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Personal Injury Awards and the Nonexistent Income Tax - What is a Proper Jury Charge

COMMENTS

PERSONAL INJURY AWARDS AND THE NONEXISTENT INCOME TAX — WHAT IS A PROPER JURY CHARGE?

The underlying theory of damages in a personal injury action is that the award of a sufficient sum of money will place the plaintiff in the same position in which he would have been had the injury not occurred.[1] Usually the plaintiff seeks compensation for pain and suffering, for medical expenses, for loss of wages, and for impairment of future earning capacity.[2] This latter element may account for the bulk of the award, especially where the action is for wrongful death or where the plaintiff has been permanently disabled. The effect of the income tax laws on this aspect of the law of damages is the subject of this comment.

The Internal Revenue Code expressly exempts from federal income taxation "damages received (whether by suit or agreement) on account of personal injuries."[3] It would seem proper, therefore, to deduct from the sum awarded for impairment of future earning capacity, the amount which the plaintiff would have been taxed in the future as he actually earned the wages. To do otherwise is to give plaintiff tax-free future wages. It has, therefore, been argued that a recovery for loss of future wages should be based on plaintiff's prospective net income after taxes, rather than on his prospective gross income.[4] Some courts have rejected this argument on the ground that the tax exemption is a matter between plaintiff and the Government, and in no way concerns the defendant.[5] The majority, while approving of the validity of the argument has refused to permit the deduction on the ground that the amount is too conjectural.[6]

1. Restatement, Torts § 924 (1939); McCormick, Damages § 137 (1935).

2. "(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—

(1) . . .

(2) the amount of any damages received (whether by suit or agreement) on account of personal injuries or sickness . . . ." Int. Rev. Code of 1954, § 104(a)(2). Although this section does not expressly exclude from gross income that part of the verdict which represents income that would have been earned, all of the cases discussed in this comment assume that this element of damages is excluded from gross income. The precise point has apparently never been litigated due to the fact that the jury returns as a verdict a single sum, rather than apportioning separate sums to each element of the injury. One federal court, in dicta, has stated that neither past nor future wages are taxable. Combs v. Chicago, St. P., M. & O. Ry., 135 F. Supp. 750, 757 (N.D. Iowa 1956). It is entirely possible that the lost wages element of the verdict will be held taxable if, in the future, it becomes the practice to apportion the personal injury verdict.

3. Int. Rev. Code of 1954, § 104(a)(2).

4. British Trans. Comm'n v. Gourley, [1956] 2 Weekly L.R. 41 (H.L.).

5. Billingham v. Hughes, [1949] 1 K.B. 643 (C.A.); Fairholme v. Firth & Brown Ltd., 149 L.T.R. (n.s.) 332 (K.B. 1933).

6. Southern Pac. Co. v. Guthrie, 186 F.2d 926 (9th Cir.), cert. denied, 341 U.S. 904 (1951); Stokes v. United States, 144 F.2d 82 (2d Cir. 1944); Dempsey v. Thompson, 363 Mo. 339, 251 S.W.2d 42 (1952).

THE ENGLISH RULE

Surprisingly, the problem is one of fairly recent origin. The earliest case was *Fairholme v. Firth & Brown Ltd.*,[7] decided in England in 1933. That case involved the wrongful dismissal of an employee. The court held that there should be no deduction for taxes which the employee would have normally paid, since the payment of taxes or the exemption therefrom concerned only the taxpayer and the Crown. The same reasoning was applied in *Jordan v. The Limmer and Trinidad Lake Asphalt Co.*,[8] a case involving loss of wages due to personal injuries. And then in 1949, in *Billingham v. Hughes*,[9] the English Court of Appeals expressly rejected the "net pecuniary loss" theory and accepted the reasoning of the *Fairholme* case.

The *Billingham* case was accepted law in England until 1956 when the House of Lords, in *British Trans. Comm'n v. Gourley*[10] expressly overruled it and held that the verdict entered by the trial court must be reduced by the amount of taxes which plaintiff would have paid if the amount of the award had actually been earned. The court reasoned that a contrary holding would ignore the basic compensatory nature of damages and would provide plaintiff with something in the nature of a windfall recovery. One judge dissented on the dual grounds that computation of the tax deduction would be too speculative and that the matter of the tax exemption concerned only plaintiff and the Crown.

