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THE CONVERGENCE OF I.R.C. § 104(a)(2), NORFOLK & WESTERN RAILWAY CO. V. LIEPELT AND STRUCTURED TORT SETTLEMENTS: TAX POLICY "DERAILED"

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INTRODUCTION

SINCE its inception, the Internal Revenue Code (Code) has exempted from taxation amounts received as damages for personal injuries.1 That exemption is presently encoded in section 104(a)(2),2 which except for minor deviations,3 provides that amounts received on account of personal injuries are excluded from gross income. Over the years, the exemption has attracted little criticism. Most commentators have concluded that the exclusion is justified on humanitarian

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1. In 1919 Congress enacted § 213(b)(6), the predecessor of § 104(a)(2), to provide that tort damages are to be excluded from gross income. Revenue Act of 1918, Pub. L. No. 65-254, § 213(b)(6), 40 Stat. 1057, 1066 (1919). The legislative history of the section indicates that Congress thought it doubtful that amounts received through accident or health insurance, or under workmen's compensation acts, as compensation for personal injuries or sickness are required to be included in gross income. H.R. Rep. No. 767, 65th Cong., 2d Sess. 4-5 (1918); see Nordstrom, Income Tax And Personal Injury Awards, 19 Ohio St. L.J. 212, 222-23 & n.49 (1958). Prior to the enactment of § 213(b)(6), the predecessor of § 104(a)(2), the nontaxable nature of personal injury awards was questionable. Early regulations promulgated by the Commissioner of Internal Revenue sought to tax amounts received as the result of personal injuries by analogizing them to insurance proceeds. Treas. Reg. 33 (Rev.), art. 4, ¶ 25, 20, Treas. Dec. Int. Rev. 130 (1918). Shortly thereafter, however, the Attorney General, in response to an inquiry by the Treasury Department, stated that insurance proceeds were "capital as distinguished from 'income' receipts." 31 Op. Att'y Gen. 304, 308 (1918). As a result, the Commissioner reversed his position and held that because insurance proceeds were not taxable as income, damages received from suit or settlement for personal injuries were also to be excluded. T.D. 2747, 20 Treas. Dec. Int. Rev. 457 (1918). This position was subsequently codified in § 213(b)(6).


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 . . . .

3. See infra notes 19-23 and accompanying text.
grounds even if it is at variance with tax theory.\textsuperscript{4} The inequities between personal injury victims and other taxpayers produced by section 104(a)(2) have been tolerated if not condoned by Congress.

Two separate, recent developments, however, call into question the continued desirability of section 104(a)(2). On January 14, 1983, Congress amended section 104(a)(2) expressly to exclude from gross income amounts received as damages for personal injuries "whether [paid] as lump sums or as periodic payments."\textsuperscript{5} This amendment codifies the position previously taken by the IRS,\textsuperscript{6} a position which has led to the increased use of periodic payments, or as they are often called,\textsuperscript{7} structured settlements, to satisfy personal injury tort claims. A portion of each periodic payment represents investment or interest income on a principal amount which might otherwise have been paid to the personal injury claimant had he accepted a lump-sum payment. If a claimant were to receive this amount and invest it himself, he would be taxed on the resulting income. Thus, excluding the entire amount of these periodic payments from gross income produces "horizontal" inequities in the tax treatment of personal injury claimants.\textsuperscript{8} Those claimants who accept a deferred payment arrangement receive more favorable tax treatment than those claimants who accept lump-sum settlements.

This Article contends that the disparate tax treatment of these similarly situated claimants is not based on economic reality and should be eliminated. Congress should repeal the 1983 amendment

\textsuperscript{4} See Harnett, Torts And Taxes, 27 N.Y.U. L. Rev. 614, 625-27 (1952) (suggesting that the exclusion is "rooted in emotional . . . rather than logical, factors . . . the victim is more to be pitied rather than taxed."); 69 Harv. L. Rev. 1495, 1496 (1956) (arguing that a benevolent intent can be inferred either from lack of corrective action or from emotional and traditional reasoning). Contra Note, Personal Injuries: Should Non-Taxability of Judgements Decrease Award?, 8 Tulsa L.J. 242, 244 & n.15 (1972) ("[t]he only evidence . . . tending to show a legislative intent to confer an award free from tax considerations [is] . . . in the opinions of [the] various courts.") [hereinafter cited as Personal Injuries]


\textsuperscript{8} Throughout this article the term "claimant" will be used to denote the person who claims to have been the victim of a personal injury. The term is favored over the less neutral term "victim," or the term "plaintiff" which assumes the existence of a case in litigation. The claimant is the term employed by the Model Periodic Payment of Judgments Act § 3(c)(3)(i), 14 U.L.A. 24 (Supp. 1983).
and the doctrine of economic benefit⁹ should be applied to periodic payments of damage awards thereby divesting them of their favored tax treatment.

The second development undercutting the wisdom of the section 104(a)(2) exclusion is the 1980 Supreme Court decision in Norfolk & Western Railway Co. v. Liepelt.¹⁰ The Court held that the effect of income taxes should be considered in assessing damages for personal injuries in cases arising under the Federal Employers' Liability Act (FELA).¹¹ This holding will result in reducing damage awards for lost earnings to a figure net of taxes, causing defendants to become the beneficiary of the section 104(a)(2) exemption. Moreover, Liepelt, although it has generated little interest or comment,¹² if properly understood in relation to section 104(a)(2), promises to accelerate the use of structured settlements. In light of these two unfortunate by-products of the Liepelt decision, this Article recommends that Congress amend the section to remove the tax exemption for any amounts paid as compensation for lost earnings.

I. SECTION 104(a)(2) AND PERSONAL INJURY DAMAGE AWARDS

Injured parties often initially claim extraordinarily high damages without attempting to verify the source or cause of the figure.¹³ Once the publicity of the initial complaint has passed, however, the claimant's attorney must get down to the business of calculating realistic and provable damages. The initial step is to characterize the damages, although if the parties go to trial it is questionable whether the jury pays much attention to detailed calculations of damages.¹⁴ Instead, juries often apply their own "common sense" view of the amount of

⁹. The doctrine has been addressed, but surprisingly rejected by the IRS. Rev. Rul. 79-220, 1979-2 C.B. 74. See infra pt. II(B).
¹¹. Id. at 497-98.
¹³. The National Law Journal stated: "Many lawyers feel a pressure to file inflated claims for general and punitive damages, which are not related to direct out-of-pocket losses. Indeed, it's almost axiomatic that attorneys will sue for the moon and settle for a small slice of cheese." 3 Nat'l L.J., July 27, 1981, at 1, col. 4.
damages. Nevertheless, plaintiffs' attorneys and commentators regularly categorize damages in bewildering, elaborate systems.

From the standpoint of federal income taxation, a breakdown of the damage award by categories is both unnecessary and irrelevant because no portion of the damage award is taxable. Damage payments for personal injury have been exempted from gross income since 1918, and it is therefore of no moment whether the amount represents reimbursement for lost earnings, or payment for the loss of an eye. But, of course, since it is an income tax matter, there are exceptions to the rule.

At least one opportunity presents itself for including certain amounts of the damage award in gross income; it arises from the deductibility of medical expenses as provided by section 213. If the claimant, in years prior to the damage award, has deducted the medical expenses he incurred for which the damage award is intended as reimbursement, he must report those reimbursed expenses as income in the year received. In short, the earlier deduction is reversed, and the tax savings that it generated are offset by the taxation of the

15. As a result, special interrogatories are often requested. See, e.g., Hayes v. Allstate Ins. Co., 368 So. 2d 1214, 1216 (La. Ct. App. 1979); Blanche v. Samuels, 354 So. 2d 213, 222-23 (La. Ct. App. 1977); Thibeault v. Brown, 92 N.H. 235, 237, 29 A.2d 461, 462-63 (1942); Louissaint v. Hudson Waterways Corp., 111 Misc. 2d 122, 123-24, 443 N.Y.S.2d 678, 679 (Sup. Ct. 1981); Sawdey v. Schwenk, 2 Wis. 2d 532, 534, 87 N.W.2d 500, 502 (1958); O'Quinn, Common Elements of Recovery in Personal Injury Cases, 18 S. Tex. L.J. 179, 214 (1976). Most civil cases in federal courts are resolved by a general verdict. Rule 49 of the Federal Rules of Civil Procedure makes available two procedures as discretionary alternatives to the general verdict. Under subdivision (b) the judge may, if he sees fit, ask the jury to return a general verdict, but to accompany it with answers to certain interrogatories about particular issues in the case. Under subdivision (a) the court is given authority to dispense with the general verdict altogether, and to submit the various issues in the case to the jury in the form of individual fact questions, on each of which the jury is to return a special verdict. Fed. R. Civ. P. 49; see 9 C. Wright & A. Miller, Federal Practice and Procedure § 250, at 484-86 (1971).

16. See Karon, Developing Evidence of Damages in Personal Injury Actions, 3 Trial Dipl. J. 14, 14-19 (Fall 1980) (3 categories); Nace, A Checklist for Maximizing Damages, 17 Trial 43, 43 (June 1981) (7 categories); Nordstrom, supra note 1, at 215-16 (4 categories); O'Quinn, supra note 15, at 179 (7 categories).


18. Awards paid for loss of life are also expressly excluded from gross income by I.T. 2420, 7-2 C.B. 123 (1929).


20. If the taxpayer's settlement received for personal injuries does not specify the amount that represents reimbursement for past or future medical expenses, the IRS will presume that the amount received is attributable first to past medical expenses previously deducted because that amount is a sum certain. Rev. Rul. 75-230, 1975-1
reimbursement in the year of its receipt.\textsuperscript{21} If the claimant’s marginal tax rate in the year of the inclusion is the same as it was in the year of deduction, neither the government nor the taxpayer has benefited, except that the taxpayer enjoyed a modest tax-free “loan” from the government. Admittedly, the reversal of the earlier deduction by the inclusion of the reimbursement in gross income is a crude method, prone to favoring either the taxpayer or the government depending on the tax rate applied to the deduction compared to the tax rate applied to the later inclusion.\textsuperscript{22} But it is accurate enough in light of the need for an administratively convenient rule. Moreover, such treatment does adhere to the fundamental tax principles that each tax year should be “sealed off” from the other and that the income tax operates on an annual rather than transactional basis.\textsuperscript{23}

C.B. 93, 93. The Ruling holds that if a settlement expressly allocates a portion of the amount as reimbursement for past medical expenses, then the amount of past expenses incurred and deducted in a prior year will be includable in gross income in the year of receipt. \textit{Id.} at 93-94. Another ruling, Rev. Rul. 79-427, 1979-2 C.B. 120, 120-21, accords similar treatment in both of the above-mentioned situations if the award results from a judgment following trial instead of a settlement.

