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NO PAIN — NO GAIN? SHOULD PERSONAL INJURY DAMAGES KEEP THEIR TAX EXEMPT STATUS?

Douglas K. Chapman*

Taxation has been called "a major instrument of social and economic policy."\(^1\) Besides its obvious goal of raising revenue, taxation attempts to shift resources from the private sector to the public sector, to promote "vertical"\(^2\) equity by distributing the cost of government fairly by income classes, to promote "horizontal"\(^3\) equity by taxing equally those in approximately the same economic circumstances, and to facilitate economic growth, stability, and efficiency.\(^4\) While the effectiveness of the methods created and implemented to attain these goals is often a matter for dispute, tax policy in general is regarded as a legitimate tool for promoting economic growth and stability.\(^5\) This article will go beyond the general discussion of the goals of taxation and explore the

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2. The principle of vertical equity as applied to income taxation relies on the idea that persons who have a greater ability to support the requirement of government should pay a greater proportionate share of their incomes for that support. Id.
3. The principle of horizontal equity as applied to a system of income taxation relies on the notion of justice that similarly situated people should be treated equally and that people with equal incomes should pay equal taxes. Id.
4. Id.
5. Id. at 6.
effect that tax policy has had on the decision not to tax certain items. In particular, the focus of attention will be on section 104(a)(2) of the Internal Revenue Code which excludes from gross income the amount of any damages received on account of personal injury or sickness.

Over the almost seventy-year history of section 104(a)(2) and its predecessors, the courts, commentators, and the Internal Revenue Service (Service) have disputed both the scope of the section, the intent of the original exemption, and whether any such intent is being frustrated or perpetuated. The Tax Reform Act of 1986 has been called a revolution in tax reform. In this Act, Congress dramatically lowered individual income tax rates, but to keep the Act revenue neutral, Congress drastically broadened the tax base. In so doing Congress has included many items in gross income that heretofore have been exempted.

One item that should have been included in the new Act was a provision for the inclusion in gross income of that portion of personal injury awards representing "lost earnings." Additionally, the new Act should have provided for the inclusion of any punitive damage awards for personal injury.

The two ongoing issues that have surrounded section 104(a)(2) have been the scope of the section, and more recently, the question of whether juries should be informed of the tax consequences that may result from any award made to the plaintiff. The first of these issues is really a plaintiff-I.R.S. dispute and in fact does not directly affect defendants. The second of these issues, and the one that has received the most recent attention, is more properly characterized as a plaintiff-de-
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fendant question, as it may or may not directly affect the size of any award. For the most part, these two issues have been dealt with as mutually exclusive problems, when in fact they are inextricably inter- twined. When both issues are reviewed together, the economic realities of the problems demand that changes be made.

This article will examine the history of section 104(a)(2), first by looking to the present scope of the section as determined by the courts and the perceived congressional intent bringing about the initial exemption.19 Second, it will turn to the unsettling, if proper, effect that judicial decisions have had on the question of the jury's awareness of the taxability or nontaxability of awards. Finally, the article will recommend a solution, albeit a radical one from the perspective of plaintiffs, that is based more on the economic realities of a personal injury award than on a doubtful congressional intent perpetuated by the judiciary.

I. The Scope of Section 104(a)(2)

Section 104(a)(2) provided that:

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 account of personal injuries or sickness . . . .

Additionally, the regulations provided that "damages . . . means an amount received (other than workmen's compensation) through prosecution of a legal suit or action based upon tort or tort type14 rights, or through a settlement agreement entered into in lieu of such prosecution."15

As recently amended,16 the statute now provides that amounts received as damages for personal injuries, "whether as lump sums or as periodic payments," are excluded from gross income.17 This amendment means that an injured party can receive a damage award either in a single payment or in periodic payments, also referred to as structured settlements.18 In periodic payment awards, the award is actually made

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12. See infra notes 23-50 and accompanying text.
up of two components, the principal sum of the award plus interest.\textsuperscript{19} Since interest on damage awards is normally taxable,\textsuperscript{20} the interest generated from the investment of a lump sum award normally would be subject to taxation. Such is not the case, however, under the so-called structured settlement provided for by section 104(a)(2). What has been created is a method for taxpayers to actually generate "interest income" that is tax exempt. This clearly is at odds with the goal of promoting horizontal equity.

The section limits the exclusion to natural persons, and the amount of damages received are tax-exempt, whether the award results from a final judgment or from a compromise settlement.\textsuperscript{21} The language is broad and refers to "personal injuries" without distinguishing between physical and non-physical injuries.\textsuperscript{22}

A. Judicial Interpretation: Compensatory Damages

After the enactment in 1919 of section 213(b)(6) (now section 104(a)(2)),\textsuperscript{23} the courts wasted little time in defining the exclusion. Two requirements seemed readily apparent. First, the recovery must be one based on a "tort or tort type" right,\textsuperscript{24} and second, the recovery must be for a personal injury.\textsuperscript{25}

Since there is no federal common law of torts, the state law controls the determination of whether a claim is based on a tort or tort type right.\textsuperscript{26} Breach of contract to marry has been recognized since 1928 as a tort type right, and a recovery based on such a claim is therefore nontaxable.\textsuperscript{27} This holding is in contrast to more recent contract cases that have held that a contractual release of privacy rights does not constitute a tort type claim.\textsuperscript{28} In Starrels v. Commissioner, the court recognized the danger of a judicial expansion of the exemp-
tion by affirming the tax court's position that:

[I]f payments "could be made tax exempt by merely referring to a right of privacy which was never invaded and possibly never intended to be invaded, the narrowly conceived statutory exclusion for damages on account of 'personal injuries' . . . would be expanded beyond its normal meaning. We think Congress intended no such result."

As to the second requirement, common sense tells us that a physical injury is clearly a personal injury and it has been well settled that a recovery for a physical injury is tax exempt. But courts long ago established that recoveries for nonphysical injuries are also tax exempt. In *Hawkins v. Commissioner* the court held that the amount received by Hawkins was for a personal injury suffered by reason of a defamatory statement. Although Hawkins did present some evidence of injury to his health, this case clearly established that a nonphysical injury was within the scope of "personal injury."

