133 Cal. App. 3d 565, 571, 184 Cal. Rptr. 87, 90 (1982) (although proper to give instruction, refusal to do so not error since income tax instruction can be confusing); St. John's River Terminal Co. v. Vaden, 190 So. 2d 40, 42 (Fla. Dist. Ct. App. 1966) (not error to refuse instruction), cert. denied, 200 So. 2d 814 (Fla. 1967).

9 See, e.g., Domeracki v. Humble Oil & Ref. Co., 443 F.2d 1245, 1251 (3d Cir.) (few members of general public aware of exemption; instruction will dissuade juries from increasing award), cert. denied, 404 U.S. 883 (1971); Blanchfield v. Dennis, 292 Md. 319, 327, 438 A.2d 1330, 1334-35 (1982) (potentially harmful error not to proffer requested instruction);
This Note will examine the inherent complexities of the net income rule, and suggest that some courts' efforts to reach a middle ground by allowing evidence in some cases but not others simply adds to the inconsistencies already existing in this area. It will be suggested that under current Code section 104(a)(2), the gross income rule is preferable. Furthermore, suggested amendments to this section that would repeal the tax exemption for amounts paid as lost earnings, thereby bringing it into conformity with generally accepted tax theory, will also be examined. Finally, this Note will discuss the anomaly that exists when a court instructs a jury that an award is not subject to taxation, yet further instructs that income taxes are irrelevant and should not be considered in calculating a damage award. This Note will suggest that the question of whether a jury should be instructed on the nontaxability of an award should be left to the discretion of the trial judge, and that the court should allow such an instruction only if the issue has been brought to the jury's attention during trial or if a juror has made such an inquiry.

GROSS VERSUS NET INCOME

The predecessor of section 104(a)(2) was enacted in 1919 and, until its 1983 revision, reappeared in subsequent statutes with few substantive changes. The section received scant attention in

Dempsey v. Thompson, 363 Mo. 339, 342, 251 S.W.2d 42, 45 (1952) (sensible to instruct jury that any award they grant will not be subject to federal or state income taxes); Bussell v. DeWalt Prods. Corp., 105 N.J. 223, 229, 519 A.2d 1379, 1382 (1987) (when requested, trial court should instruct jury as to nontaxability of damage award).


11 The most significant amendment to section 104(a)(2) was enacted in 1983. See I.R.C. § 104(a)(2) (Supp. IV 1986). Congress amended the section to exclude from income damages received "whether as lump sums or as periodic payments." Id. The legislative intent was to provide statutory certainty that periodic payments were excludable. See S. Rep. No. 646, 97th Cong., 2d Sess. 4, reprinted in 1982 U.S. CODE CONG. & ADMIN. NEWS 4580, 4583.

The passage of this amendment encouraged the use of structured tort settlements. See Frolik, supra note 2, at 566, 572-74. However, since a portion of each periodic payment received pursuant to the structured settlement represents interest to the recipient, "excluding the entire amount of these periodic payments from gross income produces 'horizontal'
its early years, undoubtedly because individual income tax rates were relatively insignificant prior to the 1940's.12 As income tax rates increased, however, defendants in personal injury actions began to argue that it was inequitable to calculate damages for lost earnings based on gross income without making a reduction for taxes saved.13 They argued that the party being compensated would not have received such a large amount had he not been injured.14 Hence, defendants maintained that the gross income rule resulted in overcompensation to the plaintiff and that the net income rule should have been applied.15 In response, advocates of the gross income rule argued that the net income rule contravened the humanitarian intent of Congress,16 unnecessarily complicated a jury's award calculation17 and ignored economic realities.18

The New York Court of Appeals recently addressed these contentions in Johnson v. Manhattan & Bronx Surface Transit Operating Authority.19 In Johnson, the mother of a deceased child brought a wrongful death action.20 At trial, the defendant sought inequities in the tax treatment of personal injury claimants. Those claimants who accept a deferred payment arrangement receive more favorable tax treatment than those claimants who accept lump-sum settlements." Id. at 566. The inequity arises because the claimant receiving a lump sum settlement will be taxed on any interest earned on investment of the award. Rev. Rul. 65-29, 1965-1 C.B. 59.

See Nordstrom, supra note 6, at 212.

See Stokes v. United States, 144 F.2d 82, 87 (2d Cir. 1944). The Stokes court was the first to address the issue, holding that deductions from a personal injury award for income tax were "too conjectural." Id.

See Chapman, supra note 10, at 416. The law of damages attempts to put the plaintiff in as good a position as if he had not been injured. See, e.g., Great Am. Surplus Lines Ins. Co. v. Bass, 486 So. 2d 789, 793 (La. Ct. App.), cert. denied, 489 So. 2d 245 (La. 1986); Abbinett v. Fox, 103 N.M. 80, 86, 703 P.2d 177, 183 (1985) (principal of making injured party whole); see also W. KEETON, D. DOBBS, R. KEeton & D. OWEN, PROSSER AND KEETON ON THE LAW OF TORTS § 2, at 7 (5th ed. 1984) ("primary purpose is to compensate for damage suffered at the expense of the wrongdoer"); J. STEIN, DAMAGES AND RECOVERY, PERSONAL INJURY AND DEATH ACTIONS § 1 (1972) (goal of returning plaintiff to status quo).

