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Recent Decisions

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ESTATE TAX CREDIT—VALUATION OF LIFE ESTATE—A Life Estate Forming The Basis Of An Estate Credit Under Section 2013 Of The Internal Revenue Code Should Be Valued With Reference To Extrinsic Facts And Circumstances Rather Than By Application Of The Actuarial Tables Set Out In The Regulations Where The Transferor And Transferee Have Died In A Common Disaster. Estate of Lion v. Commissioner, 438 F.2d 56 (4th Cir. 1971), *cert. denied,* 40 U.S.L.W. 3036 (U.S. Jul. 13, 1971).

Mr. and Mrs. Lion died simultaneously in an airplane crash. Mr. Lion's will created a residuary trust in which his wife was entitled to a life estate and contained a clause stating a presumption of the wife's survivorship in the event of simultaneous death. The executor of Mrs. Lion's estate filed an estate tax return claiming a credit under Section 2013 of the Internal Revenue Code[1] computed on the actuarial value of the life estate. The Tax Court assumed arguendo that the transfer had been effected and ruled that the life estate had no value in Mr. Lion's estate and disallowed the credit.[2] *Held, affirmed*: The imminency of Mrs. Lion's death presented an exceptional circumstance justifying appraisal of the life estate without reference to the actuarial tables promulgated in the regulations. A beneficial life estate that vests and terminates within a matter of minutes is worthless. Estate of Lion v. Commissioner, 438 F.2d 56 (4th Cir. 1971), *cert. denied,* 40 U.S.L.W. 3036 (U.S. Jul. 13, 1971).

Under section 2013 the estate of a decedent is entitled to an estate tax credit for the estate tax paid on property transferred to the decedent by a person who died within ten years before, or within two years after the decedent's death. Basically the credit is equal to the amount of estate tax paid by the transferor's estate attributable to the property received by the decedent or a proportion thereof, depending on the number of years between the death of the transferor and the transferee, but is not to exceed the amount of tax on the transferee's estate attributable to the transferred property.[3] The limitation imposed by section 2013 (c)[4] would seem to exclude from the operation of the credit any property

[1] INT. REV. CODE of 1954, § 2013.

[2] Estate of Lion v. Comm'r, 52 T.C. 601 (1969).

[3] Treas. Reg. § 20.2013-1(b) (1958). Treas. Reg. § 20.2013-2 (1958). Treas. Reg. § 20.2013-3 (1958).

[4] INT. REV. CODE of 1954, § 2013(c).

that is without value in the estate of the transferee; however, it is well settled that a life estate qualifies for the credit even though it is not includible in the estate of the transferee.[5]

The issue dealt with by the court in Lion concerned the method of valuation to be used in appraising the life estate bequeathed to Mrs. Lion by her husband, given the fact of simultaneous death and indulging the assumption that a transfer had been effected. The regulations have adopted "fair market value" as the general standard of valuation.[6] Due to the problems inherent in applying this concept to the valuation of limited interests in property, the regulations prescribe that remainders and life estates be valued with reference to the actuarial tables promulgated in the regulations[7] and proceed on the premise that the sum of the separate values of the divided interests, determined by the application of actuarial tables, will equal the appraised value of the entire estate. The question in Lion is if, and under what circumstances, a departure from actuarial valuation of limited interests is permitted.

The non-imperative language contained in section 20.2013-4,[8] which refers to the sections prescribing actuarial valuation, was interpreted by the court in Lion as permitting alternate methods of valuation where the application of the actuarial tables would not comport with "recognized valuation principles."[9] It was held that the actuarial tables must defer to proven facts establishing a lesser life expectancy. This rule is consistent with a series of decisions affirming non-actuarial valuation of charitable remainders where facts existing at the time of the testator's demise establish the life expectancy of the life beneficiary to be considerably less than that reflected in the actuarial tables.[10] The opposite result was reached, however, in Estate of Wien v. Commissioner[11] which involved the valuation of the decedent's ownership interest in a life insurance contract on the spouse's life where the decedent and the insured died in a common disaster. Although the government and counsel for the estates differed greatly as to the effect of simultaneous death on the value of the contracts, they agreed that the method of valuation pre-

[5] Treas. Reg. § 20.2013-1(a) (1958) (no requirement that property forming basis of credit be identified in gross estate of transferee). Rev. Rul. 59-9, 1959-1 CUM. BULL. 232.

