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## Income Tax Issues in Personal Injury Litigation

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# COMMENTS

## INCOME TAX ISSUES IN PERSONAL INJURY LITIGATION

Steven T. Potts

### I. INTRODUCTION

Tax considerations are important in most transactions today. This is true of damage awards and settlements in personal injury and wrongful death litigation. Counsel for plaintiffs and defendants should be aware of how receipts and payments will affect their clients' income taxes when they negotiate settlements. Further, if settlement cannot be reached, the question arises whether evidence should be presented to the jury on the tax consequences of a verdict. The following comment explores the inclusion in and deduction from gross income of damages and settlements, and the possibility of presenting evidence and instructing juries on tax consequences.

### II. TAXATION OF PERSONAL INJURY DAMAGES AND SETTLEMENTS

#### A. *Inclusion in Gross Income*

##### 1. *Compensatory Damages*

If the plaintiff and the defendant negotiate a settlement, or if a court awards the plaintiff damages, the issue arises whether the amount received is taxable. To calculate taxable income a taxpayer must first compute gross income. The Internal Revenue Code [hereinafter I.R.C.] includes in gross income "all income from whatever source derived."<sup>1</sup> In order for an item to be excluded from gross income, the I.R.C. must specifically provide an exclusion. The exclusion for personal injury damages is provided in I.R.C. § 104(a)(2) as follows:

Except in the case of amounts attributable to (and not in excess of) deductions allowed under section 213 (relating to medical,

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1. I.R.C. § 61 (1984).

etc., expenses) for any prior taxable year, gross income does not include— . . . the amount of any damages received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal injuries or sickness . . . .<sup>2</sup>

Broadly stated, the effect of section 104(a)(2) is to exclude damages or amounts received in settlement on account of personal injuries.<sup>3</sup> Various reasons have been given as to why Congress enacted section 104(a)(2). One is that the amount received is in exchange for one's personal capital.<sup>4</sup> Another is that Congress intended to convey a tax benefit to those suffering personal injuries.<sup>5</sup>

Significantly, the exclusion applies only to amounts received for tort-type claims. A person may not claim an exclusion for the proceeds from the sale of a part of his body,<sup>6</sup> nor may he enter into an agreement before the injury or claim arises and hope to exclude the proceeds.<sup>7</sup> Further, only amounts received in settlement of the tortfeasor's obligation may be excluded. Consequently, interest or other income received from the settlement or award is includible in gross income.<sup>8</sup>

The exclusion of the award itself and the inclusion of interest on the award provide a significant incentive in settlement negotiations for the defendant to pay a yearly annuity rather than a lump sum. If the amount received by the plaintiff arises from a personal injury, then the full amount of each yearly payment may be excluded from gross income, whereas yearly interest received on a lump sum is taxable in the year the interest is received.<sup>9</sup>

One element of damages that a taxpayer might receive is compensation for lost future income. Had the taxpayer not been in-

2. I.R.C. § 104(a)(2) (1984).

3. Treas. Reg. § 1.104-1(c) (1960).

4. See *Starrels v. Comm'r*, 304 F.2d 574, 576 (9th Cir. 1962); and *Hawkins v. Comm'r*, 6 B.T.A. 1023, 1024-25 (1927): "Here there is only the compensation which the law sanctions as the only remedy which has thus far been devised for an injury which in its nature is wholly personal and nonpecuniary."

5. *Norfolk and Western Ry. Co. v. Liepelt*, 444 U.S. 490, 500-01 (1980) (Blackmun, J., dissenting); *Haynes v. United States*, 353 U.S. 81, 84-85 (1957); *Epmeier v. United States*, 199 F.2d 508, 511 (7th Cir. 1952); *Huddell v. Levin*, 395 F. Supp. 64, 87 (D.N.J. 1975).

6. In *United States v. Garber*, 589 F.2d 843 (5th Cir. 1979), the taxpayer attempted to exclude amounts received for the sale of her blood. Since no tort liability had been involved, however, the § 104(a)(2) exclusion was held not applicable.

7. *Roosevelt v. Comm'r*, 43 T.C. 77 (1964), involved a taxpayer's agreement with a stage-play producer whereby the parties provided by contract that money paid to Roosevelt would be compensation for invasion of privacy. The court held that no tort occurred, however, since by entering into the contract Roosevelt had given his consent. *Id.* at 86.

8. Rev. Rul. 65-29, 1965-1 C.B. 59.

9. I.R.C. § 104(a)(2) excludes damages received, whether as lump sums or as periodic payments. See also Rev. Rul. 65-29, 1965-1 C.B. 59; Rev. Rul. 79-220, 1979-2 C.B. 74.

jured, he would have been able to work. Since the earnings from his employment would have been includible in his taxable income, the question arises as to whether damages for lost earnings are includible in gross income. Because future earnings, in a tort action, are simply a measure of the harm resulting from a personal injury, and because damages on account of personal injuries are excludable from gross income, lost future earnings have always been considered excludable by the Internal Revenue Service [hereinafter I.R.S.]. As the Ninth Circuit Court of Appeals explained in *Roemer v. Commissioner*:<sup>10</sup>