See Burlington N., Inc. v. Boxberger, 529 F.2d 284, 292 (9th Cir. 1975).

See Hall v. Chicago & N.W. Ry., 5 Ill. 2d 135, 151-52, 125 N.E.2d 77, 86 (1955); Frolik, supra note 2, at 566; see also infra notes 67-70 and accompanying text (discussing humanitarian intent).

See, e.g., Frankel v. United States, 321 F. Supp. 1331, 1349 (E.D. Pa. 1970) ("Under our present complicated tax laws, the possibilities that a fact finder would have to consider defy imagination."); aff'd, 466 F.2d 1226 (3d Cir. 1973); Highshef v. Kushito, 135 N.E.2d 251, 256 (Ind. 1956) (discussing numerous variables to consider); see also infra notes 47-52 & 73-76 and accompanying text (same).

See Frolik, supra note 2, at 566.


Id. at 202, 519 N.E.2d at 327, 524 N.Y.S.2d at 417.
to introduce evidence of the decedent's after-tax income in the calculation of damages based on lost earnings. The trial court disallowed this evidence. On defendant's appeal, the Appellate Division, First Department, upheld the trial court's ruling. The Court of Appeals subsequently affirmed the First Department, holding that "no deduction or consideration of after-tax net should be allowed into evidence or charged to the jury." A contrary rule, the court stated, would "inject an unacceptably speculative and distracting feature into the jury's consideration of damages." Writing for the court, Judge Bellacosa found support in recent New York legislation specifically authorizing the consideration of after-tax income in personal injury and wrongful death actions based on medical or dental malpractice. The court stated that the statute "clearly suggests that any expansion of these rules for now should come from the Legislature," and that it was "pertinent to note that this limited statutory authorization came about in the context . . . of the . . . insurance and liability crises." Judge Bellacosa acknowledged that the decision was contrary to that in *Norfolk & Western Railway v. Liepelt*, the leading United States Supreme Court decision for cases brought under the Federal Employers' Liability Act ("FELA").

In *Liepelt*, the Supreme Court held that the effect of income taxes should be considered in calculating lost earnings in cases arising under FELA. Writing for the majority, Justice Stevens rejected the argument that income taxes are too conjectural and too

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21 *Id.* at 201, 519 N.E.2d at 327, 524 N.Y.S.2d at 416.
22 *Id.* at 201, 203, 519 N.E.2d at 326, 328, 524 N.Y.S.2d at 416, 417.
23 *Id.* at 203, 519 N.E.2d at 328, 524 N.Y.S.2d at 417.
24 *Id.* at 204, 519 N.E.2d at 328-29, 524 N.Y.S.2d at 418.
26 *Johnson*, 71 N.Y.2d at 205, 519 N.E.2d at 329, 524 N.Y.S.2d at 418-19.
27 *Id.*
28 444 U.S. 490 (1980); see *Johnson*, 71 N.Y.2d at 204, 519 N.E.2d at 328-29, 524 N.Y.S.2d at 418.
30 *Liepelt*, 444 U.S. at 493-94. *Liepelt* involved a wrongful death action brought under FELA. *Id.* at 491. The jury returned a verdict in favor of the plaintiff in the amount of $775,000, despite the existence of expert testimony offered by defendant calculating the plaintiff's net pecuniary loss at $138,327. *Id.* at 492. On appeal, the appellate court held that it was "not error to exclude evidence of the effect of income taxes on future earnings of the decedent." *Id.* at 491 (quoting *Liepelt* v. Norfolk & W. Ry., 62 Ill. App. 3d 653, 669, 378 N.E.2d 1232, 1245 (1978)).
complex for a jury to consider. Justice Stevens likened taxes to other factors routinely considered in calculating lost earnings, such as the future health of the plaintiff, future interest rates, and future inflation, pointing out that these issues are also subject to estimation and prediction. He further noted that application of the net income rule logically requires application of the “add-back” rule, which, once the initial calculation is made on an after-tax basis, requires the “add back” of interest projected to be earned from investment of the award. Justice Stevens determined that the necessity of this further adjustment did not preclude the use of the after-tax calculation. Finally, Justice Stevens rejected the argument that the net income rule runs contrary to a humanitarian intent of Congress, stating that he found no evidence of such an intent in the legislative history of section 104(a)(2).

Dissenting, Justice Blackmun, joined by Justice Marshall, suggested two probable purposes for the exclusion from gross income of amounts received as damages for personal injuries. The first was the intent of Congress “to confer a humanitarian benefit on the victim . . . of the tort.” Justice Blackmun noted that if this

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31 Id. at 494. Justice Stevens stated that “effective methods of presenting the essential elements of an expert calculation in a form that is understandable by juries [have been developed].” Id.

