Income Tax Effects on Personal Injury Recoveries

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great the nonassertive value of the statement the danger of misuse requires it to be excluded. Among statements offered nonassertively, prior inconsistent statements are peculiar. Because they are clothed with many safeguards including the opportunity to question the witness on the stand and because they serve a vital state interest, prior inconsistent statements are more readily admissible than most other statements offered nonassertively. Even with prior inconsistent statements it would appear that any substantial danger of misuse by the jury would bring the statement within the prohibition of the confrontation clause.

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INCOME TAX EFFECTS ON PERSONAL INJURY RECOVERIES

In spite of their obvious importance, the income tax effects on personal injury recoveries have caused considerable confusion for more than fifty years. In the midst of this confusion the attorney is called upon to advise his client in such a manner that the latter can pay the proper tax required of him, if any. The purpose of this Comment is to examine the income tax effects on personal injury recoveries in four areas. Specifically, this Comment will examine the successful plaintiff's income tax liability, the deductibility of defendant's personal injury payment, income tax as a factor in measuring damages, and instructions to the jury as to income tax consequences.

Plaintiff's Income Tax Liability

As to income taxability, injury awards are divided into two classes, personal and non-personal; each is accorded a different tax treatment. The rule for non-personal compensatory injury awards is that damages and other recoveries follow the tax treatment which would have been accorded the underlying claim. Thus, in all non-personal injuries, the question is "[i]n

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1. The exemption of personal injury awards from gross income was first found in the Int. Rev. Code of 1918, § 213(6).
2. This principle was first recognized in Farmers' and Merchants' Bank v. Commissioner, 59 F.2d 912 (6th Cir. 1932). It is now well established. See United States v. Safety Car Heating Co., 297 U.S. 88 (1936); Durkee v. Commissioner, 162 F.2d 184 (6th Cir. 1947); Raytheon Prod. Corp. v. Commissioner, 144 F.2d 110 (1st Cir. 1944); Swastika Oil & Gas Co. v. Com-
lieu of what were the damages awarded.

This well-established “in lieu of” test means that if the underlying claim would have been taxable, i.e., damage to income or lost profits, then the recovery would also be taxable. If the underlying claim would not be taxable, i.e., damages to capital or goodwill, then the award compensating for such loss would also be nontaxable.\(^4\)

As to compensatory personal injury awards, there is no need to examine the underlying claim. The rule is simply stated in Section 104 (a) (2) of the Internal Revenue Code:

“In general—Except in the case of amounts attributable to (and not in excess of) deductions allowed under section 213 (relating to medical, etc. expenses) for any prior taxable year, gross income does not include—

“(2) the amount of any damage received (whether by suit or agreement) on account of personal injuries or sickness; ....”

It has been suggested that the reason compensatory personal injury awards were excluded from gross income was the congressional desire to give a tax benefit to the injured plaintiff.\(^6\) In truth, however, the justification for the exemption was the belief that such payments were not income within the meaning of the sixteenth amendment,\(^7\) because such accessions were not

\(^3\) Hall v. Chicago & N.W. Ry., 5 Ill.2d 135, 125 N.E.2d 77 (1955); Dixie Feed & Seed Co. v. Byrd, 52 Tenn. App. 619, 376 S.W.2d 745 (1963), appeal dismissed, 379 U.S. 15 (1964); see Note, 69 Harv. L. Rev. 1495 (1956).

\(^7\) H.R. Rep. No. 767, 65th Cong., 2d Sess. 9-10 (1917).
derived from capital, from labor, or from both combined. Such payments were merely an attempt to make the plaintiff whole again, to compensate him for his losses. Of course, this reasoning is not totally accurate, since the compensatory personal injury award normally includes elements, such as lost wages or future earnings, which would otherwise be taxable. Nonetheless, the illogical rule has persisted, in part, at least, because of the difficulties of separating the taxable and nontaxable elements of the personal injury and the public policy of not desiring to overburden the injured plaintiff. Since the difficulties in making such a separation are not as burdensome in the non-personal injury, a plaintiff suffering from this type of injury will not receive the same tax advantage.

When one examines the language exempting personal injury awards from taxability in Section 104 of the Internal Revenue Code, several observations can be made. First, the language is broad; it covers personal injuries whether physical or not. Second, the exemption is limited to natural persons, artificial persons being excluded by implication of the first sentence of the section. Third, the amount received for personal injuries will be excluded from gross income whether the award results from a final judgment or a compromise settlement. Fourth, there is no distinction between compensatory and punitive awards for personal injuries; from a strict interpretation of the statutory language, both should be nontaxable.