[6] Treas. Reg. § 20.2031-1(b) (1958).

[7] Treas. Reg. § 20.2031-7 (1958); Treas. Reg. § 20.2031-10 (1958).

[8] Treas. Reg. § 20.2013-4 (1958) (calls for the valuation of remainders and life estates on basis of "recognized valuation principles.").

[9] *Id.*

[10] Est. of Denbigh v. Comm'r, 7 T.C. 387 (1946) (life beneficiary under annuity contract, incurably ill with cancer). Est. of Jennings v. Comm'r, 10 T.C. 323 (1948). Huntington Nat'l Bk. v. Comm'r, 13 T.C. 760 (1949) (life tenant invalid at time of death of testator). Est. of Butler v. Comm'r, 18 T.C. 914 (1952) (life tenant dying of cancer at time of death of testator). Rev. Rul. 66-307, 1966-2 CUM. BULL. 429.

[11] Est. of Wien v. Comm'r, 51 T.C. 287 (1968), *rev'd* 441 F.2d 32 (5th Cir. 1971).

scribed by the regulations should be abandoned in favor of a method recognizing the simultaneous deaths of the insured and the assured. The Fifth Circuit, however, giving effect to a Georgia Simultaneous Death Act[12] creating a presumption of the insured's survivorship, ruled that the value of the decedent's proprietary interest in the insurance contracts should be determined on the basis of the interpolated terminal reserve method[13] without considering the imminency of the insured's death.[14] The decision is predicated in part on the imperative language of the regulations[15] requiring valuation by application of the interpolated reserve method; however, the decision goes further and endorses the exclusion of extrinsic facts and circumstances from the valuation process. This conflict as to the office of extrinsic facts and conditions in the valuation process can best be resolved by an understanding of the purpose which the actuarial method and the interpolated reserve method are designed to serve.

Neither the actuarial method of valuing interests in property nor the interpolated reserve method of valuing ownership interests in life insurance policies approximates market value; nevertheless, these methods have been adopted as a matter of administrative convenience.[16] To do otherwise and adhere to an administrative procedure permitting the adduction of conflicting evidence of factors which are relevant to the valuation process but which are not susceptible to any certitude of proof would greatly complicate the administrative process and would not necessarily assure a more accurate result;[17] however, this argument does not justify resort to the actuarial method or the interpolated terminal reserve method when, at the time of the testator's death, the life expectancy of the insured or the life beneficiary can be unequivocably proven. The valuation of a remainder or a life estate where the life tenant is confined in a hospital with terminal cancer[18] or has died in the same mishap as the testator does not present the valuation problems that attend the appraisal of a remainder or life estate where the anticipated duration of the life tenant's life is a matter of speculation or conjecture.

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[12] GA. CODE ANN. 56-2426 (1970).

[13] The owner of a life insurance contract on the life of another is deemed to have certain proprietary rights in contract which are subject to estate taxation should the assured predecease the insured. INT. REV. CODE of 1954, § 2033. The regulations provide these rights should be valued at the contract's replacement cost or, in the alternative, on the basis of the interpolated reserve. Treas. Reg. § 20.2031-8 (1958).

[14] *Accord*, Old Kent Bank and Trust Co. v. U.S., 292 F. Supp. 48 (W.D. Mich. 1968), *rev'd*, 430 F.2d 392 (6th Cir. 1970); Est. of Chown v. Comm'r, 51 T.C. 140 (1968), *rev'd*, 428 F.2d 1395 (9th Cir. 1970).

[15] Treas. Reg. § 20.2031-8 (1958).

[16] 2 J. BONBRIGHT, VALUATION OF PROPERTY 742 (1937). Note, *Future Interests in Estate Taxation*, 47 YALE L.J. 1359 (1938).

[17] *Future Interests*, *supra* note 16, at 1359.

[18] Est. of Butler v. Comm'r, 18 T.C. 914 (1952).

The more flexible rule in Lion, allowing non-actuarial valuation of a life interest when the life expectancy incorporated in the actuarial table is clearly refuted by facts and conditions existing at the time of the decedent's death and prescribing use of the actuarial tables in default of better evidence, is compelling and reasonable. This rule does not jeopardize the expeditious administration of the estate tax system and restores a semblance of accuracy to the valuation process.