An individual who wins a personal injury suit is usually given a lump sum award that includes an amount for items that ordinarily would be taxable, such as lost income. Although it might be logical to allocate a lump sum award between its excludable and taxable components, the Commissioner has long excluded from income the entire monetary judgment . . . [A] lump sum award is not allocated between the personal aspects of the injury and the economic loss occasioned by the personal injury, nor is the taxpayer precluded from use of section 104(a)(2) when the predominant result of the injury is a loss of income.<sup>11</sup>

## 2. *Medical Expenses*

Two exceptions exist to the general rule that damages received on account of personal injuries are excludable from gross income. The first exception is for damages received for medical expenses. I.R.C. § 104(a) grants the exclusion "except in the case of amounts attributable to (and not in excess of) deductions allowed under section 213 (relating to medical, etc., expenses) . . ."<sup>12</sup> If a plaintiff previously deducted medical or other expenses in calculating his taxable income, he must include in his gross income the part of the damages received that is allocable to those previously deducted expenses.<sup>13</sup> If the judgment or settlement agreement includes a reasonable allocation, this allocation will be used. Otherwise, the amount allocable should be the amount of the expenses previously deducted, if the damages are equal to or greater than this amount.<sup>14</sup>

The settlement agreement may also allocate an amount to compensate for future medical expenses arising from the injury

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10. 716 F.2d 693 (9th Cir. 1983).

11. *Id.* at 696-97.

12. I.R.C. § 104(a) (1984).

13. Rev. Rul. 75-230, 1975-1 C.B. 93.

14. *Id.*

suffered. If so, the future expenses actually incurred to the extent of the allocation will not be deductible in computing federal income tax liability.<sup>15</sup> Expenses incurred above the amount allocated, however, will be deductible.<sup>16</sup>

### 3. *Punitive Damages*

Despite former I.R.S. policy to the contrary, punitive damages may be a second exception to the general rule that damages arising from personal injuries are excludable. I.R.C. § 104(a)(2) provides that "gross income does not include . . . the amount of *any* damages received . . ."<sup>17</sup> The wording seems clear and unambiguous and for years the I.R.S. advised that punitive damages received on account of personal injuries were excludable because the statute clearly said so.<sup>18</sup> Further, the Treasury Regulations define "damages received" as: "an amount received . . . through prosecution of a legal suit or action based upon tort or tort type rights, or through a settlement entered into in lieu of such prosecution."<sup>19</sup> It would appear, then, that punitive damages fall within this definition.

On July 16, 1984, however, the I.R.S. issued a new revenue ruling that reversed its earlier stance: "An award of punitive damages . . . does not compensate a taxpayer for a loss but adds to the taxpayer's wealth. Furthermore, punitive damages are awarded not 'on account of personal injury,' as required by section 104(a)(2), but are determined with reference to the defendant's degree of fault."<sup>20</sup> To support its latest ruling, the I.R.S. relied on *Commissioner v. Glenshaw Glass Co.*<sup>21</sup>

Although no personal injury had been involved in *Glenshaw*, the Court stated in a footnote that personal injury damages are nontaxable because they correspond to a return of capital and thus are by definition compensatory. The Court further explained that this reasoning does not apply to punitive damage awards.<sup>22</sup>

Thus, while the underlying policy appears to support the in-

15. Rev. Rul. 75-232, 1975-1 C.B. 94.

16. *Id.* at 95.

17. I.R.C. § 104(a)(2) (1984) (emphasis added).

18. Rev. Rul. 75-45, 1975-1 C.B. 47. See also *Roemer*, 716 F.2d at 700.

19. Treas. Reg. § 1.104-1(c) (1960).

20. Rev. Rul. 84-108, 1984-29 I.R.B. 5, 7. Technically, both Revenue Rulings 75-45 and 84-108 involve wrongful death cases. But damages for wrongful death have always been considered personal injury damages. See *Brooks v. United States*, 273 F. Supp. 619, 628-29 (D.S.C. 1967); *Anderson v. United Air Lines, Inc.*, 183 F. Supp. 97 (S.D. Cal. 1960).

21. 348 U.S. 426 (1955). *Glenshaw* involved a taxpayer's attempt to exclude punitive damages received on account of fraud and anti-trust violations.

22. *Id.* at 432 n.8.

clusion of punitive damages in gross income, a literal reading of both the I.R.C. and the Treasury Regulations supports the exclusion of punitive damages from gross income. Given this incongruity, the matter promises to be a subject of controversy.

### B. *Deductibility of Civil Judgments and Settlements*

While plaintiffs want to exclude from gross income the amount of damages received, defendants hope to deduct any payments made. The I.R.C. does not specifically provide for deduction of damages. As a result, a defendant need not concern himself with whether the claim arises from a personal injury, breach of contract, or other claim. Instead, if a defendant wants to deduct damage payments, he must show that the payments are ordinary and necessary expenses incurred in carrying on a trade or business, or that they are incurred in the production of income.<sup>23</sup> If the payment is not an ordinary and necessary expense, it might be capitalized as part of the cost of an asset, or it could be nondeductible for some other reason, depending on the origin and nature of the claim.