21. An analogous situation, also traceable to the deductibility of medical expenses under §213, is worth noting. The IRS has ruled that out-of-pocket medical expenses (otherwise qualifying for deductibility under §213) will not be deductible to the extent they have been prospectively reimbursed by an earlier damage award. When a settlement specifically allocates an amount of future medical expenses, all medical expenses paid after receipt of settlement will be deductible only to the extent that they exceed the amount allocated by the settlement. Rev. Rul. 75-232, 1975-1 C.B. 94. A later ruling, Rev. Rul. 79-427, 1979-2 C.B. 120, by incorporation of Rev. Rul. 75-232, inferentially dictates that a damage award should be treated similarly. This treatment bars a double recovery: Because the expense was reimbursed with tax-free dollars, the expense cannot be allowed to generate tax savings by way of a deduction. Rev. Rul. 79-427, 1979-2 C.B. 120. If, on the other hand, the taxpayer receives a damage award for personal injury damages that does not specify the amount allocated to the various elements of the damage, Rev. Rul. 79-427, 1979-2 C.B. 120 holds that an amount properly allocable to future medical expenses is determinable from the evidence presented by the taxpayer at trial and by the itemization presented upon appeal. Thus, future medical expenses will be deductible only to the extent that they exceed the portion of the award so allocated. The validity of this Ruling as to the allocation of lump-sum damage awards is questionable in light of the holding in Niles v. United States, 520 F. Supp. 808 (N.D. Cal. 1981), in which the court refused to follow the rationale of Rev. Rul. 79-427, and declared that the IRS lacked the authority to allocate a portion of a lump-sum personal injury award to future medical expenses. \textit{Id.} at 813. Citing the lump-sum nature of the jury verdict, the court held that the award could not be allocated into its component parts with any degree of certainty. \textit{Id.} at 812.

22. Since the additional income that arises from reimbursement represents an add-on to other income, it is taxed at the taxpayer’s highest marginal rate. If all other factors remain constant, the marginal rate is likely to be higher in the year of reimbursement than in the year of the deduction. The addition of income in the year of reimbursement may boost the taxable income into a higher bracket, whereas in the year of deduction, part or all of the deduction may offset income of a lower bracket, thus reducing the value of the deduction.

Absent this exception, section 104(a)(2) grants tax-free status to personal injury damage awards. This exclusion of income produces inequity in that taxpayers other than personal injury victims with equal consumable incomes are subject to taxation. That is, $20,000 of disposable income received as a payment or reimbursement for personal injury is free of taxes, while $20,000 of wages are subject to taxes and correspondingly produce less disposable income. This unequal treatment is seen most dramatically in the exclusion from taxation of damage awards that represent reimbursement for lost earnings (either future or past). The section 104(a)(2) exemption favors earnings that are "earned" by virtue of being paid as a damage award, over earnings that are "earned" (i.e. wages) by the efforts of the taxpayer.

Section 104(a)(2), however, does not fully shield damage awards for lost earnings from taxation. The investment earnings made possible by a lump-sum settlement are included in gross income. Because the lump-sum award for loss of future earnings will be discounted to account for the acceleration of what would have been income arising over a number of years, the dollar figure of the damage award will be less than the arithmetical total of the lost future wages. For example,

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24. In part, § 104(a)(2) is a "tax expenditure" because it subsidizes injured parties by its failure to tax their damage awards: the amount of the subsidy being dependent upon the marginal tax rate of the claimant. A "tax expenditure" is any provision of the Code that promotes social or economic objectives through the use of deductions, credits, exclusionary exemptions, deferrals or preferential rates. Such an item is considered an "expenditure" because the goal might have been achieved by way of a direct expenditure from the budget. Surrey, Tax Incentives as a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures, 83 Harv. L. Rev. 705, 706 (1970).

25. Of course, any additional interest income that a claimant might realize by personally investing a portion of a periodic payment after its actual receipt would be included in gross income as well. This Article, however, focuses on the disparate treatment of the investment income portion of the periodic payment itself and its practical equivalent, the earnings derived from the investment of a lump-sum settlement to offset the discount to present value.

26. For many years courts have recognized that lump-sum awards for future damages had to be discounted to present value. The "adequate allowance [must] be made, according to circumstances, for the [future] earning power of money." Chesapeake & O. Ry. v. Kelly, 241 U.S. 485, 491 (1916). The proper rate is often in debate. Compare Blue v. Western Ry., 469 F.2d 487, 497 (5th Cir. 1972) (the rate of discount is equal to the appropriate rate of interest that could be anticipated over the remaining work-life of the plaintiff), cert. denied, 410 U.S. 956 (1973) with Wilkinson v. Yamashita-Shinnihon Kisen, K.K., 366 F. Supp. 110, 117 (D. Md. 1973) (held appropriate to use the present high interest rates of 5% to determine the rate of discount), modified mem., 538 F.2d 327 (4th Cir. 1976). The argument is not merely between short-term versus long-term interest rates, but also as to what kinds of investments. The general rule is that one looks to a reasonable rate of return from conservative investments. See, e.g., Johnson v. International Ins. Co., 347 So. 2d 1279, 1283 (La. Ct. App. 1977). Another issue to consider is whether the effects of inflation should be considered and thereby reduce or offset the discount. Most
if the injured party suffered a loss of $20,000 of future earnings per year for ten years, assuming a discount rate of 10%, the $200,000 of lost earnings would have a present value of $122,891. Thus, because the interest income earned by investing the discounted damage award is taxable, the total after-tax consumable dollars available to the claimant will be less than the total pre-tax lost earnings. In our example, the claimant would receive $122,891 as the discounted value of the lost earnings. If he were to invest it at a 10% rate of interest he could consume $20,000 for 10 years if the interest were tax-free. But section 104(a)(2) does not exempt the investment interest earned by a lump-sum damage award or settlement, and so the after-tax rate of return will be less than 10% and the consumable income will amount to something less than $20,000 per year.27

The claimant is not necessarily disadvantaged by this outcome; had he not been injured and continued to work the resulting earnings would have been taxed. The consumable income would have been $20,000 per year less the income taxes owed. Indeed it is likely that the lump-sum damage settlement resulted in more consumable income as only a portion of the lost earnings, in our example the interest earned on the $20,000, was taxed, while if the taxpayer had earned the $20,000, the entire amount of it would have been included in gross income.

The tax exemption of section 104(a)(2) also produces inequity between taxpayers who incur reimbursable medical expenses and those who incur nonreimbursable medical expenses. To the extent that

commentators agree that inflation should be considered with the result that the rate of discount would be lowered to a true “real” return, as opposed to the interest that merely maintains the purchasing power of the original lump-sum award. E.g., Formuzis & O’Donnell, *Inflation and the Valuation of Future Economic Losses*, 38 Mont. L. Rev. 297, 303-04 (1977); Henderson, *The Consideration of Increased Productivity and the Discounting of Future Earnings to Present Value*, 20 S.D.L. Rev. 307, 310 (1975); Note, *Future Inflation, Prospective Damages, and the Circuit Courts*, 63 Va. L. Rev. 105, 133 (1977). Nor is there agreement as to which elements of a damage award must be reduced to present worth, i.e. discounted. Logically, any damage payment that represents reimbursement for an expense, lost earnings, or suffering that will occur in the future should be discounted. In cases arising under FELA, damage awards for future lost earnings or medical expenses must be discounted, but damage awards for future pain and suffering are not. O’Byrne v. St. Louis S.W. Ry., 632 F.2d 1285, 1286 (5th Cir. 1980) (per curiam); Texas & Pac. Ry. v. Buckles, 232 F.2d 257, 264 (5th Cir.), cert. denied, 351 U.S. 984 (1956). States vary whether to discount the damages for pain and suffering. Compare Oberhelman v. Blount, 196 Neb. 42, 49, 241 N.W.2d 355, 360 (1976) (future pain and suffering must be reduced to present worth) with St. Paul Fire & Marine Ins. Co. v. Dillingham, 112 Ga. App. 422, 424, 145 S.E.2d 624, 626 (1965) (no reduction to present value for future pain and suffering).

27. For example, if the tax rate were 20%, the after-tax rate of return would be 8%, and the taxpayer could consume only $17,891 per year (assuming no change in the marginal rate of taxation).
nonreimbursed medical expenses result in a deduction under section 213(a), reimbursed and nonreimbursed expenses are treated alike: In both instances the income devoted to medical expenses is relieved from taxation. Section 213(a), however, permits medical expense deductions only to the extent such expenses exceed 5% of adjusted gross income (AGI).\textsuperscript{28} Up to the threshold of 5% of AGI, the taxpayer must pay for medical expenses with after-tax dollars. Because no such comparable threshold exists for exempt reimbursement payments, section 104(a)(2) grants greater tax relief to reimbursed taxpayers than section 213(a) grants to nonreimbursed parties. In addition, some nonreimbursed taxpayers will be ineligible for the section 213(a) deduction because it is an itemized deduction per section 63.\textsuperscript{29} If the taxpayer lacks a sufficient amount of itemized deductions, none of the nonreimbursed medical expenses will be deductible and they will have to be paid entirely with after-tax dollars.\textsuperscript{30}

II. STRUCTURED TORT SETTLEMENTS

The above-discussed inequities engendered by section 104(a)(2) might be borne as an unfortunate, but unavoidable consequence of an understandable congressional desire to assist personal injury victims. Other inequities, however—horizontal inequities—exist among personal injury claimants because of the current tax treatment\textsuperscript{31} of deferred payment arrangements (structured settlements), which are frequently used to settle personal injury claims. Those claimants who accept a deferred payment arrangement receive more favorable tax treatment than those claimants who accept a lump-sum settlement.

The term structured settlement refers to the practice by which the claimant agrees to be paid over a number of years or to be paid an annuity for life rather than accepting a fixed, lump-sum amount.\textsuperscript{32}

\textsuperscript{28} I.R.C. § 213(a) (1976).

\textsuperscript{29} A taxpayer is eligible to itemize under I.R.C. § 63(c) (Supp. V 1981) if he has "excess" deductions, or total deductions that exceed the applicable zero bracket amount as defined in I.R.C. § 63(d) (Supp. V 1981).

\textsuperscript{30} The vast majority of taxpayers who benefit from itemization are those entitled to a mortgage interest deduction per § 163. In 1978, 89.8 million individual income tax returns were filed with 25.8 million, or 29% of the returns, claiming itemized deductions. Of those returns claiming itemized deductions, 19.5 million, or 77%, claimed a deduction for home mortgage interest. In 1979, 92.7 million returns were filed with 26.5 million, or 29% of the returns claiming itemized deductions, and 20.9 million or 79%, claimed a deduction for home mortgage interest. Internal Revenue Statistics of Income—1979, Individual Income Tax Returns 1, 31, 35 (1982); Internal Revenue Service Statistics of Income—1978, Individual Tax Returns 55 (1981).

\textsuperscript{31} See infra pt. II(A).

\textsuperscript{32} Choulos, Structured Settlements: Cure or Curse? 16 Trial 73, 73-74 (Nov. 1980); Corboy, supra note 7, passim; Eligett, The Periodic Payment of Judgments,
Expenses incurred by the claimant prior to the settlement are usually reimbursed by a lump-sum payment, while future anticipated damages are compensated by subsequent periodic payments. The payments may be a fixed amount, a fixed amount adjustable for inflation, or an amount varying according to the future needs of the claimant. In some instances, the parties may ignore any total calculation of damages and merely agree to a monthly or annual figure sufficient to meet the projected financial needs of the victim.