Today, section 104(a)(2) allows for tax exempt recoveries for traditional injuries incurred in automobile accidents, from defective or harmful products, and in slip-and-fall type accidents. It also goes well beyond those injuries and provides for the excludability of compensatory awards for libel and slander, breach of contract to marry, mental and physical strain and injury to health and personal reputation in the community, death of a spouse, and injuries to the body or mind, whether intentionally or negligently caused.

B. *Judicial Interpretation: Punitive Damages*

In personal injury cases the question of the excludability of puni-
tive damages has not been conclusively resolved. In 1975, the Service issued Revenue Ruling 75-45,\textsuperscript{39} which excluded from gross income punitive damages resulting from physical injury in a wrongful death claim. The facts of this ruling were that the taxpayer was releasing a right to assert a wrongful death claim in return for the monetary settlement. Under the ruling payments made as a result of prosecution of such a wrongful death action were deemed to be punitive in nature.\textsuperscript{40} However, in the area of libel cases, the Service has taken a position different from that of Revenue Ruling 75-45. In Revenue Ruling 58-418,\textsuperscript{41} the Service ruled that excludability of damages in a libel suit depended on whether the damages were compensatory or exemplary. The compensatory damages were excludable whereas the exemplary damages were not. This position was maintained by the Service and argued successfully at the trial level in Roemer v. Commissioner,\textsuperscript{42} where the tax court reconciled the inconsistent revenue rulings by pointing out that Revenue Ruling 75-45 related to an award of damages due to personal injuries, whereas Revenue Ruling 58-418 related to lost profits resulting from injury to business reputation.\textsuperscript{43} The Ninth Circuit Court of Appeals reversed this decision,\textsuperscript{44} but in reversing failed to settle the question. The court found that damage to one's reputation was a personal injury and thus, the resulting defamation suit was for a personal injury.\textsuperscript{45} The court, in reaching this conclusion, pointed out that whereas a defamatory attack on one's character may impair both personal and professional relationships, all the damage done flows from the same personal attack on the defamed individual.\textsuperscript{46} In the matter of punitive damages, the court held that the damages should be excluded, relying on Revenue Ruling 75-45, and what it perceived to be a liberal interpretation by the Service of the language "any damages" in section 104(a)(2).\textsuperscript{47}

In 1984, the Service clearly identified its position when it issued Revenue Ruling 84-108.\textsuperscript{48} In this ruling the Service revoked Revenue Ruling 75-45 and determined that punitive damages awarded in a

\textsuperscript{39} Rev. Rul. 75-45, 1975-1 C.B. 47.
\textsuperscript{40} Id.
\textsuperscript{42} 79 T.C. 398 (1982).
\textsuperscript{43} Id. at 405-06.
\textsuperscript{44} Roemer v. Commissioner, 716 F.2d 693 (9th Cir. 1983).
\textsuperscript{45} Id. at 700.
\textsuperscript{46} Id.
\textsuperscript{47} Id.
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wrongful death action were includable in the recipient’s gross income. In rationalizing this decision, the Service looked to the Supreme Court’s opinion in Commissioner v. Glenshaw Glass Co.\textsuperscript{49} that punitive damages in an antitrust case and punitive damages received in a fraud case are includable in gross income because they are not a substitute for any amounts lost by the plaintiff or a substitute for an injury to the plaintiff or his property.\textsuperscript{50} Then, citing Starrels v. Commissioner, in which the Ninth Circuit held that only damages that compensate a taxpayer for a loss are excluded under section 104(a)(2), the Service determined that the punitive damages were not compensatory and therefore were not excludable.\textsuperscript{51}

II. The Legislative History

On February 3, 1913, the sixteenth amendment\textsuperscript{52} was ratified by the states and became part of the Constitution. In March of that same year, Woodrow Wilson became President and World War I was imminent.\textsuperscript{53} With the entry into the war by the United States, Congress appropriated nineteen billion dollars toward the war effort\textsuperscript{54} and acted to raise income taxes and lower exemptions.\textsuperscript{55} The Revenue Act of 1918 was still in the Senate Finance Committee when World War I ended in November, 1918.\textsuperscript{56} It eventually became law, although the final version of the bill yielded only six billion dollars in revenue instead of the seven to eight billion dollars called for.\textsuperscript{57} The Revenue Act of 1918 included section 213(b)(6), the predecessor of section 104(a)(2).

Against this brief historical background, it is appropriate to examine the legislative history of that Act\textsuperscript{58} in an attempt to glean the intent of Congress in creating the personal injury exclusion. Unfortunately, on the actual expression of intent, the silence of Congress is

\textsuperscript{49} 348 U.S. 426 (1955).
\textsuperscript{50} Rev. Rul. 84-108, 1984-2 C.B. 32, 34.
\textsuperscript{51} Id. (citing Starrels v. Commissioner, 304 F.2d 574 (9th Cir. 1962)).
\textsuperscript{52} U.S. Const. amend. XVI states: “The Congress shall have power to lay and collect taxes on income, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration.”
\textsuperscript{53} R.E. Paul, Taxation for Prosperity 21 (1947).
\textsuperscript{54} Id. at 25.
\textsuperscript{55} Id. at 26.
\textsuperscript{56} Id. at 27.
\textsuperscript{57} R.E. Paul, Taxation in the United States 116-17 (1954).
deafening. Examination of Senate69 and House of Representative60 Hearings, Remarks by the Secretary of the Treasury,61 Hearings Before the Senate Finance Committee,62 and the House Ways and Means Committee,68 and the House and Senate Debates64 yield no discussion of the provision itself. Indeed, there is contained but one reference regarding section 213(b)(6):

Under the present law it is doubtful whether amounts received through accident or health insurance, or under workman's compensation acts, as compensation for personal injury or sickness, and damages received on account of such injuries or sickness, are required to be included in gross income. The proposed bill provides that such amounts shall not be included in gross income.68