At one time, courts allowed damage payments to be deducted if the taxpayer's primary purpose in settling was to prevent adverse effects on its operations.<sup>24</sup> The problem with relying upon the taxpayer's primary purpose in settling a claim, however, is that it is a subjective test. Thus, the courts have fashioned another test to determine whether damage payments are currently deductible: they look at the origin and character of the plaintiff's claim.<sup>25</sup> Under the objective origin of the claim test, payments are deductible if the claim arises from ordinary and necessary business activities.<sup>26</sup> Thus, damages paid for libel have been held deductible as ordinary and necessary business expenses when a newspaper editor unlawfully criticized his competition during the course of an interview.<sup>27</sup> In another case, *Mulgrew Blacktop, Inc. v. United States*,<sup>28</sup> a corporation's deduction of a payment made in settlement of an

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23. I.R.C. §§ 162, 212 (1984). Sometimes taxpayers also argue the deductibility as a loss under I.R.C. § 165. The Tax Court, however, has avoided discussion of § 165 in favor of § 162. See *Grossman & Sons, Inc. v. Comm'r*, 48 T.C. 15 (1967).

24. See *Anchor Coupling Co., Inc. v. United States*, 427 F.2d 429 (7th Cir. 1970), cert. denied, 401 U.S. 908 (1971).

25. *Id.* at 432-33.

26. The timing of the deduction is another matter. I.R.C. § 461(h) (1984), added by the Tax Reform Act of 1984, will cause payments arising from workers' compensation or tort claims to be deductible when the payments are made. Other payments are deductible in "the proper taxable year under the method of accounting used in computing taxable income." I.R.C. § 461(a) (1984).

27. *Vanderbilt v. Comm'r*, 16 T.C.M. (CCH) (1957).

28. 311 F. Supp. 570 (S.D. Iowa 1969).

automobile accident was upheld as a trade or business expense under I.R.C. § 162. The court found that the payment arose out of the ownership of the car, that the car was owned in the course of the corporation's business, and that it had been driven with the consent of the corporation. "Such expenses are ordinary and necessary business expenses deductible in the year incurred."<sup>29</sup>

Deductions are not allowed, however, for payments made to settle title to assets or for claims arising from a corporation's capital stock.<sup>30</sup> Moreover, the taxpayer's reason for settling a claim is irrelevant. Thus, a taxpayer might settle a claim in order to facilitate the sale of its assets or to avoid adverse effects on the market price of its stock. Such payments are deductible as long as the claim arose from some ordinary and necessary activity incurred in the business operation. On the other hand, if the claim does not arise from an ordinary and necessary business activity, but the taxpayer settles to avoid adverse publicity on its operations, the test is not met and the payment is not deductible under I.R.C. § 162.<sup>31</sup>

Assuming that a taxpayer can show that damage payments are deductible as ordinary and necessary trade or business expenses or expenses incurred in the production of income, a further question arises as to whether he can deduct the punitive element of those damages. Although it might seem that deducting punitive damages would be contrary to public policy, they generally are deductible. The Treasury Regulations provide that "[a] deduction for an expense paid or incurred . . . which would otherwise be allowable under section 162 shall not be denied on the grounds that allowance of such deduction would frustrate a sharply defined public policy."<sup>32</sup> The I.R.S. has also issued a revenue ruling which provides that punitive damages incurred in the ordinary conduct of business are deductible under I.R.C. § 162.<sup>33</sup> This ruling relies on the fact that the only payments prohibited as deductions under section 162 are those prohibiting deduction of fines or penalties paid for the violation of a law, portions of anti-trust treble damage

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29. *Id.* at 572.

30. In *Anchor Coupling* the taxpayer breached an agreement to allow Borg-Warner Corp. to purchase its assets. Borg-Warner sued, and Anchor Coupling settled the lawsuit for \$600,000. This payment was a non-deductible capital expenditure because it was made to settle title to Anchor Coupling's assets. *Anchor Coupling*, 427 F.2d at 433.

31. See *Vermont Bank and Trust Co. v. United States*, 296 F. Supp. 682 (D. Vt. 1969), where the taxpayer settled a dissenting stockholder's claim that her shares had been undervalued during a merger. Even though the taxpayer contended the shareholder's claim was merely a nuisance suit, the court held amounts paid to the stockholder represented additional sums paid to purchase the treasury stock. Hence, they were nondeductible.

32. Treas. Reg. § 1.162-1(a) (1984).

33. Rev. Rul. 80-211, 1980-2 C.B. 57.

payments, bribes, and kickbacks.<sup>34</sup>

In sum, damages incurred in civil litigation are deductible if the origin and nature of the plaintiff's claim arises from the ordinary conduct of the taxpayer's business or income-producing activities. Such payments may be deductible regardless of whether they are for compensatory or punitive damages.

### III. PROPRIETY OF ADMITTING EVIDENCE OF TAX CONSEQUENCES AND INSTRUCTING THE JURY THAT THE PLAINTIFF'S AWARD IS NONTAXABLE

Since damages received by a plaintiff in a personal injury action generally result in no tax liability for the plaintiff, issues arise in many lawsuits as to whether the defendant should be allowed to present evidence of the plaintiff's income tax bracket and whether the court should instruct the jury that the award will not be subject to tax. Defendants want the instruction, believing that it will result in lower verdicts. For the same reason, plaintiffs want no reference made to income taxes.