Once the parties have agreed on the amount of the periodic payment, the defendant is free to seek out the least expensive way to fulfill his obligation. Although some use is made of irrevocable, funded trusts (the claimant being the beneficiary), the preferred method is to purchase an annuity payable to the claimant for the prescribed period of time. Defendants generally hide the actual cost of the annuity.
from the claimant since it is often considerably less than anticipated by the claimant or less than the lump-sum amount that it supplanted. The cost of a lifetime annuity may be surprisingly low if the claimant's life expectancy was severely diminished by the accident. However, because of this secretiveness, the parties, and the claimant's counsel in particular, are free to publicly ascribe a large value to the settlement and thereby garner the attendant publicity.

A. Amended Section 104(a)(2) Fosters Horizontal Inequity

On January 14, 1983, section 104(a)(2) was amended to provide that damage awards received as periodic payments on account of personal injuries are excluded from gross income. The amendment merely codified, rather than changed, the current interpretation of the law. Prior to the amendment, the IRS had held that periodic payments, including the portion of the deferred payments that represents interest earned on the deferred principal, are nontaxable. Thus, the total amount of a deferred settlement payment escapes taxation even though every periodic payment is comprised of a mix of principal and investment income arising from the deferred portion of the principal.

An equitable and consistent income tax should treat a claimant's decision to receive an annuity (or the income from an irrevocable trust) in lieu of outright receipt of the principal sum as providing

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32, at 16-17 (while trusts offer several investment advantages over annuities, management expenses and tax liabilities upon distribution of a trust corpus may make annuities a preferable funding device).

38. See, e.g., Choulos, supra note 32, at 75; Annuities, supra note 32, at 368.

39. See Fuller, supra note 32, at 27; Sedgwick & Judge, supra note 32, at 585-86; Annuities, supra note 32, at 368.

40. See Verbeck & Michaels, supra note 7, at 19-20; Annuities, supra note 32, at 367-68; Nat'l L.J. Nov. 23, 1981, at 18, col. 3.


42. Rev. Rul. 79-313, 1979-2 C.B. 75 (annually increasing payments from the defendant's liability company are received as damages within the meaning of § 104(a)(2), subject to the limitation of Rev. Rul. 65-29); Rev. Rul. 79-220, 1979-2 C.B. 74 (annuity payments from a policy owned by the defendant's liability company are received as damages within the meaning of § 104(a)(2), subject to the limitations of Rev. Rul. 65-29 1965-1 C.B. 59); Rev. Rul. 77-230, 1977-2 C.B. 214 (trust distributions made from income or corpus of the trusts involved in this ruling are received as damages within the meaning of § 104(a)(2)).

43. That a deferred payment consists of both principal and interest is most clear in the event that the defendant purchases an annuity, payable to the claimant, as an insured method of payment. Annuities, almost by definition, are a return of principal together with interest. 1 B. Bittker, Federal Taxation of Income, Estates and Gifts ¶ 12.3.1 (5th ed. 1981).
comparable economic benefit and, therefore, necessitating comparable taxation. Yet this is not the case. If, for example, rather than a deferred payment, the claimant accepted a lump-sum settlement and then invested it, the subsequent interest income would be included in gross income.\textsuperscript{44} If the claimant used the lump sum to purchase an annuity, he would be taxed on that portion of the proceeds that represented interest income.\textsuperscript{45} In short, section 104(a)(2) does not extend its protection to the income earned on invested damage awards, even though the parties are likely to have anticipated such earnings and calculated the amount of the settlement accordingly.

For purposes of consistency and equity, Congress should tax interest income that is paid to the claimant even though the interest is earned on principal that was not received by the claimant, but rather held or invested for his benefit under a deferred payment plan.\textsuperscript{46} The principal need not be retained by the defendant-payor, because the interest is exempt even though earned by and paid through the use of an annuity, or by a funded irrevocable trust.\textsuperscript{47} Given the inconsistent taxation of the interest income, the current tax system impels wise claimants to accept a deferred payout of the settlement, thereby obtaining the benefits of the section 104(a)(2) tax exemption for the interest income earned upon the principal sum of the settlement.

Imagine two sixty-year old tort victims, X and Y, both of whom suffer $100,000 in lost future earnings, the $100,000 figure being the discounted value of their lost earnings for the next five years. If X settles for a lump sum of $100,000 and invests it in 10% corporate bonds which mature in 5 years, X would have $10,000 a year taxable income and a return of the $100,000 at the end of the fifth year. X would have consumable income of $150,000 less the income taxes on

\textsuperscript{44} Rev. Rul. 65-29, 1965-1 C.B. 59.
\textsuperscript{45} I.R.C. § 72(b) (1976); see Hindert, supra note 32, at 9-10 (illustrating how § 72(b) operates).
\textsuperscript{46} Nor is tax exemption of the interest consistent with the treatment of interest arising from other deferred payment arrangements. The interest portion of a taxpayer purchased annuity is taxable. I.R.C. § 72(a) (1976). Any interest resulting from deferred payments of life insurance proceeds are taxable. The exemption for life insurance proceeds applies only to the amount of the at-death benefit. I.R.C. § 101(d) (1976).
\textsuperscript{47} Deferred payments of damage awards may assume various forms. The purchase of an annuity payable to the claimant is the most widely used form. Moore, supra note 32, at 50; Sedgwick & Judge, supra note 32, at 584. Another method is an irrevocable funded trust usually with a bank trustee. When the obligation to pay the claimant terminates, usually at the death of the claimant, the trust terminates. The balance of the trust fund then reverts to the defendant or his insurer. Fuller, supra note 32, at 29. A third possibility is to have the defendant's casualty insurer underwrite its own annuity plan. The insurer would set aside and invest a lump sum, the income from which would be used to fulfill the periodic payment obligation. Verbeck & Michaels, supra note 7, at 19.
the interest. If we assume a tax rate of 25%, X will pay $12,500 in
taxes ($10,000 x 5 x 25%), leaving net income of $137,500. (A com-
parable result would occur if X had used the $100,000 to purchase a five-
year annuity). If Y, on the other hand, chooses to accept deferred
payments of $10,000 per year for five years with a payment of
$100,000 at the end of the fifth year, Y's gross income would be
$150,000, all of which is tax free. (Again, the same result would occur
if Y had accepted a five-year annuity purchased at a cost of $100,000).

Obviously, such disparate tax treatment finds little justification in
economic realities. The chief difference in the above example between
X and Y is the retention by X of the power to consume the principal or
to choose the form of its investment.48 X also retained the ability to
change investments or to terminate the investment and consume the
principal. This "freedom of choice," however, might not exist if X
purchased an annuity, or had invested in some similarly restrictive
investment. Even an apparently flexible investment might be subject
to any number of restraints that would discourage the recipient, as a
practical matter, from exercising the freedom of investment that was
apparently obtained by the acceptance of a lump-sum settlement. If,
for example, the recipient purchased long-term bonds as a means of
providing a stable income, and if interest rates subsequently rose, the
bonds would decline in value. To change investments, the recipient
would have to absorb a loss of principal; something he might not be
willing to accept. Still, in our example, X does have continuing "do-
minion and control" over the damage award, while Y surrendered
that control upon agreeing to a deferred payment arrangement. Does
that modest difference in control warrant such a difference in tax
treatment?

The doctrine of constructive receipt might seem to apply because it
calls for taxation based upon underlying economic realities rather
than the mere surface arrangements.49 The relevant Revenue Rul-

48. The line between consumption and investment will not always be clear. A
disabled claimant might spend part of a lump sum on structural changes to his
housing so that he could care for himself, e.g. a modified kitchen. Alternatively, he
might invest the lump sum and use the income and principal to hire a cook to prepare
his meals. The outcome would be the same: The difference is one of using principal
to procure a labor-saving consumer durable versus using principal to employ labor.

49. The doctrine of constructive receipt originated as a means of preventing
taxpayers from artificially manipulating the timing of the taxation of their income by
refusing to accept income that was actually available to them. Ross v. Commissioner,
169 F.2d 483, 491 (1st Cir. 1948); Treas. Reg. § 1.446-1(c)(6) (1973). A taxpayer is in
constructive receipt when "[i]ncome although not actually reduced to a taxpayer's
possession is constructively received by him in the taxable year during which it is
credited to his account, set apart for him, or otherwise made available so that he may
ings, however, which seem to be correct, hold that the doctrine of constructive receipt is not applicable to periodic payments of tort settlements. The Regulations define constructive receipt of income as income “not actually reduced to a taxpayer’s possession,” but which “is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given.” In short, the taxpayer “may not deliberately turn his back on income and select his year of reporting.”

Returning to our example, one might argue that Y constructively received the $100,000 settlement at the moment in the negotiations when, rather than agreeing to deferred periodic payments he could have demanded immediate payment of the $100,000. The argument, although appealing, must be rejected in light of the cases that have considered when and how constructive receipt should apply to deferred compensation arrangements. Suffice it to say that the cases, and the subsequent Revenue Rulings, have decisively concluded that the doctrine of constructive receipt does not govern the transaction merely because the taxpayer negotiated a deferred compensation agreement. Although deferred compensation is not completely analogous to a deferred payment damage award, the two are conceptually close enough to allow the former to be instructive as to the latter. Hence, the constructive receipt doctrine does not seem to justify taxation of periodic payments in the year of settlement.

B. A Proposed Solution—The “Economic Benefit Doctrine”

A better solution to the inequities of section 104(a)(2) would be the repeal of the 1983 amendment and the application of the doctrine of

50. See supra note 43. Although not specifically on point, these rulings inferentially negate the applicability of the doctrine of constructive receipt to periodic payments of damage awards.
53. For an exhaustive discussion of the application of the doctrine of constructive receipt to the various forms of deferred compensation, see Metzer, supra note 52, at 538-50. Representative cases include Eckhard v. Commissioner, 182 F.2d 547 (10th Cir. 1950); Deutsch v. Commissioner, 26 T.C.M. (CCH) 649 (1967), aff’d per curiam, 405 F.2d 889 (9th Cir. 1969); Basila v. Commissioner, 36 T.C. 111 (1961); Hall v. Commissioner, 15 T.C. 195 (1950), aff’d per curiam, 194 F.2d 538 (9th Cir. 1952).
54. See supra note 53.
56. See supra notes 52-53.
economic benefit, which arose in the context of employee compensation, to structured settlements. The doctrine originated in Old Colony Trust Co. v. Commissioner, which established that the predecessor to section 61 (section 22a) included as income any economic or financial benefit conferred upon the employee as compensation, whatever the form or mode by which it is effected. Over the years, the doctrine that indirect employee compensatory benefits result in taxable income was applied most often in the context of determining the proper tax year for that income. A series of cases held that the purchase by an employer of retirement annuity contracts produced taxable income to the employee in the year the employer paid the contract premiums. With the subsequent passage of the liberalized statutory deferred income provisions, however, the doctrine came to have little application to deferred compensation arrangements.

