Vanderbilt Law Review

Volume 9
Issue 3 *Issue 3 - April 1956*

Article 6

4-1956

Consideration of Tax Aspects in Awarding Damages for Personal Injuries

Doris B. Gorman

NOTES

CONSIDERATION OF TAX ASPECTS IN AWARDING DAMAGES FOR PERSONAL INJURIES

The recent decision of the House of Lords, in *British Transport Commission v. Gourley*[1] has completely changed the English position on the question of whether income taxes should be considered in determining personal injury damages based on actual or prospective loss of earnings. The House of Lords held that the lower court should have taken the tax aspects into account and that the damage award must be reduced accordingly. By this holding, the House of Lords overruled *Jordan v. The Limmer And Trinidad Lake Asphalt Co.*[2] and *Billingham v. Hughes*,[3] which until then represented the ruling law in England on the subject.

The part income taxes play in determining damages for loss of earnings is a question of real importance in view of the present income tax rates and the high scale of personal injury awards, plus the fact that beginning with the Revenue Act of 1918[4] personal injury damage awards have been expressly excluded from gross income under the United States Internal Revenue Code.

Surprisingly enough, there are relatively few cases in which the problem has been at issue. The first English case in which the matter arose was decided in 1933.[5] The question has been decided, with conflicting results by only two American state supreme courts.[6]

In the first reported English case, *Fairholme v. Firth & Brown Ltd.*,[7] an employee had been wrongfully dismissed and the court had to decide whether the employee's liability for income tax and surtax on his salary[8] was a factor to be considered in assessing his damages. The court answered in the negative on the ground that the incidence and extent of the income tax are matters between the Crown and the taxpayer, and are of no concern to the wrongdoer. While "Parliament might have provided, and may still provide, that sums awarded as compensation for loss of income shall themselves be subject to taxa-

1. [1956] 2 Weekly L.R. 41 (H.L.) (Lord Keith of Avonholm dissenting).
2. [1946] K.B. 356.
3. [1949] 1 K.B. 643 (C.A.), 9 A.L.R. 2d 320 (1950).
4. Revenue Act of 1918, § 213 (b) (2), 40 STAT. 1057 (1919).
5. Fairholme v. Firth & Brown Ltd., 149 L.T.R. (n.s.) 332 (K.B. 1933).
6. Hall v. Chicago & N.W.Ry., 5 Ill. 2d 135, 125 N.E.2d 77 (1955), *reversing* 349 Ill. App. 175, 110 N.E.2d 654 (1953); Dempsey v. Thompson, 363 Mo. 339, 251 S.W.2d 42 (1952), *reversing* 360 Mo. 177, 227 S.W.2d 675 (1950).
7. 149 L.T.R. (n.s.) 332 (K.B.1933).
8. An award reimbursing lost wages caused by wrongful dismissal would constitute taxable income under INT. REV. CODE OF 1954, § 61 (a).

tion,"[9] this was a matter for the Inland Revenue authorities to decide and was outside the province of the court. This principle of *res inter alios acta* was the backbone of the English, Scottish and Canadian cases[10] prior to the decision in the *British Transport* case.[11]

Several English, Scottish and Canadian cases in the period between 1946 and 1947 passed on whether income taxes should be deducted in fixing personal injury awards. *Jordan v. The Limmer And Trinidad Lake Asphalt Co.* involved damages for accrued loss of wages only; future wages were not involved. The court followed the *Fairholme* decision and held that even where plaintiff's wages were subject to withholding taxes, to be deducted by the defendant, such taxes were not to be regarded in assessing damages; the sum awarded must be the full rate of wages obtained in the employment and not "take-home" pay.[12] It does not appear that *M'Daid v. The Trustees of the Clyde Navigation*[13] was called to the court's attention. *M'Daid* was a Scottish case of the same year in which the injured workman was customarily paid a weekly wage from which P.A.Y.E. taxes were deducted. Lord Sorn decided that in awarding damages for loss of earnings, a judge should consider the net sum which was paid to the injured workman after the payment of the tax rather than merely the gross sum which the workman earned. It should be noted, however, that in reaching this decision Lord Sorn's attention was not directed to the *Fairholme* case. *Blackwood v. Andre*,[14] decided one year later, expressly repudiated the *M'Daid* rule; Lord Keith, who was the one dissenting judge in the *British Transport* case, held that no deduction for income tax liability should be made from the amount awarded for loss of earnings.[15]