Historically, most courts had adopted the rule that juries should not be instructed and evidence should not be admitted regarding plaintiffs' income taxes.<sup>35</sup> In 1980, however, the United States Supreme Court decided in *Norfolk & Western Railway Co. v. Liepelt*<sup>36</sup> that instructions and evidence should have been given at a trial involving the Federal Employers' Liability Act [hereinafter FELA].<sup>37</sup> In the wake of *Liepelt*, state and federal courts have begun to rethink their positions on these issues, which include:

1. Should evidence of the plaintiff's future income taxes be admissible?
2. Should juries be instructed on tax consequences of the plaintiff's damage awards?
3. Should the choice of forum matter?
4. Will the difference in tax consequences between compensatory and punitive damages cause jury instructions to be too confusing?
5. Should juries be instructed that punitive damages are tax deductible by the defendant?

The remainder of this comment addresses these issues.

34. *Id.* (citing S. REP. NO. 522, 91st Cong., 1st Sess. 1 (1969), reprinted in 1969 U.S. CODE CONG. & AD. NEWS 2027, 2310).

35. This is the rule in Montana as well; see *Bracy v. Great Northern Ry. Co.*, 136 Mont. 65, 343 P.2d 848 (1959).

36. 444 U.S. 490 (1980). *Liepelt* arose out of a wrongful death action.

37. 45 U.S.C. §§ 51-60 (1982).



### A. *The Liepelt Decision*

Prior to *Liepelt*, most courts had adopted the view that jury instructions and evidence relating to income taxes were improper. In *Liepelt*, the Supreme Court accepted certiorari because it believed that tax consequences are more significant now than they once were.<sup>38</sup> Further, the Court noted a shift in the position of some courts allowing instructions and evidence regarding tax consequences.<sup>39</sup>

The *Liepelt* Court acknowledged that there were reasons both for and against admitting evidence of and instructions regarding potential income tax effects. The most convincing argument that the Court noted for admission is that after-tax income is the real measure of financial loss suffered by the plaintiff, not gross income.<sup>40</sup> The Court also realized, however, that the prediction of future tax consequences is speculative and possibly too complex for a jury.<sup>41</sup> Further, the Court acknowledged that if such evidence is admitted and the jury is instructed accordingly, then possibly other evidence ought to be admitted, such as evidence of future taxes estimated to be paid on interest earned from investment of the award and evidence of attorney's fees necessary to recover the award.<sup>42</sup>

In dismissing *Liepelt's* arguments that a jury should not hear evidence of future income tax consequences, the Court concluded that if future income taxes are difficult to estimate, so are many other estimates necessary to decide a case.<sup>43</sup> The Court also rejected *Liepelt's* argument that other evidence should also be admitted if evidence of future taxes must be allowed.<sup>44</sup>

The Court believed that while a jury would tend to be conscious of income taxes, it would be unaware of the exclusion for personal injury damages under I.R.C. § 104(a)(2). Consequently, the Court reasoned, the failure to instruct a jury that "the plaintiff's award, if any, will not be subject to tax" is likely to produce a higher verdict than should be given.<sup>45</sup> The Court concluded by

38. *Liepelt*, 444 U.S. at 491.

39. *Id.*

40. *Id.* at 493.

41. *Id.* at 494.

42. *Id.*

43. *Id.*

44. *Id.* at 495. The Court thought that "logically" an award comprising the discounted present value of future earnings should be adjusted upward for the effect of income taxes on earnings from investment of the award. Evidence of attorney's fees, however, should not be considered by a jury because the FELA does not provide for their recovery.

45. *Id.* at 497.

quoting from *Burlington Northern, Inc. v. Boxberger*,<sup>46</sup> a 1975 Ninth Circuit FELA decision: “ ‘[T]o put the matter simply, giving the instruction can do no harm, and it can certainly help by preventing the jury from inflating the award and thus overcompensating the plaintiff on the basis of an erroneous assumption that the judgment will be taxable.’ ”<sup>47</sup>

### B. *Decisions Subsequent to Liepelt*

Some state courts have followed the *Liepelt* ruling while others, not wishing to change the law in their jurisdictions, question how far the *Liepelt* rule actually extends. Thus, to date, differences in substantive and procedural law have figured significantly in determining the outcome of disputes over jury instructions and evidence. Accordingly, decisions involving differing combinations of substantive and procedural law must be analyzed.

#### 1. *Federal Substantive Law*

After *Liepelt* it is clear that any court relying on federal substantive law must allow introduction of evidence of the plaintiff's estimated future income taxes and must instruct the jury that a damage award will not be subject to income tax. Thus, for example, federal and state courts<sup>48</sup> must allow introduction of tax evidence and instruct juries accordingly in FELA actions or suits brought under the Longshoremen's and Harbor Workers' Compensation Act.<sup>49</sup>

#### 2. *Federal Substantive Law Incorporating State Substantive Law*

When a federal act incorporates state substantive law, however, a different result may be reached. After *Liepelt*, the Supreme Court in *Gulf Offshore Co. v. Mobil Oil Corp.*<sup>50</sup> considered the necessity of instructing the jury that damages awarded would not be taxable to the plaintiff in a suit brought under the Outer Continental Shelf Lands Act.<sup>51</sup> The Court stated that the rule given in

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46. 529 F.2d 284 (9th Cir. 1975).