In view of the total exclusion of compensatory personal injury awards from gross income, the courts have been extremely strict in their interpretation of "personal injury." In the past, damages for physical injury, defamatory statements injuring the plaintiff's personal reputation, surrender of custody rights,

8. This classic definition of income was formulated in Eisner v. Macomber, 252 U.S. 189 (1920).
10. The government will receive some benefit from the award, nonetheless, since the attorney's fee is taxable to the attorney and the interest on the award is taxable. INT. REV. CODE of 1954, § 61(a)(1), (4).
wrongful death, breach of a promise of marriage, marriage procured by fraud and deceit, invasion of privacy, and alienation of affections have been considered nontaxable. However, noticeably absent from both the statute and the cases is any definition of a personal injury, and not all injuries to an individual are considered “personal.” One observation can be made from the above cases: whether the injury arose out of contract or tort is not the determining criterion. One early distinction between personal and non-personal injuries was that there must be an injury to a personal as opposed to a property right—the latter being characterized by its ability to be assigned or transferred. More recently, a more satisfactory line has been drawn between injuries to the individual’s personal and business capacities. Thus, amounts received by an individual for breach of an employment contract, for breach of a promise to reimburse an individual for attention, care, and nursing, for cancellation of a real estate lease, as compensation for past services, as a lump compromise of a partnership interest, for patent infringement, and for damage to property were all non-personal in-

25. Specialty Eng’r Co., 12 T.C. 1173 (1949) (part of award representing taxpayer’s interest in patent was capital and nontaxable).
27. Boehm v. Commissioner, 146 F.2d 553 (2d Cir. 1945), aff’d on other grounds, 326 U.S. 287 (1945) (not taxable); Commissioner v. Norfolk So. R.R., 63 F.2d 304 (4th Cir. 1933) (not taxable).
jury awards. The rationale of these cases was that the plaintiff was injured in his business capacity; hence, the injury was non-personal.

The importance of this distinction for a plaintiff's attorney is obvious. In order to work a tax benefit for his client the attorney should present the case from the viewpoint that the injury suffered was personal. For example, a doctor who is libeled may suffer damages to both his personal and his business reputations. Although damages received for an injury to personal reputation by defamatory statements are not taxable, damages received for an injury to business reputation are considered non-personal and taxable. Probably, there will be an injury to both reputations, and the Commissioner, if there is some evidence on which to make an allocation, will specify a portion of the award as taxable and a portion as nontaxable. If there is no evidence on which an allocation can be made, the commissioner will either tax or exempt the entire award, depending on the gravamen of the injury. Quite often, since there is no basis on which an allocation can be made in settlements, the commissioner will subject the entire award to the income tax.

31. Arcadia Refining Co. v. Commissioner, 118 F.2d 1010 (5th Cir. 1941); H. Liebes & Co. v. Commissioner, 90 F.2d 932 (9th Cir. 1937); Armstrong Knitting Mills, 19 B.T.A. 318 (1930). Once the Commissioner has determined that the award is income, the burden is then upon the recipient to show that the Commissioner's finding was irrelevant. Armstrong Knitting Mills, 19 B.T.A. 318 (1930).
32. Nathan Agar, 19 CCH Tax Ct. Mem. 116 (1960), aff'd, 290 F.2d 283 (2d Cir. 1961), provides an interesting illustration of the difficulties in determining whether or not a settlement is a personal injury award. Plaintiff had a five-year employment contract as an officer with a corporation, but the corporation lost confidence in him before the contract had expired. Claiming that the corporation's attitude resulted in damages to his health, plaintiff instituted a suit for personal injuries from the alleged abuse. Holding that the settlement payments were in the nature of severance pay and extra compensation—taxable as income, the Tax Court rationalized that the final inquiry in a close case must be made into the basic motivation for the corporation's payment, and that the plaintiff's belief was only evidence of the character of the payment. The court also pointed out that even if the payments had been made in the settlement of a tort claim, the gravamen of that claim was an injury to business reputation and thus non-personal.
The attorney should also be mindful of the strictness with which the courts view the language "personal injuries." For example, in *Meyer v. United States*, the plaintiff agreed to the use of her name and certain personal correspondence in a proposed film. Although the court found that no violation of plaintiff's right of privacy had in fact occurred, it added in dictum that, even if there would have been an invasion, the payments would not have been tax exempt. Later cases are in accord.

The court emphasized that the statutory exclusion was only for the amount of any damage received for personal injuries. Although logically there should be no difference in the tax treatment accorded advance and subsequent payments for privacy invasions, since both are personal injuries, only the latter are exempt from income tax.

As to punitive damages for personal injuries, the rule is that punitive damages are income and taxable to the recipient. The reason asserted for this rule is that punitive damages, unlike compensatory damages, are not a restoration of the plaintiff's capital. This rationale is consistent with respect to non-personal injuries since whether an award for this type of injury is to be taxed depends upon the underlying claim. With respect to personal injuries, however, there is no need to examine the underlying claim, and this rationale seems inappropriate. It may be that the real reason punitive personal injury awards are taxable is the tax court's unwillingness to grant an exemption in view of the large size of the awards and the lack of any public policy.