This rather cryptic statement can be better understood if the chronology of events that led to it are also examined. In January of 1915, the Commissioner of Internal Revenue ruled that insurance proceeds, received on account of an accident, were included as gross income to the insured person.68 By analogy, the Commissioner ruled that damages for "pain and suffering" received from a lawsuit or compromise were in fact no different than insurance proceeds, and thus were also includable as gross income.67 In May and June of that same year, however, the Supreme Court decided four cases that only served to muddy the waters.68 In these cases, the Court discussed the issue of how to distinguish taxable income from nontaxable return of capital, and in Doyle v. Mitchell Brothers Co., it expressed the view that not all of the proceeds of a conversion of capital assets were to be treated as income.68 Shortly thereafter, the Secretary of Treasury inquired of the Attorney General

64. 57 CONG. REC. (1919). A study of references to the Revenue Act cited by the Index reveals no discussion of § 213(b)(6).
67. Id. at 42.
69. 247 U.S. 179, 184 (1918).
as to his opinion regarding the taxability of accident insurance proceeds received by a taxpayer on account of personal injury. In response, the Attorney General discussed the recent Supreme Court decisions and concluded by saying that:

Without affirming that the human body is in a technical sense the "capital" invested in an accident policy, in a broad, natural sense the proceeds of the policy do but substitute, so far as they go, capital which is the source of future periodical income. They merely take the place of capital in human ability which was destroyed by the accident. They are therefore "capital" as distinguished from "income" receipts.

This response was followed by a statement from the Commissioner that the Treasury Department and the Service would agree with the Attorney General and hold that neither accident insurance proceeds nor damages received on account of personal injury would be taxed as income. This position was codified in section 213(b)(6) of the Revenue Act of 1918.

The exemption passed unchanged through the Revenue Act of 1939 as section 22(b)(5), and through the Internal Revenue Act of 1954 as section 104(a)(2). It was not until 1982 that the section was amended. At that time it was noted that the reason for the change was a desire on the part of Congress to clarify by statute the position already taken by the Service "that periodic payments as personal injury damages are excludable from gross income of the recipient." The explanation went on to state that "[t]his provision is intended to codify, rather than change, the present law."

That Congress intended personal injury damages to be tax exempt is fairly clear, but the underlying policy reasons for this exemption are not clear and have been subject to various interpretations since the exemption was promulgated. In the absence of an express policy statement by Congress the courts and commentators have found it necessary to construe congressional intent when dealing with section

70. 31 Op. Att’y Gen. 304 (1918); see also Cutler, Taxation of the Proceeds of Litigation, 57 COLUM. L. REV. 470 (1957).
71. 31 Op. Att’y Gen. at 308.
73. I.R.C. § 22(b)(5) (1939) (current version at I.R.C. § 104(a)(2) (1984)).
76. Id.
77. See supra notes 52-65 and accompanying text.
The primary aim in measuring damages in ordinary tort actions is compensation. This has been defined as giving an award of money to the injured person that will, as nearly as possible, place him in the position he would be in if there had in fact been no injury. In *Hawkins*, the court relied on this basic tort theory of compensation to justify the holding that damages received by petitioner for personal injury were not taxable income. Twelve years later the Tax Board of Appeals ruled in *Clark v. Commissioner* that a damage award was tax-exempt under the theory that it was "compensation for a loss which impaired petitioner's capital." This same rationale was also adopted by the Sixth Circuit Court of Appeals when it held that compensation was a true measure of damages and that it must be figured by estimating the dollar equivalent of the damage done by the tortious act. In 1955, the Supreme Court in *Glenshaw Glass Co.* held that punitive damages in an antitrust award were taxable. In reaching this decision the Court noted that personal injury damages were not taxable on the theory that they corresponded to a return of capital and that they were by definition compensatory only.

In that same year, the Supreme Court of Illinois in *Hall v. Chicago & Northwestern Railway Co.*, reversed the Illinois Court of Appeals on the issue of whether a jury should be informed of the tax exempt status of the damage award. In defending its decision the lower court stated that, "if the jury were to mitigate the damages . . . by reason of the income tax exemption . . . then the very Congressional

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78. This theory of compensation of an injured person is the central core of tort law. It is generally believed that the injured should be compensated by those who were to blame for the injury. Tort law developed as the primary means of providing redress for the injury. See generally G. E. White, *Tort Law in America* (1980).

79. *Hawkins*, 6 B.T.A. at 1025. The court said that the damages were an "attempt to make the plaintiff whole as before the injury." *Id.*

80. 40 B.T.A. 333 (1939).

81. *Id.* at 335.


84. *Id.* at 432, n.8.

85. 5 Ill. 2d 135, 125 N.E.2d 77 (1955).

86. 349 Ill. App. 175, 110 N.E.2d 654 (1953).
intent of the income tax law to give an injured party a tax benefit would be nullified.\textsuperscript{87} This case departed from the previous "return of capital" and "damages as compensation" rationale and instead imputed to Congress a humanitarian intent to benefit an injured party.

