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Evidence or Instructions Concerning Taxes in Personal Injury Actions

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EVIDENCE OR INSTRUCTIONS CONCERNING TAXES IN PERSONAL INJURY ACTIONS

THE amount recovered by a plaintiff in a personal injury action is expressly exempted from the federal income tax by the Internal Revenue Code.[1] A portion of the recovery in such an action is based on impairment of the plaintiff's earning capacity.[2] As is commonly known, money received from the exercise of one's earning capacity is subject to the federal income tax.[3] Thus, the question quite naturally presents itself: should income tax liability be a factor in determining the amount of damages to be awarded a plaintiff in a personal injury action?

Recently this question was squarely presented in *Texas & New Orleans R.R. v. Pool*,[4] a personal injury action arising under the Federal Employers' Liability Act.[5] In attempted mitigation of damages defendant railroad had sought to introduce evidence of the federal income taxes that would have been withheld from the plaintiff's gross wages from future employment had he not been disabled. The trial court refused to permit introduction of the evidence. On appeal this holding was affirmed by the Court of Civil Appeals for the Tenth Supreme Judicial District (Waco).[6]

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[1] INT. REV. CODE § 22 (b) (5).
[2] 4 RESTATEMENT, TORTS (1949) §924.
[3] INT. REV. CODE § 22 (a).
[4] Tex. Civ. App., 10th Dist. (Waco), Nov. 19, 1953. Not yet reported.
[5] 35 STAT. 65 (1908), 45 U.S.C. 1946 ed. § 51.
[6] The court stated in part as follows:

"The 9th circuit court in *Southern Pacific Railway Co. vs. Guthrie* [cited note 16 *infra*] . . . in discussing the question here presented, said: 'We think the court's view that the net take home pay, after taxes, would represent the actual loss, is correct; but we are now convinced that we cannot tell how much this would be. Under the tax law then in force, he could look forward to an additional exemption after age 65, and because he was married, the split income features of the law would give two additional exemptions when he reached 65, something about which we cannot tell.'

"Our view is that the rule announced in *Southern Pacific vs. Guthrie, supra,* is perhaps the one that should be followed. . . . The Supreme Court of Missouri, in a well considered opinion in *Dempsey vs. Thompson*, 251 S.W. 2d 42, followed the rule announced by the 9th circuit in *Southern Pacific Railway Co. vs. Guthrie, supra.* It further held in effect that the defendant (on request) would be entitled to an instruction that any amount awarded plaintiff would not be subject to Federal Income Tax. We are in accord with that view."

The court in this respect followed what is the prevailing rule both in this country and in England.[7] The court in effect conceded that the result of permitting a verdict based on the present value of the *gross* wages that might have been received absent the disabling injury is to permit the plaintiff to recover for more than his "actual loss,"[8] and that such a result is not consistent with the basic principle that damages should be compensatory.[9] The justification for such a course, the court indicated, is that the impact of future income taxes upon the gross wages is simply too speculative an element to be considered in determining the plaintiff's "actual loss." The court's holding on this point seems reasonably clear. By way of dictum, however, the court added that the defendant would be entitled, upon request, to an instruction that any amount awarded to the plaintiff would not be subject to the federal income tax.[10] Is the dictum consistent with the holding?

Let it be assumed that the present worth of the gross wages that the plaintiff would have earned is $50,000. The defendant has tried to show that because of probable income taxes the net loss or actual loss to the plaintiff is in the vicinity of, say, $40,000. This the defendant has not been permitted to do. If the jury, which has been strenuously urged to return a verdict which is compensatory,[11] is also told that the verdict will not be taxable, is it not possible that the jurors will make an effort to arrive at some *net* figure through a rough, uninformed estimate as to the impact of income taxes upon the gross wages? And would this not frustrate the basic objective that the jury shall not take taxes into account in determining the damages? Commentators have noted the seeming inconsistency involved in such procedure.[12]

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[7] See cases cited notes 15 and 16 *infra.*

[8] See note 6 *supra.*

[9] 4 RESTATEMENT, TORTS (1949) § 924.

[10] See note 6 *supra.*

[11] *Cf.* Reavio v. Taylor, 162 S. W. 2d 1030 (Tex. Civ. App. 1942) *er. ref. n.r.e.*

[12] Comments, 33 B. U. L. Rev. 114 (1953); 32 Neb. L. Rev. 491 (1953); 32 Tex. L. Rev. 108 (1953).

