JURIES AND TAX: THE EFFECT OF INCOME TAXATION ON TORT DAMAGES

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ABSTRACT

In some shape or form, most tort damages for personal injuries have been excluded from federal income taxation since 1919. Despite this rule having celebrated its 100th birthday, the tax policy justification for the exclusion eludes consensus. Whether the policy is justified or not, the exclusion raises two other issues: should compensatory damage awards reflect non-taxability, and should juries be informed about tax treatment when determining awards? Like the disagreement over policy justifications for the exclusion, states are not in accord on their damage rule or approach to jury instructions. Proponents of a rule that awards should reflect taxation and informing the jury of the tax exclusion stress compensation. Without this rule and information, juries may mistakenly believe that they must inflate damages to account for taxes, thereby handing the plaintiff a windfall. Opponents argue that awards should not reflect taxation and that providing exclusion information unnecessarily complicates trial and benefits the tortfeasor by lowering damage awards. What damages rule should a state adopt, and what should a court do to implement the rule when the defendant requests an instruction informing the jury that some damages are excluded from federal income tax?

We revisit the issue of the taxation of damages and review the policy justifications that have been offered to justify the current exclusion. We then argue that the efficient rule is to measure damages by the gross harm caused by the tortfeasor. To determine how best to implement that rule, we conducted an experiment designed to determine the effects of tax jury instructions. Our conclusion is that the optimal damages rule is best implemented by giving no jury instructions on damages. Perhaps surprisingly, that is our conclusion even if tax law changed to make damages taxable. Even if a jurisdiction were to adopt an inefficient rule of damages, our

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experiment offers guidance on the approach to jury instructions that would best implement the rule.

I. INTRODUCTION....50

II. FEDERAL INCOME TAX TREATMENT OF DAMAGES....54
A. Exclusion of Damages on Account of Physical Injuries....54
B. Tax Policy Justifications for the Exclusion....58

III. TOWARD AN EFFICIENT TORT RULE....65

IV. STATE APPROACHES....74

V. JURY EXPERIMENT....79
A. Facts of the Hypothetical....81
B. Expected Results....84
C. Actual Results....86

VI. EXPERIMENT IMPLICATIONS....90

VII. CONCLUSION....92

I. INTRODUCTION

In 1973, a fireman, Delroy Liepelt, employed by the Norfolk & Western Railway, was killed as a result of the company's negligence.[1] His estate brought a wrongful death lawsuit in state court under the Federal Employee Liability Act (FELA)[2] to recover damages caused by the decedent's death.[3] Under FELA, the damages plaintiffs may recover in a wrongful death case are those that "flow from the deprivation of the pecuniary benefits which the beneficiaries might have reasonably received if the deceased had not died

1. Norfolk & W. Ry. v. Liepelt, 444 U.S. 490, 491 (1980). More facts about the accident are reported in the state court appellate opinion. *See generally* Liepelt v. Norfolk & W. Ry., 378 N.E.2d 1232, 1236–37 (Ill. App. Ct. 1978), *rev'd*, 444 U.S. 490 (1980).

2. Norfolk & W. Ry. v. Liepelt, 444 U.S. at 491. The Federal Employer's Liability Act was passed in 1908 to diminish many of the harsh defenses (for example, the fellow-servant rule, assumption of risk, and contributory negligence) that railroads used to defend against injured employee lawsuits against them. Congress has the power to adjust what is normally a state law area (the tort of negligence) on account of the interstate commerce element of railroad travel. *See* Victor E. Schwartz & Liberty Mashigian, *The Federal Employers' Liability Act, a Bane for Workers, a Bust for Railroads, a Boon for Lawyers*, 23 SAN DIEGO L. REV. 1, 3–4 (1986).

3. *See Liepelt v. Norfolk & W. Ry.*, 378 N.E.2d at 1235.

from his injuries."[4] The case went to trial in 1976.[5] The trial court refused to allow Norfolk & Western to introduce evidence as to the effect of income taxes on the decedent's future earnings,[6] and it rejected the railroad's request for a jury instruction that "your award will not be subject to any income taxes, and you should not consider such taxes in fixing the amount of your award."[7] The jury awarded the estate $775,000.[8]

Because the measure of damages under FELA is governed by federal law, the United States Supreme Court granted review.[9] In a 7-2 decision, with Justice Stevens writing for the majority, the Court held that not allowing introduction of evidence on the possible income tax payable on the decedent's past and estimated future earnings and not providing the requested tax jury instruction were reversible errors.[10] On the propriety of the instruction, the Court concluded:

> That instruction was brief, and could be easily understood. It would not complicate the trial by making additional qualifying or supplemental instructions necessary. It would not be prejudicial to either party, but would merely eliminate an area of doubt or speculation that might have an improper impact in the computation of the amount of damages.[11]

The Court also held that when determining lost wages as part of the damage calculation, net earnings should be referenced as opposed to gross earnings.[12] Recognizing that the statute authorized recovery of only what the beneficiaries would have "reasonably received," the Court reasoned that after-tax income was the "realistic measure" of their forgone benefit.[13] Therefore, the Court held, the defendants should be allowed to introduce evidence of the income tax that would be due on lost earnings in order to determine compensation for lost earnings.[14]

Significantly, Liepelt's beneficiaries, as wrongful death claimants under FELA, were not entitled to damages for their or the decedent's pain and

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4. Mich. Cent. R.R. v. Vreeland, 227 U.S. 59, 70 (1913).
5. *Norfolk & W. Ry. v. Liepelt*, 444 U.S. at 491.
6. *Liepelt v. Norfolk & W. Ry.*, 378 N.E.2d at 1245.
7. *Norfolk & W. Ry. v. Liepelt*, 444 U.S. at 492.
8. *Id.*
9. *Id.* at 493.
10. *Id.* at 498.
11. *Id.*
12. *Id.* at 494 ("We therefore reject the notion that the introduction of evidence describing a decedent's estimated after-tax earnings is too speculative or complex for a jury.").
13. *Id*. at 493.
14. *See id.* at 495.

suffering.[15] They could, however, recover for both the financial support they would have received from the decedent, equal to the decedent's lost earnings minus the amount the decedent would have spent on himself or herself, and the value of services the decedent would have performed for the family.[16] While the decedent's lost earnings would have been included in the decedent's income and therefore subject to federal income tax absent the tort, the latter (the value of the services provided to the family) would have been tax-exempt.[17]

The fact that part of the award compensates beneficiaries for benefits that would have been tax exempt may explain why the Court cited cases noting that juries may mistakenly believe damage awards would be taxed and therefore "gross up" the award, or increase it to reflect expected taxes.[18] If a damages award, say, $100,000, does not represent income that would have been taxed had it been earned and yet is taxed when received as damages, the award net of taxes, say, $70,000 with an assumed tax rate of 30%, will not make the plaintiffs whole. The jury, anticipating the tax bill, may gross up the award, say, to roughly $130,000, so that the plaintiffs are compensated for the benefits lost.

Grossing up should not be a concern for pecuniary benefits from lost earnings, however. If the jury determines that the decedent would have earned $100,000 subject to taxation, it would presumably conclude that the beneficiaries would have received at most $70,000 (assuming a 30% tax rate); if they mistakenly believed the damage award is subject to taxation, they would not increase the $100,000 award, but they might set the award at

15. *See id.* at 493.

16. *See id.* at 492.

17. We concentrate for simplicity in this Article on the federal tax treatment of tort damage awards. The treatment of these awards under state income tax laws can differ from the federal treatment, though state laws are typically consistent with federal law. *See* RESTATEMENT (THIRD) OF TORTS: REMEDIES § 13 cmt. b (AM. L. INST., Tentative Draft No. 1, 2022) ("Most states have similar or identical exclusions for state income-tax purposes, often because they adopt the federal definition of taxable income."). To the extent federal and state tax laws are consistent, our conclusions based on federal law apply equally to state law. Our conclusions might change if state and federal treatment diverged in a given state. But because we find scant empirical evidence that awards vary based on instructions, our conclusions would largely be the same even in those circumstances.

18. The Court stated that "it is entirely possible that members of the jury may assume that a plaintiff's recovery in a case of this kind will be subject to federal taxation, and that the award should be increased substantially in order to be sure that the injured party is fully compensated." Norfolk & W. Ry. v. Liepelt, 444 U.S. at 496. The Court quoted the Missouri Supreme Court and the Third Circuit, which stated similar concerns. *Id.* at 496–97 (citing Dempsey v. Thompson, 251 S.W.2d 42, 45 (Mo. 1952); then citing Domeracki v. Humble Oil & Refining Co., 443 F.2d 1245, 1251 (3d Cir. 1971)). *See gross something up*, CAMBRIDGE DICTIONARY, https:/dictionary.cambridge.org/us/dictionary/english/gross-up [https://perma.cc/HXH3-JBAH] (providing a definition of "grossing up").

$100,000 so that the beneficiaries would be made whole after taxation. The Court was concerned that damage awards would not be compensatory, as the statute required they be, because of juror misunderstanding of tax law.[19] But the Court's concern that jurors would erroneously inflate damage awards seemingly applies to awards for items other than support from lost income, such as lost services to the family or, in injury cases brought by or on behalf of the victim, for the victim's pain and suffering.[20]

Because *Liepelt* was a case brought under FELA, the Supreme Court's holding is not binding on the states in negligence actions. A survey of the states shows no consensus on the optimal treatment of this issue.[21] Some states require a jury instruction that describes the tax treatments, though the instructions vary across states.[22] Other states do not allow any such instructions,[23] but some require the judge to adjust the ultimate award on account of taxes while others do not.[24]

The most recent draft of the Restatement (Third) of Torts, disagreeing with the Supreme Court, takes the position that as a matter of common law the "amount of damages must not be reduced on the ground that the plaintiff's receipt of the damages will be exempt from income taxes or on the ground that the plaintiff would have paid taxes on income that the award of damages will replace."[25] Thus, the Restatement rejects the Supreme Court's position that the award for lost earnings should be based on net, rather than gross, loss. The Restatement does not explicitly address the jury instruction issue—that is, whether it is better to say nothing about taxes or whether it is better to tell the jury that the award will be nontaxable but somehow instruct jurors that they should not reduce their awards to account for possible tax consequences. For damages that would be taxable, the Restatement suggests that, unless the plaintiff can show that the taxes imposed on the damages will be "substantially

19. *See* Norfolk & W. Ry. v. Liepelt, 444 U.S. at 496.

20. Somewhat surprisingly, the issue has not come up again to the Supreme Court since the decision in *Liepelt*. Instead, courts have focused on whether failure to give the nontaxation instruction is automatically reversible error or harmless error depending on the circumstances, reaching different conclusions. *See, e.g.*, CSX Transp., Inc. v. Begley, 313 S.W.3d 52, 67 (Ky. 2010) ("The Supreme Court has yet to clarify whether *Liepelt* mandates reversal whenever a trial court refuses to instruct the jury that damages are exempt from state and federal income tax. Of the lower federal appellate courts, the Fourth, Fifth, and Eighth circuits have considered whether such error is reversible per se. Their conclusions differed.").