THE DISPUTE IN THE UNITED STATES

The courts of this country have been unanimous in holding that taxes should *not* be deducted in computing a plaintiff's award for impairment of earning capacity.[11] It is reasoned that the factors involved in computing the tax are so conjectural that the amount could not be determined with a sufficient degree of certainty, that the amount is dependent upon so many variables, e.g., the tax rate, the number of dependents, income from other sources, that any computation would be mere speculation.[12] American courts are, however, in conflict as to whether the charge to the jury should indicate that the damages awarded will not be subject to income tax. One school of thought suggests that, in the absence of such instruction, the jury may increase the amount of the award in order to offset the supposed tax liability.[13] Other courts, however, have argued that such instruction is extraneous, will confuse the jury and prejudice the plaintiff.[14]

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7. 149 L.T.R. (n.s.) 332 (K.B. 1933).
8. [1946] 1 K.B. 356.
9. [1949] 1 K.B. 643 (C.A.).
10. [1956] 2 Weekly L.R. 41 (H.L.).
11. See note 6 supra.
12. Texas & N.O.R.R. v. Pool, 263 S.W.2d 582 (Tex. Civ. App. 1953).
13. "Surely, the plaintiff has no right to receive an enhanced award due to a possible and, we think, probable misconception on the part of the jury that the amount allowed by it will be reduced by income taxes." Dempsey v. Thompson, 363 Mo. 339, 251 S.W.2d 42, 45 (1952).
14. "We are of the opinion that the incident of taxation is not a proper factor for a jury's consideration, imparted either by oral argument or written instruction. It introduces an extraneous subject, giving rise to conjecture and speculation." Hall v. Chicago & N.W. Ry., 5 Ill. 2d 135, 125 N.E.2d 77, 86 (1955).

THE DEMPSEY RULE

The problem first arose in *Hilton v. Thompson*,[15] in 1950, in which the Supreme Court of Missouri affirmed the trial court's refusal to instruct the jury that since the damages were not taxable nothing should be included in its verdict to compensate plaintiff for any such taxes.[16] The same court reconsidered the problem in *Dempsey v. Thompson*.[17] The trial court, conforming to the rule of the *Hilton* case, refused to charge the jury with regard to the tax exemption. The court reduced the verdict by ten thousand dollars and entered judgment for plaintiff. Defendant appealed on three grounds: (1) that he should have been permitted to show plaintiff's net earnings after taxes, (2) that the court should have instructed the jury that the verdict was tax-exempt, and (3) that the amount of the judgment was excessive.

The Missouri Supreme Court rejected defendant's first contention because ". . . too many unforeseeable and variable factors would enter into any attempted computation of income tax liability on loss of future earnings to permit of any reasonably accurate estimate thereof."[18] The court however, agreed that the trial court should have charged the jury that the award was tax free, so that the jury would not increase the verdict to offset the supposed taxes. The court stated, "surely, the plaintiff has no right to receive an enhanced award due to a possible and, we think, probable misconception on the part of the jury that the amount allowed by it will be reduced by income taxes."[19] The court made the ruling prospective only, because it felt that it would be harsh to subject plaintiff to such a ruling in view of the previous holding in the *Hilton* case. A model instruction[20] was phrased by the court to be used in subsequent cases in which such an instruction would be requested. With those qualifications the judgment of the lower court was affirmed.

THE MAJORITY RULE

The leading case representing the opposite point of view is *Hall v. Chicago & North Western Ry.*,[21] which was decided in 1955 by the Supreme Court of Illinois. During his summation, defendant's attorney stated that any verdict awarded to plaintiff would not be subject to income tax. Plaintiff objected and the trial court instructed the jury to disregard the statement. Plaintiff, nevertheless, moved for a new trial on the ground that he had been prejudiced, and

15. 360 Mo. 177, 227 S.W.2d 675 (1950).

16. "The jury was properly instructed on the factors to be considered in fixing the amount of respondent's damages and it would not have been proper to inject into the case an extraneous issue regarding the tax exempt status of the damages which might be awarded." Hilton v. Thompson, 360 Mo. 177, 227 S.W.2d 675, 681 (1950).

17. 363 Mo. 339, 251 S.W.2d 42 (1952).

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

19. Ibid.

20. "You are instructed that any award made to plaintiff as damages in this 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." Dempsey v. Thompson, 363 Mo. 339, 251 S.W.2d 42, 45 (1952).

21. 5 Ill. 2d 135, 125 N.E.2d 77 (1955).

the order granting a new trial was upheld on appeal. The court held that the interjection of the tax factor was improper because: (1) the jury was specifically told what elements to consider in determining the measure of damages. Since the court cannot assume that the jury will not follow instructions, there is no reason for mentioning the tax exemption. (2) Tax on the award is a matter between plaintiff and the Government, and the defendant has no interest therein. (3) The introduction of the tax factor would cause the jury to engage in speculation.

The first basis for the holding is questionable for two reasons. The court was emphatic in stating that it must be assumed that a jury will follow the instruction of the court.[22] Nevertheless, a new trial was granted despite the fact that the trial court instructed the jury to disregard counsel's statement.[23] It is, therefore, obvious that the court, in refutation of its own basic premise, assumed that the jury disregarded the judge's instruction and *did* consider the tax issue. It is conceded that the statement of highly prejudicial, irrelevant *facts* by counsel in his summation may be a ground for a new trial,[24] but it is difficult to see how an accurate statement of undisputed *law* can be highly prejudicial. Secondly, if we presume that the jury will not *intentionally* deviate from the court's instructions, it does not necessarily follow that it will ignore the tax factor. It is entirely possible that a jury, after arriving at an award, may, in good faith, add an amount to offset taxes, on the reasonable assumption that plaintiff is entitled to a sum representing the full amount of his damages, and not to that sum minus taxes. The jury would believe that it was complying with the court's instructions rather than disregarding them.