It is not clear, however, that the trial judge can exclude taxation from the consideration of the jury by the simple process of forbidding all mention of it at the trial. If nothing whatever is said to the jury about taxation, it is not inconceivable that the jurors may receive from one of their number an argument running somewhat like this: "We've been told to compensate the plaintiff by finding the present value of the wages he is going to lose. We've agreed that this amount is $50,000. But what's going to happen if we give this fellow a lump sum like that? The Government will take at least half. And what will be compensatory about that? I don't know what tax rates are, but it's pretty obvious that if we want this fellow to get $50,000, we'll have to return a verdict for $100,000 or maybe $150,000. The railroad can pay it, and as far as I'm concerned they ought to pay it." Is this an unlikely scene? Defendants' counsel do not think so, and have tried to avoid it by placing before the jury the basic legal fact that the verdict will not be taxed.[13] Such a case was *Hall v. Chicago & N.W. R.R.*,[14] where it was held that the defendant's lawyer, in an action under the Federal Employers' Liability Act, was not out of order in telling the jury, in the course of his summation, that the verdict, if any, would not be subject to income tax. The court's justification for this holding was a purported desire to prevent a ballooning of the verdict through an erroneous supposition on the part of the jury that the lump sum awarded to the plaintiff would be heavily taxed. Apparently the court did not take account of the fact that a jury so advised might *reduce* the verdict in order to arrive at what it conceived to be truly compensatory damages. If taxes are effectively to be removed from the consideration of the jury in personal injury cases, it appears that these two aspects of the problem must be recognized and dealt with.

[13] See Hall v. Chicago & N.W. Ry., 349 Ill. App. 175, 110 N.E. 2d 654 (1953); Dempsey v. Thompson, 251 S.W. 2d 42 (Mo. 1952); Hilton v. Thompson, 360 Mo. 177, 227 S.W. 2d 675 (1950).

[14] Cited in note 13.

As previously noted, it is the prevailing rule, both in England[15] and this country,[16] that in a personal injury action the taxability of future wages should not be considered by the jury. In this country there have been some expressions and dicta to the contrary,[17] including language in an early civil appeals case in

[15] Billingham v. Hughes, [1949] 1 K.B. 643 (C.A.), 9 A.L.R. 2d 311 (1949); Blackwood v. Andre, 1947 S.C. 333 (Scot.); Fine v. Toronto Transp. Comm., [1946] 1 D.L.R. 221 (Ont.) *But cf.* M'Daid v. Clyde Navigation Trustees, 1946 S.C. 462 (Scot.)

[16] Southern Pacific v. Guthrie, 186 F. 2d 926 (9th Cir. 1951); Chicago & N.W. Ry. Co. v. Curl, 178 F. 2d 497 (8th Cir. 1949); Stokes v. U. S., 144 F. 2d 497 (2d Cir. 1944); Dempsey v. Thompson, cited note 13 *supra;* Smith v. Penn. R.R., 99 N.E. 2d 501 (Ohio App. 1950); Tex. & New Orleans Ry. v. Pool, cited note 4 *supra.*

[17] In Phillips v. Phillips, 219 S.W. 2d 249 (Mo. App. 1949), it was held that the trial court was justified in considering the effect which tax liability would have on an alimony award to the wife in fixing the amount thereof. This case seems distinguishable on the ground, among others, that the possibility of periodic adjustments in the amount of alimony to be paid renders a consideration of the effect of taxation on the award much less conjectural than is the same consideration in a case where the award, once granted, is final.

Sunray Oil Co. v. Allbritton, 188 F. 2d 751 (5th Cir. 1953), and Wetherbee v. Elgin, Joliet, and Eastern R.R., 191 F. 2d 302 (7th Cir. 1951), dealt with situations wherein the defendant was urging, on appeal, that damages awarded in the trial court were excessive. The court in the *Wetherbee* case, after holding that the award was excessive and that the jury's action in rendering the verdict was capricious and arbitrary, noted that the award was excessively generous inasmuch as it was based on *gross* rather than *net* earnings which the plaintiff would have received but for the injury. Similar language, in a similar factual context, may be found in the dissenting opinion in the *Sunray Oil Co.* case, 188 F. 2d at 754, and in *De Vito v. United States Airlines,* 98 F. Supp. 88 (E.D.N.Y. 1951).

Avance v. Thompson, 320 Ill. App. 406, 51 N.E. 2d 334 (1943), and Cole v. Chicago, St. P., M., & O. Ry., 59 F. Supp. 443 (D. Minn. 1945), also involved situations where one party was urging that the damages awarded the other were excessive. In the course of the opinion in the *Avance* case, the court stated, "As a court of appeals . . . we can neither speculate or conjecture as to how plaintiff's financial status might be affected by business booms or depressions; . . . or how his earnings might be affected by his expenses away from home, *taxes,* work clothing, union dues, social security and old age pension. *We assume that the jury took these matters into consideration in arriving at their verdict. . . .*" 51 N.E. 2d at 341. (Emphasis supplied.) This language was quoted by the court in *Cole v. Chicago, St. P., M. & O. Ry.* In neither case, however, was the question of tax liability of the award really in issue. The language emphasized, *supra,* was seemingly loose dictum incident to the court's primary holding that the damages were not excessive. Further, if the matters enumerated by the court are, as was stated, too conjectural for the court to consider, one would suppose them to be too conjectural for jury consideration also.