Although this case established the principle that the intent of the payor in making the payment was of primary importance in determining whether a particular award is compensation for a personal injury, it is questionable whether this principle is sound. It should not be the intent of the payor which controls, but the nature of the injury. Certainly, if the taxpayer suffered injuries to his personal reputation, it could hardly be said that this award would be taxable, merely because the payor intended the payment as extra compensation. Although the intent of the payor might be a relevant factor in determining the character of the injury, other factors of equal importance mentioned in *Mason K. Knuckles*, 23 CCH Tax Ct. Mem. 182 (1964), aff'd, 349 F.2d 610 (10th Cir. 1965), were (1) lack of a previous acknowledgment of personal injuries, (2) absence of proof of personal injuries, and (3) evidence showing the plaintiff's purpose in characterizing his injury as personal was solely for tax purposes.

34. *See* note 17 supra.
36. This rule was apparently adopted from the rule for punitive damages for non-personal injuries, such awards being taxable as income. Commissioner v. Glenshaw Glass Co., 348 U.S. 426 (1955); Ralph Freeman, 33 T.C. 323 (1959); Commissioner v. Obear-Nester Glass Co., 217 F.2d 56 (7th Cir. 1954), *cert. denied*, 348 U.S. 982 (1955); Chalmers Cullens, 24 T.C. 322 (1955).
to necessitate an exemption. In short, the plaintiff receives one tax advantage in not having his compensatory personal award taxed; he should not receive a second for the punitive damages.

A final problem concerns prior medical deductions, since compensatory personal injury awards will be nontaxable only insofar as such recoveries exceed prior medical deductions. The problem becomes acute in lump sum settlements, since the tax court must then allocate not only the amount of the award which was for personal injuries, but also the amount attributable to prior medical deductions. In order to avoid the risk of having a portion of plaintiff's recovery unnecessarily subject to the income tax, the attorney should obtain a statement from the payor as to the portion of the award attributable to prior medical deductions.

The Deductibility of Defendant's Personal Injury Payment

Once it has been determined that the plaintiff is entitled to a personal injury award of a definite amount, the main tax question confronting the defendant is whether the required payment is deductible. To be deductible the personal injury payment must be directly connected with, or have proximately resulted from, the taxpayer's business. Personal expenses are specifically prohibited from deduction by the code. The deduction will also be disallowed, even though connected with the defendant's business, if it would "frustrate some sharply defined public policy."

Although a detailed analysis of the requirements for a business expense is not possible here, there are three conditions which must be satisfied. The expense must be (1) incurred in carrying on a trade or business, (2) ordinary and necessary, and (3) paid or incurred within the taxable year. A fourth condition imposed by the courts is that it be for a business purpose. Because at least one of these requirements was not satisfied, amounts paid as damages for a breach of a promise to marry,

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37. INT. REV. CODE of 1954, § 104.
41. INT. REV. CODE of 1954, § 162(a).
42. See J. MERTENS, LAW OF FEDERAL INCOME TAXATION § 25.07 (1966).
43. O.D. 546, 2 CUM. BULL. 157 (1919).
for defamation,\textsuperscript{44} and for a wrongful death action where the death had no substantial relation to defendant's business,\textsuperscript{45} have been held nondeductible, even though an incidental motive in the last two examples was the protection of the taxpayer's business.

Although the distinction between business and personal expenses is theoretically clear, in practice it is often difficult to delineate between the two. In \textit{William W. Harper},\textsuperscript{46} defendant lessor invaded plaintiff lessee's privacy by installing a listening device in the tenant's room. Although the defendant claimed his settlement payment to the plaintiff was a business expense, necessary to preserve the reputation of his rental business, the tax court held that the payments constituted a personal expense, and the protection afforded the rental business was only incidental. No allocation was made. The failure of the tax court to allocate illustrates the rule that if both personal and business expenses are incurred, the burden is upon the taxpayer to make the proper allocation between the two items.\textsuperscript{47} If an improper or no allocation is made, the taxpayer runs the risk of being denied a deduction of the entire amount.\textsuperscript{48}

\textit{Income Taxes as a Factor in Measuring Damages}

Although the Internal Revenue Code provides that personal injury awards received by a plaintiff \textit{after} a trial has concluded are nontaxable, there is no statutory language which controls the relationship of income taxes to the award during the trial. At the same time, the issue of whether income before or after taxes should be used in computing damages has received sporadic, inconsistent treatment in the courtroom. The issue is still undecided in Louisiana, although the practice is to use gross income in measuring the size of awards.\textsuperscript{49} Until recently, the decided majority of both federal and state courts had held that