The argument that evidence regarding future income taxes is too conjectural or speculative for the jury has been proffered since the early cases addressing the issue. See, e.g., Stokes v. United States, 144 F.2d 82, 87 (2d Cir. 1944) (no error in court's refusal to deduct income tax because such deductions too conjectural); Dempsey v. Thompson, 363 Mo. 339, 345-46, 261 S.W.2d 42, 45 (1952) (jury should be instructed not to consider taxes in fixing amount of award because they cannot be accurately estimated); Smith v. Pennsylvania R.R., 47 Ohio Op. 49, 54, 99 N.E.2d 501, 504 (Ct. App. 1950) (per curiam) (deduction of income tax no more speculative than many other factors considered). But see Floyd v. Fruit Indus., 144 Conn. 659, 672, 136 A.2d 918, 925 (1957) (factor of income tax no more speculative than other factors submitted to jury).

32 Liepelt, 444 U.S. at 494; see also Floyd, 144 Conn. at 672, 136 A.2d at 925 (income taxes no more speculative than many other factors considered). But see McWeeny v. New York, N.H. & H.R.R., 282 F.2d 34, 36 (2d Cir.) (difficulties of one element in formula does not justify addition of another), cert. denied, 364 U.S. 870 (1960).

33 See Liepelt, 444 U.S. at 495; see also infra notes 53-55 and accompanying text (discussing add-back rule).

34 Liepelt, 444 U.S. at 495.

35 Id. at 496 n.10. The legislative history of the statute as originally enacted suggests only that Congress believed it doubtful that the law required amounts received as damages for personal injuries to be included in gross income under the sixteenth amendment. H.R. Rep. No. 767, 65th Cong., 2d Sess. 9-10 (1918); see Chapman, supra note 10, at 414; Nordstrom, supra note 6, at 222; infra note 69 and accompanying text.

36 See Liepelt, 444 U.S. at 501-02 (Blackmun, J., dissenting).

37 Id. at 501 (Blackmun, J., dissenting).
was indeed a purpose, the net income rule would not only destroy the humanitarian benefit, but would, in fact, transfer the benefit from the victim to the tortfeasor.

The second probable purpose suggested by Justice Blackmun was a Congressional desire to avoid imposing the burdensome task of approximating the tax when computing an award. Justice Blackmun pointed out that if Congress decided it was not worth the effort to estimate the victims' tax liability "on behalf of the public fisc, it is unlikely that it would want to require this effort on behalf of the tortfeasor."

Complexities of the Net Income Rule

The net income rule requires a jury to predict both future income tax laws and the plaintiff's future tax situation. The many variables affecting an individual's future tax position, coupled with an ever changing tax law, makes this a difficult, if not impossible, task. To illustrate, at the time of the 1980 Supreme Court decision...
sion in Liepelt, the maximum income tax rate was seventy per-
cent. Under the Tax Reform Act of 1986 (the "Act"), the maxi-
mum effective income tax rate for individuals is twenty-eight
percent. A jury calculating lost earnings under the net income
rule in 1980 surely would have overestimated the taxes of any
plaintiff who would have, but for the injury, continued to work,
because of the marked decrease in tax rates just six years later.
Much of the legal commentary in favor of the net income rule was
written prior to the passage of the Act, when this dramatic
change in individual rates was perhaps inconceivable. Since the
Act's passage, however, it is suggested that the argument that the
net income rule is too speculative has been considerably strength-
ened. Changes in the tax laws may affect not only the individual's
tax rate, but every factor relevant to the calculation of an individ-

jury in reducing proof to monetary award), cert. denied, 423 U.S. 839 (1975); Dempsey v.
Thompson, 363 Mo. 339, 345-46, 251 S.W.2d 42, 45 (1952) (impossible to compute amount
of tax liability with reasonable accuracy). But see Burlington N., Inc. v. Boxberger, 529 F.2d
284, 292-93 (9th Cir. 1975). The Boxberger court held that evidence of future income taxes
could be considered upon the taking of judicial notice of current tax rates and by giving
cautionary jury instructions. Id. The court further stated:

While not subject to precise mathematical exactitude, such a projection does not
appear to be too uncertain, conjectural, or speculative for the jury to consider.
Certainly, such considerations are no more speculative than the possibility of
death from natural causes, disabling, non-compensable injuries from other causes,
or the future instability of familial relationships.

Id. (footnote omitted); see also Nordstrom, supra note 6, at 227 (prediction of future in-
come tax no more speculative than continuance of, or increase in, plaintiff's salary).

1981, 1983 & 1986). The 1980 tax schedule for single individuals had a graduated rate reach-
ing 70% when the individual's taxable income reached $108,300. Id.

See I.R.C. § 1 (1982 & Supp. IV 1986). In actuality, there are three tax rates: 15%,
28%, and 33%. See id. Technically, the highest rate is 33%, although this rate serves only
to phase out the 15% bracket for persons reaching a specified income level. Id. § 101. In
effect, this causes such a person's entire taxable income to be taxed at the maximum rate of
28%; without this 5% surcharge, a portion of such individual's income would be taxed at
15% and the remainder at 28%. Id. This 5% rate adjustment also phases out personal ex-
emptions for upper-income taxpayers. See The RIA Complete Analysis of the '86 Tax Re-

Any jury deliberating prior to 1986 would have been likely to assume that the plain-
tiff would have a maximum tax rate far in excess of 28%. See, e.g., O'Connor v. United
States, 269 F.2d 578, 584 (2d Cir. 1959) (estimate could be based on current rates since it is
unlikely there would be substantial reduction in federal income tax rates in future).