In 1949, the English Court of Appeal dealt with the question for the first time in *Billingham v. Hughes* and approved the *Fairholme* and *Jordan* holdings. Lord Singleton stated: "The practice in the courts of this country has consistently been not to have regard to income tax in the assessment of damages; and to alter the practice now would lead to great confusion, and would add immeasurably to the difficulty

9. Fairholme v. Firth & Brown Ltd., 149 L.T.R. (n.s.) 332, 333 (K.B. 1933).
10. Jordan v. The Limmer And Trinidad Lake Asphalt Co., [1946] K.B. 356; Blackwood v. Andre, [1947] Sess. Cas. 333 (Scot.); Bowers v. Hollinger & Co., [1946] Ont. 526, 4 D.L.R. 186; Fine v. Toronto Transp. Comm'n [1945] Ont. W.N. 901, 1 D.L.R. 221.
11. The theory is repudiated by Lord Goddard and Lord Reid in British Transp. Comm'n v. Gourley, [1956] 2 Weekly L.R. 41 (H.L.).
12. Atkinson, J., stated that even though *Fairholme* was decided before the existence of the regulation allowing a withholding tax, he felt its principles still applied.
13. [1946] Sess. Cas. 462 (Scot.).
14. [1947] Sess. Cas. 333 (Scot.).
15. Davies v. Adelaide Chemical and Fertilizer Co., [1947] S.A.S.R. 67 (S. Austr.), followed the *Fairholme* and *Jordan* decisions; as did the Canadian cases of Bowers v. Hollinger & Co., [1946] Ont. 526, 4 D.L.R. 186; and Fine v. Toronto Transp. Comm'n, [1945] Ont. W. N. 901, [1946] 1 D.L.R. 221.

of assessing damages and in the direction to be given to a jury."[16] The *Billingham* case remained the law of England until the *British Transport* case reversed it.[17]

The early American cases tended to be in accord in result at least with the English cases culminating in the *Billingham* decision. However, a different basis for the rulings was utilized. The *ratio decidendi* of the American courts in shying away from a contemplation of the income tax aspects of personal injury damage awards was that such factors are too conjectural for consideration.[18] This theory has continued to appear throughout the later United States cases.

For example, in *Smith v. Pennsylvania R.R.*,[19] an action for wrongful death, the court stated: "[W]e hold that it is not proper to deduct from the annual income of plaintiff's decedent Federal Income Taxes in determining the amount which the decedent would have contributed to his wife and children had he lived. Such taxes are too speculative to be considered by the jury."[20] While the Court of Appeals' opinion in *Southern Pacific Co. v. Guthrie*[21] contained language favorable to the deduction of tax liability, this was contradicted on the rehearing two years later when the court said: "[W]e think the court's view that the net take home pay, after taxes, would represent the actual loss is correct; but we are now convinced that we cannot tell how much this would be."[22]

Outside of the dictum contained in *Cole v. Chicago, St. P., M. & O. Ry.*[23] indicating that taxes (among many other items) should be considered in arriving at damages for personal injuries, it was not until 1951 that the gradual divergence in the American opinions regarding the propriety of considering tax liability began to make itself noticed. In that year, in the dissenting opinion to the memorandum decision on petition for rehearing of *Sunray Oil Corp. v. Allbritton*,[24] and in *DeVito v. United Air Lines*,[25] it was assumed that income taxes were a valid part of the procedure for arriving at damage awards. In neither case, however, did the court give any reasons for this assumption.

