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The Taxability of Recoveries in Personal Injury Cases

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COMMENT

THE TAXABILITY OF RECOVERIES IN PERSONAL INJURY CASES

Introduction

Recent cases have allowed the jury in personal injury suits to be instructed that amounts recovered in such cases are tax-free.[1] Apart from the propriety of such instructions *if* such amounts are not includible in gross income, these cases raise the more fundamental question of the actual tax treatment of such amounts.

Taxability in General

Hall v. C.&N.W. Ry.[2] and *Dempsey v. Thompson*[3] were cases involving suits under the Federal Employers' Liability Act. As the recoveries were in the form of workmen's compensation, the courts stated that they were tax-free because the Internal Revenue Code specifically excluded from gross income ". . . amounts received . . . under workmen's compensation acts as compensation for personal injuries or sickness . . . ."[4] In 1954, Congress, while attempting to clarify section 22 (b) (5) of the 1939 Code, split it into the sections: 104 and 105. As there are yet no cases construing these new sections, we must rely on the language of the sections themselves, the Congressional Committee Reports, and the construction by the courts of the now-replaced section 22 (b) (5) in order to determine what changes, if any, they have effected.

Section 104 (a) (1) of the 1954 Code, with language almost identical to that of the supplanted section, states that "gross income does not include . . . amounts received under workmen's compensation acts as compensation for personal injuries or sickness."[5] Since section 104 is the only section applicable to workmen's compensation acts,[6] the question arises whether under section 104 the whole award is excluded from gross income even though part of it is for lost wages, past or future. From the committee reports come the answers: "It [section 104] will continue to exclude from gross income [in the same manner as section 22 (b) (5) of the 1939 Code] *any amount* received under a workmen's compensation act . . . ." (italics added).[7] This

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1 Hall v. C. & N. W. Ry., 349 Ill. App. 175, 110 N.E. 2d 654 (1953); Dempsey v. Thompson, 363 Mo. 339, 251 S.W. 2d 42 (1952).
2 *Supra*, n. 1.
3 *Supra*, n. 1.
4 Int. Rev. Code §22(b)(5) (1954).
5 Int. Rev. Code §104(a)(1) (1954).
6 "Amounts received under workmen's compensation acts are not governed by this section [105]. Such amounts are fully excludable from gross income in all cases under section 104." S. Rep. No. 1622, 83d Cong., 2d Sess., (1954) §105.
7 S. Rep. No. 1622, 83d Cong., 2d Sess., (1954) §104. Also see note 6 *supra*.

would seem to indicate that the complete award in every workmen's compensation case is excluded from gross income irrespective of whether part of it compensates for lost wages.

Again following the language of the 1939 Code, Congress in the new Code has excluded gross income also "the amount of any damages (whether by suit or agreement) on account of personal injuries or sickness."[8] As in the preceding subsection, the question arises whether the total amount of damages would be excluded if it explicitly excluded an amount for lost wages, past and future. The language seems ambiguous, and the policy of the courts has been to construe any ambiguous exemption or exclusion section strictly against the taxpayer.[9] However, some of the ambiguity can be resolved by an inspection of the other subsections of 104 and 105. Sections 104 (a) (3) and 105 (a) require that amounts received by the taxpayer through accident and health insurance for personal injuries and sickness be included in gross income to the extent that they are attributable to contributions of the employer to the accident and health plans, or to the extent that they are paid by the employer. Clearly, the language of these subsections would be meaningless if the taxpayer, by the simple expediency of suing the insurance company for such damages and receiving them by way of a judgment or settlement, could bring the entire amount so recovered within section 104 (a) (2). Although this indicates that section 104 (a) (2) is not as broad as its language upon a casual insection would imply, we still have no evidence that Congress does or does not wish to include in gross income an amount of damages compensating explicitly for lost wages. A careful reading of section 105 (a) and (c), however, may furnish some indicia of how Congress regards amounts directly referable to wages. Section 105 (a) directs that amounts from accident and health insurance must be included in gross income if either attributable to contributions made by the employer or if the amounts themselves were paid by the employer. Subsection (c) of the same section then states:

> "Gross income does not include amounts referred to in subsection (a) to the extent such amounts
> (1) constitute payment for the permanent loss or loss of use of a member or function of the body, or the permanent disfigurement, of the taxpayer, his spouse, or a dependent (as defined in section 162), and
> (2) are computed with reference to the nature of the injury without regard to the period the employee is absent from work."