As a second ground for its holding the court ruled that the tax exemption is a matter between plaintiff and the Government. The court stated that ". . . if the jury were to mitigate the damages of the plaintiff by reason of the income tax exemption accorded him, then the very Congressional intent of the income tax law to give an injured party a tax benefit would be nullified."[25] It is conceded that this is a valid reason for refusing to deduct the amount which plaintiff would have paid in taxes. However, the defendant in this case did not ask to have the damages mitigated, but was merely seeking assurance that the jury would not *add* to the award under the misconception that it would be reduced by taxes.

Finally, the court stated that the interjection of the tax exemption would give rise to conjecture and speculation. Undoubtedly the court feared that the jury, upon learning that the verdict is not subject to taxes, would attempt to

22. ". . . [B]y the very nature of the jury system this court cannot indulge the presumption that juries do not follow the instructions of the courts." Hall v. Chicago & N.W. Ry., 5 Ill. 2d 135, 125 N.E.2d 77, 85 (1955).

23. But see, Pfister v. Cleveland, 96 Ohio App. 185, 113 N.E.2d 366, 368 (1953) where, under like circumstances, the court stated: "We, therefore, are of the belief that an objection by the plaintiff at the time of the occurrence with a request of the court to instruct the jury to disregard the improper remark could have cured any harm done and that failure to so do was equivalent to a waiver of the incident."

24. See, e.g., Tropp v. Jacobs, 273 App. Div. 274, 77 N.Y.S.2d 179 (1st Dep't 1948).

25. Hall v. Chicago & N.W. Ry., 5 Ill. 2d 135, 125 N.E.2d 77, 86 (1955).

deduct the amount which plaintiff normally would have paid. This possibility could be easily eliminated by instructing the jury neither to add nor deduct anything because of the tax exemption. Then neither party to the action could be prejudiced if it is to be presumed that the jury will follow the instructions of the court.[26]

Present State of the Law

The *Dempsey* rule has met with little approval in other jurisdictions. In *Highshew v. Kushto*,[27] an Indiana court, in a dictum, approved of the suggested instruction[28] of the *Dempsey* case. The Texas Civil Appeals Court, in *Texas & N.O.R.R. v. Pool*,[29] also approved the rule, but this too was dictum, since the reversal was expressly based on the issue of negligence. The dictum of the *Pool* case was subsequently repudiated by a holding of the same court.[30]

The view expressed by the *Hall* case was followed by a majority of the few jurisdictions which have considered the question. In *Maus v. New York, Chicago & St. L. R.R.*,[31] the refusal of the trial court to charge that the verdict was tax-exempt was upheld, on the ground that a correct statement of law must be charged only when it is pertinent to one of the issues. The *Dempsey* rule was expressly rejected in the case of *Missouri-Kan.-Tex. R.R. v. McFerrin*,[32] in which the Texas court repudiated its dictum in the *Pool* case. In the most recent case dealing with the subject, the Supreme Court of Arizona aligned itself with the jurisdictions which refuse to charge the tax-exempt status of the verdict. In *Mitchell v. Emblade* this court stated: ". . . we are of the view that Illinois, Texas and Ohio are correct in requiring that the case be tried on the issues and presented to the jury with a correct measure of damages, of which the incident of income tax has no part. We would prefer to assume that the jurors to the best of their ability will follow the instructions given and will not depart from the issues and the law as announced."[33] Since the judgment for plaintiff was reversed on other grounds, this, however, must also be taken as dictum.

CONCLUSION

While American courts agree that an award should not be reduced because of its tax-exempt status, there is a definite split of authority as to whether the jury should be informed of the exemption. Of the six states which have considered this latter issue, two favor the instruction[34] and four are opposed.[35] The dearth of authority on the point is emphasized by the fact that only four

26. See note 22 supra.
27. 131 N.E.2d 652 (Ind. App. 1956).
28. See note 20 supra.
29. 263 S.W.2d 582 (Tex. Civ. App. 1953).
30. Missouri-Kan.-Tex. R.R. v. McFerrin, 279 S.W.2d 410 (Tex. Civ. App. 1955).
31. 165 Ohio St. 281, 135 N.E.2d 253 (1956).
32. 279 S.W.2d 410 (Tex. Civ. App. 1955).
33. 80 Ariz. 398, 298 P.2d 1034, 1038 (1956).
34. Missouri and Indiana favor the charge.
35. Illinois, Ohio, Texas and Arizona consider such instruction improper.