Texas,[18] but most courts which have squarely considered the problem in recent years have concluded, as did the court in *Texas & New Orleans R.R. v. Pool*, that the impact of future taxes is too speculative a matter to be submitted to the jury.[19] In England the same result has been reached apparently on the theory that the benefit of the exemption from tax of the personal injury verdict should accrue to the victim and not to the tortfeasor.[20] These cases have typically dealt with the problem whether the defendant may adduce evidence concerning the probable impact of taxes upon future wages, and have held that he may not.

As has also been noted, complete silence on the issue of taxes is no assurance that the issue will effectively be removed from the consideration of the jury. And this problem seems rarely to have been dealt with in the appellate courts. Prior to the recent dictum in the *Pool* case the problem was apparently considered only by the Illinois[21] and the Missouri courts.[22] The outcome in Illinois was the *Hall* case, with the unfortunate result noted. In Missouri, however, the supreme court has suggested that in personal injury actions the jury should be instructed "substantially" as follows:[23]

You are instructed that any award made to plaintiff as damages in this

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[18] In Galveston, Harrisburg, & S.A. Ry. v. Dehnisch, 57 S.W. 64, 65 (Tex. Civ. App. 1900), an instruction to the jury that damages for diminished capacity to earn money and the calculation of the present worth of the future earnings so lost were to be calculated upon the basis of a return of six per cent per annum was held to be erroneous because "it is judicially known that some of this 6% must go for taxes and expenses of investment, to say nothing of the vicissitudes attending the loan of money." The court thus seemed to suggest that account should be taken of taxes with a view to making the verdict more compensatory. This case dealt with a contract which extended over a relatively short period of time as compared to the life expectancy of a given individual, and for this reason alone the effect of contemporaneous taxes was presumably less conjectural. It is interesting to note that this case was not discussed by the court in the recent *Pool* case.

[19] Cases cited note 16 *supra*.

[20] The same view was expressed in the *Pool* case by Chief Justice Frank O. McDonald, who concurred with the majority on the tax point but dissented on other grounds.

[21] Hall v. Chicago & N.W. Ry., cited note 13 *supra*.

[22] Dempsey v. Thompson, Hilton v. Thompson, both cited note 13 *supra*.

[23] Dempsey v. Thompson, 251 S.W. 2d at 45. Emphasis added.

> case, if any award is made, is not subject to Federal or State income taxes, *and you should not consider such taxes in fixing the amount of any award made plaintiff, if any you make.*

Such an instruction, said the Missouri Supreme Court, "would at once and for all purposes take the subject of income taxes out of the case."[24] And so it would, if the italicized portion of the instruction were properly understood by the jury, for it should prevent the jury from making unwarranted increases *or* decreases in the verdict. It is not clear, however, that such language, standing alone, would be understood by a jury.[25] Indeed, it does not appear that this language was properly understood by the Illinois court in the *Hall* case, for that court, while purporting to follow the Missouri case, believed that taxes would be completely removed from the consideration of the jury if defendant's counsel was permitted to tell the jury simply that the verdict would be tax-free.

It is submitted that the desired objective of eliminating the tax issue "at once and for all purposes" would best be achieved by a more explicit instruction—possibly one substantially as follows: (1) The jury is to find the present worth of the gross wages that the plaintiff would have earned but for the disabling injury. (2) The jury is not to deduct from the amount so found any sums which it is thought the plaintiff would have to pay in taxes if he actually earned such gross wages. (3) The jury is not to add to the amount so found any sum to compensate for supposed reduction of the verdict by taxation. And it would be helpful if, in concluding such an instruction, the trial judge would emphasize generally that the tax aspects of the case are fully taken care of by the income tax laws and that the jurors are not to take any account whatever of income taxes in arriving at the estimated damages.

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[24] *Id.* at 45.

[25] *Cf.* Comments, 33 B. U. L. Rev. 114 (1953); 32 Neb. L. Rev. 491 (1953); 32 Tex. L. Rev. 108 (1953).

There is no reason to suppose that this suggestion is in any way inconsistent with the general language in the *Pool* opinion. The court of civil appeals, while not quoting the all-important *caveat* in the opinion of the Missouri Supreme Court, indicated that it adhered to the views of the Missouri court.[26] The views of the Missouri court are basically sound; the only point made here is that the instruction to the jury should be sufficiently explicit to avoid any possibility of confusion on the tax issue.

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[26] See note 6 *supra.*