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\item \textsuperscript{44} Lloyd v. Commissioner, 55 F.2d 842 (7th Cir. 1932); Robert Edward Kleinschmidt, 12 T.C. 921 (1949); Kerwin v. Fulton, 41 B.T.A. 1037 (1940), aff'd, 128 F.2d 740 (2d Cir. 1942).
\item \textsuperscript{45} Cf. Kornhauser v. United States, 276 U.S. 145 (1928).
\item \textsuperscript{46} 22 CCH Tax Ct. Mem. 705 (1963).
\item \textsuperscript{47} Arthur Jordan, 12 B.T.A. 423 (1928); Sam E. Broadhead, 25 CCH Tax Ct. Mem. 133 (1966).
\item \textsuperscript{48} See J. MERTENS, LAW OF FEDERAL INCOME TAXATION \S 25.17, at 91 n.75 (1966) and cases cited therein.
\item \textsuperscript{49} There are no Louisiana cases which expressly establish a rule either for or against the income tax deduction. However, several Louisiana judges have remarked that they used gross income in measuring damages.
\end{itemize}
income tax consequences should not be taken into consideration in computing damages and no evidence of plaintiff's tax liability was admissible.\(^5\) Past income tax records were admissible only to show what the plaintiff had earned before the injury or death, or might have earned in the future—not to show previous or future tax liability.

This majority rule has been strongly criticized.\(^5\) The basis for this criticism is that because there is no statutory language controlling the relationship of income taxes and the award during the trial, the general rule for damages should govern the size of plaintiff's award—the cardinal rule for damages in Anglo-American law being that of compensation for plaintiff's injury.\(^5\) Plaintiff should be put as nearly as possible in the same position he would have been if defendant's wrong had not injured him.\(^5\) However, because plaintiff's personal injury award is nontaxable, whereas frequently a portion or all of the underlying claim is taxable, the plaintiff will usually be in a better tax position be-


\(^{52}\) 2 F. HARPER & F. JAMES, THE LAW OF TORTS § 25.1 (1956); C. MCCORMICK, DAMAGES § 137 (1935).

cause of the injury, unless the court recognizes this tax saving and computes damages using net income as a measure of plaintiff's loss. As stated in a leading text on torts, "the argument for computing damages on estimated income after taxes is a clear one: this will measure the actual loss. If plaintiff gets, in tax-free damages, an amount on which he would have had to pay taxes if he had gotten it as wages, the plaintiff is getting more than he lost."54 The Louisiana Civil Code provides that "every act whatever of man that causes damage to another, obliges him by whose fault it happened to repair it."55 But the defendant's fault does not oblige him to bestow a bonus upon the plaintiff.

Advocates of the use of a net income formula to measure plaintiff's loss have strongly criticized the five basic arguments used by the courts in justifying the majority position. One of these arguments was that basing damages on net earnings would nullify the tax benefit conferred by Congress expressly exempting damages for personal injuries.56 As mentioned earlier, however, the original reason for this exemption was the simple belief that such award was not income within the meaning of the sixteenth amendment.57 Likewise, critics of the majority rule argue that the public policy reason which has maintained this exemption—that an injured plaintiff should not have his award reduced by a forced payment of an income tax—certainly does not necessitate any particular method of determining which elements constitute the award. In effect, the "congressional intent" argument appears to be but another attempt to justify a settled rule by imputing a non-existent intent to a legislative body.58

A second argument to justify the majority rule was made in the first case in the United States to confront this problem: future income tax liability was simply too conjectural.59 For

55. LA. CIV. CODE art. 2315.
56. See note 6 supra.
57. See note 7 supra.
58. For further discussion of this counter-argument to the congressional intent argument, see Nordstrom, Income Taxes and Personal Injury Awards, 19 Ohio St. L.J. 212 (1958); Note, 46 N.C. L. Rev. 941 (1968).
59. Stokes v. United States, 144 F.2d 82 (2d Cir. 1944). Although this reasoning has been followed in many cases, e.g., Petition of Oskar Tiedemann & Co., 236 F. Supp. 895 (D. Del. 1964); Hall v. Chicago & N.W. Ry., 5 Ill.2d 135, 125 N.E.2d 77 (1955); Dempsey v. Thompson, 368 Mo. 333, 251 S.W.2d 42 (1952); Texas & N.O. Ry. v. Pool, 263 S.W.2d 582 (Tex. Civ. App.
example, in McWeeney v. New York, N.H. & H. R.R., 60 the court was confronted with the future income tax liability and possible future exemptions of a thirty-nine year old bachelor. It wondered whether it should consider the possibility of marriage. What was the likelihood that the possible wife might have children from a previous marriage? What was the probability that the plaintiff would father children? All the while, tax rates would be continually changing. If the plaintiff were younger, the whole process would become even more conjectural. Nevertheless, critics of the gross income formula point out that mathematical certainty is not possible in awarding damages, 61 and future income tax liability is hardly more inexact than a prognosis of life expectancy and probable future earnings. Even though the result is only approximate, the generally accepted rule is that a jury or court will make an estimate of damages, if there is a reasonable basis for a computation. 62 Admittedly, the size of the deduction would probably not be totally accurate. But, if no deduction is made, the award would be even more inaccurate. The use of tax experts, income tax returns, and cross-examination of the plaintiff would greatly reduce the amount of conjecture.