47. *Liepelt*, 444 U.S. at 498, quoting *Boxberger*, 529 F.2d at 297.

48. *Liepelt* originated in an Illinois state court.

49. 33 U.S.C. §§ 901-950 (1982). See *Fanetti v. Hellenic Lines, Ltd.*, 678 F.2d 424 (2d Cir. 1982).

50. 453 U.S. 473 (1981).

51. 43 U.S.C. §§ 1331-1343 (1982).

*Liepelt* was generally applicable to federal damages actions,<sup>52</sup> but added that a court must look to the provisions of the federal act in question before it can decide whether the rule applies.<sup>53</sup> Since the Outer Continental Shelf Lands Act provides that state law applies to the extent that it is not "inconsistent" with federal law,<sup>54</sup> the Supreme Court remanded the case to determine what the state rule was regarding damages.<sup>55</sup>

Unfortunately, it is not clear what the Court meant by the word "inconsistent." For instance, if state law did not allow such instructions, then the state law would apparently be inconsistent with the federal law announced in *Liepelt*. The *Gulf* Court left the issue unresolved.

The Federal Tort Claims Act<sup>56</sup> [hereinafter FTCA] is another federal statute which incorporates state substantive law. The FTCA provides that state law determines the measure of damages, but, among other exceptions, it precludes awards of punitive damages.<sup>57</sup> The FTCA is a waiver by the United States of its sovereign immunity from suit, and as such, conditions attached to the waiver must be strictly enforced.<sup>58</sup>

Regardless of how state law might characterize compensatory damages, federal courts will look at the consequences of a particular measure to determine whether, as a matter of federal law, it is punitive.<sup>59</sup> Thus, in *Hollinger v. United States*,<sup>60</sup> an FTCA action decided by the Ninth Circuit Court of Appeals, the court required that estimated income taxes be deducted from a plaintiff's award. The court reasoned that to award more would amount to granting punitive damages.<sup>61</sup>

### 3. State Substantive Law

#### a. Federal Forum

Since state substantive law, not federal substantive law, is applied in federal courts in diversity cases, it would seem that *Liepelt* would not dictate admitting evidence and instructing juries

52. *Gulf*, 453 U.S. at 488.

53. *Id.*

54. 43 U.S.C. § 1333(a)(2) (1982).

55. *Gulf*, 453 U.S. at 487-88.

56. 28 U.S.C. §§ 2671-2680 (1982).

57. 28 U.S.C. § 2674 (1982).

58. *Flannery v. United States*, 718 F.2d 108, 111-12 (4th Cir. 1983).

59. *Id.* at 110 (citing *D'Ambra v. United States*, 481 F.2d 14 (1st Cir. 1973)).

60. 651 F.2d 636 (9th Cir. 1981).

61. *Id.* at 642.

on tax effects in diversity cases. Several early post-*Liepert* cases demonstrate this view.

In *Estate of Spinosa v. International Harvester Co.*,<sup>62</sup> a diversity case involving New Hampshire law,<sup>63</sup> the First Circuit Court of Appeals decided that a jury instruction on tax consequences had been properly excluded. The *Spinosa* court held that the *Liepert* decision did not mandate an across-the-board change in the majority rule regarding calculation of a decedent's projected future earnings. Although no New Hampshire case law existed on point, the federal appellate court found that it was proper for the trial court to apply the majority rule as it had in the past.<sup>64</sup>

Likewise, the Fifth Circuit Court of Appeals in *Croce v. Bromley Corp.*<sup>65</sup> decided to apply state law rather than the *Liepert* rule in a wrongful death action arising out of an airplane crash. The suit had been brought under a state statute rather than federal law, and the trial court had refused to instruct the jury on the nontaxability of the award. The court saw this as a crucial distinction,<sup>66</sup> and found no suggestion that the Supreme Court in *Liepert* had intended to require a trial judge to give such an instruction in wrongful death actions predicated upon state law.<sup>67</sup>

Other circuit courts of appeal, on the other hand, have applied the *Liepert* rules in diversity cases. In *Grant v. City of Duluth*<sup>68</sup> the Eighth Circuit Court of Appeals recognized that Minnesota law did not require a trial court to instruct a jury regarding income tax effects in a wrongful death action. The court, however, favored the policy enunciated in *Liepert* and held that the jury should have been so instructed.<sup>69</sup> In addition, the court suggested that due process might require giving the instruction, but it declined to elaborate.<sup>70</sup>

Likewise, the Seventh Circuit Court of Appeals recently decided in a diversity case arising under Illinois law, *In re Air Crash Disaster Near Chicago, Ill.*,<sup>71</sup> that evidence of income tax consequences was properly admitted and that the jury had been prop-

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62. 621 F.2d 1154 (1st Cir. 1980).

63. *Id.* at 1158.

64. *Id.*

65. 623 F.2d 1084 (5th Cir. 1980).

66. *Id.* at 1096.