This same reasoning was adopted by the Seventh Circuit Court of Appeals in \textit{Epmeier v. United States}\textsuperscript{88} when it stated that the provisions of section 22(b)(5) (now 104(a)(2)) were undoubtedly intended to relieve a taxpayer who has the misfortune to become ill or injured.\textsuperscript{89} This humanitarian approach was not readily accepted, however. In 1962, the Ninth Circuit Court of Appeals in \textit{Starrels v. Commissioner} decided the issue based on the \textit{Glenshaw Glass Co.} reasoning that there can be no "exemption of payments made for injuries which have never occurred because such payments are not compensatory and hence cannot be considered a restoration of capital."\textsuperscript{90}

\section*{III. Litigation}

For more than twenty-five years after section 104(a)(2) was first promulgated, the nontaxability of damage awards for personal injuries was not a significant issue in the actual litigation of cases.\textsuperscript{91} As tax rates and the number of taxpayers increased, however, there was a heightened awareness and sensitivity on the part of defense attorneys to the tax effects on their clients in personal injury suits involving loss of future earnings.\textsuperscript{92} The primary focus has been in two areas: 1) whether the anticipated future income of the injured party should be calculated based upon gross (before tax) earnings or net (after tax) earnings; and 2) whether courts should permit juries to be instructed as to the nontaxable nature of personal injury awards.\textsuperscript{93}

In attempting to decrease the actual award from a "gross" amount to a "net" amount defense attorneys have tried to introduce into evidence the amount of income tax the plaintiff was paying prior to his injury. Most arguments against such evidence, and in favor of using the gross income as the measure of damages rely on the premise that the future tax rates of the individual plaintiff are too speculative to predict

\textsuperscript{87} Hall, 5 Ill. 2d at 152, 125 N.E.2d at 86.

\textsuperscript{88} 199 F.2d 508 (7th Cir. 1952). The case was dealing with insurance benefits that were tax exempt, but discussed the humanitarian intent behind § 22(b)(5).

\textsuperscript{89} \textit{Id.} at 511.

\textsuperscript{90} \textit{Starrels}, 304 F.2d 574, 577 (9th Cir. 1962).


\textsuperscript{92} \textit{Id.} at 212-13.

\textsuperscript{93} Mayor and Hepburn, \textit{The Treatment of Income Taxes in Determining Personal Injury Awards}, 18 \textit{JURIMETRICS J.} 186 (1977-78).
and that the computations required to accurately assess the net income are too complex to perform or evaluate properly even if done by a tax expert, let alone a jury. 94

The purpose for defense attorneys wanting to give the jury instruction that the award is tax exempt is ostensibly that if no such instruction is given, the jury will add on an amount it erroneously believes the plaintiff will have to pay in income tax to the already calculated amount of damages. Arguments used in this context are that juries have been awarding larger and larger awards in recent years due to inflation and the growth of the economy, and that the general public has become more tax conscious through the media, particularly through publicity given to the gameshow winners of the 1950's. 95 There has been an intense legal analysis of this litigation issue in recent years, both in favor of and against the "net income" proposition. This article is not intended to critique those analyses and will merely summarize the basic premises upon which the analyses were founded.

In a leading commentary 96 Nordstrom evaluates the first of the two litigation issues. When discussing the issue of measuring damages, the premise adopted is that recovery for future income has as its primary purpose the compensation of the victim, not the punishment of the defendant. 97 The article goes on to discuss opposing arguments including the proposition that using a "net income" approach to damages frustrates the intent of Congress to bestow a benefit on the injured party. 98 The author's counterargument is that this intent was not what motivated Congress to enact section 104(a)(2); Congress merely wanted to clear up the confusion as to whether tort damages were income under the sixteenth amendment. 99

Another article devoted entirely to the issue of cautionary jury instructions adopts the rationale that the plaintiff will receive a more adequate award if the instructions are given. 100 While never expressly mentioning congressional intent, the article does endorse the theory that the purpose of damages in negligence cases is to make the plaintiff

94. Id. at 187-88.
96. Nordstrom, supra note 91, at 212.
97. Id. at 219.
98. Id. at 222.
99. Id. at 222-23.
“whole,” not to give him a bonus.101

A third commentary states that Congress intended to treat damage awards under section 104(a)(2) as restoration of lost capital.102 Using this as a starting point, the author concludes that the jury should be informed as to the tax consequences of the damage award.103 The basis for this conclusion seems to be that the jury would, in the absence of such instructions, increase the award for tax purposes and thereby give the plaintiff an undeserved and unjust windfall.104

Yet a fourth view advocates the full disclosure to the jury regarding the tax consequences of personal injury awards for lost income.105 The jury should be informed of the tax exemption and should be instructed that they should not, therefore, recompense the plaintiff for taxes that they believe would have been due on the award.106 Further, evidence of the plaintiff's past tax history should be admissible and should be used to reduce his estimated future gross income to a net figure which would serve as a basis for the award.107 A key factor in this analysis is the author's conclusion that Congress never intended to benefit an injured plaintiff when it created the exemption.108 Without evidence of such an intent, the article urges that it would be “wise to follow the general rule of damages, and only restore to the plaintiff that which he has lost.”109

Finally, and what certainly seems to be a minority view within the area of legal commentary, is the position that gross earnings should be the appropriate basis for damage awards.110 The proponent of this theory argues that, although Congress originally did not intend to confer a tax benefit through the exemption, the section has not been repealed primarily because of the prevailing public policy to not overburden an injured plaintiff; a “net earnings” rule would defeat this public policy.111

These issues have received very different treatment from the
courts. For the most part, the view supported by a majority of cases is that, in fixing damages for loss of future earnings in personal injury suits, the income tax consequences should not be taken into consideration. Further, the basis for the damage award should be the plaintiff's gross income with no reduction in this amount by any income tax saving that may result because of the tax exempt treatment of the award. Generally, the same can be said about the question of jury instructions. The majority of courts have held that the incidence of income taxation should not be included in jury instructions nor communicated to the jury during the trial itself. Attention should be given to the judicial reasoning behind these decisions as they relate to the various interpretations of congressional intent.

In Dempsey v. Thompson the court based the damages on gross income because of the perceived impossibility of adequately computing tax liability, but held that the jury instructions regarding tax exemption were allowable at the trial court's discretion. A later Illinois case, Hall v. Chicago & Northwest Railway Co., disagreed with part of the holding in Dempsey and held that the issue of taxation was not a proper factor for a jury's consideration imparted either by oral argument or written instrument. In its explanation, the court stated that if the jury were to decrease the amount of plaintiff's award because of the tax exemption it would nullify the congressional intent to bestow a tax benefit on the injured party. This decision was later cited with approval by the Supreme Court of Ohio.

In a 1963 Tennessee case the court analyzed and adopted the majority view that the jury should not be instructed about the tax exempt treatment of the award. The court noted that the rationale for this view was, in part, that Congress intended to bestow a tax benefit through the exemption.