21. *See infra* Part IV.

22. *See infra* Part IV

23. *See infra* Part IV.

24. *See infra* Part IV.

25. RESTATEMENT (THIRD) OF TORTS: REMEDIES § 13(a) (AM. L. INST., Tentative Draft No. 1, 2022).

different" from what would have been imposed on the plaintiff absent the tort, taxes "can and should be ignored."[26]

Determining whether tax instructions should be given and the content of any such instructions depends critically on whether instructions affect verdicts, and this is true regardless of the underlying tax treatment of awards. Although several economists have studied the issue, this is the first empirical study of the impact of tax instructions on damage awards. Part II of this Article describes the current federal income tax treatment of damages and sets out some possible theoretical justifications for that treatment. Part III presents an economic argument for a rule that damage awards for lost earnings should not be reduced to reflect any income taxes that would have been owed even when the awards are not taxable. Part IV outlines the various positions states have taken on the issue. This review demonstrates that states take diametrically opposed positions on this issue. Some states hold it is reversible error to provide an instruction; others hold it is reversible error to not provide an instruction. As we will show, there is no clear consensus among the states. Part V describes an empirical study conducted to determine whether the inclusion of an instruction on the tax treatment of damages had a significant effect on the damages awarded. Part VI discusses the implications of our experiment for the central issue of whether tax jury instructions are helpful and appropriate. We conclude in Part VII.

II. FEDERAL INCOME TAX TREATMENT OF DAMAGES

A. Exclusion of Damages on Account of Physical Injuries

Section 104(a)(2) of the Tax Code states simply that gross income does not include "the amount of any damages (other than punitive damages) received (whether by suit or agreement and whether as lump sum or as periodic payments) on account of personal physical injuries or physical sickness . . . ."[27] The scope of this provision is perhaps surprisingly broad. When the exclusion applies, that is, when the taxpayer receives compensation for a physical injury or sickness, then not only are damages for pain and suffering excluded, but damage awards for emotional harm connected with

26. *Id.* § 13(b).

27. I.R.C. § 104(a)(2). An exclusion for damages has been a part of the U.S. tax system since 1919. Internal Revenue Amendments, Pub. L. No. 65-254, § 213(b)(6), 40 Stat. 1057, 1066 (1919). For a more detailed discussion of the history of the exclusion, see Douglas A. Kahn, *Taxation of Damages After* Schleier *– Where Are We and Where Do We Go From Here?*, 15 QUINNIPIAC L. REV. 305 (1995).

the physical malady,[28] medical expense recoveries,[29] recoveries for predicted future medical expenses, awards for lost wages or earnings (both past and future),[30] and even awards to a spouse for loss of consortium[31] are excluded as well.

A simple example illustrates the tax treatment of damages received on account of a physical injury. Suppose Dennis Defendant is carelessly driving his car and crashes into Paula Plaintiff, who is walking on the sidewalk. Paula sues Dennis for negligence, and the court awards Paula the following amounts: (1) $100,000 for pain and suffering incident to the physical injury;[32] (2) $20,000 for lost past wages; (3) $50,000 for future lost wages; and (4) $15,000 for emotional distress resulting from the physical injury. Under section 104(a)(2) of the Tax Code, this entire damage award would be nontaxable to Paula.[33] All the payments are "on account of personal physical" injury and therefore excluded under the Code.[34] Even though Paula would have earned wages that would have been taxed had she not been injured, no tax is imposed on any part of her recovery. Note that the tax treatment is the same whether Dennis pays the award with his own funds or Dennis has liability insurance that covers the payment to Paula.[35] The result is also the

28. Treas. Reg. § 1.104-1(c)(1) (stating that "damages for emotional distress *attributable to a physical injury or physical sickness* are excluded from income under section 104(a)(2)") (emphasis added). As discussed in more detail below, this differs from the tax treatment of damages awards for emotional or mental harm that is not caused by physical injury for which the defendant is liable. *See* RESTATEMENT (THIRD) OF TORTS: LIAB. FOR PHYSICAL AND EMOTIONAL HARM § 45 cmt. b (AM. L. INST. 2012) (defining "pure or stand-alone emotional harm" as emotional harm that is not "consequential to bodily harm").

29. This exclusion is the least surprising since it is merely reimbursing the taxpayer for an expense. Consistent with that treatment, there is an exception to the exclusion for medical expense reimbursement awards when the award reimburses the taxpayer for medical expenses that the taxpayer had previously deducted. I.R.C. § 104(a). However, this treatment is really a specific application of the tax benefit rule (I.R.C. § 111) rather than some policy exception to I.R.C. § 104(a)(2).

30. This exclusion is arguably the most surprising since those amounts would have been taxed if the taxpayer had not been injured and earned them.

31. H.R. REP. NO. 104-586, at 144 (1996).

32. *See generally* Steven P. Croley & Jon D. Hanson, *The Nonpecuniary Costs of Accidents: Pain-and-Suffering Damages in Tort Law*, 108 HARV. L. REV. 1787, 1789 n.11 (1995) (distinguishing between "physical" loss, referred to as "pain and suffering," and "psychological" harm, which "typically[] [is] emotional distress").

33. I.R.C. § 104(a)(2).

34. *Id.*

35. If the insurance company indemnifies Dennis, he still does not have income although the insurance company satisfies his personal liability. *See* Jeffrey Kahn, *The Tax Treatment of Liability Insurance Coverage*, 163 TAX NOTES 1381, 1381 (2019).

same whether a factfinder determines damages or the parties establish the amount through settlement.[36]

In general, a damage award will be taxable to the recipient in only three situations. First, as section 104(a)(2) explicitly provides, the exclusion does not apply to punitive damages.[37] All punitive damages are thus included in the income of the recipient no matter the nature of the underlying injury.[38] This, of course, may lead to allocation issues when parties settle: the plaintiff has an interest in treating as much of the settlement amount as possible as compensatory damages, and hence not taxable, whereas the defendant cares primarily about the total payment and is indifferent to the proportions deemed punitive and compensatory.[39]

Second, as noted above, awards to compensate for medical expenses are generally excluded under section 104(a)(2).[40] The exclusion, however, does not apply to the extent the plaintiff had previously taken a tax deduction for the payment of medical expenses.[41]

The third and final exception involves damages for an emotional injury.[42] As noted in the example above, when damages are awarded for emotional harm suffered because of a physical injury, they are excluded.[43] In our hypothetical, Paula can exclude under section 104(a)(2) the $15,000 awarded for emotional harm because she received that amount on account of the physical injury she suffered. However, section 104(a) also states, "[f]or purposes of paragraph (2), emotional distress shall not be treated as a physical

36. I.R.C. § 104(a)(2) (stating the amount of damages is excluded whether received "by suit or agreement. . . ").

37. *Id.*

38. *See* Douglas A. Kahn, *Taxation of Punitive Damages Obtained in a Personal Injury Claim*, 65 TAX NOTES 487 (1994) (providing a detailed history of this treatment).

39. *See, e.g.*, Comm'r v. Miller, 914 F.2d 586, 592 (4th Cir. 1990) (remanding case to the Tax Court to determine the allocation of a lump-sum settlement between compensatory and punitive damages).

40. *See* I.R.C. § 104(a).

41. Code § 104(a) provides that gross income includes amounts attributable to "deductions allowed under section 213" (I.R.C. § 104(a)), and section 213 allows taxpayers to take a deduction for "expenses paid during the taxable year, not compensated for by insurance or otherwise, for medical care of the taxpayer, his spouse, or a dependent . . . ." I.R.C. § 213. This is essentially a specific example of the "tax benefit" rule. *See* I.R.C. § 111.

42. *See* Treas. Reg. §1.104-1(c)(1) (explaining that emotional distress is not physical injury (and thus, not excludable) but emotional distress arising from a physical injury may be excluded); I.R.C. § 104.

43. *See supra* note 28 and accompanying discussion; I.R.C. § 104.

injury."[44] Thus, if a taxpayer suffers solely an emotional injury, the exclusion of section 104(a)(2) does not apply to any of the received damages.[45]

This distinction between derivative and pure emotional harm, of course, encourages taxpayers to claim that any emotional harm for which damages were awarded resulted from a physical injury. In several cases, the Internal Revenue Service (the Service) challenged a taxpayer's position that his or her damages were received on account of a physical injury.[46] This distinction still applies even when the taxpayer suffers physical ailments (such as headaches or stomach aches) on account of the emotional distress.[47] In those cases, the Service argues that the damages are still received on account of emotional harm, not a physical injury.[48] The difference in tax treatment between awards

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44. I.R.C. § 104. The statute generally follows tort law. The latest Restatement defines "physical harm" as "the physical impairment of the human body ('bodily harm') . . . . Bodily harm includes physical injury, illness, disease, impairment of bodily function, and death." RESTATEMENT (THIRD) OF TORTS: LIAB. FOR PHYSICAL AND EMOTIONAL HARM § 4 (AM. L. INST. 2010). The Restatement distinguishes between "bodily harm" and "emotional harm." *See id*. at cmts. a, b. If a defendant immediately causes only emotional distress, and that emotional distress is a consequential cause of further emotional distress, all the harm is considered emotional distress, and restrictive recovery rules apply. *See id*. at cmt. d; § 45 cmts. a, b; *see also* RESTATEMENT (THIRD) OF TORTS: REMEDIES § 4(b) (AM. L. INST., Tentative Draft No. 1, 2022) (distinguishing between "harm suffered from the immediate effects of" tortious conduct and "harm suffered later as a further consequence of that conduct or its immediate effects"). Consequential emotional distress is not "physical injury," even if it has some perceptible though minor physical dimension, such as nausea. If the defendant causes emotional distress, and that distress causes significant physical injury, such as a heart attack, the physical injury and the initial emotional distress are treated under the relatively relaxed standards applicable to physical harm. *See* RESTATEMENT (THIRD) OF TORTS: LIAB. FOR PHYSICAL AND EMOTIONAL HARM § 4 cmt. d (AM. L. INST. 2010).

45. *See supra* notes 28, 42 and accompanying text.

46. *See, e.g.*, Murphy v. I.R.S., 493 F.3d 170, 171 (D.C. Cir. 2007). In *Murphy*, the taxpayer had been awarded compensation for emotional distress due to her employer's retaliation against her for reporting her employer's environmental hazards. *Id.* at 171–72. In attempt to exclude the award from taxation under I.R.C. § 104(a)(2), Murphy argued that the damages were received on account of a physical injury. *Id.* at 171. The district court rejected this claim and held that the award was taxable. *Id.* at 172–73. *Murphy* is now a particularly infamous case in this area because, on appeal, the D.C. Circuit Court (wrongly) held that taxing emotional damages was unconstitutional. *See id.* at 173. After an immediate uproar, the same court quickly reversed itself and came to the correct conclusion that Murphy's damages were taxable. *Id.* at 186.

47. *See* G. Christopher Wright, *Taxation of Personal Injury Awards: Addressing the Mind/Body Dualism that Plagues Sec. 104(A)(2) of the Tax Code*, 60 CATH. U. L. REV. 211, 223–26 (2010).