16. [1949] 1 K.B. at 652.
17. Lord Tucker, one of the judges participating in the *Billingham* ruling, was of the majority in the contrary *British Transport* decision rendered six years later.
18. Stokes v. United States, 144 F.2d 82 (2d Cir. 1944); Chicago & N.W. Ry. v. Curl, 178 F.2d 497 (8th Cir. 1949). The conjectural nature of future income taxes has also been discussed in gift tax cases. See, *e.g.*, Sarah Helen Harrison, 17 T.C. 1350 (1952).
19. 59 Ohio L. Abs. 282, 99 N.E.2d 501 (1950).
20. *Id.*, 99 N.E.2d at 504.
21. 180 F.2d 295 (9th Cir. 1949), *rehearing*, 186 F.2d 926 (9th Cir.), *cert. denied*, 341 U.S. 904 (1951).
22. 186 F.2d at 927.
23. 59 F. Supp. 443, 445 (D. Minn. 1945) (dictum).
24. 188. F. 2d 751, 752 (5th Cir. 1951) (dissenting opinion).
25. 98 F. Supp. 88 (E.D.N.Y. 1951).

The 1952 Missouri Supreme Court decision in *Dempsey v. Thompson*[26] is one of the leading decisions in the field. The Missouri court overruled its decision in *Hilton v. Thompson*[27] that a defendant's request for jury instruction regarding freedom of damage awards from income taxes was properly refused. The court held that while the trial judge in the case before it did not err either in refusing to permit defendant to cross-examine plaintiff's actuarial witness relative to income tax liability[28] or in refusing to permit the defendant to argue to the jury that in arriving at the amount of their award they should consider only the amount of future earnings lost to the plaintiff after deduction of income taxes, "it does not follow that defendant was not entitled to have the jury instructed that any amount awarded plaintiff is not subject to Federal or State income tax."[29] This instruction was favored as a means of preventing an enhanced award to the plaintiff through a possible "misconception on the part of a jury that the amount allowed by it will be reduced by income taxes."[30]

The cases decided after *Dempsey* are few in number. *Maus v. New York, Chicago & St. L.R.R.* would continue the American trend of allowing no instruction to the jury.[31] *Texas & N.O.R.R. v. Pool*[32] in dictum indicated that while deductions for income taxes are too conjectural for consideration, the court would follow the *Dempsey* view that the defendant upon request is entitled to an instruction that no amount awarded plaintiff would be subject to federal income tax. *Hall v. Chicago & North Western Ry.*[33] established the definite split among American jurisdictions. The Illinois Supreme Court rejected the Missouri Supreme Court ruling in the *Dempsey* case and adopted the position represented by *Hilton v. Thompson,* which *Dempsey* had overruled. "The incident of taxation is not a proper function for a jury's consideration, imparted either by oral argument or written

26. 363 Mo. 339, 251 S.W.2d 42 (1952), *reversing* 360 Mo. 177, 227 S.W.2d 675 (1950).

27. 360 Mo. 177, 227 S.W.2d 675 (1950).

28. *Cf.* Rouse v. New York, C. & St. L.R.R., 349 Ill. App. 139, 110 N.E.2d 266 (1953).

29. 251 S.W.2d at 45 (the court made this ruling prospective only, as it considered the instruction refused in the lower court to be merely a "cautionary" one, within the discretion of the trial court, and felt that other instruction to the jury had been sufficient). The Appellate Court of Indiana in dealing with the question as one of first impression in Highshew v. Kushto, 131 N.E.2d 652 (Ind. App. 1956), approved the instruction contained in this prospective ruling.

30. 251 S.W.2d at 45.

31. 128 N.E.2d 166 (Ohio App. 1955). "The result of several such inquiries would so complicate the trial of a personal injury action into an intricate discussion of tax and nontax liabilities, and so confuse the ordinary jury with technical tax questions as to defeat the purpose of a trial." 128 N.E.2d at 167. See also Pfister v. City of Cleveland, 113 N.E.2d 366, 368 (Ohio App. 1953) (dictum).

32. 263 S.W.2d 582, 592 (Tex. Civ. App. 1953) (dictum).