Yet the doctrine continued to have independent vitality beyond the scope of its original setting. Beginning with Burnet v. Logan, the economic benefit doctrine has been used to determine the year of taxation for deferred payments from the sale of property. In Burnet,

57. The concept was not formally recognized until the 1945 case of Commissioner v. Smith, 324 U.S. 177, 181 (1945), but its antecedents extend at least to Old Colony Trust Co. v. Commissioner, 279 U.S. 716 (1929). The leading case is Sproull v. Commissioner, 16 T.C. 244 (1951), aff'd per curiam, 194 F.2d 541 (6th Cir. 1952) in which the employer in 1945 paid a bank trustee $10,500 in consideration for the services performed by the taxpayer/employee. The trustee was to pay out approximately one-half the principal and accumulated interest in 1946 and the remainder in 1947. Id. at 245. In holding that the $10,500 was taxable in 1945, the court conceded that it was not a case of constructive receipt. Instead the court held it taxable in the year that the taxpayer received the economic benefit in the form of a cash equivalent. Id. at 247; see Rev. Rul. 62-74, 1962-1 C.B. 68.
58. 279 U.S. 716 (1929).
60. 279 U.S. at 729.
61. In Old Colony Trust the Supreme Court determined that payment by the employer of the employee's income taxes constitutes additional taxable income to the employee in the year payment is made. Id. at 729. The question was not when it was income, but if it was income. Subsequent cases, see infra note 62, that involved deferred employee compensation dealt with the issue of when the deferred compensation was income, as Old Colony Trust settled the issue whether such arrangements constituted additional income.
64. See Knight, Income Tax Consequences of Nonqualified Deferred Compensation, A Recapitalization, 21 Tax Law. 163, 172-74 (1967); Metzer, supra note 52, at 538-45; Rizzo, Coping with Constructive Receipt Problems Created by Plan Distribution Elections, 53 J. Tax'n 282 (Nov. 1980).
65. 283 U.S. 404 (1931).
the sale price for stock included deferred payments keyed to the tonnage of iron ore extracted from a mine by the purchaser of the stock.\textsuperscript{66} The Court held that no income was realized in the year of the sale because the "promise [of future money payments] was in no proper sense equivalent to cash. It had no ascertainable fair market value."\textsuperscript{67} Hence, the transaction was "held open" to await the actual receipt of the future payments before a determination was made as to whether the seller had realized any income.\textsuperscript{68}

Although the government lost under the particular facts of \textit{Burnet}, in dicta the court did approve the government's contention that under appropriate conditions deferred payments were taxable in the year of sale. Taxation could precede receipt of the income because the taxpayer received economic benefit equal to the discounted value of the deferred payments.\textsuperscript{69}

In the wake of \textit{Burnet}, deferred payment sales agreements are classified either as "open" or "closed" transactions.\textsuperscript{70} If the deferred payments have an ascertainable fair market value,\textsuperscript{71} the transaction is "closed" and the gain or loss is recognized in the year of sale.\textsuperscript{72} Alternatively, the seller may claim that the sale is an "open" transaction, and report the income only when the value of the payments received exceeds his basis.\textsuperscript{73} Obviously, the latter is a very favorable

\textsuperscript{66} Id. at 410.  
\textsuperscript{67} Id. at 413.  
\textsuperscript{68} Id. at 413-14.  
\textsuperscript{69} The court did not use the term "discounted value"; rather it asked whether the tax liability could be "fairly determined." Id. at 412.  
\textsuperscript{70} The following are examples of cases holding under \textit{Burnet} that a transaction must be left open: Westover v. Smith, 173 F.2d 90, 92 (9th Cir. 1949); Commissioner v. Carter, 9 T.C. 364, 371 (1947), aff'd, 170 F.2d 911 (2d Cir. 1948), \textit{acq.}, 1958-2 C.B. 4; Lenz v. Commissioner, 28 T.C. 1157, 1162-63 (1957), \textit{acq.}, 1958-2 C.B. 6. Examples of cases holding that the transaction was closed and could be valued for tax purposes include: McCormac v. United States, 424 F.2d 607, 619-20 (Ct. Cl. 1970); Chamberlin v. Commissioner, 32 T.C. 1098, 1107-08 (1959), \textit{aff'd}, 286 F.2d 850 (7th Cir.), \textit{cert. denied}, 368 U.S. 820 (1961); O'Brien v. Commissioner, 25 T.C. 376, 385-86 (1955), \textit{acq. in part}, 1957-1 C.B. 4; see also Rev. Rul. 68-194, 1968-1 C.B. 87, 88 (citing \textit{Burnet} v. Logan with approval).  
\textsuperscript{71} According to Treas. Reg. § 1.1001-1(a) (1960), it is very rare that property will have no ascertainable fair market value.  
\textsuperscript{72} See \textit{supra} note 69 for examples of closed transaction cases. In acknowledgment of the difficulty to the seller of being liable for taxes prior to receipt of the income, Congress provided relief in the form of I.R.C. § 453 (Supp. V 1981), which allows for the seller to report the gain pro rata as the payments are received.  
\textsuperscript{73} M. Chirelstein, Federal Income Taxation 246 (3d ed. 1982). I.R.C. § 453, which provides the optional installment method, was amended in 1980 to allow contingent payment transactions to qualify as § 453 installment sales. I.R.C. § 453(c) (Supp. V 1981). Hence, the availability of "open" transaction treatment, with the tax deferred until after the return of basis, may be even more difficult to sustain. M. Chirelstein, \textit{supra}, at 247.
tax outcome for the seller, but one extremely difficult to achieve. A transaction is considered “open” only if the deferred payments do not have an ascertainable fair market value in the year of sale. IRS regulations hold that “only in rare and extraordinary cases will property be considered to have no fair market value” and therefore, deferred payment sales are in overwhelming numbers deemed “closed” transactions.

1. Applying the Doctrine to Structured Settlements

The doctrine of economic benefit has been addressed and surprisingly rejected by the IRS in the context of periodic payment of damage awards. Surely, however, the claimant who agrees to periodic payments does in fact receive economic benefit at the time of the agreement. The transaction must be considered “closed” because the periodic payments have an ascertainable fair market value, particularly if the payments are secured by an annuity or funded irrevocable trust. Thus, applying the doctrine of economic benefit to structured settlements, the claimant would realize income in the year of settlement equal to the discounted value—the ascertainable fair market value—of the future payments.

Generally, the claimant will demand the protection of a fully funded trust (or escrow account) or will require the defendant to purchase an annuity from a financially responsible third party such as an insurance company. In the case of an annuity, the claimant would have income equal to the cost of the annuity to the defendant.

75. The only practical alternative is § 453 treatment. M. Chirelstein, supra note 73, at 247.
77. See Choulos, supra note 32, at 75; Elligett, supra note 32, at 144-45; Lilly, supra note 32, at 246-47.
78. Disclosure to the claimant of the cost of the annuity could cause some problems, however. The issuer of the annuity may be unhappy about the release of its price; disclosure of that information may cost the issuer a competitive advantage if other issuers should learn of the price because the price of an annuity varies from company to company. See Choulos, supra note 32, at 75. Defendants also may not appreciate disclosing the price of the annuity because it may have cost less than what the claimant demanded as a lump-sum settlement. Annuities, supra note 32, at 368. The cost of the annuity is keyed to the claimant’s life expectancy, concerning which the parties may have quite different opinions. The defendant and the issuer may estimate a severely foreshortened life expectancy for the claimant because of the disability. Id. Claimants are likely to dispute the reliability of a foreshortened life expectancy when applied to their particular case. This is natural not only because of the normal optimistic view of the victim, but also because the longer the expected life, the greater the needs of the claimant and therefore the larger the damage award. In the majority of jurisdictions the defendant is liable for lost earnings determined by the preaccident life expectancy of the claimant. 2 F. Harper & F. James, The Law of Torts § 24.6, at 1293-94 (1956); Levmore, Self-assessed Valuation Systems for Tort
If, rather than an annuity, the parties rely upon a funded irrevocable trust or an unsecured promise to pay, valuation would be more speculative, but still determinable. A funded, irrevocable trust, which is required to pay all its income to the claimant, would complicate the valuation problem because the rate of return is uncertain. Nevertheless, a solution might be found by analogy to the field of estate and gift tax, which relies upon valuation tables to determine the present value of future trust income. Even an unsecured promise to pay would have a fair market value, albeit deeply discounted to reflect the risk factor.

The failure of the IRS and Congress to apply the doctrine of economic benefit to periodic payments becomes even more confusing upon examination of applications of the doctrine in analogous contexts. For example, one Revenue Ruling held that the discounted value of prize payments were taxable in the year they were won, even though before the winner was chosen the contest sponsor had placed the prize money in an escrow account to be paid over a two-year period. A similar result was reached in a case in which a father bought a winning Irish Sweepstakes ticket in the names of his minor children. Pursuant to Irish law, the cash prize was held by the Bank of Ireland until the children reached age 21 or until the bank received an application for release of the funds. The Tax Court held that under the doctrine of economic benefit the prize was taxable in the year it was won, rather than in the year(s) that the children turned twenty-one or in the year in which application was made for the money.

The argument for applying the doctrine of economic benefit to structured settlements is even more compelling than in the above examples. In those situations, the deferred nature of the payments was

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and Other Law, 68 Va. L. Rev. 771, 801 (1982). If the reimbursement is by an annuity, however, the actual payments will continue only for the foreshortened, post-accident life. Hence, the annuity will cost less than the discounted value of a comparable lump-sum settlement which assumes that the claimant will have a normal life expectancy. For example, if prior to the accident the claimant's life expectancy was 10 years and his earnings were $25,000 per year, his total lost earnings would be $250,000. If the accident had severely injured the claimant and reduced his life expectancy to 5 years, an annuity would need replace only $125,000 of lost earnings. The purchase of an annuity, rather than payment of a lump sum—the discounted value of the $250,000—would result in substantial savings to the defendant.

82. Id. at 246-47 (citing with approval Rev. Rul. 67-203, 1967-1 C.B. 105); accord Anastasio v. Commissioner, 67 T.C. 814 (minor child who won $100,000 in state lottery was taxable in the year of winning even though by law the prize was paid to his parents as custodians under the state's Uniform Gift to Minors Act), aff'd, No. 77-4117 (2d Cir. Dec. 8, 1977).
fortuitous—they could not have resulted from conscious tax planning on the part of the recipient. By contrast, the personal injury claimant plays a major role in determining the nature of the payments he will receive. He is engaged in settlement negotiations and is represented by an attorney who presumably will be aware of the income tax ramifications of the settlement options. Why should a claimant accept a $200,000 lump-sum settlement, for example, when he can realize far more tax-free dollars by having the defendant purchase an annuity for $190,000? The failure of the IRS and Congress to apply the doctrine of economic benefit impels the claimant to practice this mode of tax avoidance.

2. Proposed Methods of Taxing Structured Settlements

If deferred payment damage awards were deemed income in the year of the settlement, section 104(a)(2) would come into play, with the result that the fair market value of the settlement would be tax exempt. Thereafter, the tax effect of the later receipt of the periodic payments could take either of two routes. The claimant could be treated as if he had purchased an annuity at a cost equal to present value of the future payments, i.e., the amount exempted by section 104(a)(2). The periodic payments would then be taxed according to section 72.83 Under that section, each periodic payment would be allocated between a tax-free return of capital—the cost of the annuity—and a taxable investment interest component.84

In the alternative, the periodic payments could be taxed as are other closed transactions; the payments would be received tax-free until they totaled the fair market value of the settlement amount. Payments in excess of the amount exempted by section 104(a)(2) would represent taxable income.85 Functionally, the taxable payments would represent interest income. If this formula were to be applied, claimants would be taxed the same regardless of whether they accepted a lump-sum settlement or a deferred payment arrangement. In both cases the interest income would be taxed, and section 104(a)(2) would neither undercut horizontal equity nor encourage claimants to accept deferred payments of damage awards.