48. For example, suppose the plaintiff sues for emotional distress due to employment discrimination and proves that he or she has suffered headaches and stomach pains on account of the emotional stress. A damage award compensating the plaintiff for the emotional injury will be included income and taxable. The emotional harm was not "on account of" a physical injury. Instead, the physical maladies (the headache and stomach pains) were on account of the

for physical injuries and emotional distress can require segregation of a single award into these components,[49] much as an award may have to be allocated between compensatory and punitive damages.[50] And just as tort plaintiffs want to maximize the proportion of an award treated as compensatory rather than punitive, so too do they want to maximize the proportion of an award attributable to physical injuries rather than emotional distress.[51] The segregation exercise may be particularly acute where an award is for tortious behavior that extends over a length of time, some conduct involving purely emotional harm, and some involving emotional harm stemming from physical injury.[52] There is one exception to this treatment: to the extent the taxpayer has medical expenses on account of the emotional harm, the taxpayer may exclude the award up to the amount of those expenses.[53]

B. Tax Policy Justifications for the Exclusion

For over 100 years, the United States tax system has excluded from income compensation received for physical injuries.[54] Although there has never been a serious movement to revoke this exclusion, it has been narrowed.[55] As noted above, Tax Code section 104(a)(2) applies to compensation on account of "physical" injuries.[56] Prior to 1996, the language referred only to "personal" injuries, and so awards for nonphysical injuries,

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emotional injury. Other than any amounts specifically awarded for the physical ailments, the damages will be included in plaintiff's income. *See* I.R.C. § 104.

49. *See, e.g.*, Zurba v. United States, 247 F. Supp. 2d 951, 965 (N.D. Ill. 2001).

50. *See, e.g.*, Boyle v. Lorimar Prods., 13 F.3d 1357, 1359–60 (9th Cir. 1994).

51. *See, e.g.*, *Murphy*, 493 F.3d at 171.

52. *See, e.g.*, I.R.S. Priv. Ltr. Rul. 200041022 (Oct. 13, 2000).

53. "For purposes of paragraph (2), emotional distress shall not be treated as a physical injury or physical sickness. The preceding sentence shall not apply to an amount of damages not in excess of the amount paid for medical care . . . attributable to emotional distress." I.R.C. § 104(a).

54. *See generally* Sheldon D. Pollack, *Origins of the Modern Income Tax*, 66 TAX LAW. 295 (2013) (explaining the history and origin of the modern income tax). In 1918, the Treasury Department took the position that compensation for physical damages was included in the recipient's income. Treas. Reg. § 33, art. 4 (1918); *see* Kahn, *supra* note 27, at 307. That same year, however, the Attorney General issued an opinion stating that proceeds received from an accident insurance policy were not income. 31 Op. Att'ys Gen. 304, 308 (1918). That ruling led Treasury to revoke its regulation providing that compensation received for personal injuries was included in income. Congress codified that exclusion in the Revenue Act of 1918 (which was enacted in 1919). *See* Internal Revenue Amendments, Pub. L. No. 65-254, § 213(b)(6), 40 Stat. 1057, 1066 (1919).

55. *See, e.g.*, *Murphy*, 493 F.3d at 186 (holding that a narrow interpretation of section 104's exclusion was appropriate over a broader interpretation); Kahn, *supra* note 38, at 487–88 (observing Congress narrowed the scope of section 104's exclusion by eliminating punitive damages from the statute's scope).

56. *Supra* note 27 and accompanying text.

such as emotional harm, could also be excluded.[57] Congress added the physical-injury requirement as part of the Small Business Job Protection Act of 1996 and specifically stated that emotional distress did not qualify as a physical injury.[58]

Whether punitive damages received for a physical injury were covered by the exclusion was also in doubt. In 1989, Congress modified section 104 to clarify that punitive damages received on account of a nonphysical injury would not be covered by the exclusion.[59] This change, however, was not applicable to punitive damages received as part of a claim involving a physical injury.[60] In 1996, Congress modified the provision to state all punitive damages were not covered by the exclusion and thus were taxable to the recipient.[61] While the provision applied prospectively, the Supreme Court held that punitive damages received prior to 1996 were also not covered by the exemption even if received on account of a physical injury and thus were included in the taxpayer's income.[62]

Although it has been narrowed, the exclusion for damages received on account of a physical injury has been part of the United States tax system for over 100 years.[63] Despite this length of time, no definitive answer on why the exclusion exists has yet been given. That is, the tax policy justification for not taxing such receipts has remained vague. As such damages appear to be a clearly realized accession to wealth, the default rule would seem to be inclusion.[64] Therefore, some policy must justify excluding damages received on account of a physical injury.

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57. Soon after the exclusion was first adopted in the United States tax system, the Service took the position that the exclusion in section 104(a)(2) applied only to damages recovered for physical injuries. *E.g.*, Sol. Mem. 1384, 2 C.B. 71 (1920); *see* Douglas A. Kahn, *Compensatory and Punitive Damages for a Personal Injury: To Tax or Not to Tax?,* 2 FLA. TAX. REV. 327, 331 (1995). However, a few years later, the Service repudiated that position. *Id.*; Sol. Op. 132, I-1 C.B. 92 (1922). The issue was not resolved until the Supreme Court recognized in 1992 that the exclusion also applied to damages recovered for nonphysical injuries, "such as those affecting emotions, reputation, or character." United States v. Burke, 504 U.S. 229, 235 n.6 (1992).

58. Small Business Job Protection Act of 1996, Pub. L. No. 104-188, § 1605(b) 110 Stat. 1838 (1996).

59. James Serven, *The Taxation of Punitive Damages: Horton Lays an Egg*, 72 DENV. U. L. REV. 215, 260 (1995).

60. *Id.*

61. James Chris Cochran, *Careful with That Tax, Eugene: The Taxation of Punitive Damage Awards Under Section 104 of the Internal Revenue Code*, 28 CUMB. L. REV. 117, 117 (1998).

62. O'Gilvie v. United States, 519 U.S. 79, 83, 86 (1996).

63. Kahn, *supra* note 27, at 305.

64. The Supreme Court set out the generally accepted definition of income as "instances of undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion." Comm'r v. Glenshaw Glass Co., 348 U.S. 426, 431 (1995).

A thorough economic analysis of the tax policy is beyond the scope of this Article. But commentators have suggested several possible justifications.[65] The following survey briefly reviews them. While none on their own appear strong enough to support the exclusion, the sum of the group may be stronger than each part.[66]

One of the strongest possible justifications for the exclusion may be psychological—that is, either sympathy for the recipient who has been physically injured or killed and/or distaste that the government may profit from injury.[67] There is something unseemly about the government taking a percentage away from a person who has been physically injured or killed.[68] While tort damages are meant to compensate the plaintiff, money is never a perfect substitute for what was lost,[69] and so reducing the plaintiff's ultimate recovery by taxing the damages award leaves the party with an amount that may fall far short of full compensation.[70]

Another possible justification stems from both the involuntary and personal nature of the circumstances leading to the income. In several situations, because of the involuntary nature of the transaction, the tax system allows a taxpayer to avoid gain that he or she would have otherwise had to recognize.[71] For example, compare two taxpayers. Taxpayer A owns an automobile with a basis of $10,000. That taxpayer sells the car for $15,000 to an unrelated party. Taxpayer A will recognize the $5,000 gain as income. This is true even if the taxpayer reinvests the $15,000 in a new car. In contrast, assume Taxpayer B also owns an automobile with a basis of $10,000. Someone negligently destroys B's car, and an insurance company pays B $15,000 compensation for the destroyed property. While, like A, B realizes a $5,000 gain on the receipt of that payment, Code section 1033 allows B to elect to not recognize (that is, not pay taxes on) that gain as long as B reinvests

65. *See generally* Kahn, *supra* note 57, at 340–52 (discussing potential explanations of the exclusion).

66. *Id.* at 348 ("[T]he cumulative effect of the combination of the factors may be sufficient.").

67. *See id.* at 349.

68. *Id.* ("If the government were to tax damages for the loss of a body part (or the death of a relative), it would seem to many to have engaged in a vulturous act–analogous to feeding off the flesh of a dismembered arm or leg or off of the corpse of a recently departed.").

69. RESTATEMENT (THIRD) OF TORTS: REMEDIES § 20 cmt. B (AM. L. INST., Tentative Draft No. 2, 2023) (observing that "money is an especially poor substitute for the absence of pain or distress").

70. *Cf.* Kahn, *supra* note 57, at 340 (discussing the idea the "amount payable to the victim would have to be increased to cover some part of the tax on the damages").

71. *See, e.g.*, I.R.C. § 1033 (statutory provision providing for non-recognition of gain on converted (i.e., stolen) property).

at least $15,000 in another car.[72] This treatment is appropriate because of the involuntary nature of the transactions (Code section 1033 is titled "Involuntary Conversions").[73] To be sure, unlike in the case of damages for physical injuries, the realized gain that occurs when compensated for damaged property is merely deferred rather than avoided altogether.[74] But this result makes no sense in the physical injury situation, as the injured (or deceased) taxpayer cannot reinvest in anything.[75]

In addition, the tax system tends to stay out of purely personal, as opposed to commercial, transactions.[76] As noted above, the taxpayer did not voluntarily trade his or her physical well-being for cash. By contrast, selling plasma or illegally selling organs[77] would be taxable transactions. Although they involve personal aspects of the taxpayer, the taxpayer has entered the commercial space voluntarily.[78]

Other, weaker justifications have also been raised. For example, Treasury itself initially suggested that such payments should not be included in income because they were merely a return of capital.[79] Essentially, the argument is that there is no income because the money merely compensates the victim for what was lost.[80] That is, in a sense, there is no gain—the taxpayer is merely

72. *Id.* § 1033(a)(2)(A) ("If the taxpayer . . . for the purpose of replacing the property so converted, purchases other property similar or related in service or use to the property so converted[] . . . the gain shall be recognized only to the extent that the amount realized upon such conversion . . . exceeds the cost of such other property . . . ."). Thus, in our example, as long as B spends $15,000 or more on a new car, B will be able to avoid the initial realized gain.

73. *See id.* § 1033.

74. Assume B spends the entire $15,000 proceeds on a new car. While normally B's tax basis would be determined by what B paid for the asset, under section 1033, B will have the same basis in the new car as B had in the old car. Thus, the deferred gain may end up being recognized later if B later sells the new car.

75. *See* Kahn, *supra* note 57, at 347 ("In most such cases, the taxpayer has no means of reinvesting the proceeds in something similar or related in service or use to the destroyed item. If such a replacement can be located, the replacement usually is only partial, and its cost is often substantially less than the amount of damages suffered by the taxpayer.").

76. *See infra* notes 77-78 and accompanying text.

77. The National Organ Transplant Act prohibits the sale of human organs but does not prohibit the sale of a person's blood. 42 U.S.C. § 274(e).