Gary L. Hueter

JURY INSTRUCTION—TAX EXEMPT PERSONAL INJURY AWARD—Upon Request, The Jury Must[1] Be Advised of The Tax Exempt Status of Personal Injury Awards. Domeracki v. Humble Oil & Ref. Co., 443 F.2d 1245 (3d Cir. 1971).

A longshoreman sustained personal injuries while loading a ship. The jury, finding that the injuries were caused by unseaworthiness of the vessel and failure of the shipowner to provide a safe workplace, awarded damages in the amount of $270,982.00. The shipowner appealed, asserting that the jury had deliberated under the mistaken impression that the award would be subject to federal income taxation.[2] *Held, affirmed, prospectively reversed*: Upon request, trial courts in the Third Circuit must instruct the jury that any award will not be subject to federal income taxation and that the jury should not add or subtract taxes in computing the amount of any award. Domeracki v. Humble Oil & Ref. Co., 443 F. 2d 1245 (3d Cir. 1971).

The state and federal courts, as well as the commentators are split on the question whether a jury should be advised that damages received in a personal injury action are exempt from federal income taxation.[3]

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[1] Traditionally, any cautionary jury instructions regarding the taxable status of personal injury awards have been given in the sound discretion of the trial judge. Anderson v. United Air Lines, Inc., 183 F. Supp. 97 (S.D. Cal. 1960); *contra* Wagner v. Illinois Cent. R.R., 7 Ill. App. 2d 445, 129 N.E.2d 771 (1955); *see also* Combs v. Chicago St. P. M. & O. Ry., 135 F. Supp. 750 (N.D. Iowa, 1955).

[2] The shipowner also appealed on the ground that the jury failed to adhere to the court's instructions and that the jury rendered its verdict under the influence of passion and prejudice purportedly induced by the plaintiff's counsel. Domeracki v. Humble Oil & Ref. Co., 443 F.2d 1245, 1247 (3d Cir. 1971).

[3] *See, e.g.*, approving instruction: 2 Harper & James, THE LAW OF TORTS, 25.12 at 1327-28 (1956); Burns, *A Compensation Award for Personal Injury or Wrongful Death is Tax-Exempt: Should We Tell the Jury?*, 14 DE PAUL L. REV. 320 (1965); Feldman, *Personal Injury Awards: Should Tax-Exempt Status Be Ignored?*, 7 ARIZ. L. REV. 272 (1965); Nordstrom, *Income Taxes & Personal Injury Awards*, 19 OHIO ST. L.J. 212 (1958); Note, 26 FORD. L. REV. 98 (1957); Note, 42 GEO. L.J. 149 (1953); Note, 44 KY. L.J. 384 (1956); Note, 50 KY. L.J. 601 (1962); Note, 32 TEX. L. REV. 108 (1953); Note, 4 U.C.L.A. L. REV. 636 (1957); Note, 25 U. CIN. L. REV. 385 (1956); Note, 9 VAND. L. REV. 543 (1956); Note, 11 WASH. & LEE L. REV. 66 (1954); opposing instruc-

Hall v. Chicago & N.W. Ry.[4] illustrates the position taken by the majority of cases that it is error to inform the jury that an award will not be taxable. In *Hall*, counsel for the defendant advised the jury of the tax exempt status of the verdict in the course of his closing argument.[5] The court noted that in the course of the trial, the trial judge ruled that evidence of gross earnings before taxes was proper on the issue of earnings capacity.[6] Since the jury had been correctly instructed on the specific elements to be considered in determining the measure of damages, the court reasoned that any further admonition regarding the incident of taxation would be extraneous, giving rise to conjecture and speculation—whether imparted by oral argument or written instruction.[7] It was presumed that the jury would follow the instructions on the measure of damages and would compute damages, considering gross earnings before taxes rather than net after-tax earnings on the issue of earnings capacity.[8] Although proper computation of the amount of damages for decreased earnings capacity was provided for in the trial judge's ruling, that ruling did not touch the statutory determination that personal injury awards, in toto, are exempt from federal income taxation.[9]

The minority view is illustrated by *Dempsey v. Thompson.*[10] The Supreme Court of Missouri recognized the distinction between a ruling on the evidentiary consideration of potential tax liability and a cautionary instruction.[11] In *Dempsey*, the trial court's ruling that defendant's counsel could not cross examine the plaintiff's actuarial witness as to potential income tax liability because of the impossibility of computation with any reasonable accuracy, and its ruling that defendant's counsel could not argue to the jury that the jury should consider only plaintiff's lost future earnings after deduction of taxes for which he would have been

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tion: Note, 8 ARK. L. REV. 174 (1953); Note, 33 B.U.L. REV. 114 (1953); Note, 42 IOWA L. REV. 134 (1956); Note, 35 N. CAR. L. REV. 401 (1957); Note, 21 U. CHI. L. REV. 156 (1953).