67. *Id.* at 1097. The court also noted the absence of inflated damages which would have indicated that the jury was unaware of the exclusion of damages from the plaintiff's gross income. *Id.*

68. 672 F.2d 677 (8th Cir. 1982).

69. *Id.* at 683.

70. *Id.*

71. 701 F.2d 1189 (7th Cir. 1983).

erly instructed concerning the effect of income taxes.<sup>72</sup> Addressing the issue of whether evidence of income taxes ought to be admitted at trial, even though state substantive law controls in a diversity case, the appeals court turned to Rule 402 of the Federal Rules of Evidence, which provides: "All relevant evidence is admissible, except as otherwise provided by the Constitution of the United States, by Act of Congress, by these rules, or by other rules prescribed by the Supreme Court pursuant to statutory authority. Evidence which is not relevant is not admissible."<sup>73</sup> The court then reasoned that since the Supreme Court in *Liepelt* had held that such evidence was relevant,<sup>74</sup> it is thus generally admissible in federal court.<sup>75</sup>

The court did acknowledge, however, that in some circumstances state substantive law might still apply in determining the admissibility of evidence in a federal diversity case: "[T]he relevance of the evidence is ascertainable only by reference to the substantive law of the state. To the extent that the state evidentiary rule defines what is sought to be proved—here, the measure of damages—it may bind the federal court . . ."<sup>76</sup> The court then reviewed several situations in which state substantive law might be so intertwined with the measure of damages that a federal court would find it necessary to apply the state rule regarding admissibility of income tax consequences. First, a state rule might be based upon the premise that computation of net income is too speculative or confusing because of tax rate fluctuations and the prediction of exclusions and exemptions.<sup>77</sup> Second, state substantive law could be based upon the notion "that inaccuracies resulting from the projection of gross rather than net income are offset by the undercompensating effects of ignoring inflation and attorney's fees . . ."<sup>78</sup>

The *Air Crash Disaster* court considered another rationale for permitting state law to control. Since *Liepelt* requires state courts to apply federal admissibility rules in federal actions, the reverse

72. *Id.* at 1193.

73. FED. R. EVID. 402.

74. *Air Crash Disaster*, 701 F.2d at 1192 (citing *Liepelt*, 444 U.S. at 495). FED. R. EVID. 401 provides that relevant evidence "means evidence having any tendency to make the existence of any fact that is of consequence to the determination of the action more probable or less probable than it would be without the evidence."

75. *Air Crash Disaster*, 701 F.2d at 1192-93.

76. *Id.* at 1193-94. On the other hand, rather than being based upon evidentiary considerations, this could merely be a statement about the ability of a particular state's juries to comprehend tax consequences.

77. *Id.* at 1194.

78. *Id.*

also might be true: federal courts should apply state admissibility rules in diversity actions.<sup>79</sup> Nevertheless, the court was not convinced that this conclusion was always warranted: "*Liepelt* expressly relied on the overwhelming federal interest in uniformity of practice under FELA, and the supremacy clause gives the federal government power to impose even a procedural rule on state courts in these circumstances."<sup>80</sup>

Thus, the *Air Crash Disaster* court concluded that the Federal Rules of Evidence govern admissibility of evidence in a diversity case, unless state substantive law is so inextricably tied to the measure of damages that it must be followed. Deciding whether a state evidentiary rule should apply in a diversity case would be difficult when the state rule is that evidence of income tax consequences is inadmissible.<sup>81</sup> However, since the *Air Crash Disaster* Court believed that Illinois courts would admit evidence of the plaintiff's income taxes, it held that state substantive law did not preclude admission of the evidence.<sup>82</sup>

The court next decided whether juries should be instructed that the plaintiff's award, if any, would not be subject to tax: "Ordinarily in diversity cases state law determines the content of jury instructions, and federal law governs only the manner in which instructions are requested and given."<sup>83</sup> This is the rule, because jury instructions contain the substantive law to be applied to the facts. In *Air Crash Disaster*, however, the court believed that the Illinois courts' refusal to instruct juries regarding tax effects had been due either to administrative concerns,<sup>84</sup> or to mistaken views of federal tax law.<sup>85</sup> Since no substantive legal concern was present, the court concluded that it was not bound by the Illinois practice.<sup>86</sup>

The *Air Crash Disaster* decision illustrates a potential advantage for defendants in federal courts, including those in Montana. Montana state courts, like those in Illinois, have held that juries are not to be instructed on the non-taxability of damage awards. If

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79. *Id.*

80. *Id.* at 1195.

81. *Id.* at 1193.

82. *Id.* at 1195.

83. *Id.* at 1199.

84. *Id.* at 1200. The court cited two such concerns: (1) Illinois courts believed that instruction was unnecessary if the measure of damages is made clear; and (2) giving this particular cautionary instruction would invite a flood of others. The court did not fear either at the federal level. *Id.*

85. *Id.* at 1199-1200. Illinois courts had previously stated that the federal tax exclusion for personal injury damage awards was intended to convey a tax benefit to the recipient. The *Air Crash Disaster* court cited *Liepelt* and said no such tax benefit was intended. *Id.*

86. *Id.* at 1200.

a Montana federal district court concludes that evidence of a plaintiff's income taxes is relevant, and that the Montana Supreme Court has no substantive reason to oppose instructing juries on the consequences of income taxes to the plaintiff, then the federal court might well follow the Seventh Circuit's decision in *Air Crash Disaster*.