Another argument frequently asserted is based upon the "collateral source" doctrine. 63 This doctrine states that compensation received by a party from a source wholly independent of the tortfeasor will not lessen the damages recoverable from the tortfeasor. 64 The validity of this doctrine is questionable since the plaintiff is only entitled to compensation. 65 But even if accepted, the doctrine is not applicable to the instant problem. First, it is difficult to understand how a situation in which the government...

1953). It is enlightening that in the original case the court disposed of this problem in five words: "... such deductions are too conjectural." Stokes v. United States, 144 F.2d 82, 87 (2d Cir. 1944).
60. 282 F.2d 34 (2d Cir. 1960).
62. 25 C.J.S. Damages § 26(c) 1966. For example, it is an accepted practice for the jury to estimate future earnings. § Restatement of Torts §§ 910, 924(d) (1939).
64. 22 Am. Jur. 2d Damages § 206 (1965). Thus, plaintiff who has been paid his salary or a pension during disability, or had his medical expense paid by another or by insurance, can nevertheless recover the full amount of his damages from the defendant. 2 F. Harper & F. James, The Law of Torts § 25.22 (1956).
releases an individual from an obligation could be considered "compensation." Nothing is given to the plaintiff; he simply is excused from a duty. Second, even if the "release" were considered "compensation," the Internal Revenue Code merely exempts the award from taxation, and has no relevance to the elements to be considered in determining the amount of the award. The exemption does not even come into being until after the trial has ended.66

An additional argument used to justify the majority rule is that the introduction of income taxes into the courtroom would unduly complicate the trial and cause difficulties in trial administration.67 But, even though taxes are complicated, "are they any more complicated than annuity and mortality tables, reduction to present worth or any of a hundred problems that courts and justices solve every day?"68 Although the introduction of income tax evidence would certainly add an element of complexity into the courtroom, the additional element is necessary to prevent the defendant from paying an unwarranted sum to the plaintiff. Tax experts could assist the court. Moreover, since the introduction of evidence and proof of income tax liability would benefit the defendant, it would seem that the burden of proof of such liability should be placed upon him. He would thus either carry the burden and minimize his liability, or fail to carry it with the resulting consequences.

Finally, it has been argued recently that the advantages resulting to the plaintiff from figuring the award on gross earnings are justified by the fact that these blessings are offset by attorney's fees and inflation. First made in McWeeney v. New York, N.H. & H.R.R.69 this contention established the flexible rule that damages should be based on gross earnings except

69. McWeeney v. New York, N.H. & H.R.R., 282 F.2d 34 (2d Cir. 1960). Although this rule was formulated in a jury case, it has been followed in non-jury cases. Petition of Marina Mercante Nicarague, 364 F.2d 118 (2d Cir. 1966); Cunningham v. Rederiet Vindeggen A/S, 333 F.2d 308 (2d Cir. 1964).
where such an award "would be plainly excessive even after taking full account of the countervailing factors [i.e., inflation and attorney's fees] . . . ." 70 Although the McWeeney rule, formulated in the Second Circuit and adopted in the Seventh Circuit, 71 might appear just at first glance, it was pointed out in a strong dissent that the defendant too must live with inflation, and that it was not inconceivable that the plaintiff would invest the money in such a way that he would be protected against both inflation and deflation. As for attorney's fees, it can be argued that the public policy of not overburdening the defendant should exempt him from paying this amount. It is thus contrary to this policy for the losing party to be burdened with this increased payment. The McWeeney rule has been further criticized as discriminatory with respect to the plaintiff, since the controlling factor has no relation to the amount of damage suffered and would not reduce the element of conjecture as to his future tax liability. 72

Thus the past justifications for the majority rule are subject to attack, and it might be advisable for the courts to modify their present position and apply a net earnings formula in awarding damages. Relying on a series of articles in favor of the deduction of income taxes from the award, 73 federal courts more recently have computed damages using net earnings as a measure of plaintiff's loss in both personal injury and death awards. 74 In the same light, the British House of Lords in 1955 overruled numerous decisions and held that income tax consequences must be considered in assessing damages. 75 With in-

70. McWeeney v. New York, N.H. & H. R.R., 282 F.2d 34, 38 (2d Cir. 1960). In this case the annual income involved was $4,800.00 and the deduction was denied. The deduction was likewise denied where annual incomes involved were $6,281.00, Cunningham v. Rederiet Vindeggen A/S, 333 F.2d 308 (2d Cir. 1964), and $11,150.00, Montellier v. United States, 315 F.2d 180 (2d Cir. 1963). The deduction was appropriate in a case involving an annual income of $16,000.00. LeRoy v. Sabena Belgian World Airlines, 344 F.2d 266 (2d Cir. 1965), cert. denied, 382 U.S. 878 (1965).