114. Id. at 1408. See also infra notes 159-60 and accompanying text.
115. 363 Mo. 339, 251 S.W.2d 42 (1952).
116. Id. at 45.
117. 5 Ill. 2d at 152, 125 N.E.2d at 86.
118. Id.
121. Id. at 627, 376 S.W.2d at 749.
Federal cases had generally been in accord with this view.\textsuperscript{122} In \textit{Huddell v. Levin}\textsuperscript{123} the district court decided to follow the "gross earnings" rule as it was the rule in New Jersey and because it was consistent with the humanitarian intent of Congress as perceived by the court.\textsuperscript{124} By 1980 all but one of the circuit courts of appeals had adopted the traditional "gross earnings" rule, or its modified form. Only the Ninth Circuit admitted evidence of future taxation in all cases.\textsuperscript{125}

The seemingly settled state of the law in this area came to an end in 1980, however, with the Supreme Court decision of \textit{Norfolk & Western Railway Co. v. Liepelt},\textsuperscript{126} a wrongful death action originally brought in Illinois under the Federal Employer's Liability Act (FELA).\textsuperscript{127} Appellant Norfolk & Western argued that the trial court erred in excluding evidence showing the effect that income taxes would have had on the decedent's estimated future earnings, and that it also erred in refusing to allow a jury instruction that said: "[Y]our award will not be subject to any income taxes, and you should not consider such taxes in fixing the amount of your award."\textsuperscript{128} It was error, appellant reasoned, because absent evidence of the effects of taxation the claimants would receive substantially more than the value of the loss they had suffered. Further, if a cautionary jury instruction were not given, the jury would award claimants a bonus in the form of taxes that would have been paid on the award if it were taxable.\textsuperscript{129} Claimant argued that Congress never intended to limit the recovery to the net value of the loss suffered, because Congress intended to bestow a humanitarian benefit on tort victims through the tax exemption of section 104(a)(2), and if a windfall did occur it belonged to the injured party.\textsuperscript{130}

Writing for the majority,\textsuperscript{131} Justice Stevens reversed the Illinois


\textsuperscript{123} 395 F. Supp. 64 (D.N.J. 1975).

\textsuperscript{124} Id. at 89.

\textsuperscript{125} Note, Evidence or Jury Instruction on Impact of Income Taxes on FELA Damage Awards, 34 Tax Law 483, 486 (1980-81).

\textsuperscript{126} 444 U.S. 490 (1980).

\textsuperscript{127} 45 U.S.C. §§ 51-60 (1986).

\textsuperscript{128} 444 U.S. at 492.

\textsuperscript{129} Id.

\textsuperscript{130} Id.

\textsuperscript{131} 444 U.S. 490. Justice Stevens delivered the opinion of the Court in which Chief Justice Burger, and Justices Brennan, Stewart, White, Powell, and Rehnquist joined.
decision on both counts. His analysis of the issues stressed that under the FELA recoverable damages are measured in terms of the pecuniary loss that the decedent’s beneficiaries might establish in a wrongful death action. Accordingly, Justice Stevens wrote, “it is his after-tax income, rather than his gross income before taxes, that provides the only realistic measure of the decedent’s ability to support his family.” In ruling that it was error to refuse the requested jury instruction, Justice Stevens quoted the Ninth Circuit to the effect that giving the instruction would not hurt and would help prevent any overcompensation to the plaintiff in case the jury erroneously assumed that the award would be taxed and correspondingly inflated the award.

Justices Blackmun and Marshall dissented, with Justice Blackmun writing the opinion. While noting that admitting tax evidence regarding net earnings and allowing the cautionary jury instruction might be urged as common sense and as a recognition of the financial realities, he disagreed with the majority. The basis of his dissent rests in the use of net income in calculating lost earnings. In his view Congress had clearly created a benefit when it decided not to tax personal injury damage awards, and while there was no clear articulation of the underlying reasons for this, Justice Blackmun reasoned that it was unlikely Congress intended to benefit the tortfeasor instead. Rather, he opined that perhaps Congress had wanted to avoid the administrative difficulties involved in calculating a tax on future income. In the alternative, he pointed out that Congress may have intended to confer a humanitarian benefit on the victim or victims of the tort. The majority opinion he felt, was inconsistent with both of these purposes. Regarding the question of jury instructions, Justice Blackmun stated that such instructions would only be burdensome and confusing to the jury, and was almost an affront to the jury’s practical wisdom.

The Leipelt decision is most significant in the area of federal law. Since the case was decided solely under FELA, it is not binding

132. Id. at 493.
133. Id. at 493.
134. Id. at 498 (quoting Burlington Northern, Inc. v. Boxberger, 529 F.2d 284, 297 (9th Cir. 1975)).
135. 444 U.S. at 499. (Blackmun, J., dissenting).
136. Id. at 501-02.
137. Id. at 501.
138. Id. at 503.
139. Id.
140. Frolik, supra note 18, at 600.
on state courts when federal law is not a basis for decision. In addition to affecting all FELA actions, however, Liepelt will probably govern in wrongful death and personal injury actions brought under the Jones Act and under the Death on the High Seas Act (DOHSA). Liepelt may ultimately have an effect on civil rights actions brought under section 1983 which protects persons from deprivation of their civil rights by persons acting under color of state law. It has been suggested that since an action under section 1983 is governed by federal law the courts must follow Liepelt for any part of an award that is nontaxable. There is disagreement among commentators as to whether Liepelt will have any effect on suits for damages brought under the Federal Tort Claims Act.

A proponent of Liepelt contends that it will facilitate a more accurate determination by the jury of what kind of damage award the claimant should fairly receive. Critics of Liepelt, however, argue that under Liepelt section 104(a)(2) will not subsidize claimants, as Congress probably intended, but will instead reduce the liability of defendants in personal injury suits. Further, the one who may ultimately benefit from the tax exemption and receive the windfall will be the defendant's casualty insurance company. Finally, since Congress has apparently countenanced any overcompensation to the tort victim by not repealing or amending section 104(a)(2), the Liepelt majority erred in ignoring this congressional intent when it admitted the taxability evidence.