See, e.g., Comment, Tax Issues of Personal Injury and Wrongful Death Awards, 19
Tulsa L.J. 702, 717 (1984). In 1984, one commentator stated that the "fear of undercompen-
sation caused by changes in the tax rates is unfounded. Empirical evidence demonstrates
that a plaintiff's future tax liability will worsen given the massive federal deficits." Id.; see
also Brin, Economic Projections in Determination of Damages; Inflation and Income
ual's tax liability, including items that must be included in gross income, allowable itemized deductions, and the amount of the individual's personal exemption. Thus, when considering future income taxes, the jury must predict more than just the tax rate. For example, in estimating an individual's itemized deductions, a 1980 jury would have inaccurately calculated the personal interest deduction because it could not have foreseen the gradual reduction and repeal of this allowance. In addition to predicting the tax laws themselves, a jury must estimate numerous other factors unique to the taxpayer, including the amount and source of a plaintiff's other income, whether this other income is derived from active or passive activity, the number of personal exemptions, and the plaintiff's marital status.

A further complication of the net income rule was addressed in Liepelt, when the Supreme Court noted that a court applying the net income rule in a case involving a lump sum award should add back to the award the amount of taxes the plaintiff would have to pay on interest earned from investment of the proceeds. To illustrate, assume the plaintiff would have earned $50,000 a year in income for a period of twenty years, or $1,000,000. The present value of this award based on a discount rate of ten percent would be $425,680. The interest earned on the award, however, would be taxable. Thus, the actual net cash available to the

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47 See supra note 41 and accompanying text.
48 See I.R.C. § 163(h)(1) (West Supp. 1988). Personal interest is defined to include interest paid on non-mortgage secured loans, unsecured loans, and credit cards. Id. § 163(h)(2). Congress, however, retained the deduction for qualified residence interest. See id. § 163(h)(3).
49 See I.R.C. § 61(a) (1982 & Supp. IV 1986). Gross income includes all income from whatever sources derived unless specifically excluded. Id.; see also Comment, supra note 6, at 295 n.47 (tort victim's future outside earnings will affect tax rate and must be considered by jury); supra note 1 and accompanying text (factors constituting gross income).
50 See RIA Analysis, supra note 44, ¶¶ 445-76. The 1986 Tax Reform Act imposed limitations on the deductibility of passive losses; generally, passive losses are deductible only to the extent of passive income. Id.; see I.R.C. § 469(a) (West Supp. 1988).
53 See Liepelt, 444 U.S. at 495. But see Flannery v. United States, 718 F.2d 108, 112 (4th Cir. 1983), cert. denied, 467 U.S. 1226 (1984) (no adjustment allowed for income tax payable on interest income since award might be invested in tax exempt securities); Sauers v. Alaska Barge, 600 F.2d 238, 247 (9th Cir. 1979) (same).
plaintiff would be reduced by the amount of tax he would have to pay on the interest earned. Accordingly, the "add-back" rule requires that the tax on the interest must be added back to an award that is calculated on an after-tax basis.65

Despite its complex and speculative nature, many courts nevertheless require the use of the net income rule on the theory that the gross income rule results in overcompensation to the plaintiff.66 Contrary to this theory, however, in certain circumstances the gross income rule will actually result in undercompensation to the plaintiff.67 Furthermore, the net income rule may actually increase a defendant's liability.68 In brief, the argument that the gross income rule necessarily results in overcompensation ignores economic realities.69

In addition to noting the speculative nature of the net income

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66 See, e.g., Mosley v. United States, 538 F.2d 555, 559 (4th Cir. 1976) (calculation of actual lost income requires deduction of decedent's ordinary living expenses including income tax); O'Connor v. United States, 269 F.2d 578, 585 (2d Cir. 1959) (same); Brooks v. United States, 273 F. Supp. 619, 628 (D.S.C. 1967) (unless income tax taken into consideration, beneficiaries will receive more than if deceased lived); see also Nordstrom, supra note 6, at 219 (goal of tort remedy is compensation for actual loss).

67 See Franz, Should Income Taxes Be Included When Calculating Lost Earnings?, TRIAL, Oct. 1982, at 53, 56. Professor Franz discussed the possibilities of both overcompensation and undercompensation of the plaintiff, and the situations where each is likely to occur. See id. With the use of a computer program, he compared different variations of damage calculation. See id. He concluded:

[The] failure to deduct income taxes from lost income does not relieve the plaintiff of all tax liability, even though the award itself is not taxable. In case of relatively high discount rates . . . and fairly long repayment periods, the plaintiff actually may be undercompensated. . . .

. . . . [A]n award net of taxes on income necessarily undercompensates the plaintiff, unless the initial award is sufficiently inflated to make allowance for taxes due on interest.