73. See note 51 supra.

74. E.g., Cunningham v. Rederiet Vindeggen A/S, 333 F.2d 308 (2d Cir. 1964); Furumizo v. United States, 245 F. Supp. 981 (D. Hawaii 1965). However, in Brooks v. United States, 273 F. Supp. 619 (D. S.C. 1967), noted in 46 N.C. L. Rev. 941 (1968), a distinction was made between wrongful death and personal injury awards and the holding that net earnings should be used in computing damages was limited to wrongful death actions.

75. British Transp. Comm'n v. Gourley, 3 All E.R. 796 (1955). The opinion by Lord Jowitt emphasized that "to ignore the tax element at the present day would be to act in a manner which is out of touch with reality." Id. at 802.
creasing insurance rates and a no-fault doctrine of tort liability possible in the future, the use of the net earnings formula in awarding damages would be one way to decrease the strain on insurance companies and hopefully decrease insurance premiums.

It is the opinion of this writer, however, that the gross earnings formula is the best rule, in spite of the fact that the past arguments justifying this rule are inaccurate. The reason is simple. The government has decided not to tax personal injury awards. The question is who should receive the benefit of this exemption: the plaintiff or the defendant? Although the statute exempting personal injury awards was enacted under a misconception, the statute has not been repealed, primarily because of the public policy against overburdening the injured plaintiff. When the net earnings formula is used, the defendant receives the advantage of this tax exemption, and the public policy against overburdening the plaintiff is defeated. In spite of the fact that Congress's original misconception surrounding the exemption has become well known, this policy has prevented any change in the law. Critics of the gross income formula believe that the present majority practice works a hardship on the defendant. But if Congress had enacted an income tax law and had at the same time made no exemption for personal injury awards, defendant would still be required to compensate a disabled plaintiff for his loss without regard to income taxes, and plaintiff would then pay a certain sum to the government. Should the fact that Congress has not followed this policy, but has enacted an income tax law exempting personal injury recoveries from this tax, decrease defendant's payment? To answer in the affirmative is to deny plaintiff his tax benefit, which public policy has dictated that he have. In addition, it should be recognized that plaintiff's benefit in many cases is partly or even completely destroyed by attorney's fees.

*Instructing the Jury as to Income Tax Consequences*

At this point, it is necessary to distinguish two related problems: whether the correct measure of damages should be based upon plaintiff's gross or net income, analyzed in the preceding section of this paper; and whether juries should or should not be given an income tax instruction. Frequently, a court's refusal to allow an income tax instruction results from a con-
fusion of these two questions. Measuring damages by gross income does not necessarily lead to the conclusion that juries should be denied an instruction to the effect that the award is not income within the meaning of the tax laws and that they should neither add nor subtract to the award because of this fact. If such an instruction is refused, it is likely that the plaintiff will receive two tax bonuses—the first in having his award based on gross income and the second in the extra compensation which it is quite likely the jury will mistakenly add to the award to protect the plaintiff from income taxes.

There are two basic types of income tax instructions. The first type arises in those jurisdictions which use the net income formula in awarding damages. Here the charge should state that the jury should consider the fact that plaintiff’s award is not subject to income taxes. Affirmative action—the deduction of past and future income taxes—is required by this charge. An example is: “If you decide to render a verdict in favor of plaintiff, you should calculate any past or future loss of earnings on the basis of net income, after deduction of income taxes.” In those systems which use the net earnings formula, this type of instruction would appear to be required. Otherwise, both the plaintiff in a case without a jury and the defendant in a case with a jury would be discriminated against, since a pro-plaintiff measure of damages would be used in the non-jury case and a pro-defendant measure of damages would be used in the jury case.

The main argument against using this instruction is that the jury cannot perform this complicated task. Proponents of this line of reasoning forget, however, that federal juries often handle complicated economic questions such as anti-trust suits and tax refunds. In addition, the burden is upon the plaintiff to

76. E.g., Highshew v. Kushto, 235 Ind. 505, 134 N.E.2d 555 (1956). The state supreme court denied the requested charge on the grounds that it involved “intricate instructions on tax and non-tax liabilities with all the regulations pertinent thereto.” Id. at 505, 134 N.E.2d at 556. Although the charge is not listed, language in the case indicates that the instruction consisted of nothing more than that the award would not be subject to income tax and the plaintiff should neither add to nor subtract from the award because of this fact. Thus, the size of plaintiff’s tax liability would never arise.