IV. Present Status

The Supreme Court's decision in Liepelt is, among other things, a microcosm of the policy conflict surrounding section 104(a)(2) since its

142. Frolik, supra note 18, at 591.
145. Comment, supra note 141, at 301.
146. Id.
147. "Liepelt may have a greater-than-expected effect on the measure of damages for cases brought under the FTCA." Frolik, supra note 18, at 593. "Since Liepelt is not binding on state damages law, Liepelt is not controlling in FTCA actions." Comment, supra note 141, at 300.
148. Note, supra note 125, at 494.
149. Frolik, supra note 18, at 594; see also Comment, supra note 141, at 296-97.
150. Frolik, supra note 18, at 594-95.
151. Comment, supra note 141, at 297.
inception. The majority opinion speaks for those courts and commentators who believe that personal injury damages should only be sufficient to make the victim "whole." They believe that Congress had this view and only created the exemption to further this policy, and that damage awards only reflect a "return of capital" rather than income.

An objective examination of the legislative history reveals no express statement as to this elusive intent. The administrative and judicial activities that took place at the time the exemption was promulgated lead to the conclusion that Congress did, in fact, merely seek to codify the conclusion already reached by the Treasury Department and the Attorney General that personal injury damages were not income under the sixteenth amendment and were, therefore, not taxable. This analysis is effectively utilized by those who support the majority opinion of Liepelt. The logical extension of this is that damage awards should be reduced to the amount that the victim would have realized as net income and the award should not be inflated by the jury in the belief that taxes would have to be paid on it.

At the same time, an examination of the actions of Congress since 1918 leads to the conclusion that Congress intended to continue the tax exemption, even in an era when taxes and damages are high and

152. See supra notes 59-72 and accompanying text.

153. Although the recent tax history shows a decrease in maximum tax rates, that is a relatively new phenomenon. The original rate in 1913 had a maximum rate of 7% and was gradually increased to a maximum rate of 92% in 1952. (A maximum rate of 94% was imposed in 1944-45 in response to the increased demands of World War II.) J. Pechman, Federal Tax Policy 302 (1983).

154. The evidence suggests that a substantial but uneven increase in verdict awards has been occurring for years. For the past 10 years, the average yearly increase in verdict awards is 15.23%. For 1984 it was 15.36%, and for 1985, the increase is 12.24% using incomplete figures. However, higher increases were recorded for five of the 10 years:

<table>
<thead>
<tr>
<th>Year</th>
<th>Increase</th>
</tr>
</thead>
<tbody>
<tr>
<td>1976</td>
<td>16.61%</td>
</tr>
<tr>
<td>1979</td>
<td>17.71%</td>
</tr>
<tr>
<td>1980</td>
<td>24.54%</td>
</tr>
<tr>
<td>1981</td>
<td>30.49%</td>
</tr>
<tr>
<td>1983</td>
<td>27.54%</td>
</tr>
</tbody>
</table>

The increase in 1981 was almost thrice that of 1984, and 2 1/2 times the preliminary figure of 12.24% for 1985. You will note that verdicts peaked in 1981, and have been decreasing since. Our report gives equal weight to changes in the midpoint verdict and the unadjusted verdict average. The unusually high verdicts rendered in some years do, unquestionably, affect the unadjusted averages. If verdicts of high and low extremes were excluded from these calculations, we believe that the fluctuations would be smaller and the yearly average increase would also be somewhat smaller.

have become a significant issue in personal injury litigation. This intent is manifested in the recent amendment of section 104(a)(2) that not only perpetuates the section's existence but also seems to broaden its scope.\textsuperscript{156} Those proponents of the "humanitarian intent" view expressed in Justice Blackmun's dissent in \textit{Liepelt},\textsuperscript{158} rightly seize upon this as a proper justification for the belief that it is the present intent of Congress to confer a benefit on the tort victim and that a jury should not take taxes into account in handing down damage awards.

Both views of congressional intent are at least partially correct, and both have been convincingly argued in order to justify the desired result. There does, however, seem to be a much more basic issue that is threatened by \textit{Liepelt}, and that is the issue of fairness and consistency of awards. Whether Congress in 1918 and thereafter chose to provide for such an exemption out of feelings of generosity, pity, fear of bad publicity, or mistaken beliefs as to the nature of such an award, it is clear today that section 104(a)(2) is not providing consistent treatment, that is, horizontal equity\textsuperscript{157} among taxpayers. A brief summary should point out the deficiencies now operating within section 104(a)(2).

Originally, the section, through judicial interpretation, allowed for the exclusion of all damages for personal injury. This was true whether those damages were for pain and suffering, medical expenses, mental anguish, or lost wages; and the courts did not distinguish among compensatory, exemplary, or punitive damages.\textsuperscript{158} The language "any damages" was given the broadest possible interpretation. More recently, some courts, aided by the Supreme Court's decision in \textit{Liepelt}, have constructively repealed the tax exemption of section 104(a)(2) by nullifying its effects on damage awards. In those courts that follow both prongs of the message of \textit{Liepelt}, the jury will be aware of the tax-exempt nature of any damages and can adjust its award accordingly. In addition, the calculation of damages will be made on a "net income" theory as opposed to a gross income theory. However, in the non-\textit{Liepelt} jurisdictions, damage awards are still made on a gross income theory and juries are not informed of the non-taxability of such awards. There is still a third group of courts that have adopted the second part of \textit{Liepelt},\textsuperscript{159} and allow jury instructions to the effect that damages are

\textsuperscript{155} \textit{See supra} notes 16-20 and accompanying text.
\textsuperscript{156} 444 U.S. 490, 498 (Blackmun, J., dissenting).
\textsuperscript{157} \textit{See supra} note 3.
\textsuperscript{158} \textit{See supra} notes 23-38 and accompanying text.
\textsuperscript{159} For a detailed history of the lower courts that allow or disallow a jury instruction as to the tax consequences, and those states that allow evidence of net income, see Frolik, \textit{supra} note
not taxable. Thus, the jury hears a damage plea based on the "gross income" theory, and then is left to its own devices to adjust the award. The choice of forum, the basis of the case, and the degree of sophistication in a jury all now have an impact on the prospective award that a plaintiff might receive.