This language would seem to indicate, though far from conclusively,

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8 Int. Rev. Code §104(a)(2) (1954).
9 Waller v. U.S., 81 F.Supp. 210 (1948).

that Congress views any amounts connected with wages of the employee as gross income. If the amounts are paid by the employer or stem from contributions made by him, the presumption seems to be that such amounts are compensation for wages and includible as such in the gross income of the employee, unless it is clearly shown that such amount was paid out solely because of the injury itself without any relation to the loss of wages due to the injury.

The judicial history of the sections in question lends little aid to the problem of construing their language. As was mentioned, sections 104 and 105 are the successors of section 22 (b) (5), the predecessor of which, section 213, was passed in 1918. No important amending of the language regarding sickness and injury compensation was done until 1954. Moreover, a careful examination of the litigation on sections 213 and 22 (b) (5) has disclosed no cases dealing directly with the taxability of the amounts recovered in personal injury cases where a part of the amount was compensation for lost wages. The bulk of the litigation is confined to the issue of whether retirement benefits under various pension plans are taxable. The courts have uniformly held that if the taxpayer retired because of injuries or disabilities, and not merely because of age, the benefits were excluded from gross income under the above-named sections of the Code.[10] These court decisions support the view that amounts received solely because of the nature of the injuries or disabilities should be excluded; whereas retirement benefits for old age smack too much of added compensation for former services and, like wages, should be included in gross income. The Commissioner, as well, has been biased against any arrangement which related benefits to rate of salary and length of employment, because it seemed unfair to exclude payment in lieu of earnings while taxing the earnings themselves.[11]

PRIVATE TORT ACTIONS

An even more involved problem arises in the field of personal injury recoveries through private tort actions. A verdict in the typical tort action for personal injuries will be one of two types: namely, general or special. The special verdict is generally composed of four or more headings. Usually these are pain and suffering, medical expenses, loss of wages to the present, and loss of future wages.

In determining whether or not damages are taxable, the courts have

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[10] Allen v. Spencer, 214 F.2d 205 (D.C. Cir. 1954); Prince v. U.S., 119 F.Supp. 421 (1954); Sims v. Commissioner, 196 F.2d 238 (D.C. Cir. 1952); Murphy v. Commissioner, 20 T.C. 746 (1953).

[11] Press Release, 5 CCH 1953 Fed. Tax Rep. ¶6136 (1953); GCM 23511, 1953 Cum. Bull. 86. See Schlenger, *Disability Benefits under 22(b)(5)*, 40 VA. L. REV. 549 (1954).

repeatedly looked to the underlying right of recovery.[12] Thus, if damages include a specific allowance for lost profits, this allowance would be taxable because the profits, if actually received as such, would be taxable.[13] A similar situation arises regarding the interest received because of the postponement of the receipt of the amount of damages.[14] On the other hand, damages from libel and slander have been held to be non-taxable because character and reputation are strictly personal attributes, and are not measurable in terms of wealth.[15]

It is quite apparent, then, that the amount in a special verdict which compensates for pain and suffering is not taxable. It is not an amount received from capital or labor, or from both combined; it has no cost basis; and it is not an increase in worth in any *accepted* sense of the word. It is strictly a personal item.[16]

In considering the amount of the verdict granted for medical expenses, it must be noted that should a deduction have been allowed for such expenses in the year they were incurred under section 213 of the 1954 Code, that portion of the medical expense recovery would most probably be subject to federal tax.[17] In the event that no deduction had been taken in a prior year, the portion of the verdict relating to medical expenses would probably be tax-free.[18]

It is in the area of loss of earning power that the most perplexing problems face the attorney. The loss of earning power is further divided, as was above indicated, into loss of earnings to the present, and loss of future earnings.

Assuming, for the purposes of this problem, that section 104 (a) (2) of the 1954 Code would not be construed so broadly as to exclude from gross income any amount whatsoever which is received as personal injury damages no matter what it is compensating for,[19] there would seem to be no reason why the loss of wages from the time of

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[12] Glenshaw Glass Co. v. Commissioner, 18 T.C. No. 108 (1952); Raytheon Products Corp. v. Commissioner, 144 F.2d 110 (1st Cir. 1944).

[13] Raytheon Products Corp. v. Commissioner, *supra*, n. 12; Durkee v. Commissioner, 162 F.2d 184 (6th Cir. 1947).

[14] Theodore Pope Riddle, 27 B.T.A. 1339 (1933); I.T. 2420, VII-2 Cum. Bull. 123 (1928).