77. This type of instruction was given in Floyd v. Fruit Indus., Inc., 144 Conn. 659, 136 A.2d 518 (1957). At the same time, the jury was cautioned “against attempting to use evidence which the defendants had offered . . . in any arithmetical computation because of the inherent uncertainty in the amount of taxes which the decedent would have to pay. . . .”Id. at 673, 136 A.2d at 926.
establish his total past and future loss of earnings. Once this is done, it would not be an impossible task for the jury to deduct a certain portion of the award for income taxes. Past income tax returns and tax experts could be made available to assist the jury. Mathematical exactness would not be required. Nonetheless, even though this writer feels that juries could handle this complicated task, this type of instruction should be given only in those jurisdictions which use the net income formula in awarding damages. Louisiana is not currently one of those states.

A second type of instruction should be used in those jurisdictions which apply gross income in measuring damages. In these jurisdictions, the charge should likewise consist of one or two sentences, and should explain that the award is nontaxable and that the jury should not consider income taxes in the computation of damages. No affirmative action is necessitated. An example of this type instruction would be:

“Any award made to plaintiff, if any is made, is not income within the meaning of the income tax laws. If you decide to make an award, follow the instructions previously given, and neither add nor subtract from that award on account of federal or state income taxes.”

Basing their belief on the premise that juries will add nothing to the award on account of income taxes hoping thereby to allow the plaintiff to receive just compensation, the majority of American courts, using the gross income measure of damages, almost universally refuse to allow any sort of income tax instruction. However, this basic assumption should be questioned.


79. Proper drafting of the instruction can hardly be over emphasized. It has even been suggested that the primary problem with the income tax instruction is one of form and not substance. See Comment, 18 WASH. & LEE L. REV. 1 (1961).

By design, juries are composed of a cross-section of the American populace who pay income taxes and possess no legal discipline. The impact of taxes is so well known that it is at least reasonable to assume that the jury might add to the verdict an amount which it erroneously believes to be due for income taxes. Since the plaintiff is entitled to have the jury instructed as to each item of his loss, it seems only just that the defendant, who must pay the damages, is likewise entitled to have the jury instructed in such a manner that he does not over-compensate the plaintiff. “Even handed justice requires nothing less than this.”

Unfortunately, because the majority of American courts refuse to allow an instruction to the effect that plaintiff's award is nontaxable, there is little evidence to illustrate the actual role income taxes play in the minds of jurors. One possibly enlightening case, however, is Wagner v. Illinois Central R.R. When no income tax instruction was given on the first trial, the plaintiff, suing for personal injuries, received $130,000.00. At a second trial, a simple instruction to the effect “that any award made to plaintiff as damages... is not subject to federal income taxes, and you should not consider such taxes in fixing the amount of any award made to plaintiff” resulted in a verdict and judgment of $80,000.00 Although this second award was not allowed because the appellate court found the income tax instruction prejudicial error, the case demonstrates the possible effect a jury's misconception of tax consequences might have on the size of awards.

Courts have offered several reasons for their refusal to give the instruction: it is unnecessary, since the jury will follow the general instruction on damages; it is cautionary in nature; seldom given. See e.g., McWeeney v. New York, N.H. & H. R.R., 282 F.2d 34 (2d Cir. 1960); contra, Anderson v. United Air Lines, Inc., 183 F. Supp. 97 (S.D. Cal. 1960).

81. See Dempsey v. Thompson, 363 Mo. 339, 346, 251 S.W.2d 42, 45 (1952); “Can there be any sound reason for not so instructing the jury? We can think of none. Surely, the plaintiff has no right to receive an enhanced award due to a possible and, we think, probable misconception on the part of a jury that the amount allowed by it will be reduced by income taxes. Such an instruction would at once and for all purposes take the subject of income taxes out of the case.”


84. Id. at 446-47, 129 N.E.2d at 772.


it introduces an extraneous matter; it would unduly complicate the trial; it would constitute prejudicial error; and it might influence jurors to subtract from plaintiff's award. Even when the gross income measure of damages is used, however, these reasons do not justify the refusal of courts to give the second type of instruction suggested, that jurors should not consider income tax in awarding damages. As mentioned earlier, jurors are drawn from all sections of life and possess normal conceptions and misconceptions. One advantage the members of a jury possess is their common knowledge, from which they are permitted to draw. The judge's instructions are a control device over the jury, and a cautionary instruction on income tax would certainly seem justified. An element of complexity would not be added to the trial. The idea that plaintiff's award is nontaxable and that nothing should be added to or subtracted from the award because of this fact is certainly not overly complicated. The English language surely can be fashioned to convey this meaning to twelve laymen. Finally, if the instruction is carefully framed, the plaintiff would not receive a reduced verdict and would certainly not suffer prejudicial error. Granted, he will not receive an increased verdict, but he will receive both adequate compensation and the tax benefit.