[4] Hall v. Chicago & N.W. Ry., 5 Ill. 2d 135, 125 N.E.2d 77 (1955).

[5] *Id.* at 84.

[6] *Id.* at 85.

[7] *Id.* at 86.

[8] *Id.* at 85.

[9] Awards received by settlement or verdict in personal injury actions are not taxable under federal income tax laws. INT. REV. CODE of 1954, § 104 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
> . . . .
> (b) The amount of any damages received (whether by suit or agreement) on account of personal injuries or sickness . . . .

[10] Dempsey v. Thompson, 363 Mo. 339, 251 S.W.2d 42 (1952).

[11] *Id.* at 45.

liable if not injured, were upheld.[12] The court recognized that a determination that potential tax liability for future earnings is too conjectural and speculative for active jury consideration. The court also recognized that such a determination is independent of a determination that most jurors do not know of the exemption under section 104 of the I.R.C.[13] Consequently, a ruling that evidence of potential tax liability for future earnings is or is not a proper subject for jury consideration in determining the measure of damages cannot be associated with existence or nonexistence of a probable misconception on the part of the jury as to the existence of a special federal statute exempting personal injury awards from taxation in the year when received.

The first argument asserted in favor of the majority position is that the cautionary instruction is unnecessary—it introduces an extraneous element into the jury's deliberations. The court in *Hall* asserted, in effect, that to use the cautionary instruction is to presume that the jury would not otherwise follow the court's instructions regarding consideration of potential tax liability on future earnings but for the cautionary instruction that personal injury awards are tax exempt.[14] Courts accepting this position reason that (1) the jury is given instructions concerning the factors which may be considered in computing an award of damages; (2) those instructions do not mention any increase or decrease in the amount of the award on the basis of income tax considerations; (3) juries must be presumed to follow the court's instruction; consequently, there is no need for a cautionary instruction specifically directing the jury to disregard income tax considerations.

This argument is no longer valid. It ignores the pervasive impact of federal income taxation. The Third Circuit in *Domeracki* took judicial notice of the "tax consciousness" of the American public and characterized it as the "positive and persuasive" reason for giving the cautionary instruction.[15] The cautionary instruction is given for the purpose of eliminating the possibility that the jury might increase the award by an amount equal to the amount of federal income tax which they probably assume must be paid.[16] The instruction serves to eliminate the jury's mistaken impression that the plaintiff's award will be includable in his gross income for purposes of computing his income tax in the year the award is received.[17]

The second argument advanced in favor of the majority position is

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[12] *Id.*

[13] *Id.*

[14] Hall v. Chicago & N.W. Ry., 5 Ill. 2d 135, 125 N.E.2d 77, 85 (1955).

[15] Domeracki v. Humble Oil & Ref. Co., 443 F.2d 1245, 1251 (3d Cir. 1971).

[16] *Id.*

[17] *Id.* at 1249.

that the cautionary instruction introduces extraneous considerations in addition to being unnecessary per se.

In *Hall* the court allowed the trial judge's instruction that only evidence of gross in futuro income before taxes is to be considered on the issue of damages.[18] The court then refused to allow any oral argument or written instruction regarding the award's tax exempt status, stating that such an instruction would introduce "an extraneous subject, giving rise to conjecture and speculation."[19] Pursuant to its goal of elimination of extraneous subjects, conjecture and speculation, the trial court correctly instructed the jury regarding the evidentiary-taxation quagmire. However, refusal of the cautionary instruction does not serve the same purpose.

The courts adopting the majority view have failed to observe the critical distinctions between active jury consideration of those factors involved in determining the incidence of taxation on an amount of income which might have been earned in the future, and jury recognition of a legislative exception of the total amount of the injured person's award from federal income taxation.[20] Although, in fact, the injured plaintiff may suffer loss only to the extent of his net or "take-home" earnings, *i.e.*, gross earnings less taxes, most jurisdictions allow the admission of the plaintiff's gross earnings as evidence in calculating lost in futuro earnings as an element of damages.[21] Evidence presented to the jury regarding lost wages does not reflect the plaintiff's actual loss, but rather an amount which may be considerably higher, depending upon the plaintiff's particular tax bracket. Computation of the plaintiff's net in futuro earnings would entail the introduction of evidence regarding possible shifting tax rates, changes in the taxpayer's family status, changes in exemption and deduction provisions, changes in the cost of living and other variables in addition to evidence of wages which the plaintiff has actually lost.[22] An instruction, such as that given in *Hall*, to the effect that the jury should consider only evidence of gross in futuro income on the issue of lost wages as damages is well founded. Indeed, without it, the tax computation itself could supercede the basic issues of liability and damages.