Id. at 57.

68 See Frolik, supra note 2, at 596-97. Professor Frolik stated that the "[c]oncern that Liebelt might increase a defendant's liability is not mere conjecture." Id. at 597. He noted that in one Ninth Circuit case, DeLucca v. United States, 670 F.2d 843, 846 (9th Cir. 1982), "[r]educing the loss of future earnings to reflect the effect of taxes, and adding an amount to compensate for taxes on the investment income resulted in the defendant owing slightly more than if taxes had been left out of all calculations." Id. at 597 & n.160.

69 See id. at 597; see also Franz, supra note 57, at 57 (economic complexities suggest that simplest method of avoiding overcompensation is gross income rule).
rule, the Johnson court\textsuperscript{60} and others\textsuperscript{61} adhering to the gross income rule have recognized the difficulties juries have in understanding and applying evidence concerning income taxes.\textsuperscript{62} Accordingly, if the net income rule is adopted, a greater use of expert testimony will be necessary,\textsuperscript{63} resulting in longer trials and increased litigation expenses.\textsuperscript{64}

\textit{Humanitarian Intent}

Congress' intent in enacting the exclusion for damages received on account of personal injuries is not expressed in the legislative history of section 104(a)(2).\textsuperscript{65} As a result, courts must attempt to ascertain for themselves the congressional intent.\textsuperscript{66} Those that favor the gross income rule believe that within the ex-

\textsuperscript{60} \textit{Johnson}, 71 N.Y.2d at 204, 519 N.E.2d at 329, 524 N.Y.S.2d at 418.
\textsuperscript{61} See, e.g., \textit{Yukon Equip., Inc. v. Gordon}, 660 P.2d 428, 434-35 (Alaska 1983). The Alaska Supreme Court refused to overrule its prior holding that future taxes should not be deducted, reiterating that:

"Income tax rates, provisions relating to deductions and exemptions, and other aspects of income tax laws and regulations are so subject to change in the future that we believe that a court cannot predict with sufficient certainty just what amounts of money a plaintiff would be obliged to pay in federal and state income taxes on income that he would have earned in the future had it not been for a defendant's tortious conduct."
\textsuperscript{62} See, e.g., \textit{Johnson v. Penrod Drilling Co.}, 510 F.2d 234, 237 (5th Cir.) (en banc) (per curiam) ("justice is better served if these contingencies, variables and predictions [involved in estimating taxes] are withheld from the jury's consideration"), \textit{cert. denied}, 423 U.S. 839 (1975); Comment, supra note 6, at 294 & n.46 (Liepelt Court did not respond convincingly to arguments that tax evidence is too complex to present to juries). \textit{But see} Burlington N., Inc. v. \textit{Boxbeger}, 529 F.2d 284, 293 (9th Cir. 1975) (today's judges and jurors are sophisticated enough to understand evidence with help from experts).
\textsuperscript{63} See Mayor & Hepburn, \textit{The Treatment of Income Taxes in Determining Personal Injury Awards}, 18 \textit{Jurimetrics} J. 186, 208 (1977) (jury will be unable to understand plaintiff's tax liability without assistance of experts).
\textsuperscript{64} See Comment, supra note 6, at 295; see also \textit{Yukon Equip.}, 660 P.2d at 434 (may be "more burdensome than beneficial"); \textit{Tenore v. Nu Car Carriers, Inc.}, 67 N.J. 466, 494, 341 A.2d 613, 623 (1975) (fairness required defendant be given opportunity to introduce evidence of plaintiff's tax liability or to develop matter on cross-examination).
\textsuperscript{65} See Chapman, supra note 10, at 413-14. Professor Chapman discussed the legislative history of section 104(a)(2) beginning in 1913. \textit{Id. at} 413-17; \textit{see also} \textit{Norfolk \\& W. Ry. v. Liepelt}, 444 U.S. 490, 496 n.10 (1980) (finding no humanitarian intent in congressional history); Comment, supra note 6, at 297 & n.61 (congressional intent unclear).
\textsuperscript{66} See Chapman, supra note 10, at 415-16.
clusion lies a congressional intent to bestow a humanitarian benefit upon the victims of torts.67 In support of this view, they point to the continued existence of the exclusion since its enactment in 1918.68 In particular, these courts argue that by amending the section without repealing the exclusion, Congress has manifested an intent to benefit the tort victim.69 One commentator has suggested that regardless of whether Congress intended to benefit plaintiffs, "it is doubtful that Congress ever intended Section 104(a)(2) to reduce the financial burdens of personal injury defendants."70

Application of the Net Income Rule—Compounding the Confusion

There is no uniform position among states on whether to apply the gross income or the net income rule. Further complicating the matter are decisions permitting introduction of tax evidence only in certain circumstances.71 For example, some courts have held that the net income rule should be applied only to past lost

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67 See, e.g., Kalavity v. United States, 584 F.2d 809, 812 (6th Cir. 1978) (tax exemption for damage awards created for benefit of injured party); Hall v. Chicago & N.W. Ry., 5 Ill. 2d 135, 151, 125 N.E.2d 77, 86 (1955) (net income rule would thwart congressional intent to benefit injured party); Dixie Feed & Seed Co. v. Byrd, 52 Tenn. App. 619, 627, 376 S.W.2d 745, 749 (1963) (same), appeal dismissed, 379 U.S. 15 (1964).