In addition, with the issuance of Revenue Ruling 84-108, the Service has taken the position that punitive damages are not within the scope of the section 104(a)(2) exemption. While that question remains unclear, plaintiffs receiving punitive damages face a Service dedicated to including those damages in gross income.

This has created mass uncertainty as to the award a particular jury might arrive at through its determination, which is sometimes influenced by information of the tax consequences and sometimes arrived at with little or no consideration of the tax consequences. The results can be quite varied, but can generally be categorized as follows. With section 104(a)(2) in its present state, those jurisdictions that have not adopted Liepelt or a similar theory are likely to arrive at inflated awards by allowing for plaintiff's payment of taxes on the award. Such an inflated award, when in fact it is tax-exempt, provides a windfall to the plaintiff and concurrently penalizes the defendant to the extent he is found liable to pay taxes that are not required to be paid by the plaintiff. While it is possible for the jury to arrive at a correct decision, from the tax aspects, past history indicates that this is not the likely result, as juries are not usually aware of the tax-exempt nature of these damages.

On the other hand, if Liepelt is followed, it is likely that damage awards will decrease as juries are informed of the tax exemption. Ideally, this would result in awards that are more accurate when considering what the plaintiff has actually lost, thus eliminating or reducing the likelihood of a windfall to the plaintiff and a penalty to the defendant. It has been argued that this only benefits the defendant, and the system should not provide a windfall to the wrongful party, but it can be equally argued that if the plaintiff has been adequately compensated the defendant is not receiving a windfall. There is nothing wrong with

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18, at 587-88 nn. 101-06.
160. The conflict still exists between the Service's position and the Ninth Circuit's decision in Roemer, 716 F.2d at 693. It appears that only congressional action or the Supreme Court will ultimately resolve the conflict.
161. For a detailed listing of the jurisdictions that have chosen not to adopt a Liepelt or a similar theory, see Frolik, supra note 18, at 586 n.101.
162. Knachel, supra note 95.
163. Frolik, supra note 18, at 594-95.
the defendant not having to pay a windfall to the plaintiff. The more immediate problems that arise from the two prongs of Liepelt are the speculative nature of taxes, the possible inaccuracies in trying to project future “net earnings” based on uncertain future tax rates, and the possible confusion to a jury when, after hearing a damage plea based on the “net income” theory, it is instructed to take into account the tax-exempt nature of the awards.

As an alternative, one commentator has called for the repeal of section 104(a)(2) at least as to damages for “lost wages.” While this possible solution has certain merit, it does not fully eliminate the possible inconsistent treatment that could occur. For without the tax-exemption of section 104(a)(2), there are still several possible results depending upon whether or not the court has followed Liepelt. In a jurisdiction that does not follow the theory of Liepelt, it is entirely possible for a jury to inflate the award for income taxes, thus arriving at an award that does adequately compensate the plaintiff. If a jury does not adjust an award for income taxes, it is likely that plaintiff will end up with substantially less than the jury intended. In such a case, the defendant has received a windfall at the expense of the plaintiff.

In those jurisdictions that have adopted the second prong of the Liepelt theory, the jury should be able to determine an accurate award based on current tax rates and on the damages they wish to award to plaintiff. The defendant would, in essence, pay the tax, but there would be no windfall to either plaintiff or defendant. If there were a windfall it would be to the government. In those jurisdictions that have fully embraced the Liepelt doctrine, the net income calculation of damages is so speculative as to make any calculation more a “shot in the dark” than a fairly reasoned determination of the plaintiff’s actual damage from his lost earnings.

V. A Recommendation

What was once a well settled question, or at least one that generated little concern, has been turned into a quagmire of uncertainty for both plaintiffs and defendants. The Liepelt decision, the “structured settlement” amendment of section 104(a)(2), Revenue Ruling 84-108, and what has always been questionable congressional intent have made the tax-exempt status of personal injury damage awards both complicated and unpredictable. A clarification by Congress is needed. This

164.  Id. at 595.
165.  Id. at 603.
article recommends a solution in two parts. Part one is that Congress should repeal section 104(a)(2) in its present state and should enact new legislation providing for the excludability of personal injury damages only to the extent they are a reimbursement for actual expenses, pain and suffering, mental anguish, and loss of services. Specifically not within the scope of any new legislation, and thus clearly includable in gross income, should be any awards for lost earnings and for punitive damages. While this directly contradicts those arguments based on a humanitarian intent to exclude such damages, it seems only too logical that a plaintiff, fully compensated for injuries not based on earnings, needs no more humanitarianism than any other taxpayer who is required to pay his annual extraction of taxes on his earnings. If, in fact, the ultimate goal of damages is to make the plaintiff whole and return him to the position he would have been in without the injury, then subjecting the damages for lost earnings to the income tax truly puts him back where he would have been. Further, it is clear from the characterization of punitive damages that they are not intended to compensate the plaintiff but are instead intended to penalize the defendant and should never have been brought within the exemption of section 104(a)(2).

As discussed above, however, merely subjecting these damages to the income tax may not eliminate the possible inconsistencies and windfalls that might occur. To that extent, part two of the solution requires the federal and state courts to adopt the second prong of the Liepelt theory and allow jury instructions detailing the taxability and non-taxability of damages. That prong of the Liepelt decision dealing with the "net income" theory of calculating damages should be overruled by the Supreme Court. As Justice Blackmun in his dissent, and several critics have pointed out, this theory is far too speculative. As recent history proves, tax rates can change dramatically from year to year, and individual taxpayer's taxable income can vary annually as a result of deductions and personal exemptions, and even a change in marital status can alter the tax impact from year to year. Thus, attempting to base damages on the "net income" theory can produce extremely

166. In 1980 the maximum tax rate applied to individuals was 70%. The Economic Recovery Tax Act of 1981 brought about a reduction of this maximum rate to 50% and most recently the Tax Reform Act of 1986 will lower the maximum rate to 28%. I.R.C. § 1(j) (1986).

