

INSTRUCTIONS TO JURY ON EFFECTS OF INCOME TAX IN PERSONAL INJURY AWARDS

McWeeney v. New York, New Haven & Hartford R.R.
282 F.2d 34 (2d Cir. 1960)

Plaintiff brought suit under the Federal Employers' Liability Act for injuries received while working for the defendant railroad. At the time of his injuries, he was a bachelor, aged 36, earning approximately \$4800 per year. The jury found him totally disabled and awarded a verdict of \$87,000 on which judgment was rendered. The railroad appealed on the ground that the lower court erred in refusing to give requested instructions to the jury concerning (1) the immunity of a personal injury damage award from federal income tax,¹ and (2) the deduction of income tax from plaintiff's gross income in determining his expected future earning capacity. The appellate court affirmed, holding the refusal to give the instructions was within the court's discretion and not error.

Legal writers have presented persuasive arguments in favor of these instructions in recent years² and have enjoyed some success in influencing courts.³ This court, in both its majority and dissenting opinions, reviews some of the customary arguments on the subject and also adds some new considerations to the controversy.

IMMUNITY OF PERSONAL INJURY DAMAGE AWARD FROM FEDERAL INCOME TAX

The court's argument in support of the trial judge's refusal to give the first instruction⁴ was, that although it was an accurate statement of law, it was merely cautionary; therefore a refusal to give it to the jury would not justify a reversal, unless it could be shown that the verdict was excessive due to the jury's assumption that the amount awarded would be subject to taxes. This is the majority view under existing law,⁵ but considering the prevailing public awareness of taxes which has developed in contemporary American society, it is unrealistic to think that juries do not consider them. Such an instruction appears extremely valuable, and as the dissent in this case points out, "It would be natural enough for the layman to conclude that

¹ Int. Rev. Code of 1954, § 104(a)(2).

² See *e.g.*, Morris and Nordstrom, "Personal Injury Recoveries and the Federal Income Tax Law," 46 A.B.A.J. 275 (1960).

³ See *e.g.*, O'Conner v. United States, 269 F.2d 578 (2d Cir. 1959); Anderson v. United Air Lines, Inc., 183 F. Supp. 97 (S.D. Cal. 1960); Meehan v. The Central R.R. Co., 181 F. Supp. 594 (S.D. N.Y. 1960).

⁴ This instruction was as follows: "If you arrive at a verdict under the Court's charge in favor of plaintiff, you will not add any sum of money to the amount of the verdict on account of federal or state income taxes, since the amount awarded to the plaintiff is not taxable income to the plaintiff within the meaning of these laws." 282 F.2d at 35.

⁵ See Annot., 63 A.L.R.2d 1393. (1959).

the plaintiff's receipts from the judgment would be taxed.⁶ Recent cases have argued that there is no sound reason for refusing the instruction.⁷ In the railroad's appellate brief, it is pointed out that the tax on a verdict of this size would be approximately \$55,000, were it not for the immunity of personal injury damage awards. A juror with mistaken ideas about taxation would therefore be expected to make a substantial allowance for this in his measure of damages. Consequently, it would seem that the only way to enforce uniform court procedure and protect a defendant against verdicts improperly inflated to compensate for non-existent taxes, is to make the instruction mandatory if requested.

DETERMINATION OF FUTURE EARNING CAPACITY—DEDUCTION OF INCOME TAX FROM GROSS INCOME

The second requested instruction⁸ raises an issue which in effect has two aspects: (1) the introduction of evidence bearing on the amount of income tax plaintiff might be expected to pay on his future earnings, and (2) the instruction that the computation of an award for loss of future earnings must be based on plaintiff's expected "net" earnings after taxes.⁹ In this case, the trial judge ruled against the requested instruction early in the trial so that no evidence of plaintiff's tax liability was presented. In upholding the trial judge, the court presents four objections to the instruction: (1) that future income taxes are too speculative to be considered, (2) that it would be too difficult for the jury to make accurate estimates since the interest to be earned on an annuity would itself be subject to taxes, (3) that future inflation would offset any present over-compensation, (4) that attorneys' fees would reduce plaintiff's ultimate compensation in any event.

The contention that future income taxes are too speculative is persuasive, but it is unlikely that they are any more speculative or conjectural than other factors which the jury must consider (*e.g.*, future earnings and life expectancy). Furthermore, the measure of future income taxes would be regulated by the so-called "certainty of damage rule." Although this rule applies primarily to the measure of lost profits in tort and contract actions, it applies also to future earning capacity to the extent that courts will require a reasonable degree of "certainty" in regard to evidence admitted for that purpose.¹⁰ Most courts will not allow evidence of plaintiff's

⁶ 282 F.2d at 41.

⁷ *Anderson v. United Air Lines, Inc.*, *supra* note 3; *Dempsey v. Thompson*, 363 Mo. 339, 251 S.W.2d 42 (1952).

⁸ This instruction was as follows: "If your verdict is in favor of plaintiff, you must calculate any past or future loss of earnings on the basis of his net income after deduction of income taxes." 282 F.2d at 35.

⁹ These questions may arise in two types of actions—death and personal injury. Since the problems involved are somewhat different in each case, this discussion will be confined to loss of future earnings in personal injury cases where there is a total disability.