At present, such encouragement is quite strong. For example,86 if a thirty-five year old male claimant receives a $1 million settlement tax-

84. Id. § 72(b).
85. See Ginsburg, Taxing the Sale for Future Payment, 30 Tax L. Rev. 471, 567 (1975); cf. Rev. Rul. 62-74, 62-1 C.B. 68 (a cash prize placed in an escrow account results in realizable income equal to discounted value. The excess of future payments received over the discounted value is taxable income in the years received).
86. The example that follows can be found in Hindert, supra note 32, at 9.
free under section 104(a)(2) and purchases a life annuity with thirty years of guaranteed payments, he will receive $7,789.22 per month, or $93,470.64 per year, totalling $2,804,119.20. As a section 72 annuity, the annual payments are apportioned between the nontaxable return of capital, $25,640.96, and the taxable investment income, $67,829.68. Arbitrarily assuming his taxable income to be $60,000 and the taxpayer to be married, filing a joint return, the annual tax will be $17,705. Thus, the taxpayer would have $50,124.68 net after-tax income plus the $25,640.96, yielding $75,765.64 consumable dollars. Conversely, if the claimant had rejected a lump-sum settlement, and had insisted upon an annuity purchased by the defendant, he would have received the $93,470.64 in its entirety.

The comparison, however, is of course meaningless; no defendant would be willing to purchase an annuity costing $1 million. Rather, the defendant would want to buy an annuity that would pay the claimant an amount equal to the after-tax dollars that the claimant would have obtained if he had accepted a lump-sum settlement and purchased his own, partly taxable annuity—in the above example, $75,765.64 per year. By doing so, the defendant would receive the entire benefit of section 104(a)(2)'s failure to tax the interest portion of periodic payments.

Depending on the particular circumstances and the bargaining power of the parties, structured settlements will confer the section 104(a)(2) tax savings upon either the claimant, the defendant or both. To the extent the claimant garners a portion of the tax savings, a horizontal inequity is created among personal injury award recipients. Moreover, the potential shift of some or all of the section 104(a)(2) tax savings to defendants was certainly not one of the purposes behind the section's enactment. By divesting structured settlements of their favored tax treatment both of these effects could be remedied. Deferred periodic payments should be treated as either "closed transactions" or as section 72 annuities.

III. Is Ignorance Bliss? The Right to Instruct Juries as to the Effect of Section 104(a)(2).

A. The State of the Law Before Liepelt

For years, courts and commentators have debated whether a jury should be instructed that personal injury awards are tax exempt.\(^{89}\)

87. I.R.C. § 72(b) (1976) excludes a portion of each annuity payment from gross income. The excluded portion is a percentage equal to the ratio of the amount invested in the annuity contract compared to the expected total return under the annuity contract.
88. Based upon tax rates per I.R.C. § 1 for tax year 1982.
90. E.g., Burlington N., Inc. v. Boxberger, 529 F.2d 284, 297 (9th Cir. 1975) (court must instruct jury); Hall v. Chicago & N.W. Ry., 5 Ill. 2d 135, 148-49, 125
Under the traditional rule, the jury neither hears evidence nor receives any instructions concerning the federal income tax consequences of damage awards.\textsuperscript{91} Defendants, in their attempt to overturn tradition, have argued that absent such instructions, a jury unaware of section 104(a)(2) might inflate an award by an amount that it erroneously believes the plaintiff would have to pay in federal income taxes.\textsuperscript{92} Additionally, defendants have sought the right to introduce evidence as to the effect of income taxes upon the calculation of damage awards for loss of future earnings.\textsuperscript{93}


Claimants prove the claimed loss of future earnings by offering evidence of their past income and pre-accident projected future income. Defendants have argued that the relevant figures for calculating loss of earnings are the past and future earnings of the claimant net of federal income taxes. Because the damage award is supposed to place the claimant in the financial position that he would have been in "but for" the accident, and because the award is tax free, the claimant, it is argued, would be unjustly enriched unless an award for loss of earnings is calculated according to after-tax dollars.

For example, if as a result of the defendant's negligence, a fifty-five year old male became totally disabled and lost ten work years, and if his pre-tax, pre-accident wages were $20,000 a year, he would have lost $200,000 of future earnings. Defendants claim that to calculate lost earnings in the above manner over-compensates the claimant; it leaves more income at his disposal than if he had earned the income and paid taxes. Instead, if lost earnings were determined net of federal income taxes, and assuming the claimant's tax rate was 20%, he would have had $16,000 of disposable after-tax income each year. The total after-tax lost earnings would be $160,000, compared with $200,000 pre-tax, for a difference of $40,000. Defendants contend that this amount, $40,000 in our example, represents a windfall to the claimant and an unnecessary and unfair burden on the defendant.

Over the years, defendants have had mixed success in introducing the issue of taxes. Numerous trial courts have refused requests by defendants to instruct the jury that damage awards are tax exempt.


97. See 2 F. Harper & F. James, supra note 77, § 25.12, at 1326-27; Dennis, Sirmon & Drinkwater, supra note 90, at 197; Feldman, supra note 90, at 272-73; Morris & Nordstrom, supra note 90, at 274; Nordstrom, supra note 1, at 218-19; Personal Injuries, supra note 4, at 247-48.

98. See supra note 95.


100. See supra note 91.
When the issue has been appealed, the majority of jurisdictions have held that a refusal to allow an instruction as to the tax-free nature of damages does not constitute reversible error. Federal circuit courts

have split on the issue, with five circuits upholding the trial judge’s refusal to allow the instruction,\textsuperscript{102} while two other circuits have held that a refusal of such instruction constitutes reversible error.\textsuperscript{103}

As for allowing evidence of the effect of taxes on the past and future earnings of the claimant, courts have shown even more reluctance. Only nine states permit the defendant to offer evidence of the effect of taxes and thereby prove the claimant’s loss of after-tax, consumable income.\textsuperscript{104} Here again, the federal circuits have split, with the major-

\textsuperscript{102}Circuits upholding the lower court’s refusal to allow such instruction: Taenzler v. Burlington N., 608 F.2d 796, 802 (8th Cir. 1979) (personal injury); Kennett v. Delta Air Lines, Inc., 560 F.2d 456, 462-64 (1st Cir. 1977) (wrongful death); Bach v. Penn Cent. Transp. Co., 502 F.2d 1117, 1123 (6th Cir. 1974) (wrongful death; not error to refuse, but would be within the discretion of the trial court); Raycraft v. Duluth, Missabe & Iron Range Ry., 472 F.2d 27, 33 (8th Cir. 1973) (personal injury; refusal to resolve issue); Nichols v. Marshall, 486 F.2d 791, 794 (10th Cir. 1973) (personal injury and wrongful death; not error to refuse, but would be within discretion of trial court); McWeeney v. New York, N.H. & H.R.R., 282 F.2d 34, 39 (2d Cir.) (personal injury), \textit{cert. denied}, 364 U.S. 870 (1960).


ity refusing the admittance of evidence on the effect of federal income taxes on future earnings.\(^{105}\)

Commentators agree that the wiser course is to instruct juries that damage awards are tax exempt because such knowledge is relevant and necessary to the calculation of a just damage award.\(^{106}\)


\[^{106}\text{See, e.g., Feldman, supra note 90, at 282; Computation, supra note 90, at 667; Personal Injuries, supra note 4, at 251.}\]
disagreement exists among commentators, however, concerning the desirability of introducing evidence as to the effect of taxes on the lost earnings of the claimant.\(^{107}\) Those who oppose the introduction of such evidence cite the belief that the tax savings of section 104(a)(2) should not inure to the benefit of the defendant in the form of smaller damage awards.\(^{108}\)

Possibly because of the concern that defendants should not benefit from section 104(a)(2), until recently little progress had been made in convincing courts to admit evidence of the effect of taxes.\(^{109}\) In contrast, England has allowed the admission of such evidence since 1955.\(^{110}\) In the United States the landmark case may turn out to be a 1980 Supreme Court decision, *Norfolk & Western Railway Co. v. Liepelt.*\(^{111}\)

**B. The Liepelt Decision**

In *Liepelt,* the Court held that in a suit under FELA,\(^{112}\) it was reversible error to refuse to instruct the jury that damage awards are exempt from federal income taxes.\(^{113}\) The Court further held that it was reversible error to exclude evidence of the effect of federal income taxes in determining the damages suffered by the plaintiff from the loss of future earnings.\(^{114}\) As stated succinctly by Justice Stevens: "It is his [the plaintiff's] after-tax income, rather than his gross income before taxes, that provides the only realistic measure of his ability to support his family."\(^{115}\)

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108. *Damage Awards,* *supra* note 12, at 296-97. Other rationales include: Kennelly, *supra* note 90, at 97 (incidence of tax is a collateral matter which should not be considered because it is too speculative and because the jury is not apprised of the various other deductions which will affect the amount recovered); Levmore, *supra* note 77, at 813-14 (arguing awards based on gross earnings provide optimal deterrence for the tortfeasor); Nordstrom, *supra* note 1, at 227-30 (citing judicial convenience).

109. See *supra* notes 92-93.


111. 444 U.S. 490 (1980).


113. 444 U.S. at 498.

114. *Id.* at 494. However, the Court stated that introduction of such evidence may not be necessary if the impact of future income tax in calculating the award would be *de minimis.* *Id.* n.7.