68 See Frolik, supra note 2, at 594. Professor Frolik noted: "If section 104(a)(2) was initially passed as an aid to claimants, or if its continued vitality can best be defended as an intentional federal subsidy to tort victims, then its ability to perform that humanitarian function has been severely undercut by Liepelt." Id.; see also Comment, supra note 6, at 297 (Congress apparently sanctioned any overcompensation to tort victims by not repealing or amending section).

69 See Chapman, supra note 10, at 415-16. Justice Blackmun expressed this viewpoint in his Liepelt dissent: "By not taxing the award, Congress has bestowed a benefit. Although the parties disagree over the origin of the tax-free status of the . . . award, it is surely clear that the lost earnings could be taxed as income." Liepelt, 444 U.S. at 500 (Blackmun, J., dissenting) (footnotes omitted) (emphasis added); see also Raines v. New York Cent. R.R., 51 Ill. 2d 428, 430, 283 N.E.2d 200, 282 (§ 104(a)(2) reflects deliberate congressional intent to award tax windfall to injured plaintiffs (quoting Hall v. Chicago & N.W. Ry., 5 Ill. 2d 135, 151-52, 125 N.E.2d 77, 86 (1955)), cert. denied, 409 U.S. 983 (1972).

70 Frolik, supra note 2, at 594. Professor Frolik noted that the Liepelt holding will cause defendants to benefit from section 104(a)(2). Id. But see Comment, supra note 46, at 721 ("Although a reduced award is 'beneficial' to the defendant in a purely economic sense, it is not actually a true 'benefit' in a legal sense if the law does not define it as such.").

71 See, e.g., Martinez v. United States Fidelity & Guar. Co., 423 So. 2d 1088, 1091 (La. Ct. App. 1982) (if tax liability would be de minimus, no evidence of tax liability may be introduced, but question is open in other situations); Marynik v. Burlington N., Inc., 317 N.W.2d 347, 350 (Minn. 1982) (if tax liability not de minimus, evidence should be admitted); see also Comment, supra note 46, at 718-19 (courts apply de minimus concept by allowing evidence of income taxes only when tax liability severe).
earnings, not to future lost earnings. The rationale for these holdings is that there is no uncertainty in the calculation of taxes a plaintiff would have paid, since the jury could calculate the taxes by applying the tax laws existing at the time the income would have been earned. The flaw in this position is that it will impact the lost earnings award differently depending on the time period between injury and trial.

Some courts apply the net income rule only when the plaintiff is in an upper income tax bracket. Not only do these decisions add another factor to the already complex calculation, but courts find it difficult to delineate upper and lower income tax brackets.

Proposed Amendment

The problems arising in calculating a plaintiff's future tax liability led the Johnson court to hold that "without express statutory direction to the contrary, the damages component of a plaintiff's award as to lost wages... should be based on gross projected earnings and no deduction or consideration of after-tax net should be allowed into evidence." The need for statutory direction has been recognized by several commentators. They have suggested that the confusion that has led to conflicting decisions in both federal and state courts can be eradicated if Congress amends sec-

72 See, e.g., Varlack v. SWC Caribbean, Inc., 550 F.2d 171, 178 (3d Cir. 1977) (applying Virgin Islands law) (future earnings subject to gross income rule whereas past earnings subject to net income rule); Beaulieu v. Elliott, 434 P.2d 665, 673 (Alaska 1967) (same).

73 See Varlack, 550 F.2d at 178; Beaulieu, 434 P.2d at 673.

74 See Beaulieu, 434 P.2d at 673.

75 See Morgan Guar. Trust Co. v. Texsgulf Aviation, Inc., 604 F. Supp. 699, 701-02 (S.D.N.Y. 1985). In Morgan Guaranty, the gap between pre-tax and after-tax income was extreme: based on a 50% income tax rate the difference was $5,000,000. Id.; see also Savers v. Alaska Barge & Transp., Inc., 600 F.2d 238, 247 (9th Cir. 1979) (using net income rule for taxpayers in upper income bracket); First Nat'l Bank v. Material Serv. Corp., 597 F.2d 1110, 1120 (7th Cir. 1979) (using net income rule when tax impact substantial).


77 Johnson, 71 N.Y.2d at 206, 519 N.E.2d at 330, 524 N.Y.S. 2d at 419.

78 See Chapman, supra note 10, at 408; Frolik, supra note 2, at 567.

tion 104(a)(2) to bring it into conformity with generally accepted tax theory. Currently, section 104(a)(2) excludes amounts received for lost earnings, notwithstanding the fact that these payments merely reimburse plaintiffs for amounts that would have been included in gross income. Furthermore, other types of compensation that closely parallel the lost earnings component of a personal injury damage award are includable in gross income. The proposed amendments would repeal the exclusion for damages received as lost earnings in personal injury and wrongful death actions, and could be tailored to incorporate a preferential treat-

United States, 584 F.2d 809, 812-13 (6th Cir. 1978) (gross income rule applicable to lower and middle income tax brackets) and Johnson v. Penrod Drilling Co., 510 F.2d 234, 236-37 (5th Cir.) (en banc) (per curiam) (apply gross income rule to avoid speculation and burden on administration of justice), cert. denied, 423 U.S. 899 (1975).