[15] "Even to the economist, character and reputation or other strictly personal attributes are not capital or otherwise measurable in terms of wealth . . ." C. A. Hawkins v. Commissioner, 6 B.T.A. 1023 (1927); Mrs. Lyde McDonald v. Commissioner, 9 B.T.A. 1340 (1928).

[16] Mrs. Lyde McDonald v. Commissioner, *supra*, n. 15, (where damages for breach of contract which included amounts for pain and suffering were excluded from gross income).

[17] Int. Rev. Code §213(a) (1954); U.S. v. Lewis, 340 U.S. 590 (1951); Haberkorn v. U.S., 173 F.2d 587 (6th Cir. 1949); Security Flour Mills v. Commissioner, 321 U.S. 281 (1944).

[18] Int. Rev. Code §104 (1954).

[19] "It cannot be broadly asserted that compensation for an injury is not income nor taxable as such." H. Liebes & Co. v. Commissioner, 90 F.2d 932, 935 (9th Cir. 1937).

disability to the present should not be taxed when received as damages. In the case of almost every taxpayer, there would be no conjecture as to his gross income. His deductions are known, as are his deductible losses, as well as the tax rates. The underlying right of recovery of this portion of the verdict is his loss of wages. The wages would have been taxed if the taxpayer had actually worked for them. By what logic would they then be excluded when received as damages? In an income tax decision directly construing that part of section 22 (b) (5) relating to our problem, it was held that the portion of amount paid to ill seamen which corresponded to their loss of wages to the present did not come within the section and therefore was taxable income.[20] Section 105 of the 1954 Code offers no aid, except by way of analogy, as was pointed out previously, because it concerns itself solely with amounts paid to the taxpayer from accident and health insurance plans or employee benefit associations.

Finally, we consider the taxability of damages for loss of future earnings based on the present value of those earnings. An important problem to consider in this respect is the method used by the court to estimate the present worth of those future wages lost as a result of the injury. Will the court compute the amount by deducting a sum equalling the probable amount of income tax the plaintiff would have paid had he actually worked for those wages? Or will the court, without regard to income tax, award merely a lump sum in the amount of the total wages lost? The former we shall call the net income method, the latter, the gross method.

There seems to be a sharp and unresolved split of authority regarding the method of computing the present worth of future earnings.[21] This split might be resolved if the Commissioner would take a definite stand on the taxability of the recoveries in such cases.[22] For it is quite apparent that no court will insist upon the net income method of determining the amount if the amount itself will be subject to federal income tax. The courts in *Hall v. C.&N.W. Ry.* and *Dempsey v. Thompson,* under the belief that their awards to the plaintiffs would not be taxable, nevertheless held for the gross income method. The court in the *Dempsey* case presented the argument in this fashion:

[20] I.T. 3977, 2 Cum. Bull. 92 (1949); *cf.* Farmers & Merchants Bank of Cattlesburg, Ky. v. Commissioner, 20 B.T.A. 622 (1930).

[21] For gross: Stokes v. U.S., 144 F.2d 82 (2d Cir. 1944); C. & N. W. Ry. v. Curl, 178 F.2d 497 (8th Cir. 1949); Smith v. Pennsylvania Ry., 59 Ohio L. Abs. 282, 99 N.E.2d 501 (1950).
For net: So. Pac. Ry. v. Guthrie, 180 F.2d 195 (9th Cir. 1949), *cert. denied,* 341 U.S. 904 (1951); Wetherbee v. Elgin, Joliet, and Eastern Ry. Co., 191 F.2d 302 (7th Cir. 1951); Pfister v. City of Cleveland, 160 Ohio St. 164, 113 N.E.2d 366 (1953); Sunray Oil Corp. v. Allbritton, 188 F.2d 751, 754 (5th Cir. 1951) (dissenting opinion).

[22] As of the writing of this paper, the Treasury Regulations under the 1954 Code have not been published.

> "It is also true that, had [the plaintiff] not been injured, his future earnings would have been subject to income tax, although the impact thereof could by no means be accurately measured, being variable by law and possible change of family or exemption status."[23]