115. *Id.* at 493.
In rejecting the majority rule on exposure to the effects of federal taxes, the Court made short shrift of the time-honored argument that income taxes are too speculative or too complex for a jury to calculate.\textsuperscript{116} The Court pointed out that future earnings also are subject to a variety of vicissitudes, including unemployment, health problems and inflation, and thus calculation of lost future earnings is necessarily a matter of "estimate and prediction."\textsuperscript{117} The Court rejected as irrelevant the argument that taxes should be ignored because plaintiffs are not reimbursed for attorney's fees.\textsuperscript{118} Justice Stevens concluded that the determination of a plaintiff's future income tax liability can be presented to juries in an understandable manner, thanks to the "practical wisdom of the trial bar and the trial bench."\textsuperscript{119}

Justices Blackmun and Marshall dissented in a thoughtful opinion authored by Blackmun in which he reasoned that instructions to the jury about the tax-free nature of the damages should be governed by state law.\textsuperscript{120} Since the case arose in Illinois, which does not require such instructions, Blackmun stated that it was "not error to refuse to instruct the jury as to the nontaxability of the award."\textsuperscript{121}

Blackmun's hostility to such instructions ran even deeper, however. He would, as a general rule, bar instructions about the tax-free nature of damage awards because the "decision . . . opens the door to [the] possibility" of "[c]harging the jury about every conceivable matter as to which it should not misbehave or miscalculate."\textsuperscript{122} The Justice was silent as to what bogey men he saw lurking on the horizon, but he probably meant such matters as attorney's fees, costs for expert witnesses and other expenses of litigation that reduce the amount of a damage award that actually accrues to the benefit of the plaintiff.\textsuperscript{123}

Justice Blackmun was somewhat more compelling in his objection to the use of an after-tax figure to calculate lost earnings. He viewed the section 104(a)(2) non-taxability of damages as evidence of congressional intent to bestow a benefit upon plaintiffs.\textsuperscript{124} Blackmun cited two possible reasons that may have motivated Congress to grant the

\begin{itemize}
\item \textsuperscript{116} Id. at 494.
\item \textsuperscript{117} Id.
\item \textsuperscript{118} Id. at 495-96.
\item \textsuperscript{119} Id. at 494.
\item \textsuperscript{120} Id. at 503-04 (Blackmun, J., dissenting).
\item \textsuperscript{121} Id. at 504 (Blackmun, J., dissenting).
\item \textsuperscript{122} Id. at 503 (Blackmun, J., dissenting).
\item \textsuperscript{123} These arguments were, in fact, raised by the respondent in the \textit{Liepelt} case. Id. at 495. Other courts and commentators have also cited these objections. See, e.g., McWeeney v. New York, N.H. & H.R.R., 282 F.2d 34, 38 (2d Cir.), \textit{cert. denied}, 364 U.S. 870 (1960); Louissaint v. Hudson Waterways Corp., 111 Misc. 2d 122, 129-30, 443 N.Y.S.2d 678, 682-83 (Sup. Ct. 1981); Feldman, \textit{supra} note 90, at 276.
\item \textsuperscript{124} 444 U.S. at 500 (Blackmun, J., dissenting).
\end{itemize}
section 104(a)(2) tax exclusion windfall to plaintiffs. First, "Congress may have decided that it is simply not worthwhile to enact a complex and administratively burdensome system in order to approximate the tax treatment of income if, in fact, it had been earned over a period of time by the decedent." The Justice cited no authority for this proposition and in fact no evidence exists that Congress, or even the IRS, ever held such a view.

Blackmun's other probable explanation for the congressional section 104(a)(2) largesse seems closer to the mark. He suggested that "Congress may have intended to confer a humanitarian benefit on the victim or victims of the tort." This may well explain the continued existence of section 104(a)(2). Undoubtedly, many congressmen would find it harsh indeed to force an accident victim to share his damage award with Uncle Sam. They would prefer to forgo the revenue, rather than face a newspaper headline that read: "Victim loses arm to train, must pay $200,000 in taxes." Moreover, because a damage award is designed to make the plaintiff "whole again," the public, not attuned to concepts of basis, realization and involuntary conversion, is unlikely to rue the victim his tax-foregone "windfall" at the cost of a lost arm.

C. The Ramifications of Liepelt

1. Extending Liepelt Beyond FELA Cases

The Supreme Court opinion in Liepelt should control in all FELA actions whether the claim is for wrongful death or for personal injury. The effect of Liepelt, however, is likely to be felt beyond

125. Id. at 501 (Blackmun, J., dissenting).
126. The House Ways & Means Committee Report, H.R. Rep. No. 767, 65th Cong., 2d Sess. 3-4 (1918), which accompanied H.R. 12,863, the Revenue Act of 1918, simply stated that "under the present law it is doubtful whether amounts received . . . are required to be included in gross income." Upon consideration of H.R. 12,863 by the House, § 213(b), the predecessor of § 104(a)(2), was accepted without comment and repeatedly passed over during the sessions in which the bill was considered for amendment and review. The only amendment to § 213(b) was offered on Sept. 3, 1918, and proposed to eliminate taxation of life insurance payable to a corporation. 56 Cong. Rec. 10371 (1918). T.D. 2747, 20 Treas. Dec. Int. Rev. 457 (1918) exempted personal injury recoveries from inclusion in gross income prior to the passage of the Revenue Act of 1918.
127. 444 U.S. at 501 (Blackmun, J., dissenting).
128. See supra notes 2 & 4.
129. See 444 U.S. at 492-93. Post-Liepelt decisions by lower courts, however, have split on the extent to which the Liepelt holding is applicable to FELA actions. Some courts have correctly chosen to apply Liepelt to all FELA actions involving either wrongful death or personal injury claims. O'Byrne v. St. Louis S.W. Ry., 632 F.2d 1285, 1286-87 (5th Cir. 1980) (per curiam); Lang v. Texas & P. Ry., 624 F.2d 1275, 1279 (5th Cir. 1980); Cazad v. Chesapeake & O. Ry., 622 F.2d 72, 76 (4th Cir. 1980); Oltersdorf v. Chesapeake & O. R.R., 83 Ill. App. 3d 457, 464, 404 N.E. 2d...
FELA cases. The statutory language of FELA governs wrongful death and personal injury actions brought under the Jones Act\textsuperscript{130} (recovery for injury or death of seaman). Therefore, \textit{Liepelt} will affect the calculation of damages for suits brought thereunder.\textsuperscript{131} Similarly, the measure of damages under the Death on the High Seas Act (DOSHA)\textsuperscript{132} is the same as the measure of damages for wrongful death under FELA.\textsuperscript{133}

Additionally, at least theoretically, \textit{Liepelt} could have an impact on civil rights actions brought under section 1983 of title 42.\textsuperscript{134} A section 1983 damage award does not represent a reimbursement for a personal injury per section 104(a)(2) and a civil rights award that represents back pay are taxable.\textsuperscript{135} Neither the courts nor the IRS, however, has addressed the question whether a civil rights award that does not represent back pay is taxable. Arguably an award that represents damages for injury to constitutional rights is in essence a recovery of capital and should therefore be nontaxable. Although courts measure section 1983 damages by referring to common-law damage rules, federal law governs section 1983 actions.\textsuperscript{136} To the extent that a section 1983 award is nontaxable, then following \textit{Liepelt}, the jury should be instructed that the award is tax free.

\textit{Liepelt} represents a statutory interpretation of the FELA and was not decided on a constitutional basis.\textsuperscript{137} Therefore, while binding precedent in FELA and similar actions brought in state and federal

\textsuperscript{132} See \textit{Liepelt}, 444 U.S. at 494, which stated that introduction of evidence of tax may be excluded in some cases if the impact of future income taxes in calculating the award would be \textit{de minimis}, causing more confusion than it is worth.
\textsuperscript{133} 317 N.W.2d at 350-51.
\textsuperscript{137} 137. See 444 U.S. at 492-93.
courts, *Liepelt* is not binding in state cases involving common law actions based on state statutes or in diversity actions brought in federal courts. In actions brought under the Federal Tort Claims Act (FTCA), state law governs the measure of damages. The measure of damages under state law is, however, limited by federal statutory law which provides that damages are to be compensatory, and not punitive. Because *Liepelt* is not binding on issues of damages under state law, it should not be controlling in FTCA actions.

Prior to *Liepelt*, however, not all courts awarded damages in FTCA actions according to state law. Some federal circuits were allowing income tax evidence in FTCA actions, despite contrary state law, under the theory that failure to do so would result in punitive damages. Other courts have looked to state law first, and if it was silent have applied a federal rule. Still other courts have looked solely to the federal law of the circuit, in some cases citing an overriding federal interest as the reason for ignoring state law.

Because they awarded damages on theories other than state statutory or common law, these decisions indicate that *Liepelt* may have a greater-than-expected effect on the measure of damages for cases brought under the FTCA. Although such cases are tried without juries, rendering the *Liepelt* holding as to jury instructions inapplicable, *Liepelt* can nonetheless be applied to allow evidence on the calculation of lost earnings.

In a wrongful death case under the FTCA, the Ninth Circuit, citing *Liepelt*, held that an amount of money must be added to an award to reflect the income tax that will be paid on interest earned on


140. Under 28 U.S.C. § 1346(b) (1976), "the law of the place where the act or omission occurred" is applicable.


142. See Felder v. United States, 543 F.2d 657, 668-70 (9th Cir. 1976); Hartz v. United States, 415 F.2d 259, 264 (5th Cir. 1969); O’Connor v. United States, 269 F.2d 578, 584-85 (2d Cir. 1959).

143. See, e.g., Deweese v. United States, 576 F.2d 802 (10th Cir. 1978); Mosley v. United States, 405 F. Supp. 357 (E.D.N.C. 1974).

144. E.g., United States v. Sommers, 351 F.2d 354, 360 (10th Cir. 1965); Furumizo v. United States, 245 F. Supp. 981, 1014 (D. Hawaii 1965), aff’d, 381 F.2d 965 (9th Cir. 1967).


146. DeLucca v. United States, 670 F.2d 843 (9th Cir. 1982).
a lump-sum award. Another Ninth Circuit case concluded that in a FTCA case involving personal injury, lost income should be calculated net of taxes. Similarly, a federal district court held that in a personal injury suit under the FTCA, Liepelt would be controlling if the court were considering the loss of support suffered by the wage earner's dependents. Other unexpected results of Liepelt include decisions to apply it to diversity and state action cases. One state court followed Liepelt in an action controlled by state law, and cited in its reasoning the desirability of a uniform state-federal rule.

2. Benefiting Defendants Contrary to Congressional Intent

By reducing damage awards for lost earnings to a figure net of taxes, the Liepelt holding will cause defendants to become beneficiaries of the section 104(a)(2) tax exemption. It is true that the Liepelt rule will benefit defendants only as to part of their liabilities, since out-of-pocket damages or damages for pain, suffering or loss of limbs are not affected. Still, it is doubtful that Congress ever intended section 104(a)(2) to reduce the financial burdens of personal injury defendants.

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. Moreover, if the states continue their gradual shift toward allowing juries to be instructed as to the tax-free nature of damage awards, and to calculate damages for lost earnings as an after-tax amount, then the states will also frustrate the congressional purpose behind section 104(a)(2). Instead of subsidizing claimants, the section 104(a)(2) tax forbearance will subsidize those who ultimately pay for the defendant's torts: the casu-

147. Id. at 845-46.
152. In 1958, there did not appear to be any state cases allowing admission of evidence of income tax. See Nordstrom, supra note 1, at 213 n.3. By 1982, at least nine states permitted admission of evidence of income tax, at least in wrongful death cases. See supra note 104. In 1958, only one state allowed an instruction to the jury on the taxability of the award. See Nordstrom, supra note 1, at 213 n.3. As of 1982, six states permitted the jury to be instructed as to the taxability of a damage award. See supra note 101.
alty insurance company. Although not every tort suit is aimed at the deep pockets of a casualty insurer, most are. The noninsured or minimally insured defendant is likely to be a judgment-proof defendant. Certainly, the dramatic million dollar settlement must be paid by an insurer (or a self-insuring institution) if the plaintiff is to have any hope of collecting the award. Liepelt, therefore, apparently signifies a fortuitous windfall for the casualty insurers of America.

3. Liepelt's Swinging Pendulum

Depending on the facts presented and on a court's application of the holding, Liepelt may prove less advantageous to defendants than generally believed, and could redound to the benefit of claimants. The Liepelt requirement that lost future earnings be calculated net of taxes should lower the amount of damages for which the defendant is liable. But, it inferentially follows that the effect of taxes should be included in all calculations concerning the damage award. As stated by counsel for the plaintiff in Liepelt, "in discounting the estimate of future earnings to its present value, the tax on the income to be earned . . . is now [prior to Liepelt] omitted." Justice Stevens agreed and admitted that, "[I]logically, it would certainly seem correct that [the present value] amount, like future wages, should be estimated on an after-tax basis."