See Frolik, supra note 2, at 605. Professor Frolik concluded: Congress should amend section 104(a)(2) to repeal the tax exemption for amounts paid as compensation for lost income. This reform would avoid the complicated interplay of numerous variables introduced by the [net income rule]. By removing this obstacle and bringing section 104(a)(2) into conformity with generally accepted tax theory, personal injury claimants and defendants could put away their tax codes and concentrate on fundamental issues of liability and the calculation of damages.

Id.; see also Comment, supra note 6, at 297 (Congress could repeal statutory exclusion of lost income awards).

See Morris, Taxing Economic Loss Recovered in Personal Injury Actions: Towards a Capital Idea, 38 U. Fla. L. Rev. 735, 736 (1986). Professor Morris notes that it "seems improper to exclude from income an economic benefit which would have been included had it not been received incident to a personal tort action." Id. at 760.

See Frolik, Personal Injury Compensation as a Tax Preference, 37 Me. L. Rev. 1, 13 (1985). For example, a "continuation of pay" award, which provides a federal employee compensation for a traumatic injury, is not excluded from gross income. Id. Professor Frolik discussed the taxability of income received under Internal Revenue Code sections 37, 104, and 105, stating that "[e]quity would seem to be better served by comparable treatment among these forms of compensation, which might come in the form of . . . all compensation for lost earnings coupled with a generous deduction scheme for disability engendered expenses." Id.

Congress can, if it so chooses, tax a particular item of income at a preferential rate, and has done so. For example, prior to the 1986 revision of the Internal Revenue Code, a taxpayer was allowed to deduct 60% of capital gains from gross income. Act of Nov. 6, 1978, Pub. L. No. 95-600, tit. IV, § 402(a), 92 Stat. 2867, repealed by Act of Oct. 22, 1986, Pub. L.
ment of this income, thereby allowing Congress to continue to confer a humanitarian benefit on the tort victim.

JURY INSTRUCTIONS

The issue of whether a jury should be instructed on the non-taxability of a personal injury damage award has recently been addressed by the New York Court of Appeals in Lanzano v. City of New York. In Lanzano, the plaintiff contended that the trial court's instructions to the jury that the award would not be subject to income tax were prejudicial and caused the jury to return a smaller verdict than it would have absent the instruction. The court rejected the argument, stating that ignorance of a relevant rule in a complex field could contribute to a jury proceeding on erroneous speculations and "rendering unfair and inaccurate verdicts." Writing for the court, Judge Bellacosa stated that "it is better practice in all cases where jury awards are excluded from taxation . . . for the jury to be instructed in substance that such awards . . . are not subject to income taxes, and that it should not add or subtract from the award on account of income taxes." Accordingly, the Lanzano court held that the instruction that had been given was not error and expressly authorized its use. The United States Supreme Court considered the jury instruction issue

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85 See Morris, supra note 82, at 747. Professor Morris suggested three alternative amendments to section 104(a)(2) that would each treat a personal injury award preferentially. Id. The first is the exclusion model which would exclude 50% of the amount received from gross income. Id. at 752. The second would treat the amount as a capital gain. Id. at 753. The third would offer an election to treat the income as if it were received over a period of five years, thus avoiding the harshness of having the award taxed in one year. Id. at 757.