33. 5 Ill. 2d 135, 125 N.E.2d 77 (1955), *reversing* 349 Ill. App. 175, 110 N.E.2d 654 (1953).

instruction. It introduces an extraneous subject giving rise to conjecture and speculation."[34]

Thus the American decisions at the present time have resolved into two positions: (1) the jury should not be instructed with respect to the tax status of any personal injury compensation;[35] (2) while deductions for income taxes are too conjectural for consideration by a jury, the defendant on request is entitled to an instruction that any amount awarded plaintiff would not be subject to federal taxation.[36] The present English view represented by *British Transport,* of course, goes much farther than the second American rule and allows the jury to consider all the income tax consequences of the particular award.

The courts have said that it is impossible to assert with mathematical precision what deductions should be made and that the determination of the income tax factor in setting damages involving loss of wages is too speculative for the judge or jury.[37] But is such a determination any more difficult than guessing how long and to what extent the plaintiff will be disabled, what the future wage rate will be, what the labor market will be, or what unemployment compensation will be? Certainly it seems clear that the argument of difficulty in ascertaining the proper deductions for income taxes should not apply to wages lost prior to the verdict. Further, it is questionable whether this is a valid argument with regard to estimated future wages, in view of the speculative matters which juries have been instructed to consider in related fields such as the taxing of alimony awards, the reduction of damages to present worth, and the reflection in damage awards of the current purchasing power of the dollar.

The matter of income tax as a factor in the fixing or adjustment of maintenance awards to a divorced wife has been considered in both English and American cases.[38] In *Phillips v. Phillips,* it was stated that while the courts may not readjust a tax burden in a way not intended by Congress, still "any decrease in the wife's net income because of taxes or any other reason may be considered in fixing the

34. *Id.,* 125 N.E.2d at 86; *accord,* Combs v. Chicago, St. P., M. & O. Ry., 135 F. Supp. 750 (N.D. Iowa 1955); Wagner v. Illinois Cent. R.R., 7 Ill. App. 2d 445, 129 N.E.2d 771 (1955).

35. Upheld by decisions of the following courts: The United States District Court for the Northern District of Iowa; Ohio Appeals; Illinois Supreme Court; Appellate Court of Illinois.

36. Approved by decisions of the following courts: Indiana Appellate Court; Missouri Supreme Court; Texas Civil Appeals Court.

37. Margevich v. Chicago & N.W. Ry., 1 Ill. App. 2d 162, 116 N.E.2d 914 (1953), *cert. denied,* 348 U.S. 861 (1954); Dempsey v. Thompson, 363 Mo. 339, 251 S.W.2d 42 (1952), *reversing* 360 Mo. 177, 227 S.W.2d 675 (1950); Maus v. New York, Chicago & St. L. R.R., 128 N.E.2d 166 (Ohio App. 1955); Pfister v. City of Cleveland, 113 N.E.2d 366 (Ohio App. 1953); Billingham v. Hughes, [1949] 1 K.B. 643 (C.A.); Fairholme v. Firth & Brown Ltd., 149 L.T.R. (n.s.) 332 (K.B. 1933).

38. See Annot., 153 A.L.R. 1041 (1944).

amount of her alimony."[39] The New York case of *Burden v. Burden*[40] allowed an increase in the alimony allowance to the wife for the reason that she must pay income taxes thereon. Taxes on alimony payments do, of course, differ from those involved in estimated future income. First, there is no specific exclusion by the income tax law of alimony awards other than those which qualify as lump sum payments.[41] Second, the alimony award in which taxes are included may be reopened and adjusted from time to time as circumstances change. A jury instruction to use the present purchasing power of the dollar when measuring personal injury damages was held proper in *Burke v. San Francisco*.[42] The Wisconsin Supreme Court in *Dabareiner v. Weisflog*[43] upheld a similar instruction, and many courts have held that the trial judge may judicially notice a material decrease in the purchasing power of the dollar.[44] Again, however, differences must be noted between a determination by a jury of the income taxes involved in estimated future income and the adjustment of an award by the jury to reflect the present purchasing power of the dollar: the former vary with each case and in each case are conjectural; but the present purchasing power of the dollar is fixed at a definite percentage for all cases decided at a certain time.