If the estimated rate of return on the principal to be paid to the claimant is reduced to reflect taxes, then the discount rate should be lowered and the principal sum to be paid the claimant would be raised. Thus, while the future amount of the lost stream of earnings declines if it is calculated net of taxes, the present value of those same earnings increases if the discount is also calculated net of taxes.

For example, assume a claimant suffered ten lost work-years and lost earnings of $20,000 per year for a total of $200,000. Under Liepelt, the lost earnings should be calculated net of taxes. Assume a 15% tax rate, or after-tax yearly earnings of $17,000 for a total of $170,000 lost future earnings. The defendant's liability will be the discounted present value of $170,000 earned ratably over ten years. If

153. Cf. O'Connell, A Proposal to Abolish Defendants' Payment for Pain and Suffering in Return for Payment of Claimants' Attorneys' Fees, 1981 U. Ill. L. Rev. 333, 340 (the vast majority of automobile tort claims are paid by insurers; tortfeasors are generally judgment-proof beyond the limits of their liability insurance).
156. 444 U.S. at 495.
157. Id.
we assume a discount rate of 10% then the defendant will owe $104,458; if the claimant invests the $104,458 at an annual rate of interest of 10%, he can consume $17,000 a year for the ten years. At the end of the ten years the fund will be exhausted.

However, if he invests the lump-sum award to yield a 10% rate of return, the claimant will be taxed on that interest income. Hence, the after-tax rate of return—the consumable interest income—will not amount to $85,542 over the ten-year period. Rather the after-tax rate of return will be 10% less the claimant's post-accident, post-settlement rate of return. If we suppose a 10% rate of taxation (less than the 15% pre-accident rate in acknowledgement of the lower amount of post-accident taxable income), then the claimant will earn only $58,988 after tax consumable dollars on the lump-sum settlement. This means that the claimant would have only $16,345 per year for ten years. To ensure that the claimant will have $17,000 a year to spend, the defendant would have to pay $109,100 as a lump-sum settlement amount. The increase in the lump-sum amount, from $104,458 to $109,100 ($4,642) reflects the effect of lowering the discount rate from 10% to 9%; the latter being the discount rate net of a tax rate of 10%.

If the damage award in part represents anticipatory payments for future expenses, the cost of those expenses will not be reduced on account of taxes, but the earnings on the present value of the reimbursement damage payment will be reduced by taxes. For example, if the claimant anticipates annual medical expenses of $2000 per year for ten years for a total of $20,000, the cost to the defendant for reimbursement of the $20,000 of medical expenses would be the present discounted value of $20,000 or $12,289, assuming a 10% discount rate. However, because the claimant will be taxed on the interest income earned on the lump sum, the rate of discount must be lowered to reflect a lower after-tax, consumable rate of investment return. If we assume a 15% tax rate, the discount rate becomes 8.5% and the present discounted value of the $20,000 is $13,728.

Thus, Liepelt requires a larger payment by the defendant to provide adequate reimbursement for the future expenses of the claimant. In cases in which the award is primarily due to damages other than for the loss of future earnings, the defendant's liability will increase if the effect of taxes is included in the damage award calculation. Even if the damage award represents only reimbursement for the loss of earnings, the defendant may still owe more to the claimant if taxes are considered than if they had been ignored.

On the other hand, while a lower rate of discount increases the present value of future lost earnings or future expenses, a lower discount rate diminishes the amount owed to the claimant for damages that occurred prior to the payment of the award.158 For example, if

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158. Under the traditional rule, prejudgment interest was not allowed for amounts due for bodily harm or pain and suffering. Restatement (Second) of Torts
the claimant was injured in 1977, and incurred $20,000 of out-of-pocket medical expenses, but judgment and payment did not take place until 1982, the defendant might owe five years of interest on the $20,000 damage award. If the rate of discount is 10%, then the defendant would owe $20,000 plus $12,210 interest, for a total of $32,210. However, if the claimant had received the $20,000 in 1977 and invested to yield 10%, the interest would have been taxed. If we assume that the claimant's effective tax rate was 20%, then the rate of discount would be 8%. That is, to put the claimant in the same position that he would have been in had reimbursement been forthcoming at the time of the incurrence of the $20,000 expense would only require reimbursement of the after-tax lost interest of 8%. Hence, the defendant would owe only $20,000 plus $9387 interest, a total of $29,387; a savings of $2823 or 8.89%.

Concern that Liepelt might increase a defendant's liability is not mere conjecture. The Ninth Circuit, in reliance on Liepelt, has held in two cases that the calculation of damages for loss of earnings must include additional amounts to compensate for taxes on the investment income that will be earned on the award. Reducing the loss of future earnings to reflect the effect of taxes, and adding an amount to compensate for income taxes on the projected investment income resulted in the defendant owing slightly more than if taxes had been left out of all calculations.

Only a few commentators have noted the possible perverse results of Liepelt, one of whom offered the following example. Assume a thirty-year old male with a thirty-two year work-life expectancy, earning $20,000 when he became totally disabled. Assume further that his annual income would increase by 10% per year, and that the proper rate of discount was 10% (ignoring the effect of taxes). Finally, assume the average effective tax rate to be 25%. Prior to Liepelt (ignoring taxes), the present value of the lost earnings would be $640,000. However, if the lost earnings are calculated net of taxes, then earnings after-tax begin at $15,000, increased by 10% per year, while the 10% discount is reduced to 7.5%. Put another way, the 10% rate of interest that the claimant can expect to earn on the

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159. DeLucca v. United States, 670 F.2d 843, 846 (9th Cir. 1982) (FTCA); Hollinger v. United States, 651 F.2d 636, 642 (9th Cir. 1981) (same).

160. DeLucca v. United States, 670 F.2d 843, 846 (9th Cir. 1982).

161. See Benich, The Reverse Tax Effect in Wrongful Death or Injury Estimates, 17 Trial 16 (May 1981); Crick, supra note 12, passim.


163. Id. at 272.
principal sum paid to him will yield 7.5% after taxes. Under these assumptions the present value of the lost earnings would be $717,905,164 an amount greater than if Liepelt were not applied and the effect of taxes were ignored—$717,905 versus $640,000.

Changes in any of the factors, such as the level of earnings growth, rate of the discount, number of years of lost earnings or the assumed effective tax rate, will determine whether the inclusion of the effect of taxes favors the defendant or the claimant. Assume, for example, a fifty-year old with a fifteen year work-life expectancy who is totally disabled, and who earned $20,000 a year. Assume an annual income growth of 10%, a rate of discount of 8% and a tax rate of 10%. If taxes are ignored, the defendant would owe the claimant $367,121. But if taxes are included, then the defendant owes only $325,795, a savings of $51,326 or 14%.166

Lipelet will usually work to the advantage of the defendant, may occasionally have little effect on the outcome, and can, under appropriate circumstances, actually favor the claimant. Analysis of the variables yields the following generalizations:167

1) If an award for future damages does not include loss of future earnings, Liepelt favors the claimant, since the claimant must be reimbursed for the effects of taxation upon the earnings arising from the lump-sum payment.168

2) The greater the proportion of future damages that consist of lost earnings, the more Liepelt will work to the advantage of the defendant.169

164. Id.

165. See infra notes 167-73 and accompanying text.

166. To illustrate further, assume a fifty-five year old disabled claimant with a ten year work-life expectancy who earned $20,000, with projected earnings growth of 8% per year, a discount rate of 8%, and an effective tax rate of 10%. Before taxes the defendant would owe $200,000. After taxes the defendant would owe $186,165, a savings of $13,835 or 7%. If all the variables remain constant, except that the lost work years increase to fifteen (from ten), then the defendant's liability before taxes would be $300,000, but after taxes it would be $284,566, for a savings of $15,434 or 5.1%.

167. See Crick, supra note 12, at 273, for a similar, but abbreviated, series of generalizations.

168. For example, assume the claimant is awarded damages only for future medical expenses estimated at $5000 per year for 20 years or a total of $100,000. If the rate of discount is 8%, the present value of $5000 for 20 years is $49,091. If taxes are taken into account and if the claimant's income tax rate was 18.75%, then the rate of discount, net of taxes, would be 6.5%, and the present value of $5000 per year for 20 years would be $55,093. A net gain to the claimant of $6002 ($55,093-$49,091 = $6002).

169. Assume the claimant suffers $200,000 of damages consisting of $100,000 loss of earnings ($5000 per year for 20 years) and $100,000 of medical expenses ($5000 per year for 20 years).
3) To the extent the award is for damages incurred prior to the settlement, Liepelt favors the defendant. If the damages represent pre-settlement lost earnings, the defendant is twice blessed.\textsuperscript{170}

4) The greater the number of lost work years, the less Liepelt favors the defendant.\textsuperscript{171}

5) The level of the effective tax rate is most critical when the number of lost work years is relatively few. A high tax rate would favor the defendant, particularly if the pre-tax rate of discount is relatively high.\textsuperscript{172}

6) The higher the relative initial rate of projected wage growth and the rate of discount the greater the present value of the lost

(a) If the rate of discount is 8\% the present value of the $200,000 of damages would be $98,181.

(b) If taxes are taken into account and the claimant’s tax rate is 18.75\% then the rate of discount is 6.5\%, and the loss of earnings would be reduced to $81,250 ($100,000 less 18.75\% rate of tax). The present value of the damages would be $99,849.

(c) Same assumptions as (b) except that the damages consist of $150,000 in future lost earnings and $50,000 of medical expenses. Assuming a 6.5\% after-tax rate of discount and an 18.75\% tax rate, the after-tax loss of earnings would be $121,875. The present value of the damages would be $94,640.

170. For example, (a) assume damages of $100,000 all incurred prior to the date of the settlement. None of the damages represent lost earnings, and the damages were incurred at a rate of $20,000 per year for 5 years. If the defendant is required to pay an interest rate of 10\% on the accumulated damages then the total award will be $122,102.

(b) Same facts as (a) except that taxes must be taken into account. Assume the claimant’s tax rate is 15\% so that the rate of interest owed by the defendant is lowered to 8.5\%. The damage award would be $113,806.

(c) Assume the same facts as (a) except that the claimant’s damages consist of $80,000 in lost past wages and $20,000 of other damages. Assume a 15\% tax rate; the lost earnings net of taxes are reduced to $68,000, total damages $88,000. The damage award would be $104,286.

171. For example, (a) assume the claimant lost five work years in which earnings per year were $20,000. Assume a 20\% tax rate and a pre-tax rate of discount of 10\%; after-tax rate of 8\%. After-tax yearly earnings thus equal $16,000, with a five-year total of $80,000; present discounted (after-tax) value equals $63,883. If Liepelt did not apply, the loss would equal $100,000, discounted to $75,816. A savings for the defendant of $11,933 and a ratio of 84\% ($63,883: $75,816).

(b) Same facts as (a) above except that the tax rate is 40\%. After-tax lost earnings total $60,000, discounted (6\% rate) to $50,548. Thus, saving the defendant $25,268.

