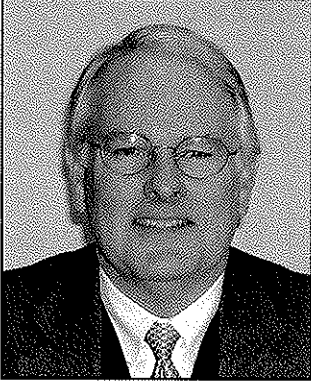


The After-Tax Analysis Argument: Why Income Taxes Should Be Considered in Calculating Damages for Lost Earnings in Personal Injury Cases

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Imagine the accident never happened. Plaintiff never broke his arm in the collision. He showed up for work the next day. He worked several construction projects that summer. He received a paycheck every two weeks. State and federal income

taxes were deducted from each paycheck. Now take that all away and ask yourself: What amount of money would fairly and reasonably compensate plaintiff for the wages he lost as a result of the accident? Should we use a before-tax or after-tax analysis? Most Wisconsin courts today refuse to allow juries to receive evidence concerning the impact of income taxes on the amount of damages to be awarded in personal injury actions. Instead, plaintiffs are allowed to recover their entire gross income without any deduction for taxes. This is despite the fact that personal injury awards are exempt from taxable income under both state and federal law.¹

It is not entirely clear why most Wisconsin courts refuse to admit evidence of income taxes to calculate damages for lost earnings in personal injury cases. Wisconsin courts have blindly done so, however, for over fifty years. The problem with an award of gross wages is that it constitutes an unjustified windfall to plaintiff. Plaintiff never would have had the spending benefit of his entire gross wages had the accident not occurred. Why, then, should we award plaintiff his entire gross wages when the purpose of compensatory damages in personal

injury cases is to make a person “whole?”² It defies practical wisdom.

This article discusses the history of after-tax analysis in Wisconsin and explores the rationale and support behind the decision to use before-tax income in personal injury cases. Next, this article explains the federal rule that allows the introduction of evidence showing the effect of income taxes in calculating net pecuniary loss. Finally, this article concludes that after-tax analysis is the only fair and reasonable way to calculate lost earnings in personal injury cases.

I. *Hardware Mutual*: The Wisconsin Rule?

Many plaintiffs’ attorneys will tell you that the question of whether income taxes should be considered in determining an award for lost earnings in Wisconsin was decided in 1959 in *Hardware Mutual Casualty Company v. Harry Crow and Son, Inc.*³ *Hardware Mutual* was a personal injury action to recover damages (including lost earnings) sustained by an electrician after a truck backed into him at a construction site.⁴ At trial, the defendants suggested that since the earnings the plaintiff would have received had he not been injured would have been subject to income tax and since an award for lost earnings is not subject to income tax, the jury should be instructed accordingly so that it can make an appropriate reduction for income tax in its award for lost earnings.⁵ The trial court refused to give the instruction.⁶

On appeal, the Wisconsin Supreme Court affirmed the trial court’s decision and held that it was not reversible error to refuse to give the requested jury

instruction.⁷ In doing so, the court cited a 1955 Illinois Supreme Court case, *Hall v. Chicago and North Western Railway Company*, which said:

[W]hether the plaintiff has to pay a tax on the award is a matter that concerns only the plaintiff and the government. The tort-feasor has no interest in such question. And if the jury were to mitigate the damages of the plaintiff by reason of the income tax exemption accorded him, then the very Congressional intent of the income tax law to give an injured party a tax benefit would be nullified.⁸

While our supreme court generally agreed with the Illinois Supreme Court's reasoning in *Hall* that the effect of income tax on a personal injury award should be left to the legislature and held that the award for lost earnings in the *Hardware Mutual* case "should not be reduced by reason of its freedom from income tax," the court predicated its ruling on the following:

Upon the present record, we do not feel called upon to decide whether any type of instruction dealing with the income tax matter could properly be given in a similar case⁹

Thus, despite what most plaintiffs' attorneys will tell you, the court's decision in *Hardware Mutual* did not resolve the issue of whether income tax can ever be considered in determining an award for lost earnings. Rather, the court merely declined to hold that refusal to give the requested instruction in that particular case was prejudicial error.¹⁰

II. After *Hardware Mutual*

The Wisconsin Supreme Court revisited the after-tax analysis issue again in 1959 in *Behringer v. State Farm Mutual Auto Insurance Company*.¹¹ In *Behringer*, the plaintiff sought damages for injuries arising out of a two-car automobile accident,

including damages for lost earnings.¹² The defendant-driver requested that the trial court give the following jury instruction:

You Are Further Instructed that in determining the amount of damages for personal injuries you are not to add to or include in the award of damages anything to compensate the plaintiff for federal or state income taxes, since any damages recovered as an award for personal injuries are not subject to and therefore are free of either federal or state income taxes.¹³

After the trial court refused to give the instruction, the defendant appealed, and the supreme court affirmed the decision:

We had a similar issue before us in [*Hardware Mutual*]. We held that it was not prejudicial error not to give the instruction on income tax there requested. We reach the same conclusion here, as we cannot hold that the failure to give such an instruction resulted in prejudice to the appellants.¹⁴

Our supreme court then explained that the requested instruction, if given, would be proper and that, if the instruction is given, "it should state not only that the jury is to add nothing for income tax but also that nothing is to be deducted from the award because of such factor."¹⁵ The supreme court did not, however, say that the instruction *must* be given or that a jury may *never* consider income tax in calculating lost earnings in a personal injury case.