167. This is not solely a problem of changes in the amount of a taxpayer's personal deductions, although such changes could certainly affect the tax, but also a change in the tax laws either authorizing new deductions or repealing past deductions.

unfair and unpredictable results. On the other hand, when jury instructions on the taxability of damages for lost earnings are allowed the jury can make a reasoned decision as to the amount it feels will adequately compensate the plaintiff, and adjust it for the income tax that will be levied. The problem of "speculative" calculations will be avoided by allowing the jury to take into account the taxes after hearing damages based on gross earnings. Since the plaintiff will be taxed only in the year of receipt and the jury will know the current tax rates, the jury can then calculate what it desires the plaintiff to recover and set the award to give exactly the amount necessary for the plaintiff to "net" the proper amount.

In the past, such a change in the taxability of damages could have created a serious income bunching problem, but with the passage of the Tax Reform Act of 1986 the potential for such a problem has been limited. With the lowering and flattening of the tax rate schedule, the adverse tax consequences on bunched income inherent in a progressive, marginal tax system have been minimized. Congress has demonstrated, by repealing the income-averaging provisions and doing away with the preferential treatment of capital gains, that it no longer perceives a need to afford relief from income bunching. Thus, the plaintiff will not face a substantially more burdensome tax liability from receiving his lost earnings in a lump sum than he would from receiving it over the number of years used in making the projection.

A second area of concern that taxing damages for lost earnings might raise is the problem of allocation of damages between lost earnings and excludable damages. This is not to be ignored; it is a prob-

169. As an example, suppose a taxpayer were to be awarded "several years of lost earnings," and the damages had been calculated on the net earning theory prior to the T.R.A. of 1986. The earnings would have been reduced by a tax rate that could range as high as 50% to calculate the "net" amount. However, some of those earnings attributable to 1987 or thereafter would only have to be taxed at 28%. This could lead to an error as high as 22% by using the net earnings theory.

170. Income bunching has historically increased the tax burden because of the progressive, marginal tax system. By bunching income into one year, instead of over several years, the taxpayer loses the benefit of having some of the income taxed at the bottom of the schedules in each year. Instead the bunched income will only benefit the lower rates in the one year. Additionally, bunching has the effect of subjecting the last dollars to a higher marginal rate than they would be subjected to if they were earned over a period of years.


172. Section 301 of the T.R.A. of 1986 repeals § 1202, which provided for the 60% deduction on net capital gains. As a result, capital gains, which are actually accumulated appreciation, are taxed as a lump sum at ordinary income tax rates.

173. If in fact Congress were to amend § 104(a)(2) to tax the damages from lost earnings and punitive damages, it would be beneficial to plaintiffs to have as much of any award as possible
lem that can be dealt with. In resolving questions of allocation, the courts have relied on the "payor's intent" test.\textsuperscript{174} Under this test the court will not normally investigate the validity of an underlying claim but, instead, will attempt to determine the intent of the payor. As one court held:

When the terms of an agreement result from deliberate negotiations this Court is not prone to give it a different interpretation. However, when the agreement neither conforms to the business or economic realities of the situation nor is the product of conflicting tax interests, we believe it is appropriate for this Court to examine the surrounding circumstances and make our own determination.\textsuperscript{175}

Subjecting any settlement agreement to judicial scrutiny, when appropriate, is essential to verify the validity of the characterization, and it also provides a mechanism to prevent abuses.

VI. Conclusion

Section 104(a)(2) provides for the exclusion from income taxation of damages awarded for personal injury. The congressional intent behind this exclusion is at best not clear. The scope of the exclusion initially was broadened to include all damages, but there is little justification for including in this tax-exempt treatment either damages for lost earnings or punitive damages. Although the Service has recently challenged the excludability of punitive damages, it has not raised the issue of the taxability of damages from lost earnings. Instead, it is the parties and the courts who have taken up this question, through the development of the net earnings theory of \textit{Liepelt} and the introduction of jury instructions on the taxability of damage awards.

At the same time Congress has amended section 104(a)(2) to allow total exclusion for structured settlements. This only aggravates an already confused situation and promotes unequal treatment of similarly situated taxpayers.

The result has been an inconsistent and at times unfair system that may provide a windfall to the plaintiff or the defendant. Whether punitive damages should be taxed, whether the jury should be instructed as to the nontaxability of damages, and whether the damages should be calculated on a gross earnings theory or net earnings theory are questions that, left unresolved, will only lead to further confusion allocated for "pain and suffering" which would still be excludable.

\textsuperscript{174} See Agar v. Commissioner, 290 F.2d 283 (2d Cir. 1961).

\textsuperscript{175} Wood v. Commissioner, 34 T.C.M. 817, 820 (1975).
and taxpayer feelings of unfairness.

Recent developments have raised questions as to the validity of past interpretations of congressional intent as well as the theories that the exclusion is based on humanitarian motives or merely for the compensation of the victim. While these theories of excludability seem valid when applied to personal injury damages for actual expenses, pain and suffering, and mental anguish, they are unsatisfactory to justify the exclusion for punitive damages or that segment of any award for lost earnings. Lost earnings should be equated to actual earnings that are taxable, and punitive damages are a penalty imposed upon the defendant, making them noncompensatory by definition.

In an era of tax reform that is premised on broadening the tax base, Congress should re-evaluate the present treatment of personal injury damages. Since there is a recognized need for increasing revenues and little justification to continue the exclusion in its present form, Congress should change section 104(a)(2) to limit the exclusion and federal and state courts should adopt the second prong of the Liepelt theory.