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NOTES AND COMMENTS

Damages—Income Tax as a Factor in Measuring Personal Injury Awards

The Internal Revenue Code of 1954 specifically excludes from gross income "the amount of any damages received (whether by suit or agreement) on account of personal injuries or sickness."¹ Rationally it would seem that loss of earnings which are included in a personal injury award should be taxable;² but since the code does not by its language exclude any of the component parts of the award from the exemption it has been presumed that this replacement of lost earnings is included.³

In personal injury litigation, income tax considerations give rise to at least two distinct problems. The first is whether plaintiff's gross earnings or net earnings (after taxes) prior to the injury should be the basis for determining loss of past and future income in computing the amount of the damages. The second problem is whether the jury may properly be reminded in argument, or instructed by the court, that the final award is not subject to federal and state income tax.

In resolving the first problem the overwhelming weight of authority is that the computations must be based on gross income, not net earnings after income tax payments. The rationale of the cases is that the introduction of the income tax consequences into the case would be too conjectural and would tend to confuse rather than help the jury in determining the proper amount of damage.⁴

England for many years was in accord with the American courts in holding that no deduction for income tax liability should be made from the amount awarded for loss of earnings.⁵ This authority has recently

¹ Int. Rev. Code of 1954, § 104 (A) (2). This provision is broad enough to cover damages for both impairment of earning capacity and past loss of earnings.

² The Internal Revenue Code of 1954, § 61 (A) as construed by Commissioner v. Glenshaw Glass Co., 348 U. S. 426 (1955), includes as gross income any receipt by the taxpayer that is not specifically excluded by the Code.

³ Combs v. Chicago, St. Paul, Minneapolis and Omaha Ry. Co., 135 F. Supp. 750 (N. D. Iowa 1955). Another reason that has been given is that since the verdict is general there is no way to determine the amount apportionable to loss of earnings so the entire award in practice becomes tax free. See Pfister v. City of Cleveland, 96 Ohio App. 185, 113 N. E. 2d 366 (1953).

⁴ Rouse v. New York, C. & St. L. Ry. Co., 349 Ill. App. 139, 110 N. E. 2d 266 (1953); Dempsey v. Thompson, 363 Mo. 339, 251 S. W. 2d 42 (1952); Pfister v. City of Cleveland, 96 Ohio App. 185, 113 N. E. 2d 366 (1953); Smith v. Pennsylvania Ry. Co., Ohio App., 99 N. E. 2d 501 (1950); Chicago & N. W. Ry. Co. v. Curl, 178 F. 2d 497 (8th Cir. 1950); Southern Pacific Co. v. Guthrie, 186 F. 2d 926, 927 (9th Cir. 1951); Stokes v. United States, 144 F. 2d 82, 87 (2d Cir. 1944); Runnels v. City of Douglas, 124 F. Supp. 657 (D. C. Alaska 1954); O'Donnell v. Great Northern Ry. Co., 109 F. Supp. 590 (N. D. Cal. 1951); Cole v. Chicago, St. P., M. & O. Ry., 59 F. Supp. 443, 445 (4th Div. 1945).

⁵ Billingham v. Hughes, (1949), 1 K. B. 643, 9 A. L. R. 311.

been overruled by *Transport Com. v. Gourley*.⁶ Gourley, a civil engineer, suffered severe injuries while traveling in a railway train operated by the British Transport Commission. Liability being established, only the quantum of damages remained to be ascertained. Apart from a provision for pain and suffering, £37,720 was awarded for loss of earnings, of which £15,220 was granted for actual loss of earnings before the trial and £22,500 for estimated future loss of earnings. The judgment (for £37,720 on account of loss of earnings) made no allowance for any income tax or surtax which would have been payable by the plaintiff had he received it in the ordinary course of his professional activities rather than by way of damages. The counsel for the defendant requested that the amount be reduced by the amount of tax plaintiff would have had to pay if he had earned it, and the request was refused. On appeal the House of Lords established the amount of unassessed income tax at £30,725 and upheld the defendant's contention that this should be deducted.