¹⁰ See *McCormick*, *Damages* § 28, at 105 (1935).

aggressiveness or special ability as tending to show the probability of future wage increases above the average increase for a worker in his position.¹¹ Similarly, evidence bearing on future income taxes would be confined within reasonable limits of certainty.

The court's next objection is that if net earnings are used as a measure of plaintiff's loss, it would be necessary to add to the final award an allowance for the taxes on the interest which would be earned on the present value of plaintiff's future net earnings.¹² To illustrate, plaintiff's annual salary after taxes in this case was about \$4000. His life expectancy at the time of trial was twenty-nine years; thus his expected future earnings would total roughly \$116,000. In view of the earning power of the dollar, however, it would take a much smaller sum to earn that amount over a period of twenty-nine years; at an interest rate of 5%, it would take an annuity of about half as much or roughly \$58,000. That means that the interest on the present value of the expected future earnings would total about \$58,000, which amount is subject to income tax. In order to compensate for the tax on this interest, the obvious solution would seem to be to add the expected taxes to the present value, *i.e.*, if the tax rate were 20%, to add on about \$11,600. However, the additional interest on this amount is also subject to taxes which would necessitate further augmentation *ad infinitum*. The court suggests that this computation presents a task which a jury cannot reasonably be expected to perform. This difficulty may have been over estimated.

To compensate for future taxes on the interest of the annuity, all that need be done is to adjust the discount rate by dividing it by the value of 1 plus the tax rate. If the tax rate were 20%, and the interest rate 5%,

then the adjusted rate would be $\frac{.05}{1 + .20}$ or .0416. This represents the

discount rate which would precisely compensate for the tax on the interest. Unfortunately, 4.16% does not appear in the standard present value tables now in common usage. This, however, merely throws the burden on the defense attorney to provide the jury with some method of arriving at a present value based on a nonstandard rate. This could be done by introducing more complete present value tables with the discount rate given in increments of a tenth of one percent and calling an actuary to testify as to the accuracy of the method of computation.¹³ The defense attorney would have the task of preparing the special tables but the necessary cal-

¹¹ *Ibid.*

¹² Int. Rev. Code of 1954, § 72(b): "Gross income does not include that part of any amount received as an annuity under an annuity, endowment, or life insurance contract which bears the same ratio to such amount as the investment in the contract (as of the annuity starting date) bears to the expected return under the contract (as of such date)."

¹³ See Leasure, "How to Prove Reduction to Present Worth," 21 Ohio St. L.J. 204 (1960).

culations are not difficult.¹⁴ Certainly it would be better to allow the defense attorney to present this evidence, if he is willing to take the time and effort to do it properly, than to deny him this privilege absolutely.

While the court's first two arguments against the tax instruction support the proposition that problems of jury control and trial practice justify resulting over compensation, its final arguments contend that no actual over compensation results because the hardships of future inflation and attorneys' fees entitle plaintiff to more than he gets anyway. Thus the court says, "We won't tell the jury to deduct income taxes from gross earnings because we want them to add on a little bit extra for inflation and attorneys' fees which we won't tell them about either." If these items are valid considerations which the law should take into account in determining damages for personal injuries, then they should be squarely confronted by the court and not thrown in as a catch-all when it appears that other factors might have caused some over compensation. Furthermore, it is hard to see how future inflation is any more speculative or conjectural than future income taxes. Therefore, it is inconsistent to give consideration to inflation on appeal when it was not even suggested in the trial court and then support a refusal to consider future income taxes because they are too conjectural.

In personal injury litigation, courts should be duly attentive to the problems posed by contingent fees, *i.e.*, the large portion of the verdict which the plaintiff must pay over to his attorney for legal services. However, any remedial efforts by the courts must take into account the fact that the problem is by no means unilateral. It is unfair to the defendant, who has his own attorney's fees to pay, to expect him also to pay the plaintiff's attorney fees, particularly since this is an obligation contracted by the plaintiff himself.

CONCLUSION

Although the above arguments taken individually do not seem to justify a trial court's refusal to give the requested instructions, it must be admitted that to undertake the additional responsibility of the income tax problem would add further complexity to the already greatly encum-

¹⁴ The formula used to compute the present value of \$1.00 given annually for a certain number of years at a certain discount rate is:

$$\text{Present Value} = \frac{1 - \frac{1}{(1 - i)^n}}{i}$$

("i" is the discount rate and "n" the future life expectancy)

Taking this case as an example, if the jury found that income after taxes was \$4,000 per year, that the life expectancy was twenty-nine years, that the discount rate was 5% and that the tax rate on the interest was 20%, the present value would be \$58,300. This represents \$6,700 less than the figure obtained without using the income tax factor (\$65,000). This difference would seem to justify the extra effort needed to insert the tax factor into the award.

bered proceedings of a jury trial. Whether the value of greater precision in damage measurement outweighs this additional burden on the court, however, should be the controlling issue. Since the greater part of the load must be borne by the defense attorney himself, it would be better to allow him to decide, rather than the trial judge, whether or not the possible savings to be had are worth the additional effort needed to insert this item into the measure of damages. If more ideal justice is to prevail, then courts must accept the challenge of the tax problem and in cases such as this, present the appropriate instructions to the jury when requested.