The cautionary instruction, however, must be distinguished from an

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[18] Hall v. Chicago & N.W. Ry., 5 Ill. 2d 135, 125 N.E.2d 77, 85 (1955).

[19] *Id.* at 86.

[20] *See, e.g.*, Note, 4 U.C.L.A. L. REV. 636, 641 (1957) *citing* Combs v. Chicago St. P.M. & O. Ry. Co., 135 F. Supp. 750 (N.D. Iowa 1955); Note, 11 WASH. & LEE L. REV. 66, 74 n.40 (1954); a prime example of the confusion is found in Highshew v. Kushto, 235 Ind. 505, 134 N.E.2d 555, 556 (1956); and *see also* Note, 33 B.U.L. REV. 114 (1953).

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

[22] *Id.*

instruction regarding speculative in futuro tax liability. The cautionary instruction takes effect only upon completion of the jury's determination of the amount of damages to be awarded pursuant to the trial judge's instructions regarding the proper measure of damages. The substance of the cautionary instruction only tangentially affects the determination of the total amount of damages; that is, in a negative way, insofar as the instruction serves to obviate the jury's probable mistaken assumption regarding the present tax incidence on the award. One instruction does not serve to cure the other, nor does use of the cautionary instruction serve to indulge a presumption that the jury did not follow the prior instruction. It should be evident that the instructions are separate, distinct and mutually exclusive. One instruction deals with speculative future tax liability on projected earnings; the other deals with a probable misconception regarding the incidence of taxation on the award in the year the plaintiff receives it. They serve independent purposes, both conveying an accurate and understandable statement of law to the jury. The reasons given for refusal of the instruction in *Hall* have no basis in fact or reason. That decision and the so-called majority view should no longer be followed.

The instant case and *Dempsey* observe the foregoing distinctions. The rulings of the trial court in *Dempsey* regarding gross in futuro earnings served to keep the evidentiary-taxation quagmire out of the purview of the jury, and thereby eliminated the conjecture and speculation attendant to computations of in futuro tax liability on prospective earnings. Although the court reasoned that the prior rulings did not preclude the granting of the cautionary instruction, it did not state the true basis for its determination.[23] The court relied on the same "positive and persuasive" reasons relied upon in the instant case: tax consciousness of jurors and their probable misconception that the amount allowed by them would be reduced by income taxes.[24]

The Third Circuit's decision in *Domeracki* is significant because the court properly observed the distinction between the cautionary instruction in question and instructions and rulings concerning in futuro tax liability on in futuro earnings:

> Although some courts and writers have confused the evidentiary issue with the question of a cautionary instruction, *we believe that the considerations relating to the former issue have no relevance to the second.* The instruction requested in this case would not require the introduction of any additional evidence.[25]

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[23] Dempsey v. Thompson, 363 Mo. 339, 251 S.W.2d 42, 45 (1952).

[24] *Id.*

[25] Domeracki v. Humble Oil & Ref. Co., 443 F.2d 1245, 1251 (3d Cir. 1971) (emphasis added).

The decision reconciles the split of authority on the question by a well reasoned analysis of the bases for a grant of a cautionary instruction. It represents a new view in the Third Circuit, and in federal courts in general.[26] Other courts should follow the *Domeracki* analysis and grant the cautionary instruction.

Gerald Nels Olson

[26] *See* McWheeney v. New York, N.H. & H.R.R., 282 F.2d 34, 41 (2d Cir. 1960); Cunningham v. Bay Drilling Co., 421 F.2d 1398 (5th Cir. 1970); Prudential Ins. Co. v. Wilkerson, 327 F.2d 997 (5th Cir. 1964); New York Cent. R.R. v. Delich, 252 F.2d 522 (6th Cir. 1958); and Payne v. B. & O. R.R., 309 F.2d 546 (6th Cir. 1962).