The effect this case will have in the United States remains to be seen.⁷ The present English view appears to be unsound, at least within the United States, because the assessment of damages on the basis set out in the *Gourley* Case does not lend itself to practical application. Effective tax rates in the United States fluctuate with the changing of the congress and are governed by variables such as age, number of dependents, deductions, extent of the plaintiff's own private fortune, separate income of his wife if he is married, etc.⁸ Also, in most jurisdictions there is no way to determine what part of the award is attributable to loss of earnings as was done in the above English case.

However, to allow no instruction at all as to the income tax consequences may result in an excessive award to the plaintiff through a misconception on the part of the jury that the award is taxable. This leads to the second problem which is whether the jury should be told that the final award is not subject to income tax.

In a recent case, *Maus v. New York, Chicago & St. Louis Ry. Co.*,⁹ the plaintiff brought an action under the Federal Employers' Liability Act¹⁰ against the defendant railroad for personal injuries sustained in the course of his employment. The defendant requested the court to charge the jury as follows: "I charge you as a matter of law that by virtue of the Internal Revenue Act of 1954, any amount received by the plaintiff.

⁶ (1956) 3 All E. R. 796, 2 Weekly L. R. 41.

⁷ Many of the cases cited note 4 *supra* and note 12 *infra* rely on *Billingham v. Hughes* in following the view that income tax is of no consequence to the jury. Is it possible that the *Gourley* decision may cause American courts to take a new look at the problem.

⁸ *Dempsey v. Thompson*, 363 Mo. 339, 251 S. W. 2d 42 (1952), reversing *Hilton v. Thompson*, 360 Mo. 177, 227 S. W. 2d 675 (1950).

⁹ 165 Ohio St. 281, 135 N. E. 2d 253 (1956), *affirming* Ohio App., 128 N. E. 2d 166 (1955).

¹⁰ 53 Stat. 1404 (1939); 45 U. S. C. § 51 (1953).

as compensation for personal injury is exempt from federal income taxation, and you must take this fact into consideration in arriving at the amount of your verdict in this case." The trial judge refused to give the charge and he was affirmed on appeal. The court in holding that the charge should not have been given to the jury based its decision on the fact that taxation is not a proper factor for the jury to consider because it introduces an extraneous subject giving rise to conjecture and speculation.¹¹

At the time of this writing, the courts of Arizona, Georgia, Illinois, Indiana, Missouri, Ohio, Texas, and the Federal District Court for the Northern District of Iowa have considered this question. Seven of the eight jurisdictions held that it is improper to apprise the jury that the final award is not subject to income tax.¹²

In *Dempsey v. Thompson*,¹³ the leading case allowing such instruction, the plaintiff brought an action for personal injuries and the court held that the defendant was entitled to have the jury instructed that any amount awarded to the plaintiff was not subject to the income tax.¹⁴ The court said, "The present economic conditions are such that most citizens, most jurors, are not only conscious of, but acutely sensitive to, the impact of income taxes. Under the Federal and State income tax laws of Missouri the net income of all persons is taxable except such as is specifically exempted. Few persons, other than those who have had special occasion to learn otherwise, have any knowledge of the exemption involved in this case. It is reasonable to assume the average juror would believe the award involved in this case to be subject to such taxes. It seems clear, therefore, that in order to avoid any harm such a misconception could bring about, it would be competent and desirable to instruct the jury that an award of damages for personal injuries is not subject to Federal or State income taxes."¹⁵

¹¹ But see the concurring opinion which states that a charge could be drawn which if requested should be given by the trial judge.

¹² *Mitchell v. Emblade*, 80 Ariz. 398, 298 P. 2d 1034 (1956); *Atlantic Coastline Ry. Co. v. Brown*, 93 Ga. App. 805, 92 S. E. 2d 874 (1956); *Hall v. Chicago & North Western Ry. Co.*, 5 Ill. 2d 135, 125 N. E. 2d 77 (1955), *reversing* 349 Ill. App. 175, 110 N. E. 2d 77 (1955); *Wagner v. Illinois Central Ry. Co.*, 7 Ill. App. 2d 445, 129 N. E. 2d 771 (1955); *Highshew v. Kushto* (Ind. Sup. Ct.), 134 N. E. 2d 555 (1956), *reversing* (Ind. App.), 131 N. E. 2d 652 (1956); *State v. Santry*, 160 Ohio St. 164, 113 N. E. 2d 366 (1953); *Maus v. New York, Chicago & St. Louis Ry. Co.*, 165 Ohio St. 281, 135 N. E. 2d 253 (1956); *Missner-Kansas-Texas Ry. Co. v. McFerrin* (Civ. App. Texas), 279 S. W. 2d 410 (1955); *Combs v. Chicago, St. Paul, Minneapolis and Omaha Ry. Co.*, 135 F. Supp. 750 (N. D. Iowa 1955).