Following the supreme court's decisions in *Hardware Mutual* and *Behringer* in 1959, the Wisconsin Civil Jury Instructions Committee approved the following Instruction in 1960:

1735 DAMAGES: NOT TAXABLE AS INCOME. In determining the amount of damages for personal injuries, you must not include in the award, or add to it, any sum to compensate the plaintiff for state or federal income taxes, since damages received as an award for personal injuries are not subject to income taxes. You will not, of course, subtract from, or exclude from, your award of damages any amount because the plaintiff is not required to pay income taxes.

This instruction was updated in 1981 and reviewed without change in 1990.¹⁶ The Committee's Comments to WIS JI-Civil 1735 emphasize, consistent with the holdings in *Hardware Mutual* and *Behringer*, that "it is not error to refuse to advise the jury of the tax consequences of an award"

No Wisconsin appellate court has directly revisited the after-tax analysis issue, or interpreted the meaning and scope of WIS JI-Civil 1735, since 1960. Yet most Wisconsin trial courts to this day rely on *Hardware Mutual* and its progeny to exclude evidence of income tax in determining damages for lost earnings in personal injury cases.

Noteworthy, however, is that the Wisconsin Court of Appeals recently upheld a jury award for lost earnings based on an after-tax analysis in *Pierce v. American Family Mutual Insurance Company*.¹⁷ In *Pierce*, the plaintiff brought a wrongful death action after her mother was killed in a snowmobile accident.¹⁸ In calculating plaintiff's pecuniary loss, economist Dr. Karl Egge applied an after-tax analysis.¹⁹ Specifically, Dr. Egge testified that he

calculated [plaintiff's] past pecuniary loss as \$140,000 by calculating [her deceased mother's] *after-tax earnings* for the years between her death and the date of the trial, the value of the services [the decedent] would have provided

for her daughter, and reducing by the estimated amount of [the decedent's] earnings that [she] would have personally consumed.²⁰

On review, the appellant argued that the economist's testimony was irrelevant and highly prejudicial because it failed to follow Wisconsin methodology.²¹ The court of appeals disagreed and concluded that the expert testimony did, in fact, comport with established Wisconsin law.²² There was no discussion in *Pierce*, however, of WIS JI-Civil 1735 or either of its predecessors, *Hardware Mutual* and *Behringer*.

III. The Federal Rule

Recall that the Wisconsin Supreme Court found guidance in an Illinois case, *Hall v. Chicago and North Western Railway Company*, when it refused to reduce the lost earnings award in *Hardware Mutual*.²³ The *Hall* case was an action brought under the Federal Employers' Liability Act for personal injuries sustained in a freight car accident.²⁴ At the time the *Hall* decision was rendered, most federal judges refused to allow juries to receive evidence concerning the impact of income taxes on the amount of damages to be awarded in personal injury actions.²⁵ That all changed, however, in 1980 with the U.S. Supreme Court's decision in *Norfolk and Western Railway Company v. Liepelt*.²⁶

In *Norfolk*, the plaintiff brought a claim for wrongful death benefits under the Federal Employers' Liability Act on behalf of a fireman's estate who was killed in a locomotive collision.²⁷ At trial, the defendant objected to the use of gross earnings without any deduction for income taxes and offered expert testimony concerning plaintiff's net pecuniary loss.²⁸ The trial judge overruled the objection and excluded any evidence concerning income tax.²⁹ On appeal, the Supreme Court recognized that "the prevailing practice [to not allow evidence of income tax] developed at a time when federal taxes were relatively insignificant" and that "some courts are now following a different practice."³⁰ Accordingly, the court considered the

evidence question and concluded emphatically that income tax is a relevant factor in calculating the monetary loss suffered in a personal injury action.³¹

The reason for the Supreme Court's decision in *Norfolk* was two-fold: First, the court determined that after-tax income, rather than gross income, is the "only realistic measure" of pecuniary loss because the injured party's spending power would have been diminished by state and federal income taxes:

The amount of money that a wage earner is able to contribute to the support of his family is unquestionably affected by the amount of the tax he must pay to the Federal Government. It is his after-tax income, rather than his gross income before taxes, that provides the only realistic measure of his ability to support his family. It follows inexorably that the wage earner's income tax is a relevant factor in calculating the monetary loss suffered [in a personal injury action].³²