### b. *State Forum*

In *Liepelt*, the United States Supreme Court did not extend its holding to state courts deciding state substantive law.<sup>87</sup> Most of the state courts that, prior to *Liepelt*, had held that evidence of and jury instructions relating to income taxes were improper have not been persuaded by *Liepelt* to abandon that rule. An example of this reaction to *Liepelt* is *Irwin v. Pacific Southwest Airlines*,<sup>88</sup> where a California appeals court recognized that California courts had always refused to instruct juries on the tax effects of personal injury awards and decided to continue to do so.<sup>89</sup> Deciding that *Liepelt* pertained only to the interpretation of federal statutory claims, the court concluded that it was not bound to follow the Supreme Court when a case is brought under state law.<sup>90</sup> Appellate courts in Pennsylvania,<sup>91</sup> Illinois,<sup>92</sup> and Washington<sup>93</sup> have reached the same conclusion. The issue, however, has not yet reached these states' highest courts.

The Montana Supreme Court has held in the past that evidence should not be presented and that juries should not be instructed on the effects of income taxes on damage awards. All of these decisions, however, arose from FELA actions. When first presented with the issue in 1959, in *Bracy v. Great Northern Railway Co.*,<sup>94</sup> the court refused to permit the instruction. The common sense view, according to the court, was that future tax liability is subject to too many variables to be considered in an award for impairment of future earnings.<sup>95</sup> While the court recognized

87. 444 U.S. at 490. The Court decided the tax issues only with respect to *Liepelt*.

88. 133 Cal. App. 3d 709, 184 Cal. Rptr. 228 (1982).

89. *Id.* at 717, 184 Cal. Rptr. at 232.

90. *Id.*

91. *Richardson v. LaBuz*, \_\_\_ Pa. Commw. \_\_\_, 474 A.2d 1181, 1197 (1984).

92. *Tonarelli v. Gibbons*, 121 Ill. App. 3d 1042, 460 N.E.2d 464 (1984); *McCann v. Lisle-Woodridge Fire Protection Dist.*, 115 Ill. App. 3d 702, 450 N.E.2d 1311 (1983); *Johnson v. Hoover Water Well Serv., Inc.*, 108 Ill. App. 3d 994, 439 N.E.2d 1284 (1982).

93. *Bingaman v. Grays Harbor Community Hosp.*, 37 Wash. App. 829, 685 P.2d 1090 (1984); *Maicke v. RDH, Inc.*, 37 Wash. App. 750, 683 P.2d 227 (1984).

94. 136 Mont. 65, 343 P.2d 848 (1959).

95. *Id.* at 74, 343 P.2d at 853.

some division among other jurisdictions, it found the general rule to be that the instruction should not be given. Further, it believed that when a jury is instructed on what it may consider in arriving at a verdict, the judge should not instruct on what the jury is not permitted to consider.<sup>96</sup>

In 1977, in *Torchia v. Burlington Northern, Inc.*,<sup>97</sup> another FELA case, the court again approved a trial court's refusal to instruct a jury that personal injury damages were not taxable, finding the refusal to be "in accord with the weight of authority."<sup>98</sup> Although the *Torchia* court discussed the Ninth Circuit's *Boxberger* decision, from which the Supreme Court later quoted approvingly in *Liepelt*, the Montana court was unimpressed.<sup>99</sup> Nevertheless because of the *Liepelt* decision, the Montana Supreme Court will be forced to allow the tax instruction as well as evidence of taxation in future FELA actions brought in Montana courts.

Since *Liepelt* is not binding on state court adjudications involving state substantive law, the Montana Supreme Court is free to adopt its own rule in these cases. That the Montana Supreme Court has specifically rejected the Ninth Circuit's reasoning in *Boxberger*,<sup>100</sup> on which the *Liepelt* court relied, suggests that the *Liepelt* decision will not persuade the Montana court to adopt the *Liepelt* rule in state substantive law cases.

### C. Problems Associated with Punitive Damage Awards

In some instances a jury may find that punitive damages should be awarded. "Where the acts complained of are shown to be wanton, malicious, or oppressive and of such a character as to indicate a reckless disregard for the rights of the plaintiff, the jury, in their discretion, may award a reasonable amount as punitive damages, in addition to compensatory damages."<sup>101</sup> Tax consequences associated with punitive damage awards may necessitate special jury instruction considerations.

#### 1. Plaintiff

In the past, both punitive and compensatory damages awarded

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96. *Id.* at 75, 343 P.2d at 853.

97. 174 Mont. 83, 568 P.2d 558 (1977), *cert. denied*, 434 U.S. 1035 (1978). *Accord* McGee v. Burlington Northern, Inc., 174 Mont. 466, 571 P.2d 784 (1977).

98. *Torchia*, 174 Mont. at 96, 568 P.2d at 566.

99. *Id.* at 96-97, 568 P.2d at 566.