¹³ 363 Mo. 339, 251 S. W. 2d 42 (1952), *reversing* *Hilton v. Thompson*, 360 Mo. 177, 227 S. W. 2d 675 (1950).

¹⁴ The court suggested a proper instruction which is as follows: "You are instructed that any award made to plaintiff as damages in this case, if any award is made, is not subject to federal and state income taxes, and you should not consider such taxes in fixing the amount of any award made to the plaintiff, if any you make." *Id.*, 346, 251 S. W. 2d at 45.

¹⁵ *Dempsey v. Thompson*, 363 Mo. 339, 346, 251 S. W. 2d 42, 45 (1952).

The purpose in awarding damages in personal injury litigation is to make the injured party whole. This contemplates that the award for damages received should place the injured person as nearly as possible in the condition he would have occupied if the wrong had not occurred.¹⁶ If we apply this principle, it follows that the jury should take the tax element into consideration in respect to that portion of the recovery which represents lost earnings, because if the person had not been injured tax would have been paid on the wages received by him.

The principle that the purpose of a damage award is to make the injured party whole is not applied by the majority of the courts, however, when the plaintiff receives benefit from a collateral source. Thus, where the plaintiff's actual damages are recouped in part by the payments of a third party, such as continuance of wages by an employer while the plaintiff is not at work,¹⁷ the tortfeasor's liability is not affected by the amount conferred by the third party upon the injured person.¹⁸ By analogy it would follow that the wrongdoer could not take advantage of the windfall given the plaintiff by way of a tax benefit.¹⁹ The tortfeasor cannot be heard to complain of contracts or agreements between the plaintiff and third parties which would tend to lessen the award if taken into consideration. The defendant has no interest in whether the plaintiff must pay the tax or not.

This problem has not as yet been presented to the North Carolina Supreme Court. If and when this question is put before our court it is suggested that the better holding is that the jury should not be told of the income tax exemption. The majority of courts are apparently of the view that the giving of such an instruction would, in general, not be in the interest of better judicial administration in that the injection of the question of income tax liability into jury cases would probably give rise to more problems than it would solve.²⁰ North Carolina also follows the view that the tortfeasor cannot take advantage of contracts and agreements between the plaintiff and third parties which reduce his damage.²¹ This would tend to indicate that no such charge should be allowed.²²

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¹⁶ McCORMICK, DAMAGES § 137 (1935).

¹⁷ 17 AM. JUR., DAMAGES § 200 (1938). See also *Hammond v. Shiff*, 100 N. C. 161, 6 S. E. 753 (1888); where the N. C. court held that collection of insurance by the plaintiff did not mitigate defendant's damage.

¹⁸ *Majestic v. Louisville & N. Ry. Co.*, 147 F. 2d 621, 626 (6th Cir. 1945); 1 SUTHERLAND, DAMAGES § 158 (4th ed. 1916); McCORMICK, DAMAGES § 87, 90 (1935).

¹⁹ *Hall v. Chicago & North Western Ry. Co.*, 5 Ill. 2d 135, 125 N. E. 2d 77 (1955); *Combs v. Chicago, St. Paul, Minneapolis and Omaha Ry. Co.*, 135 F. Supp. 750 (N. D. Iowa 1955).

²⁰ See cases cited note 4 *supra*.

²¹ See case cited note 17 *supra*.

²² N. C. GEN. STAT. 105-141 (2) exempts from gross income the amount of any damages received on account of personal injuries. See also Sec. 105 (d) of the Internal Revenue Code which in effect says that amounts received by an employee under an employer-financed accident and health plan which constitute wages or