Second, the court determined that tax consequences are not too speculative or complex for a jury and are easily understandable with the help of expert testimony:

[Federal courts] have regarded the future prediction of tax consequences as too speculative and complex for a jury's deliberations. Admittedly there are many variables that may affect the amount of a wage earner's future income tax liability 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 introduction of evidence describing a [plaintiff's] estimated after-tax earnings is too speculative or complex for a jury.³³

Consequently, federal law now requires the use of after-tax earnings in calculating the pecuniary loss suffered in a personal injury action brought under the Federal Employers Liability Act or the Longshoremen's and Harbor Workers' Compensation Act.³⁴

IV. Conclusion

For decades, plaintiffs' attorneys have attempted to convince Wisconsin trial courts (with general success) that *Hardware Mutual* and its progeny stand for the proposition that evidence of income tax can never be admitted to reduce an award for pecuniary loss in a personal injury case. Clearly, however, no Wisconsin appellate court has ever announced such a rule. Moreover, the rationale cited in *Hardware Mutual* was based upon the application of antiquated federal law. Lawsuits brought in state court under the federal statutes are now governed by the rule established in *Norfolk*, which requires the use of after-tax income.³⁵ Thus, if *Hall* were decided today, the Illinois Supreme Court would have no choice but to allow evidence of income tax to be introduced.³⁶ And based on the court of appeals' decision in *Pierce*, at least some Wisconsin circuit courts are receptive to the policy arguments in favor of admitting evidence of after-tax income to determine the amount of damages for lost earnings in personal injury cases.

Compensatory damage awards are supposed to make a person "whole," not afford a windfall.³⁷ An award of damages based on before-tax gross income places the plaintiff in a better economic position than he or she would have been had the accident not occurred and the plaintiff been able to continue working. Consequently, evidence of income taxes is highly relevant to the measure of damages awarded in a personal injury case and the only fair and reasonable measure of pecuniary loss is the wage earner's after-tax earnings.³⁸ For these

reasons, defense counsel should urge Wisconsin judges to reexamine the rationale and support behind the decision to use before-tax income in personal injury cases, and encourage courts to allow juries to receive evidence concerning the impact of income taxes on the amount of damages to be awarded in personal injury actions.

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References

- 1 26 U.S.C. § 104(a)(2) (“the amount of any damages (other than punitive damages) received . . . on account of personal physical injuries or sickness” is excluded from gross income); Wis. Stat. § 71.05(6)(a) (computation of taxable income under Wisconsin law is based upon federal adjusted gross income).

- 2 *White v. Benkowski*, 37 Wis. 2d 285, 290, 155 N.W.2d 74 (1967); *Brockmeyer v. Dun & Bradstreet*, 113 Wis. 2d 561, 574-76, 335 N.W.2d 834 (1983).
- 3 6 Wis. 2d 396, 94 N.W.2d 577 (1959).
- 4 *Id.* at 398-401.
- 5 *Id.* at 406.
- 6 *Id.* at 406-08.
- 7 *Id.* at 408.
- 8 5 Ill. 2d 135, 151-52, 125 N.E.2d 77 (Ill. 1955) (emphasis added).
- 9 6 Wis. 2d at 407-08.
- 10 *Id.*
- 11 6 Wis. 2d 595, 603-04, 95 N.W.2d 249 (1959).
- 12 *Id.* at 596, 603-04.
- 13 *Id.* at 603.
- 14 *Id.* at 603-04.
- 15 *Id.* (citing *Atherley v. MacDonald, Young & Nelson, Inc.*, 298 P.2d 700, 709 (Cal. App. 1956)).
- 16 WIS JI-Civil 1735, Comments.
- 17 2007 WI App 152, 303 Wis. 2d 726, 736 N.W.2d 247.
- 18 *Id.*, ¶ 3.
- 19 *Id.*, ¶¶ 16-18.
- 20 *Id.*, ¶ 15 (emphasis added).
- 21 *Id.*, ¶ 16.
- 22 *Id.*, ¶¶ 18-19.
- 23 6 Wis. 2d at 603-04.
- 24 5 Ill. 2d at 136-37.
- 25 *Norfolk & Western Ry. Co. v. Liepelt*, 444 U.S. 490, 490-91 (1980).
- 26 *Id.* at 493-96.
- 27 *Id.* at 491.
- 28 *Id.* at 492.
- 29 *Id.* at 492-93.
- 30 *Id.* at 490-91.
- 31 *Id.* at 493-96.
- 32 *Id.* at 493-94.
- 33 *Id.* at 494.
- 34 *Id.* at 493-94; *Jones & Laughlin Steel Corp. v. Pfeifer*, 462 U.S. 523, 534 (1983).
- 35 WIS JI-Civil 1735, Comments.
- 36 *Id.*
- 37 *White*, 37 Wis. 2d at 290; *Brockmeyer*, 113 Wis. 2d at 574-76.
- 38 *See Norfolk*, 444 U.S. at 493-96.