100. *Id.*

101. *Ramsbacher v. Hohman*, 80 Mont. 480, 489, 261 P. 273, 277 (1927).



for personal injuries were considered to be excludable from the plaintiff's gross income.<sup>102</sup> In light of Revenue Ruling 84-108,<sup>103</sup> however, it is no longer safe to say that all damages awarded to the plaintiff in a personal injury or wrongful death action are tax-free. If a defendant wishes to instruct the jury as to the taxation of an award to the plaintiff when punitive damages are justified, the court ought to instruct that only the compensatory damages will not be subject to tax.

The problem with instructing a jury that one element of damages will be excludable from the plaintiff's income while another is not is that this could be confusing. Ultimately, however, this should not be determinative. Competent lawyers and judges ought to be able to phrase instructions effectively in a form understandable by juries.<sup>104</sup>

The important point is that plaintiff's counsel should not be caught unaware of the change in the I.R.S.'s position with respect to punitive damages. Thus, in a case where the judge must instruct the jury regarding tax consequences to the plaintiff, plaintiff's counsel may want the jury to be instructed that not all of the award will be tax-free.

## 2. Defendants

If a jury decides that punitive damages are warranted, calculation of the amount is largely left to the jury's discretion.<sup>105</sup> However, some general rules exist:

The jury should take into consideration the attendant circumstances, such as the malice or wantonness of the act, the injury intended, the motive for the act, the manner in which it was committed and the deterrent effect upon others. . . . According to the general rule, *it is proper for the jury to consider defendant's wealth and pecuniary ability in fixing the amount of damages.*<sup>106</sup>

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102. See text accompanying note 19.

103. 1984-29 I.R.B. 5. See note 20 and accompanying text.

104. The argument that jury instructions on income taxes would be too confusing was addressed in *Liepert*, 444 U.S. at 494. The Supreme Court noted that many variables make a jury's decision difficult:

But the practical wisdom of the trial bar and the trial bench has developed effective methods of presenting the essential elements of an expert calculation in a form that is understandable by juries that are increasingly familiar with the complexities of modern life. We therefore reject the notion that the instruction of evidence describing a decedent's after-tax earnings is too speculative or complex for a jury.

*Id.*

105. *Ramsbacher*, 80 Mont. at 489, 261 P. at 277.

106. *Id.* (quoting 17 C.J. 994, 995 (1927)) (emphasis added).

Both compensatory and punitive damages are deductible for income tax purposes if the claim arises from ordinary and necessary activities associated with carrying on a trade or business or with maintaining property to produce income.<sup>107</sup> Since the objective in awarding compensatory damages is to make the plaintiff whole, the fact that the defendant may deduct these damages in computing his taxable income is irrelevant.<sup>108</sup>

Punitive damages, however, present a different situation. The objective in awarding punitive damages is to punish. If a jury determines that a defendant ought to pay \$1,000,000 in punishment for its act, it would be relevant for the jury to know that the award may cost the defendant only about one half that amount in after-tax income.

#### IV. CONCLUSION

Tax consequences surrounding personal injury and wrongful death cases are significant and becoming more complex. While all damages or settlements arising from personal injury litigation have historically been excluded from a plaintiff's gross income, the I.R.S. has begun to scrutinize whether *all* personal injury damages should be accorded this treatment. On the other hand, nearly all damages paid by a defendant remain tax-deductible, if the litigation arises from ordinary and necessary trade, business, or investment activities.

The fact that most people are unaware of these tax consequences suggests that evidence and jury instructions concerning income taxes would be helpful in making verdict decisions. Moreover, the possibility of a large verdict makes this a significant issue.

There are legitimate arguments to be made both for and against admitting evidence and giving instruction on tax consequences. Many state courts do not allow juries to hear evidence

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107. See text accompanying notes 24-35.

108. A recent Minnesota decision is interesting. In *Hanson v. Chicago, Rock Island & Pac. R.R. Co.*, \_\_\_ Minn. \_\_\_, 345 N.W.2d 736 (1984), the plaintiff requested that the jury be instructed that any damages awarded against the defendant would be fully tax-deductible. The jury awarded \$500,000. The trial court believed the verdict was too high, and it granted a remittitur. On appeal, the plaintiff asserted that the instruction merely informed the jurors that the award would not be a nondeductible penalty. The court believed this was unnecessary, stating that "[s]ince the jury is already told that damages are to be awarded that will fairly and adequately compensate the plaintiff for his injury, it is unclear why more needs to be said." *Id.* at 738. While the instruction might have informed a jury that the award would not penalize the defendant, it tended to encourage the jury to increase the amount of the award at government expense. *Id.* at 739. Only compensatory damages were involved in *Hanson*; thus, the court had no reason to discuss whether this type of instruction could properly be given with respect to punitive damages.

and instructions regarding taxes. In recent years, however, federal courts have moved in the other direction. If a jury has neither the information nor the knowledge to properly award damages, compensatory damages will likely acquire a punitive effect, while punitive damages will not punish. Therefore, the trend initiated by the federal courts should be extended so as to fully inform the jury about the tax consequences of the damages they award. State courts should follow suit in a manner that is reflective of their substantive law, yet allow the jury to make as informed a decision as is possible in awarding damages.