78. *See* United States v. Garber, 607 F.2d 92, 99–100 (5th Cir. 1979) (discussing the issue of voluntariness in reversing a tax evasion conviction when the defendant was selling plasma). *See generally* Jeffrey H. Kahn, *GoTaxMe: Crowdfunding and Gifts*, 22 FLA. TAX REV. 180 (2018) (explaining how using commercial organizations such as GoFundMe may turn "gifts" into taxable income).

79. *See* T.D. 2747, 20 Treas. Dec. Int. Rev. 457 (1918). That decision cited three Supreme Court cases as the basis for excluding damage payments. None of those cases involved the taxation of damages for injuries, but instead dealt with situations where the Supreme Court held that return of "capital" should not be taxed as income. *E.g.*, Lynch v. Turrish, 247 U.S. 221, 230–31 (1918).

80. *See* F. Patrick Hubbard, *Making People Whole Again: The Constitutionality of Taxing Compensatory Tort Damages for Mental Distress*, 49 FLA. L. REV. 725, 742 (1997).

being made whole. On its own, this justification is weak.[81] The main counter to it is that the question is not whether the taxpayer is being made "whole," but whether it is a measurement of his or her tax gain or loss.[82] For example, if Taxpayer A owns common stock with a basis of $10,000 and sells the stock to an unrelated party for $100,000, that taxpayer has a $90,000 gain. It is not an argument to say that the cash made the taxpayer "whole"—the tax basis is used to measure gain or loss. The taxpayer has the burden of proving basis,[83] so the "loss of human capital" theory does not, on its own, provide sufficient support for the exclusion.[84]

Finally, and importantly, the exclusion might be justified on the ground that damages are replacing value that otherwise would not have been taxable to the recipient or lost dollars that the taxpayer was required to spend on account of the defendant's carelessness.[85] Take pain and suffering, for example. Damages for this compensate the victim for the pain they endured in the past and may endure in the future.[86] Without the injury, the plaintiff would presumably have less physical discomfort. The money paid to the plaintiff is meant to replace the loss of pain-free living. Living pain-free is not value that is taxed to the recipient. So, pain and suffering awards are replacing something that would not have otherwise been taxed to the plaintiff. Similarly, some jurisdictions allow recovery for loss of the enjoyment of life, either as part of pain and suffering or independently.[87] Enjoyment of life would not have been taxed.

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81. *See* Kahn, *supra* note 57, at 346–47 (noting that while the return of capital theory has some "superficial appeal[] . . . it does not withstand scrutiny").

82. Hubbard, *supra* note 80, at 733–34 (discussing gain as a requirement for taxation of income).

83. With few exceptions, the taxpayer has the burden of proof versus the Internal Revenue Service. *See* Welch v. Helvering, 290 U.S. 111, 115 (1933).

84. *See* Hubbard, *supra* note 80, at 740 (criticizing the loss of "human capital" theory because human capital has no identifiable value reflecting the taxpayer's investment).

85. *Cf. id.* at 727 (noting that "damages for mental trauma do not replace something, like lost wages, that would otherwise be income" in trying to explain whether emotional damages constitute income).

86. *See* RESTATEMENT (THIRD) OF TORTS: REMEDIES § 20 cmt. B (AM. L. INST., Tentative Draft No. 2, 2023) ("Any tort system committed to the rightful-position standard and make-whole relief . . . must recognize that full compensation includes compensation for the physical and emotional pain and related harms accompanying bodily harm.").

87. *See, e.g.*, McDougald v. Garber, 536 N.E.2d 372, 375–76 (N.Y. 1989); *id.* at 377 (Titone, J., dissenting) (stating that a clear distinction exists between "loss of enjoyment of life" and "pain and suffering"). *See generally Loss of Enjoyment of Life as a Distinct Element or Factor in Awarding Damages for Bodily Injury*, 34 A.L.R.4th 293 §§ 3, 4[a]-[c], 4.5 (originally published 1984) (surveying states). The tentative draft of the Restatement (Third) of Torts on remedies treats "loss of capacity to enjoy life" as compensable and as part of the umbrella term "pain and suffering." RESTATEMENT (THIRD) OF TORTS: REMEDIES § 20 cmt. C (AM. L. INST., Tentative Draft No. 2, 2023).

The justification is even stronger for reimbursements of medical expenses (past and possible future).[88] The defendant (or the defendant's liability insurance company) is merely reimbursing the plaintiff for dollars that the plaintiff must spend on account of the defendant's actions. Here, the plaintiff experiences no economic gain since the defendant is merely replacing lost dollars that the plaintiff would not have otherwise spent.[89]

These considerations also support the Code's taxation of punitive damages, whether received on account of a physical injury or not. Punitive damages are not compensatory[90]—they do not replace lost dollars or replace something of value that would not have otherwise been taxed. Although it leads to some administrative allocation difficulty,[91] taxing punitive damages does not make the taxpayer worse off than if he or she had not been injured.

Tax policy difficulties appear, however, in the tax treatment of lost earnings and damages received solely for emotional injury.[92] In the lost earnings case, damages replace something that would have been taxed if the taxpayer had not been injured and had collected earnings. If a taxpayer is physically injured and as a result loses $100,000 of earnings, why should the taxpayer be able to exclude the full $100,000 award when, without the injury, he or she would have received only the net amount of the earnings after paying taxes? A fully satisfactory answer is hard to see. One explanation is that Congress recognizes that money is never a perfect substitute for what the victim has suffered and lost because of the physical injury.[93] While foregone earnings provide juries with a somewhat simple mathematical method of

88. *See* Kahn, *supra* note 57, at 346 (explaining that reimbursement for medical expenses is excluded from income and that medical expense reimbursements "*should not be* taxable") (emphasis added).

89. *Cf.* Clark v. Comm'r, 40 B.T.A. 333, 335 (1939) (using similar reasoning). There, a lawyer provided bad advice to the Clarks, which caused them to have to pay a significant amount more in tax than they would have if the lawyer had provided better advice. *Id.* at 334. The lawyer agreed to reimburse the Clarks for the amount of tax his mistake caused them to pay. *Id.* at 334–35. The Service argued that payment was income to the Clarks. *Id.* The Board of Tax Appeals (the former name of what is now the Tax Court) disagreed and held that the payment was merely a reimbursement of a loss caused by the lawyer and therefore was a nontaxable return of capital. *Id.* at 335.

90. Hubbard, *supra* note 80, at 742 (observing that "punitive damages do not fall within the exclusion because they do not compensate . . . ") (internal quotation marks omitted). *See* RESTATEMENT (THIRD) OF TORTS: REMEDIES § 1 and cmt. c (AM. L. INST., Tentative Draft No. 1, 2022) (distinguishing between compensatory damages and punitive damages).

91. *See* Hubbard, *supra* note 80, at 740 (analyzing whether taxation of punitive damages "worth the administrative difficulties").

92. *See id.* at 727 (writing at the time congress shifted to a narrower, newer approach towards taxation of emotional damages that "there may be merit in the new approach" as well as "serious constitutional questions" at play with requiring that emotional damage stem from physical injury to qualify for section 104's exclusion).

93. *See* Hubbard, *supra* note 80 and accompanying text.

calculating loss, the payment represents more than replacing lost taxable dollars.

A better possible justification is that Congress has determined that this group of taxpayers deserves favorable tax treatment. Congress, of course, provides favorable treatment for all types of groups and activities.[94] Congress is undoubtedly aware that awards for lost earnings are frequently part of the compensation package for physical injuries. Despite the fact that the award is replacing something that would have been taxable, Congress has purposely kept the exclusion for such awards.[95] This would suggest that Congress views those who have been physically injured as a group that may deserve some special and favorable tax treatment. If one accepts this policy justification, it will bear heavily on what the correct rule is for the issue of whether tax instructions should be provided to a jury.

The justification offered for physical pain and suffering would appear to apply to damages received for pure emotional distress. The damages received are compensatory: they are meant to replace the loss of mental well-being that the plaintiff would have had without the negligence of the defendant. Of course, a general sense of emotional well-being is not taxable. So again, damages in pure emotional distress cases appear to be replacing something of value that would not have been taxed if the plaintiff had experienced it. Why, then, are these awards taxed?

Several possible reasons may explain the disparate treatment of emotional damages that do and do not derive from a physical injury. One possibility is that Congress simply does not view taxpayers who suffer only emotional distress to be as sympathetic as those who have been physically injured.[96] Throughout legal history, emotional harm has been viewed with much more suspicion than physical harm.[97] In the world of torts, injured plaintiffs with emotional harm that does not derive from a physical injury are subject to significantly more stringent conditions in lawsuits against a careless

94. For example, expenses connected with an investment rental activity are currently deductible while expenses connected with investment stock trading are not. *See* I.R.C. § 62(a)(4) (demonstrating Internal Revenue Code's differential tax treatment of expenses depending on activity).

95. *See* Hubbard, *supra* note 80, at 744 (explaining Congressional decision to shift to an approach that was narrower and provided exclusion for "physical injuries").

96. *Cf.* Kahn, *supra* note 57, at 350 (arguing that the compassion rationale underlying potential congressional motivation "has much greater force . . . for physical injury than when the injury is not physical").

97. *See* Wright, *supra* note 47, at 236 (noting that a version of the Restatement (Third) of Torts has a narrower definition of physical injury to prevent dilution of physical injury's definition by injuries that are merely emotional).

defendant.[98] The taxation of these damages may be a continuation of the disfavored status of pure emotional harm.

Given possible tax policy justifications, the question remains: does the tax system reach the right result with its current treatment? That is, is excluding payments received for physical injuries while taxing payments received for pure emotional harm sound tax policy? This Article does not and, as we will explain below, need not resolve these questions. Our focus is the treatment of tax consequences when providing information to juries determining damages in tort cases.

As we will discuss, the optimal tort damages rule and possible jury instructions to implement it do not depend on the tax treatment of damages. Whether the damages are included or excluded from taxable income does not dictate the efficient tort rule or rule of trial practice.[99] That is, the question for us is still this: will providing an instruction on the taxation of damage awards (no matter what the tax rule is) lead to more efficient damage awards? In a physical injury case, that instruction may be that the award will be excluded. In a case of discrimination that causes emotional distress, that instruction may be that the award will be taxable. In both cases, the instructions might note that punitive damages are taxable. We leave the appropriate tax treatment of damages to the readers and another day.

III. TOWARD AN EFFICIENT TORT RULE

We take as our starting point an economic goal of tort law: the maximization of social wealth.[100] Other normative approaches exist, of course, and this Article is not the place to delve into the arguments for the different approaches.[101] We note, though, that efficiency is relevant whatever the normative goal, and our conclusions, therefore, are not necessarily inconsistent with different frameworks.

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98. The Restatement (Third) of Torts distinguishes between emotional harm that produces bodily harm and is consequential to bodily harm on the one hand, and pure or stand-alone emotional harm on the other. RESTATEMENT (THIRD) OF TORTS: LIAB. FOR PHYSICAL & EMOTIONAL HARM § 45 cmt. b (AM. L. INST. 2012). The ability to recover for the former is governed by traditional tort rules. By contrast, recovery of negligently caused pure emotional distress is limited to two situations, where the tortfeasor's conduct places the victim in the zone of physical danger or occurs in the course of a limited set of activities. *Id.* § 47 cmt. a.