Courts which reject the net income method of computing present value of loss of future earnings do so primarily for the same reason as did the court in the *Dempsey* case.[24] No one will deny that the net income of an individual is extremely difficult to compute as to future years. There are many reasons for this: possible changes in tax laws, as well as changes in the taxpayer's own exemption status due to family increases or decreases, wage fluctuations, old age, and possible blindness.[25] The arguments against the net income method, however, ignore similar defects in the gross income method of computing future earnings. Gross income, as well as net income, is difficult to compute; for what man can now say how much he will be earning twenty, ten, or even five years from now?[26] There are so many factors to be considered, such as, salary increases or decreases, variability of fees (if a professional man), possibility of time lost because of protracted illnesses, and retirement age; and none of these factors is any more readily foreseen than factors which are considered in computing net income or take-home pay. Though it has found favor with the majority of the courts, the gross income view seems completely untenable if the court feels the recovery will be tax-free, or if the law becomes settled that it is not taxable. The action is one in tort; and the purpose of any tort recovery (assuming punitive damages are not in consideration) is to compensate the injured party, thereby placing him back in the same position he was in before the injury.[27] The gross income method estimates the injured person's wage loss without regard to any income tax which he surely would have paid had he actually earned those wages. If this amount is then excluded from gross income in the year it is received by the injured party, this party will receive a windfall in the amount of the tax he would have paid. That this can be an extraordinary amount is shown by the following example. If an unmarried taxpayer, with a net income of $8000.00, were to receive a tort judgment of $10,000.00, and this judgment were not taxable, his income tax for that year would be only $2196.00. If this recovery were taxable, his taxes for the year would be $6936.00,

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[23] *Supra,* n. 1, p. 44.
[24] See note 21.
[25] See 33 B.U.L.Rev. 114.
[26] "What Guthrie's ultimate earnings, net or gross would be, cannot be foretold." So. Pac. Ry. v. Guthrie, *supra,* n. 21, p. 927.
[27] 3 Restatement, Torts §903, comment a (1932).

thereby making the $10,000.00 judgment worth only $5260.00, or about one-half of its original value.[28]

Next, we consider the problem created by the return of a general verdict. A different situation arises where the plaintiff in a personal injury suit has received a lump sum in the form of a general verdict, or has settled for a lump sum, with no allocation being made for the various rights of recovery such as loss of wages, pain and suffering, and medical expenses. There is recent authority that such recoveries are not taxable because no allocation can be made to the various claims mentioned above.[29] The majority view, however, which seems more consistent with the policy of the courts to make a "best estimate" of such matters, explicitly provides for an apportionment of general verdicts into their probable elements.[30] The courts, in making such apportionments, seem to be influenced by the proportion each element asked for by the taxpayer in his original claims bears to the total amount sought as damages.[31] Under the apportionment view, then, the same rules and arguments would apply for the taxability of general verdicts as applied to special verdicts.

CONCLUSION

There seems to be a fertile field for work by the Commissioner in the area of taxability of the recovery of lost wages as a portion of the verdict in a personal injury case. The area has been sparsely litigated, and the courts which have passed on the issue are in direct conflict. The new Internal Revenue Code fails to state the intention of Congress with sufficient clearness as to eliminate many of the question marks surrounding the problem.

The Commissioner undoubtedly would argue for the application of the underlying right theory, thereby taxing that element of recovery which compensates for loss of wages because the wages themselves, if earned, would have been taxable. The taxpayer would argue for a strict construction of the statute excluding from gross income "the amount of *any* damages . . . on account of personal injuries . . . ."[32]

A decision either way would force the courts of a number of jurisdictions to alter their method of arriving at the amount of wages lost. If the Commissioner wins and the amount is to be taxed, those courts which compute loss of wages on a net basis, that is, by deduct-

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[28] See Harnett, *Torts and Taxes*, 27 N.Y.U. L. REV. 614, 615.

[29] ". . . Where the verdict is general, there is no way of determining the amount proportioned to wages, so that the entire verdict becomes tax free." Pfister v. City of Cleveland, *supra*, n. 21, p. 368; *cf.* Farmers & Merchants Bank of Cattlesburg, Ky. v. Commissioner, *supra*, n. 20.

[30] Telefilm, Inc. v. Commissioner, 21 T.C. No. 152 (1953).

[31] Obear-Nester Glass Co. v. Commissioner, 20 T.C. No. 152 (1953); Glenshaw Glass Co. v. Commissioner, *supra*, n. 12; Durkee v. Commissioner, *supra*, n. 13.

[32] Int. Rev. Code §104.

ing the amount of income tax the plaintiff would pay if he had earned the money, would do the taxpayer a great injustice by continuing to use that method. On the other hand, if the taxpayer wins and the amounts are not taxed, those courts which use the gross income method to compute the amount would in effect be giving the plaintiff a windfall of considerable value by not deducting from such recovery an amount reasonably equal to the tax he would have paid had he worked for the wages.

It is submitted that the weight of judicial authority indicates that, were the issue contested by the Commissioner, amounts recovered in personal injury cases should be taxable according to the underlying right of recovery.

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