In England and Canada injured persons are permitted to recover the aggregate of lost future earnings without reduction to their present worth. In the United States, however, the principle of reduction of such damages to their present value is generally recognized[45] on the basis that a person normally does not receive all of his future earnings in a lump sum, but periodically over a number of years. Annuity tables are used to show present worth.[46] It must be recognized, of course, that the problem of reducing damages to present worth and that of estimating income taxes present different aspects. In reducing awards to present worth there are no individual variances to be considered; the process of reduction is the same for each case. Contrarily, in the determination of income taxes one of the main problems

39. 219 S.W.2d 249, 273 (Mo. App. 1949).
40. 48 N.Y.S.2d 859 (Sup. Ct. 1944).
41. INT. REV. CODE OF 1954, § 71 (c) (1).
42. 244 P.2d 708 (Cal. App. 1952).
43. 253 Wis. 23, 33 N.W.2d 220, 12 A.L.R.2d 605 (1948); *accord,* Burlington Transp. Co. v. Stoltz, 191 F.2d 915 (10th Cir. 1951). *But see* dissent in Halloran v. New England Tel. & Tel. Co., 95 Vt. 273, 115 Atl. 143, 145 (1921) (advocating there be no consideration of decrease in money value).
44. *E.g.,* Kircher v. Atchison, T. & S.F. Ry., 32 Cal. 2d 176, 195 P.2d 427 (1948); Eichten v. Central Minnesota Cooperative Power Ass'n, 224 Minn. 180, 28 N.W.2d 862 (1947); Van Cleave v. Lynch, 109 Utah 149, 166 P.2d 244 (1946).
45. Snyder v. General Elec. Co., 287 P.2d 108 (Wash. 1955); Prager, *Computation of Damages in Personal Injury Cases,* 4 KAN. L. REV. 91 (1955).
46. Annuity tables show the cost of an annuity which will produce an income of $1.00 per year and be exhausted at the end of the annuitant's expected life.

is that of adequately considering the individual variances which in fairness require computation.

It is true that any minute consideration by the jury of the individual tax position of the plaintiff would necessarily be impossible. The income tax is premised on allowing the taxpayer to subtract from his gross income certain deductions which will result in a lower net taxable income. A jury could make no allowance for these personal deductions. They could not take into consideration that the amount of tax payable by a taxpayer depends upon a number of other circumstances; for example, the extent of the taxpayer's own private fortune, the separate income of his wife if he is married, the number of his children and other dependents.[47] They could not take into consideration the long-range plans plaintiff may have to maintain or increase insurance premiums on life and endowment policies, to purchase tax-free stocks for investment purpose, or to make nontaxable contributions to charitable institutions.

But to allow no instruction at all on the income tax aspects may result in an excessive award to the plaintiff through a misconception on the part of the jury. There is no reason to believe that jurors will usually be familiar with the provision of the Internal Revenue Code which frees personal injury awards from taxation, and in discussion within the jury room it is not unlikely that some juror may suggest the possibility that the award may be subject to taxes and, therefore, should be increased accordingly.

In the final analysis, it would seem that the legislative intent to exempt the entire personal injury award from taxation for policy reasons,[48] as expressed in section 104(a) of the Internal Revenue Code,[49] is the stumbling block to any American adoption of the *British Transport* rule allowing consideration of the income tax consequences of a particular award. The House of Lords in reversing the English trend on this issue, was confronted only with case law on the subject and was not faced with an Inland Revenue provision to the contrary. The American courts, however, are faced with the fact that Congress specifically excluded personal injury awards from taxation, and it is hard to reconcile with section 104(a) a reduction of awards

47. Dempsey v. Thompson, 363 Mo. 339, 251 S.W.2d 42 (1952), *reversing* 360 Mo. 177, 227 S.W.2d 675 (1950); Fairholme v. Firth & Brown Ltd., 149 L.T.R. (n.s.) 332 (K.B. 1933).

48. Similar exclusions have been made by Congress in the INT. REV. CODE OF 1954 to cover: workmen's compensation, § 105; insurance proceeds, § 101; gifts & inheritances, § 102; bad debt recoveries, § 111.

49. INT. REV. CODE OF 1954, § 104, provides:

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

"(2) the amount of any damages received (whether by suit or agreement) on acount of personal injuries or sickness."