99. *See infra* notes 123-124 and accompanying text.

100. *See* GUIDO CALABRESI, THE COSTS OF ACCIDENTS 26–31 (1970) (discussing reduction of accident costs as a goal of the tort law system); WILLIAM M. LANDES & RICHARD A. POSNER, THE ECONOMIC STRUCTURE OF TORT LAW 15–17 (1987); LOUIS KAPLOW & STEVEN SHAVELL, FAIRNESS VERSUS WELFARE 86 (Harv. L. Rev. Ass'n ed., 2002).

101. *See, e.g.*, Ronald M. Dworkin, *Is Wealth a Value?*, 9 J. LEGAL STUD. 191, 191 (1980) (arguing that the theory of wealth maximization represents a "normative failure").

The economic approach to tort law focuses primarily on the social costs of behavior and secondarily on the social costs of administering a tort system.[102] Social wealth, or efficiency, implies the minimization of the full costs of tortious conduct.[103] We focus on unintentional torts, or accidents, because they account for the great majority of torts,[104] though much of our analysis could be extended to intentional torts.

The primary importance of the social costs of behavior implies a focus on deterrence.[105] In general, rules should induce actors to take precautions to avoid injuries up to the point at which the marginal cost of an additional precaution equals the marginal reduction in expected accident costs the precaution would bring about.[106] The expected accident cost is the probability of the accident multiplied by the cost of the accident.[107] This principle recognizes that precautions can be taken either by injurers or victims, and the social costs of precautions are the sum of the two.[108]

A secondary, though important, concern of the economic approach to tort law is the administrative costs of operating a tort system.[109] Administrative costs are real social costs.[110] If an optimal level of deterrence can be achieved more cheaply by one set of substantive and procedural tort rules than another, efficiency requires adoption of the first set. More precisely, efficiency requires the minimization of the sum of expected accident costs, precaution costs, and administrative costs.

Tort liability rules tend to create optimal deterrence.[111] The primary liability standard in tort law is negligence, and a negligence standard confronts the actor with the prospect of liability if, but only if, the actor fails to incur the private costs of optimal precautions.[112] In some settings, strict liability creates

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102. *See* CALABRESI, *supra* note 100, at 26–28.

103. *See* Robert Cooter, *Unity in Tort, Contract, and Property: The Model of Precaution*, 73 CALIF. L. REV. 1, 1 (1985).

104. *See* James A. Henderson, Jr., *Why Negligence Dominates Tort*, 50 UCLA L. REV. 377, 402 (2002).

105. *See* LANDES & POSNER, *supra* note 100, at 10–11; CALABRESI, *supra* note 100, at 68–69.

106. *See* RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 213–15 (8th ed. 2011).

107. *Id.* at 213.

108. *See* Dhammika Dharmapala & Sandra A. Hoffmann, *Bilateral Accidents with Intrinsically Interdependent Costs of Precaution* 1 (Univ. of Conn. Dep't of Econ., Working Paper No. 2002-11, 2002); Cooter, *supra* note 103, at 3, 6.

109. CALABRESI, *supra* note 100, at 28.

110. *See id.* at 29–30 (stating that administrative costs factor into economic analysis just as much as the cost of "further reduction of speed limits" and other more "primary" costs).

111. *See* LANDES & POSNER, *supra* note 100, at 23–24 (stating "most . . . tort doctrines are efficient"); Guido Calabresi, *Optimal Deterrence and Accidents*, 84 YALE L.J. 656, 656 (1975) (describing "optimal deterrence" as the minimization of "accident and accident prevention costs") (emphasis omitted).

112. *See* Calabresi, *supra* note 111, at 658.

incentives for optimal behavior by insuring the actor internalizes all costs associated with his or her behavior in all cases.[113] In analyzing the tax treatment of damage awards, we need not be concerned with the liability rule that triggers the legal obligation to pay damages. We assume that liability was properly imposed, be it under the negligence standard, strict liability, or even for commission of an intentional tort.

The principles set out above imply that the economic approach to tort law is not directly concerned with compensation, even though compensation is typically viewed as a primary tort goal.[114] A tort system that optimally deters conduct can result in fewer accidents and lower expected accident costs than would otherwise prevail and therefore reduce the need for compensation.[115] Compensation is not irrelevant. The prospect of compensation can induce prospective victims to avoid taking excessive precautions, and it can create incentives for efficient private enforcement of tort law.[116] But in an economic framework, compensation is not a primary objective.[117] The key is that the tortfeasor be required to pay, not who he or she is required to pay.[118]

Optimal deterrence depends on the concept of internalization.[119] An actor must incur the total costs of his or her conduct.[120] The cost of precautions is private; accident costs are visited on others.[121] To induce the actor to take optimal, or cost-justified, precautions, the actor must be confronted with a choice between incurring the cost of an additional precaution and the cost failure to take that precaution will impose on others. If a rational actor internalizes both precaution and expected accident costs, the actor will choose the level of precautions that minimizes the sum of the two.[122]

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113. *See*, *e.g.*, POSNER, *supra* note 106, at 226–27; Richard A. Epstein, *A Theory of Strict Liability*, 2 J. LEGAL STUD. 151, 170–71 (1973) (stating "[t]he plaintiff's conduct provides no defense for the defendant[]" under a strict liability regime); Richard A. Epstein, *Toward a General Theory of Tort Law: Strict Liability in Context*, 3 J. TORT L. 13 (L. & Econs. Rsch. Paper Series, Working Paper No. 10-46, 2010).

114. *See* CALABRESI, *supra* note 100, at 27.

115. *See* LANDES & POSNER, *supra* note 100, at 9–10; RESTATEMENT (THIRD) OF TORTS: REMEDIES § 2 cmt D. (AM. L. INST., Tentative Draft No. 1, 2022).

116. *Cf.* Cooter, *supra* note 103, at 6 (noting the rule of strict liability with perfect compensation gives a victim no incentive to take precaution).

117. *See* CALABRESI, *supra* note 100, at 27.

118. *See* Calabresi, *supra* note 111, at 660–62; RESTATEMENT (THIRD) OF TORTS: REMEDIES § 2 cmt D. (AM. L. INST., Tentative Draft No. 1, 2022).

119. *See* Cooter, *supra* note 103, at 3–4. *See generally* Ronald H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1 (1960).

120. *See* Cooter, *supra* note 103, at 3.

121. *See id.*; Dharmapala, *supra* note 108, at 1–2.

122. *See* POSNER, *supra* note 106, at 213–14 ("When . . . the person taking precautions and the person who may be injured if they are not taken are the same, the optimal precautions will be achieved without legal intervention.").

To achieve optimal deterrence, therefore, when an actor is held liable, the primary measure of damages must be the cost he or she imposed on others.[123] Imposing that cost on the tortfeasor will effectively force the actor to internalize the costs of his or her conduct, creating an incentive for the actor to take all but only those precautions that are cost-justified.[124] As a first approximation, the cost imposed on others is the compensatory damages suffered by the tort victim.[125] Compensation becomes important in achieving efficient outcomes, but not because of the intrinsic value of compensation.[126] It becomes the method by which the law creates incentives for optimal conduct and administrative efficiency.[127]

All of the analysis so far implies a causal relationship between an untaken precaution and an injury that would have been avoided if the precaution had been taken. Compensatory damages are a measure of the loss imposed on others that would have been avoided but for the tortious conduct.[128] When all external costs are incurred by the tort victim, an accurate calculation of the victim's loss and an award of damages to the victim in that amount achieves perfect compensation and optimal deterrence, putting aside the costs of risk aversion.[129] The tortfeasor is forced to internalize the costs of his or her conduct.[130] But, if the tortfeasor inflicts losses that are not borne by a tort plaintiff, an award of compensatory damages, which makes the plaintiff whole, does not create optimal deterrence.[131] Prospective tortfeasors are systematically under-deterred by the prospect of compensatory damages. To be sure, any damages deter to some degree. But if damages do not reflect the total cost of tortious behavior, they do not force the tortfeasor to internalize the full costs of his or her conduct.[132]

The law may confront a choice between over-compensation and under-deterrence. For example, if some actors suffer losses as a result of a tort but are not permitted to sue, a victim who is permitted to sue may be allowed to recover damages that include the losses suffered by those who cannot sue. Such an award would over-compensate the plaintiff, but it would achieve

123. *See* LANDES & POSNER, *supra* note 100, at 13 (noting that an externality exists "if damage awards in tort cases underestimate victims' losses").

124. *See* RESTATEMENT (THIRD) OF TORTS: REMEDIES § 2 cmt D. (AM. L. INST., Tentative Draft No. 1, 2022).

125. *See* Calabresi, *supra* note 111, at 660–62; RESTATEMENT (THIRD) OF TORTS: REMEDIES § 2 cmt D. (AM. L. INST., Tentative Draft No. 1, 2022).

126. *See* CALABRESI, *supra* note 100, at 27.

127. *See supra* notes 119-126 and accompanying text.

128. RESTATEMENT (THIRD) OF TORTS: REMEDIES § 2 (AM. L. INST., Tentative Draft No. 1, 2022).

129. *See* Calabresi, *supra* note 111, at 657–60.

130. *See supra* note 124 and accompanying text.

131. *See infra* note 147 and accompanying text.

132. *Cf.* Cooter, *supra* note 103, at 6.

optimal deterrence. Conversely, if the victim who can sue is allowed to recover only his or her damages, the victim is optimally compensated, but the tortfeasor is under-deterred.

When confronted with a choice between over-compensation and under-deterrence, efficiency is generally better served by over-compensation.[133] To repeat, the deterrence model of tort law cares more about creating optimal incentives for behavior than identifying the beneficiary of the monetary sanction imposed on the tortfeasor.[134]

Compensatory damages for a tort plaintiff are the costs the individual incurred that he or she would not have incurred but for the tort.[135] In a typical personal injury case, these costs include lost earnings and earning capacity, other pecuniary losses, especially medical expenses, and nonpecuniary damages, consisting primarily of pain and suffering and emotional distress.[136] Medical expenses and nonpecuniary loss would not have been suffered absent the tort, and they must be included in a damage award if the award is to create optimal deterrence.[137] This result does not depend on the tax treatment of these awards.[138] Nevertheless, these amounts do not replace value that would have been taxed absent the tort, and as we have argued, no compelling justification exists for taxing them.

Lost earnings and earning capacity are different. Absent the tort, earnings would have been taxed.[139] One can argue, therefore, that to achieve accurate compensation, damage awards for these elements must be net of the taxes that would have been due absent the injury.[140] This, indeed, was the premise of *Liepelt*.[141] The statute there allowed the recovery of compensatory damages,

133. *See id.* at 34 ("[T]he assessment of damages need not be perfect under a fault [*i.e.*, negligence] rule, because moderate variability in damages will not affect precaution."). *But see* POSNER, *supra* note 106, at 243–44 (discussing some of the economic disadvantages of overcompensation despite implying overall efficiency depends on at least avoiding underdeterrence).

134. *See supra* note 118.