172. For example, (a) assume the claimant lost five work years in which earnings per year were $20,000. Assume a 20\% tax rate and a pre-tax rate of discount of 10\%; after-tax rate of 8\%. After-tax lost earnings total $80,000; present discounted (after-tax) value equals $63,883. If Liepelt did not apply, the loss would equal $100,000, discounted to $75,816. This is a savings to the defendant of $11,933.

(b) Same facts as (a) above except that the tax rate is 40\%. After-tax lost earnings total $60,000, discounted (6\% rate) to $50,548. Thus, saving the defendant $25,268.
future earnings; hence the less value Liepelt is to the defend-
ant.173

Liepelt, apparently little appreciated or understood, has received a mixed reception. Several state appellate courts have confronted the issues raised in it, but for the most part have rejected its reasoning.174 Since Liepelt, only one state has accepted the view that the jury should be instructed that damage awards are tax exempt.175 Fewer state courts since Liepelt have dealt with the right to introduce evidence of the effect of taxes upon lost earnings, but almost all have taken a conservative stance and continued to refuse to admit such evidence.176

Apparently, Liepelt does not signify a rapid change in state rules concerning consideration of the effect of taxes on damage awards. Still, Liepelt is significant for federal law. Its holding will apply not only to FELA cases, but to any claim arising under federal tort law that involves the loss of earnings,177 including cases brought under the

173. Crick, supra note 12, at 271-72, provides the following example: (a) Assume the claimant lost thirty-two work years. His annual earnings at the time of the accident were $20,000. Pre-tax rate of discount is 6%, projected growth in earnings is 6% per year, and tax rate of 25%. The present discounted value would be $613,015.
(b) Same facts as (a) above except both the discount and the rate of growth are 10%. Present discounted value would be $717,905. That amount exceeds the present discounted value of the future lost earnings, $640,000, if taxes were ignored.


177. In Liepelt the majority noted that damages in FELA cases are a matter of federal concern, 444 U.S. at 493 (citing Michigan Cent. R.R. v. Vreeland, 227 U.S. 59 (1913)). The Liepelt holding was later held to create a federal common-law rule, to be applied to actions based on federal statutes that contain no explicit choice of law provisions. Gulf Offshore Co. v. Mobil Oil Corp., 453 U.S. 473, 486-87 (1981).
Jones Act, the DOSHA, the Outer Continental Shelf Lands Act, and possibly under section 1983. Liepelt has even been held to apply to the calculation of damages under the FTCA although by statute, state law should control. Thus, Liepelt is having an effect, although perhaps not as swiftly or dramatically as one might have thought.

It will be interesting to see whether those few jurisdictions that admit evidence of the effects of taxation will concur with the Ninth Circuit and also calculate the rate of discount net of taxes, as Justice Stevens intimated in dictum would be logical.

4. Liepelt's Encouragement of Structured Settlements

Since Liepelt generally, but not always, favors the defendant, it may be to the defendant's advantage, given the facts of a particular case, not to request that the effect of taxes be included in the calculation of damages. But if the jurisdiction follows the logic of Liepelt, and the jury is not only instructed that the award is tax free (an instruction that can only benefit the defendant), but also is provided evidence of the effect of taxes on lost earnings and on the rate of discount, what course of action should the defendant pursue? Not going to trial may be his best approach, as a structured settlement might prove far more financially favorable. If, as is almost always


180. 43 U.S.C. §§ 1331-1356 (1976 & Supp. IV 1980). Under OCSLA, the adjacent state's law applies to the area of the sea covered by the Act unless it is inconsistent with federal law. Id. § 1333(a)(2). In Gulf Offshore Co. v. Mobil Oil Corp., 453 U.S. 473 (1981), the Court faced the issue of whether Liepelt would override state law if the state law did not require that juries be instructed concerning the effect of taxes. The Court did not decide the issue, but remanded the case to the Texas Court of Civil Appeals for a determination whether the applicable state law required the instruction, and, if it did not, whether Liepelt would override it. Id. at 488.


182. The Federal Tort Claims Act of 1946, ch. 753, 60 Stat. 842 (codified as amended in scattered sections of 28 U.S.C.). State law governs the measure of damages as directed by 28 U.S.C. § 1346(b) (1976). The measure of damages under state law must be compensatory, however, and not punitive. Id. § 2674; see, e.g., DeLuca v. United States, 670 F.2d 843, 844 (9th Cir. 1982); Hollinger v. United States, 651 F.2d 636, 642 (9th Cir. 1981).

183. 444 U.S. at 495.

184. It is, of course, impossible to generalize as to when a defendant should settle rather than litigate a case. The defendant must weigh the uncertainty of winning at
the case, the jurisdiction does not allow periodic payments of a judgment,\(^{185}\) the defendant may be better off settling and agreeing to deferred, periodic payments. Settlement may be preferable if the claimant’s tax rate will lower the rate of discount used to calculate the present value of the future damages. A structured settlement in the form of an annuity worth $100,000 to the claimant would cost the defendant less than the discounted value of $100,000. The rate of discount used to calculate the cost of the annuity would be at the higher pre-tax rates because the issuer of the annuity would not be taxed on the income used to meet the periodic payment obligations.\(^{186}\)

To demonstrate: Suppose the claimant is awarded damages for lost earnings at a rate of $20,000 per year for ten years and for future medical expenses at $5000 per year for 10 years, for a total of $250,000. If the claimant’s effective tax rate is 15%, the after-tax value of the lost earnings is $17,000 per year or $170,000. Total after-tax damages would equal $220,000. If the pre-tax rate of discount is 10%, the after-tax rate would be 8.5% (10% net the claimant’s 15% tax rate). Assuming an 8.5% rate of discount, the present value of the damages is $144,350. On the other hand, if the defendant settled and agreed to pay $22,000 per year for 10 years ($17,000 per year for lost earnings plus $5000 per year for medical expenses), the cost or present value to the defendant would be only $135,180. The difference be-

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\(^{186}\) The amounts paid to fulfill the terms of the annuity will be deductible from the taxable income of the company which sold the annuity. I.R.C. § 832(c) (1976).
between $144,350 and $135,180 represents the effect of the claimant’s
taxes on the discount used to calculate the present value to the claim-
ant, versus a 10% rate of discount used to calculate the cost to the
defendant to purchase an annuity that will pay the requisite annual
amounts.

Including the effects of taxes on damage awards thus makes struc-
tured settlements more attractive to both claimants and defendants,
particularly if the jurisdiction does not provide for periodic payments
of judgments. Thus, *Liepelt* strongly encourages structured settle-
ments for personal injury claims because the interest income compo-
nent of the settlement annuity escapes taxation while the interest
earned on lump-sum payments is taxed.

The two previously existing motives for the adoption of a structured
settlement were: 1) its lower cost for the defendant (compared to a
comparable value lump-sum settlement); and 2) the tax-free nature of
the interest income which would have been taxable had the claimant
accepted and invested a lump-sum payment. After *Liepelt*, some
defendants will have another compelling reason to favor a structured
settlement. If the jurisdiction follows the logic of *Liepelt*, then the
purchase of an annuity by the defendant will forestall the increase in
the amount of lump-sum damages that would result from the decrease
in the rate of discount. Hence, *Liepelt* means more structured settle-
ments, which means greater horizontal tax inequity.

D. A Proposed Solution

The uncertain effects of *Liepelt*, particularly the possibility that the
section 104(a)(2) exemption will redound to the benefit of defendants,
could be eliminated if Congress agreed to tax amounts paid as com-
ensation for lost income. Merely overruling *Liepelt* is no solution
because state courts would be free to instruct juries that lost income
compensation is tax exempt and, therefore, to reduce damage awards
proportionately. Moreover, repeal of the section 104(a)(2) exemption
for compensation for lost income would not only avoid the unfortu-
nate by-products of *Liepelt*, but would also produce tax equity be-
tween personal injury claimants and non-injured wage earners.

Removal of the section 104(a)(2) tax exemption for lost income
damages, however, would result in a serious income-bunching prob-
lem if the claimant accepted a lump-sum settlement as compensation
for lost wages. Although income averaging under sections 1301-
1304187 would be available for recipients of significant damage
awards, the modesty of the relief offered by those sections would
hardly seem fair.188 More targeted and tailored sections would be in

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188. The amount of income subject to averaging is the taxable income of the
current year which exceeds 120% of the average taxable income for the prior four tax
order. Relief sections need not be cut from whole cloth, as parallel or analogous relief sections currently exist.

For example, in the case of trusts that accumulate income, sections 666 and 667\textsuperscript{189} provide a means for determining the additional tax due upon distribution without the laborious necessity of recalculating the additional tax owed for each of the years in which it was earned.\textsuperscript{190} Under section 667(b), the additional tax is determined by calculating the tax that would have been owed by reference to a three-year base period.\textsuperscript{191} Similarly, reimbursement for lost income could be taxed at a rate equal to the taxpayer's average effective rate paid in selected tax years prior to the injury.

Taxation of pension plans offers another analogy. Individuals at retirement have the option under section 402\textsuperscript{192} either to treat the distribution as capital gains income, and thereby avoid taxation on 60\% of the income,\textsuperscript{193} or to elect the special ten-year income averaging provided by section 402(e).\textsuperscript{194} Particularly instructive as to how damage awards might be taxed is the right of a recipient of a lump-sum pension to completely defer taxation by rolling-over the distribution into a qualifying eligible retirement fund per section 402(a), and have the income taxed only as it is withdrawn from the retirement fund.\textsuperscript{195} The use of a rollover fund effectively allows the taxpayer to convert a lump-sum distribution into a multi-year taxable annuity with the taxpayer determining the rate of the disbursement of the income, and, therefore, the probable rate of taxation.\textsuperscript{196} In short, Congress has ample ways to tax lump-sum income without subjecting it to unduly high marginal rates.

**Conclusion**

The section 104(a)(2) tax exemption represents an understandable congressional desire to confer a humanitarian benefit on tort victims. Recent events, however, call into serious question the continued desirability of section 104(a)(2) as currently enforced and interpreted. The

\textsuperscript{189} Id. §§ 666-667 (1976 & Supp. IV 1980).
\textsuperscript{190} Id. § 667(b)(1).
\textsuperscript{191} Id. § 667(b)(1)(C) (1976).
\textsuperscript{193} Id. § 1202(c) (Supp. V 1981).
\textsuperscript{195} Id. § 402(a)(5) (Supp. V 1981).
\textsuperscript{196} The individual retirement annuity to which a lump-sum pension distribution may be rolled-over is defined by § 408(b). Among the choices open to the annuitant are to select a single life annuity or to choose a smaller paying annuity that will pay for the greater of two lives: the annuitant or his spouse. Id. § 408(b)(3) (1976).
increased use of structured settlements coupled with the unfortunate effects of the Liepelt holding require that both the IRS and Congress rethink their position on section 104(a)(2).

The 1983 amendment to section 104(a)(2) codifies the IRS policy of excluding from gross income the interest portion of deferred reimbursement payments for personal injuries, a policy which has created horizontal inequities among personal injury claimants. Congress should repeal the 1983 amendment and apply the doctrine of economic benefit to periodic payments of damage awards. This would divest structured settlements of their favored tax treatment and eliminate horizontal inequities among tort claimants.

Moreover, 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 Liepelt holding. 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.