86 See supra notes 67-69 and accompanying text.


88 Id. at 211, 519 N.E.2d at 331, 524 N.Y.S.2d at 421.

89 Id., 519 N.E.2d at 332, 524 N.Y.S.2d at 421.

90 Id. at 212, 519 N.E.2d at 332, 524 N.Y.S.2d at 422.

91 Id., 519 N.E.2d at 333, 524 N.Y.S.2d at 422. In expressly authorizing such an instruction, the court stated that it was building on the holding in Coleman v. New York City Transit Authority, 37 N.Y.2d 137, 332 N.E.2d 850, 371 N.Y.S.2d 663 (1975). Lanzano, 71 N.Y. 2d at 213, 519 N.E.2d at 333, 524 N.Y.S.2d at 422. The court in Coleman held that trial courts are "not required to charge the jury that any award to the plaintiff would be free of income tax." Coleman, 37 N.Y.2d at 145, 332 N.E.2d at 855, 371 N.Y.S.2d at 670. The Lanzano court, however, stated that "[t]o the extent that Coleman . . . has been read as being inconsistent with this holding, that interpretation is declared erroneous." Lanzano, 71 N.Y.2d at 213, 519 N.E.2d at 333, 524 N.Y.S.2d at 422.
in *Norfolk & Western Railway v. Liepelt*, holding that it was error for the trial court to refuse the instruction requested by the defendant. The Court concluded that it was “entirely possible” a jury would believe an award was subject to income taxes and, as a result of this belief, substantially increase the award to fully compensate the injured party. Writing for the majority, Justice Stevens approved the Ninth Circuit’s reasoning in *Burlingham Northern, Inc. v. Boxberger* that “giving the instruction can do no harm, and it can certainly help by preventing the jury from inflating the award.” In contrast, Justice Blackmun, dissenting in *Liepelt*, stated that the instruction “does nothing more than call a basically irrelevant factor to the jury’s attention, and then directs the jury to forget that matter.” Responding to the majority’s argument that the jury might increase the award on the erroneous belief that it would be subject to income taxes, Justice Blackmun pointed out that it was also “‘entirely possible’ that the jury ‘may’ increase its damages award in the belief that the defendant is insured, or that the plaintiff will be obligated for substantial attorney’s fees . . . or on the basis of any number of other extraneous factors.” For this reason, Justice Blackmun regarded the required instruction as “almost an affront to the practical wisdom of the jury” and stated that it opened the door to courts requiring that the jury be charged about every “conceivable matter as to which it should not misbehave or miscalculate.”

**Jury Instruction Should be Discretionary**

A number of courts have held that, upon request, the jury must be instructed on the nontaxability of a personal injury or wrongful death award. These opinions aim to safeguard against

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93 Id. at 496-98.
94 Id. at 496.
95 529 F.2d 284 (9th Cir. 1975).
96 *Liepelt*, 444 U.S. at 498 (quoting *Boxberger*, 529 F.2d at 297); see Comment, supra note 6, at 293 n.37 (absent instruction, jury likely to increase award).
97 *Liepelt*, 444 U.S. at 502 (Blackmun, J., dissenting).
98 Id. at 503 (Blackmun, J., dissenting).
99 Id. (Blackmun, J., dissenting).
100 See, e.g., *Fanetti v. Hellenic Lines*, 678 F.2d 424, 431 (2d Cir. 1982) (defendant in FELA action entitled to limiting instruction to jury), cert. denied, 463 U.S. 1206 (1983); Burlington N., Inc. v. *Boxberger*, 529 F.2d 284, 297 (9th Cir. 1975) (“giving the instruction can do no harm, and it can certainly help by preventing the jury from inflating the award”); *Domeracki v. Humble Oil & Ref. Co.*, 443 F.2d 1245, 1251 (3d Cir.) (applied prospectively),
the possibility that a jury may increase a verdict on the mistaken assumption that the award is subject to income tax. Opponents of this viewpoint argue that such an instruction could prejudice the plaintiff. They argue that this instruction is illogical and creates confusion because while it brings the issue of taxation to the jury's attention, most courts later instruct the jury that the issue is irrelevant and should not be considered.

It is submitted that rather than a blanket rule allowing or disallowing the instruction that the award is not taxable, a better approach would be to leave the decision to the trial judge. One court has stated:

Where there is nothing in the evidence bearing on taxes, and the lawyers do not mention the subject in front of the jury, no instruction on the subject may be needed ... [and] [w]here the subject of income taxes on the amount of the verdict has been brought to the attention of the jury in a serious way, the judge must exercise his best judgment and discretion, and frank disclosure that the amount of the verdict is not subject to Federal or State income taxation may be the better course.

Based on this viewpoint, it is further submitted that the instruction be given only if the issue has been brought to the jury's attention during trial, or if the jury itself inquired about the taxability of the award during deliberations. In these situations,
there is less danger of prejudicing the plaintiff because the issue has not been affirmatively brought to the jury's attention.\textsuperscript{106}

CONCLUSION

The wisdom of utilizing the gross income rule rather than the net income rule has become more apparent since the enactment of the Tax Reform Act of 1986. Prior to its enactment, it was argued that future income taxes could be estimated, and that this task was not unduly speculative. The sweeping changes that occurred upon the passage of the Act, however, should compel reevaluation of this argument. Furthermore, even if it were possible to estimate future tax laws with a reasonable degree of accuracy, it must be remembered that the calculation of an individual's income tax is complex and responsive to numerous other factors. This combination of the speculativeness and the complexity of projecting an individual's tax liability has led to a wide disparity in the decisions of both federal and state courts. This Note has suggested that a logical solution would be for Congress to amend section 104(a)(2) to remove the tax exempt treatment of the lost earnings portion of damages. This element could be taxed at a preferential rate, thus retaining a humanitarian benefit for injured plaintiffs while, at the same time, eliminating conflicting decisions among the courts. In the absence of legislative action, courts should implement the gross income rule. The use of the gross income rule would prevent the jury's deliberations from becoming unduly complex.

This Note has also considered the question of whether to instruct the jury that the entire award is not subject to taxation, and has suggested that the approach least likely to prejudice the plaintiff or confuse the jury is to leave the decision to the discretion of the trial judge. Moreover, it would be preferable for the trial judge to give this instruction only when the issue has already been brought to the jury's attention.

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\textsuperscript{106} See supra notes 102-05 and accompanying text.