135. *See* RESTATEMENT (THIRD) OF TORTS: REMEDIES § 2 (AM. L. INST., Tentative Draft No. 1, 2022) ("A plaintiff who establishes a defendant's liability in tort generally is entitled to a remedy or remedies that will place that plaintiff, as nearly as possible, in the position the plaintiff would have occupied if the tort had not been committed.").

136. RESTATEMENT (THIRD) OF TORTS: REMEDIES § 15 (AM. L. INST., Tentative Draft No. 1, 2022). To avoid over-compensation and over-deterrence, awards for future pecuniary loss must be discounted to present value. *See* POSNER, *supra* note 106, at 244.

137. *See supra* notes 123-134 and accompanying text.

138. *See supra* notes 25-26 and accompanying text.

139. *See* I.R.C. § 61(a)(1) (stating compensation is included in one's taxable income).

140. *See supra* notes 11-14 and accompanying text.

141. *See* Norfolk & W. Ry. v. Liepelt, 444 U.S. 490, 499 (1980) (Blackmun J., dissenting); *supra* Part I.

and recovery of gross income exceeded compensation.[142] But the proper economic approach requires a sanction imposed on the tortfeasor that approximates the costs he or she imposes on others.[143] The victim's tax liability for earnings reflects a benefit for those supported by the government. By preventing those earnings, the tortfeasor imposes a loss—not only on the victim—but on the public as well.[144] To deduct taxes saved from an award of damages for lost earnings is to create a category of actors whose loss is not reflected in the sanction for the tortious conduct.[145] It results in under-deterrence, and hence excessive tortious conduct.[146]

In some cases, the law may efficiently deny tort standing to those who suffer loss, if, for example, their injuries are remote and difficult to prove. For example, employers are not allowed to recover the economic damages they suffer when a tortfeasor injures an employee.[147] Those other than close relatives cannot recover the emotional damages they suffer when they observe a person traumatically injured by a tortfeasor.[148] But when the victim is the government, or more accurately beneficiaries of the government, the losses are automatically and easily established by the tort plaintiff, who effectively stands as an intermediary between the tortfeasor and the government.[149] And even if the rule prohibiting injured parties from recovering damages in some contexts is inefficient, the fact that the law inefficiently precludes recovery in those contexts is no justification for an inefficient rule in the tax context. In the end, the efficient tort rule treats awards for lost earnings and earning capacity as gross amounts, not amounts net of taxes.[150] That achieves optimal deterrence, and optimal deterrence is the economic objective, even if awards over-compensate plaintiffs.[151]

The idea that damages might exceed the loss incurred by the plaintiff yet nevertheless be deemed "compensatory" is not limited in tort law to taxes

142. *See* Liepelt v. Norfolk & W. Ry., 444 U.S. at 493 (explaining that under FELA, the employee (or the employee's estate) is entitled to "pecuniary benefits . . . [which] might have been reasonably received . . . ") (internal quotation marks omitted).

143. *See* RESTATEMENT (THIRD) OF TORTS: REMEDIES § 2, cmts. B, D (AM. L. INST., Tentative Draft No. 1, 2022); *supra* notes 114-118 and accompanying text.

144. *Cf.* POSNER, *supra* note 106, at 253 (discussing the possibility that the government can be a "victim of the accident" that should be permitted to recover in the context of an unemployment hypothetical).

145. *See* CALABRESI, *supra* note 100, at 6 (noting insufficient compensation is a cost to the victim).

146. *See supra* notes 130-133 and accompanying text.

147. RESTATEMENT (THIRD) OF TORTS: LIAB. FOR ECON. HARM § 7 cmt. a (AM. L. INST. 2020).

148. *See* RESTATEMENT (THIRD) OF TORTS: LIAB. FOR PHYSICAL & EMOTIONAL HARM § 48 (AM. L. INST. 2012).

149. *See supra* note 144 and accompanying text.

150. *See supra* notes 123-127 and accompanying text.

151. *See supra* note 133 and accompanying text.

avoided. The substantive collateral tort rule holds that benefits received because of a tort by a tort victim from a source other than the tortfeasor do not generally reduce the damages for which the tortfeasor is liable.[152] When the rule applies, the victim receives more in damages than the monetary value he or she would have had absent the tort. For example, if a relative gives the injured victim $10,000 out of compassion, the tortfeasor is not entitled to a $10,000 reduction in damage liability. In some sense, the victim is over-compensated by $10,000. But the collateral source rule makes economic sense.[153] It encourages investments in insurance and acts of charity, recognizing that compensatory damages are not likely to make the victim whole, and it avoids under-deterring tortfeasors.[154] A rule that allows recovery of gross lost income creates optimal deterrence, and like the collateral source rule, it need not over-compensate.[155]

An analysis of the effect of taxation on tort damage awards can usefully be divided into four components: 1) the tax rule; 2) the tort rule; 3) evidentiary rules; and 4) jury instructions. In the last section, we discussed the tax rule, and so far in this section, we have addressed the tort rule. The appropriate tort rule is that damage awards equal medical expenses, nonpecuniary loss, and gross lost income.[156] Focusing on lost income, the tort rule is invariant to a change in the tax rule. If, for example, Congress changed the tax law to treat damage awards for lost earnings as taxable income, the optimal tort rule would not change. Efficiency would require that the tort sanction equal gross lost earnings—nothing more, nothing less. If tax law changed, the plaintiff would ultimately recover an amount that more closely approximates the income he or she would have had absent the tort, but the government, as a victim of the tort, would be made whole. The award would optimally deter, and it might more accurately compensate, when the government is recognized as a victim. But efficiency is concerned primarily with deterrence, not compensation, and whether the government chooses to exercise its right to be made whole or not is a matter of indifference to the tort rule. That choice is distributive, not allocative.

The last two components of the analysis implicate efficiency, but they relate mostly to the costs of administering the tort system. The optimal tort

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152. RESTATEMENT (THIRD) OF TORTS: REMEDIES § 10 (AM. L. INST., Tentative Draft No. 1, 2022).

153. *See* POSNER, *supra* note 106, at 253 (noting that permitting a defendant to benefit from a plaintiff's insurance policy would result in underdeterrence).

154. *See id.*; Terrance L. Tarver, *Charity Case: Is a Donation a Collateral Source?*, NASSAU CNTY. BAR ASS'N, https://www.nassaubar.org/articles/charity-case-is-a-donation-a-collateral-source/ [https://perma.cc/SU53-ZQUX].

155. In any event, over-compensation is preferable to under-deterrence as a matter of efficiency. *See supra* note 133 and accompanying text.

156. *See id.*

rule itself not only reduces primary accident costs but also administrative costs.[157] If the tort rule were that plaintiffs are entitled to net lost earnings, the amount of taxes that would have been paid becomes relevant. A court would most likely have to allow the submission of evidence on taxes, with rebuttal witnesses and cross-examination, as well as closing arguments related to the evidence. A jury would be required to resolve factual issues surrounding taxation. Evidence, argument, and resolution of factual disputes are avoided when the tort rule requires only a determination of gross lost earnings. In a nutshell, trial is cheaper.

The point of jury instructions is to achieve damages awards consistent with the tort rule. Stated otherwise, the goal is accurate awards, with accuracy measured in relation to the chosen tort rule. If, as we have argued, the optimal tort rule is that damage awards should equal the plaintiff's medical expenses, nonpecuniary damages, and gross lost income, what, if anything, should the jury be told about taxation?

Notice that if the jury awarded an amount greater than its determination of the plaintiff's medical expenses or nonpecuniary loss, believing that the award would be taxed and wanting to make the plaintiff whole—if, in other words, the jury grossed up the award by an imputed tax rate—the result would be inaccurate. Similarly, if the jury awarded an amount less than the plaintiff's gross lost earnings, believing that the award would be taxed and not wanting the plaintiff to be over-compensated, the result would be inaccurate. In either case, the jury might be mistaken about the tax rule or the tort rule, and the mistake could lead to errors. The simple solution appears to be to inform the jury as to what they should do. But appearances can be deceptive.

To begin with, giving any instruction entails an administrative cost. It has to be formulated, and it may be disputed by the parties. The length and content of instructions could vary. Moreover, any tax instruction adds to the other charges the jury receives, and the totality of charges imposes a cognitive burden on the jury.[158] As instructions grow in number and complexity, the task of the jury to understand and to apply them becomes harder. Further, any tax charge would have to be consistent with other instructions the jury receives, lest jurors be confused. Importantly, juries are typically given a general charge in personal injury cases on the meaning of compensatory damages.[159] A tax charge that instructs the jury to ignore the fact that an award

157. *See* CALABRESI, *supra* note 100, at 28.

158. Max Rogers, *Laypeople as Learners: Applying Educational Principles to Improve Juror Comprehension of Instructions*, 115 NW. UNIV. L. REV. 1185, 1191 (2021).

159. For example, the relevant instruction in Connecticut is as follows:

> Insofar as money can do it, the plaintiff is to receive fair, just and reasonable compensation for all injuries and losses, past and future, which are proximately caused by the defendant's proven negligence. Under this rule, the purpose of an award

for lost earnings will not be taxed is to implicitly tell the jury that an award for lost earnings should not be compensatory after all.[160]

Jury instructions pose a more subtle risk as well: errors of cognitive bias.[161] The field of behavioral economics explores cognitive biases. A tax instruction, even if it accurately informs the jury as to its task in determining damages consistent with the optimal tort rule, may cause cognitive errors that make awards less accurate.[162]

What's more, jurors may disregard instructions. If the only potentially useful tax instructions would have no bearing on jury determinations, administrative efficiency demands that they not be given. They impose a cost and produce no benefit. Whatever may be uncertain in the effects of tax jury instructions, this much is certain: the fewer instructions given to achieve a particular result, the better.[163]

> of damages is not to punish or penalize the defendant for (his/her) negligence, but to compensate the plaintiff for (his/her) resulting injuries and losses. You must attempt to put the plaintiff in the same position, as far as money can do it, that (he/she) would have been in had the defendant not been negligent.

CIV. JURY INSTR. COMM., CONN JUD. BRANCH, CONNECTICUT JUDICIAL BRANCH CIVIL JURY INSTRUCTIONS § 3.4-1 (2012). Other states use simpler instructions, providing little more than the direction to award the plaintiff fair and reasonable compensation. *See, e.g.*, SUPER. CT. OF DEL., PATTERN JURY INSTRUCTIONS FOR CIVIL PRACTICE § 22.1 (2000); HARVEY S. PERLMAN & STEPHEN A. SALZBURG, ALASKA CIVIL PATTERN JURY INSTRUCTIONS § 20.01B (Civ. Pattern Jury Instructions Comm. et al. eds., 2021); IND. JUDGES ASS'N, INDIANA MODEL CIVIL JURY INSTRUCTIONS § 703 (2023).