The main argument in favor of the instruction, even in those courts which use gross income in obtaining an award, is that it will remove an element of conjecture from the trial. With the evidence presently available, it cannot be proved that juries actually add an amount to the award because of income taxes. On the other hand, it is certainly not inconceivable that they might. When a simple instruction is given, the result seems certain: the award will not be increased because of income taxes.

In Louisiana, there appears to be only one reported case in

87. See note 85 supra.
88. Hall v. Chicago & N.W. Ry., 5 Ill.2d 125, 125 N.E.2d 77 (1955).
91. 9 J. Wigmore, Evidence § 2570 (3d ed. 1940).
93. It is a misconception that cautionary instructions are infrequently given. In fact, in a study of a compilation of instructions, it was revealed that of 230 instructions, 143 were in whole or in part cautionary. Morris & Nordstrom, Personal Injury Recoveries and the Federal Income Tax Law, 46 A.B.A.J. 274 (1960).
which the instruction was requested, and it was refused. Unfortunately, most courts in practice refuse the instruction. A change in the Louisiana practice should be made. If Louisiana were to adopt the net earnings formula for measuring damages, then the first type of instruction mentioned—that the jury should consider income taxes in the award of damages—should be given. On the other hand, even if it is felt that gross income should be retained in measuring damages, a second type of instruction—that the jury should not consider income taxes in awarding damages—should be given, in order to prevent an unwarranted bonus to the plaintiff as a result of the jury's probable misunderstanding of the income tax laws.

**Conclusion**

The exemption of personal injury awards from income taxes, being based on illogical grounds, has led to much confusion and inconsistency. Unlike non-personal injury awards, there is no need to examine the underlying claim. Like these awards, punitive personal injury awards are taxable. One theme runs throughout: courts are very strict in their interpretation of exactly what constitutes a personal injury, holding that some injuries to individuals are non-personal.

As for the defendant, his primary concern after the size of the award has been determined is whether the payment is deductible. It will be deductible only if the defendant can establish that the payment was a business expense.

The confusion of the exemption has extended into the courtroom. Whereas the majority of federal and state courts still use gross income in measuring damages, this practice is now being challenged, particularly in the federal courts. It is the contention of this writer that the gross earnings formula should be retained, as only this formula is consistent with the public policy behind the tax exemption of not overburdening the plaintiff. The net income formula would convert that policy into a benefit for the defendant—a result clearly not indicated. Nonetheless, the failure of courts to instruct the jury as to income tax is not justified. Although there is admittedly no proof, it is felt that the present practice in the Louisiana courtroom may in

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many cases lead to unnecessarily large verdicts, working an unjustifiable hardship on the defendant.

Paul H. Spaht

RESTRICTIONS ON MANAGEMENT RIGHTS—UNION NEGOTIATION WAIVER

The National Labor Relations Act grants employees the right of self-organization and provides an elaborate machinery for safeguarding that right by guaranteeing "laboratory" conditions for the election of a collective-bargaining representative. If, after an unhampered decision, a majority of employees in the appropriate unit designate a representative, the employer is required to bargain with that representative concerning wages, hours, and other terms and conditions of employment until a contract is concluded and reduced to writing, if one of the parties should request it, or until an impasse is reached. The Act imposes upon employer and union alike the duty to bargain in

1. National Labor Relations Act (Wagner Act), 29 U.S.C. § 157 (1964): "Sec. 7. Employees shall have the right to self-organization, to form, join, or assist labor organizations, to bargain collectively through representatives of their own choosing... and shall also have the right to refrain from any or all of such activities...."

The collective bargaining system as encouraged by Congress, administered by the Board, and enforced by the judiciary, of necessity subordinates the interest of individual employees to collective interests of all employees in the appropriate unit. Vaca v. Sipes, 386 U.S. 171 (1967). The constitutionality of the act was upheld in NLRB v. Jones & Laughlin Steel Corp., 301 U.S. 1 (1937).

2. The Board in General Shoe Corp. 77 N.L.R.B. 124, 126-27 (1948) wrote: "An election can serve its true purpose only if surrounding conditions enable employees to register a free and untrammeled choice for or against a bargaining representative... In election proceedings, it is the Board's function to provide a laboratory in which an experiment may be conducted, under conditions as nearly ideal as possible, to determine the uninhibited desires of the employees. It is our duty to establish those conditions; it is also our duty to determine whether they have been fulfilled."

3. National Labor Relations Act (Wagner Act), 29 U.S.C. § 159(a) (1964): "Sec. 9. (a) Representatives designated or selected for the purpose of collective bargaining by the majority of the employees in a unit appropriate for such purposes, shall be the exclusive representatives of all the employees in such suit for the purposes of collective bargaining in respect to the rates of pay, wages, hours of employment, or other conditions of employment...."

4. A refusal to sign is a refusal to bargain collectively and is an unfair labor practice: section 8(a) (5). H. J. Heinz Co. v. NLRB, 311 U.S. 514 (1941).