160. A similar risk of inconsistency arises when the jury is given a compensation instruction and a collateral-source instruction. The jury is told to make the plaintiff whole, but it is then told to disregard payments the plaintiff received from collateral sources which, when added to the award, appear to over-compensate the plaintiff. We do not address here the wisdom of creating this conflict, though many states apparently do not require collateral-source instructions. In any event, some courts require collateral-source instructions that may do more to minimize apparent confusion than tax instructions do. For example, the Florida model jury instructions specify that the court will make any necessary adjustments to account for benefits provided by collateral sources:

> You should not reduce the amount of compensation to which (claimant) is otherwise entitled on account of [wages] [medical insurance payments] [or other benefits (specify)] which the evidence shows (claimant) received from [his] [her] [employer] [insurance company] [or some other source]. The court will reduce as necessary the amount of compensation to which (claimant) is entitled on account of any such payments.

COMM. ON STANDARD JURY INSTRUCTIONS IN CIV. CASES, FLORIDA STANDARD JURY INSTRUCTIONS IN CIVIL CASES § 501.8 (2018) (brackets in original).

161. *See generally* STEVE CHARMAN ET AL., PSYCHOLOGICAL SCIENCE AND THE LAW 30–53 (Neil Brewer & Amy Bradfield Douglass eds., 2019) (discussing cognitive bias in legal decision-making and how it is present at every step in the current legal process).

162. *See supra* note 158 and accompanying text.

163. *See id.*

IV. STATE APPROACHES

The discussion so far implies that a legal regime must resolve three related issues: 1) what is the tort, or substantive damages, rule given the rule of taxation; 2) what, if any, jury instructions are appropriate in implementing the damages rule adopted; and 3) what evidence may be introduced at trial, considering the rules on damages and jury instructions and recognizing that the propriety of closing arguments will depend on the evidence allowed?

On the first issue, we have argued that the efficient rule is that tort compensatory damage awards should not be reduced by the amount of any income taxes that would have been due had the injury been avoided. A regime might adopt the opposite rule, however, perhaps because a statute requires it, as the Supreme Court held in *Liepelt*.[164] At a minimum, one would expect consistency between the substantive rule and jury instructions. For instance, if a legal regime adopted the rule that damages awards should not be reduced by the amount of taxes avoided, one would not expect it to insist on a jury instruction that the amount of damages should be reduced by taxes that would have been imposed absent the injury. Consistency between the substantive and instruction rules is a minimum condition of a rational approach, but an array of instruction rules can be consistent with the substantive rule. For example, if the substantive rule is that the plaintiff is entitled to gross damages, a rule that the jury should be instructed not to deduct taxes from their award and a rule that no instruction should be given are both consistent with it.

Finally, a coherent approach requires that the evidentiary rule be consistent with the instruction rule. To allow the introduction of evidence on the taxes the plaintiff would have paid in the absence of injury, yet instruct jurors they are to disregard the effect of taxes in reaching their verdict, would make no sense—and nonsensical rules invite confusion and error.[165] But just as multiple rules on instructions can be consistent with a single damages rule, multiple evidentiary rules can be consistent with a single instructions rule. For example, at least in theory, a regime might prohibit any instruction on taxation yet allow or prohibit the introduction of taxation evidence, leaving jurors to their own devices in determining what to do with evidence they receive or how to proceed without evidence. However, if evidence on taxation is

164. Although *Liepelt* interpreted the FELA, the decision "articulated a federal common-law rule[]" applicable to any federal statute that provides for compensatory damages, and only incorporates state law to the extent it is not inconsistent with federal law. Gulf Offshore Co. v. Mobil Oil Corp., 453 U.S. 473, 486–87 (1981).

165. *See supra* note 158 and accompanying text.

permitted, consistency and sound trial practice require that counsel be allowed to address tax implications in their closing arguments.[166]

Efficiency not only points to the optimal rule of damages, it provides an objective in fashioning rules of trial practice pertaining to evidence, argument, and jury instructions: trial practice rules should minimize the costs of administration in implementing the optimal substantive rule.[167] Indeed, even if a sub-optimal substantive rule is adopted, efficiency is served by minimizing the administrative costs of implementing it.[168] The objective is to maximize net social wealth, recognizing that it is a function of primary and secondary rules.[169] Identifying the least-costly trial practice rules, however, given the richness of human cognition and the possibility of cognitive errors, is challenging and imprecise.

Although the efficient substantive rule is general and straightforward, we have explained that the tax treatment of compensatory damages awards for physical injury varies by component of those awards.[170] The current federal rule provides that gross income does not include "the amount of any damages . . . received . . . on account of personal physical injuries or physical sickness . . . ."[171] The part of an award that compensates a plaintiff for lost past or future earnings replaces what would have been taxable gross income.[172] But the parts of an award that compensate the plaintiff for non-pecuniary injury (primarily pain and suffering) and expenses, such as those incurred for medical care, do not represent value that would have been taxed absent the injury.[173] These components do not replace gross income. Given tax law, the efficient damages rule requires that juries award gross lost income,[174] even though that measure over-compensates the plaintiff, plus the full estimate of non-pecuniary loss and expenses.

But even if a legal regime adopted the efficient substantive rule, a simple instruction that damage awards are not taxable, given an instruction that awards should be compensatory, risks confusion. Without a tax instruction,

166. *See Differences Between Opening Statements & Closing Arguments*, UNITED STATES COURTS, https://www.uscourts.gov/about-federal-courts/educational-resources/about-educational-outreach/activity-resources/differences [https://perma.cc/V32X-Z7U5] ("Closing arguments are the opportunity for each party to remind jurors about key evidence presented . . . .").

167. *See* CALABRESI, *supra* note 100, at 16 (noting reduction of administrative costs is a subgoal to the ultimate end of attaining justice and cost reduction).

168. *See id.*

169. *See generally* Dworkin, *supra* note 101, at 191–92 (discussing the concept of "wealth maximization").

170. *See supra* notes 135-146 and accompanying text.

171. I.R.C. § 104(a)(2).

172. *See* Comm'r v. Schleier, 515 U.S. 323, 329–30 (1995).

173. *See supra* text accompanying note 137.

174. *See supra* note 151 and preceding discussion.

jurors may well assume that awards for lost income are taxable, but they are less likely to assume that awards for non-pecuniary damages are taxable,[175] and they are even less likely to assume that awards for medical expenses incurred are taxable.[176] Indeed, the risks of confusion arise even when the jurisdiction adopts an inefficient substantive rule.

The quandary is this: a rule prohibiting tax instructions requires jurors to rely on their assumptions about taxation, which may be wrong. A rule that requires a simple instruction that damage awards are not taxable is accurate, but it can be confusing in seemingly treating components of awards jurors assumed had different pre-tort tax consequences identically. A rule that requires detailed instructions on arriving at estimates of damage award components given pre-injury and post-injury tax treatment and the overarching compensation instruction becomes complex, risking a variety of cognitive errors. What do states do?

States differ on the substantive damages rule. Some states adopt the efficient rule, favoring optimal deterrence at the cost of over-compensation. Other states adopt the alternative rule, favoring optimal compensation at the cost of under-deterrence. The Supreme Court, as we noted above, adopted the optimal-compensation approach as a matter of federal statutory interpretation in *Liepelt*.[177] States, however, are not bound by the rule in interpreting their own laws.[178] A state's choice of substantive rule is, in any event, essentially binary.[179] By contrast, states take an array of positions on the propriety and content of taxation jury instructions.[180] The *Liepelt* Court held that the trial judge may, but is not required to, admit tax evidence,[181] and it cannot refuse to instruct the jury that "your award will not be subject to any income taxes, and you should not consider such taxes in fixing the amount of your award."[182] We have not studied evidentiary rules systematically, but our impression is that, just as *Liepelt*'s position on jury instructions is consistent with its position on the admissibility of tax evidence, state evidentiary rules are at least consistent with the damages and instruction rules states adopt.

Although state rules on tax jury instructions vary substantially, they can be organized into four broad categories: (1) tax instruction is prohibited; (2)

175. *See supra* notes 135-139 and accompanying text.

176. *See id.*

177. *See* Norfolk & W. Ry. v. Liepelt, 444 U.S. 490, 493–94 (1980); *supra* notes 139-146 and accompanying text.

178. *See* Liepelt v. Norfolk & W. Ry., 378 N.E.2d 1232, 1245 (Ill. App. Ct. 1978), *rev'd*, 444 U.S. 490 (1980) (noting the court would follow the rule laid out by the Illinois Supreme Court in the absence of precedent indicating the court was bound to the contrary by the Supreme Court of the United States).

179. I.e., the state rule would either provide for an instruction on taxes or it would not.

180. *See infra* notes 183-197 and accompanying text.

181. *See* Norfolk & W. Ry. v. Liepelt, 444 U.S. at 494 & n. 7.

182. *Id*. at 492, 498.

tax instruction is permitted at the discretion of the trial court; (3) basic tax instruction is required, at least if requested by a party; and (4) complex tax instruction is required, at least if requested by a party. For present purposes, we define a "basic" tax instruction as one informing the jury that damage awards are not taxable or that they should or should not consider taxes in reaching awards. Any further detail in the instruction renders it "complex."

The first category consists of states that prohibit tax instructions, enforcing the prohibition either by holding that giving a tax instruction is automatically reversible error or is reversible if prejudicial in a given case.[183] For example, the Pennsylvania Supreme Court has held that income "tax consequences should not be considered by the jury" and "should be mentioned neither in argument nor in jury instructions."[184] Similarly, the Supreme Court of Rhode Island held "it is not proper to submit to a jury the question of the effect on such gross earning of the federal income tax . . . ."[185] South Carolina takes the same position: "[w]e find no South Carolina cases suggesting that a jury instruction on income tax consequences is appropriate. On the contrary, such a charge is prohibited by the collateral source rule."[186]

The second category assigns the propriety of a tax instruction to the discretion of the trial judge. For example, in Massachusetts, "[w]here there is nothing in the evidence bearing on taxes, and the lawyers do not mention the subject in front of the jury, no instruction on the subject may be needed."[187] But, if the judge has permitted the introduction of evidence concerning taxes, the judge may give the following instruction: "[y]our award must be based on the evidence before you in this case. The award will not be subject to federal or state income taxation and therefore you should not consider such taxes in

183. For example, the Alaska Supreme Court held that, "[i]n the absence of such evidence ['either that juries in general increase recoveries on this account or that the particular jury did so'] . . . the superior court's failure to give a 'tax' instruction [as requested by the defendant] did not amount to reversible error." Yukon Equip., Inc. v. Gordon, 660 P.2d 428, 434 (Alaska 1983) (quoting McWeeney v. N.Y., New Haven & Hartford R.R. Co., 282 F.2d 34, 39 (2d Cir. 1960), *overruled on other grounds by* Williford v. L.J. Carr Invs., Inc., 783 P.2d 235 (Alaska 1989)). The rejected instruction in that case was a simple one: "[y]our award of damages in this case, if any, will not be subject to any income taxes and you should not consider such taxes in fixing the amount of your award." *Yukon*, 660 P.2d at 433. The substantive rule in Alaska appears to be that income taxes must be deducted from awards for past earnings. PERLMAN & SALZBURG, *supra* note 159, § 20.03. However, incongruously, income taxes are not deducted from awards for future earnings. *Id.*; *see also* Rego Co. v. McKown-Katy, 801 P.2d 536, 539–40 (Colo. 1990) (holding that "the nontaxability instruction should not be given[,]" but concluding that the giving of a tax instruction in the case at bar was harmless error).

184. Gradel v. Inouye, 421 A.2d 674, 680 (Pa. 1980).

185. Oddo v. Cardi, 218 A.2d 373, 377 (R.I. 1966). The Rhode Island Supreme Court held that taxes were "not a proper factor for a jury's consideration, imparted either by oral argument or written instruction." *Id.* (citing Hall v. Chi. & Nw. Ry. 125 N.E.2d 77, 86 (1955)).

186. Giannini v. S.C. Dep't of Transp., 664 S.E.2d 450, 455 (S.C. 2008).

187. Griffin v. Gen. Motors Corp., 403 N.E.2d 402, 407 (Mass. 1980).

fixing the amount of your award."[188] A Florida appellate court summarized as follows:

> There is . . . substantial competent authority indicating that it is within the discretion of the trial court, as to whether the requested charge should be given and in the absence of an abuse of discretion it is not reversible error to refuse such a charge.[189]

In the third category, some states require a simple jury instruction, and some of these states require that juries be informed merely that the damages received will not be subject to taxation. For example, the Supreme Court of New Jersey has stated, "[i]n sum, we hold that, upon request, the trial court in a personal-injury case should instruct the jury that personal-injury damages are not subject to federal or state income taxes."[190] Other states instruct the jury that they may not consider taxes in reaching verdicts.[191] For example, in Vermont, the model jury instructions state, "[i]f you find for [Plaintiff], you must not consider any effect of federal or state income tax in deciding the amount of the award."[192]

Finally, some states require more complex instructions, though the degree of complexity varies. Michigan follows the optimal-compensation substantive rule, and its recommended jury instructions provide, "[i]f you find that plaintiff is entitled to recover for work loss beyond what is recoverable in no-fault benefits, you must reduce that by the taxes that would have been payable on account of income plaintiff would have received if he or she had not been injured."[193] Maryland instructs jurors specifically not to gross up damage awards:

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188. PAUL R. SUGARMAN & VALERIE A. YARASHUS, MASSACHUSETTS SUPERIOR COURT CIVIL PRACTICE JURY INSTRUCTIONS § 2.1.14 (2024). The Nevada Supreme Court adopted a similar approach. *See* Otis Elevator Co. v. Reid, 706 P.2d 1378, 1382 (Nev. 1985). A trial judge is required to give a tax instruction only as a curative instruction to avoid confusion if tax-related issues were discussed during trial. *Id.*

189. Atl. Coast Line R.R. Co. v. Braz, 182 So.2d 491, 495 (Fla. Dist. Ct. App. 1966) (citations omitted).

190. Bussell v. De Walt Prods. Corp., 519 A.2d 1379, 1382 (N.J. 1987). The court, likely recognizing that future earnings would be taxed, felt that a jury instruction would aid in achieving damages that reflect as closely as possible, the plaintiff's actual loss. *Id*. at 1380–81 (citing Tenore v. Nu Car Carriers, 341 A.2d 613, 619 (N.J. 1975)).

191. *See, e.g.*, Robert J. Nordstrom, *Income Taxes and Personal Injury Awards*, 19 OHIO ST. L.J. 212, 231 (1958).

192. VT. TRIAL CT. CRIM. JURY. INSTRUCTION COMM., VT CIVIL JURY INSTRUCTIONS § 11.18.

193. Comm. on Model Civ. Jury Instructions, MICH. BAR J., Jan. 2017, at 56, 57. That approach is in line with the Supreme Court's holding in *Liepelt*. *See* Norfolk & W. Ry. v. Liepelt, 444 U.S. 490, 498 (1980).

> Any compensatory damages awarded to the plaintiff are not income within the meaning of Federal and Maryland income tax laws, and the plaintiff will not owe or have to pay any income tax on the amount awarded as damages. Therefore, you should not add an amount to any award to compensate for anticipated taxes.[194]

By contrast, Alaska clarifies that damages for lost future earning capacity should not be reduced to reflect taxation.[195] Instructions in Alaska state, "[y]ou must not make any deduction for any future income taxes."[196] Ohio specifies that no adjustment of any kind should be made to an award based on taxation: "[y]ou may not consider federal (state or city) income taxes. In no event may you add to, or subtract from, an award because of such taxes."[197]

These are examples of the differing ways that state courts have treated the question of jury instructions and taxation. Despite the Supreme Court's resolution of the issue for purposes of FELA in *Liepelt*, a survey of the states reveals no consensus on the matter under state law.[198] In fact, as illustrated above, states have adopted a wide range of approaches as to whether an instruction should be given, and even states that have determined an instruction is allowed or required differ on its purpose and content.

V. JURY EXPERIMENT

To study the effect of taxation (or nontaxation) on the amount awarded for damages, we conducted an experiment to determine how tax jury instructions affect the amount awarded to an injured plaintiff. We created a fact pattern involving an injured plaintiff suing the injurer and presented the facts to mock jurors.[199] The hypothetical informed jurors that the defendant was at fault and was liable to the plaintiff.

The jurors' only task was to determine the appropriate amount of damages. The facts described the harmful physical effects the plaintiff endured. They also described the amount of time that plaintiff was unable to work on account of the injury (and a simple way to calculate the lost earnings)

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194. MD. STATE BAR STANDING COMM. ON PATTERN JURY INSTRUCTIONS, MARYLAND CIVIL PATTERN JURY INSTRUCTIONS 10:12 (5th ed. 2023).

195. *See supra* note 183.

196. PERLMAN & SALZBURG, *supra* note 159, § 20.03.

197. OHIO JURY INSTRUCTIONS ARCHIVE § 23.77 (2004).

198. A tentative draft of the Restatement (Third) of Torts asserts that: "[a] substantial majority of states addressing this issue have held that taxes should not be taken into account" in determining lost earnings. RESTATEMENT (THIRD) OF TORTS: REMEDIES § 13 cmt. B (AM. L. INST., Tentative Draft No. 2, 2023).

199. The facts of the scenario are roughly based on *Walter v. Wal-Mart*, 748 A.2d 961 (Me. 2000). The full scenario is set out in the appendix to this Article. *See infra* App. 1.

and the total amount of medical expenses incurred in treatment of the injury. To avoid complication, the fact pattern stated that the plaintiff had fully recovered and would incur no future medical expenses or lost earnings. We asked the jurors to award amounts for three categories: (1) pain and suffering; (2) lost income; and (3) medical expenses.

While each juror received the same fact pattern and the same general negligence jury instructions for determining the amount of damages, the variable was a description of the closing arguments and the tax jury instructions. Some jurors did not receive any instructions at all about the tax consequences of damages awards. Others received one of four different versions: (1) "simple" tax instructions stating that any compensation awarded to the plaintiff would not be income and therefore the plaintiff would not be required to pay any income tax on the award; (2) simple tax instructions (same as (1)) but also an instruction stating that any award for lost earnings should be net earnings rather than gross earnings; (3) simple tax instructions (same as (1)), but also an instruction stating that the juror should ignore the effect of taxation when determining the appropriate recovery amount; and finally, (4) a tax instruction that (incorrectly based on current law) informed the juror that the award would be taxable to the plaintiff. The description of the closing arguments provided to the participants was used to emphasize the tax treatment (where appropriate).

For the experiment, mock jurors were recruited via the internet marketplace website "Amazon Mechanical Turk" (AMT). Each participant completed an online survey in return for nominal payment. Participants were restricted to those who were over eighteen years of age and who, at the time of the survey, resided in the United States.[200] Each participant was told that he or she was a "juror in a civil trial." Each was asked to read a narrative and jury instructions. In an attempt to ensure that our results were based on participants who actually read and considered the facts and instructions, we used both attention questions[201] and certain markers to determine whether a response should be included in the final results.[202]

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200. The restrictions were selected to mimic actual jury qualifications. *See Juror Qualifications, Exemptions and Excuses*, U.S. COURTS, https://www.uscourts.gov/services-forms/jury-service/juror-qualifications [https://perma.cc/5PVF-LZZA] (providing a list of juror qualifications).

201. For example, we asked the participant to identify the plaintiff's occupation.

202. The jurors were informed of the exact amount of medical expenses the plaintiff incurred because of the defendant's mistake. Since jurors were informed the plaintiff would incur no future medical expenses and that the defendant admitted liability, the amount of medical expenses was certain. We excluded from the results any juror that awarded medical expenses out of line with the given amount.

A. Facts of the Hypothetical

As noted above, each juror in the study received the same hypothetical. The summary of the case stated that the plaintiff was diagnosed by his doctor with chronic gastroesophageal reflux disease (a digestive disease that affects the muscle between a person's esophagus and stomach). This caused the plaintiff to suffer from both heartburn and acid indigestion. Plaintiff's doctor prescribed lansoprazole, a drug designed to alleviate the effects of the plaintiff's disease. The doctor submitted the prescription to the defendant, a local pharmacy.

The pharmacist, however, provided the wrong drug to the plaintiff. Instead of the drug to help alleviate stomach issues, the plaintiff received and began taking Melphalen, a powerful chemotherapy drug used to fight certain cancers. As a result of ingesting Melphalen, the plaintiff first began to experience nausea and loss of appetite. After two weeks on the drug, the plaintiff collapsed while at work and was rushed to the hospital. He was diagnosed with severe gastrointestinal bleeding. The plaintiff was required to stay in the hospital for five weeks, during which he received several blood transfusions, suffered severe infections, and had bruising and skin rashes. For a two-week period at the hospital, he was unable to eat because of bleeding gums and an infection in his mouth. Visitors could not come within ten feet of him because of concerns over infection.

After the five-week stay in the hospital, the plaintiff's prior health returned. Plaintiff's doctor did not expect the plaintiff to suffer any further consequences for taking the wrong medication. Plaintiff's hospital bill was $60,800. Plaintiff also submitted evidence that he would have earned $4,000 per week from his work (as an independent contractor plumber) for the five weeks that he was out (thus losing a total of $20,000 in earnings).

The plaintiff sued the pharmacy. The jurors were informed that the pharmacy did not dispute it was at fault and was liable to the plaintiff for his injuries.[203] The only issue on which the parties disagreed was the amount of damages to which the plaintiff was entitled.

Every juror received the following general compensation instructions:

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203. In *Walter v. Wal-Mart* (on which our hypothetical is roughly based), Wal-Mart attempted to place some blame on the plaintiff for failing to notice that the pharmacist had provided the wrong prescription. 748 A.2d at 971. Wal-Mart argued that the trial court erred by not allowing a jury instruction asking the jury to consider Walter's fault in not noticing the mistake. *Id.* at 966. The Maine Supreme Court did not believe that Walter's actions rose to the level of comparative fault and therefore held the lower court did not err by refusing such an instruction. *Id.* at 969. It likely did not help Walmart that Walmart's own pharmacist stated in court that Walter "would have no way of knowing" that she had been given the wrong medicine. *Id.*

> You should award [Plaintiff] an amount of money that will fairly and adequately compensate him for his loss and injury. This amount should include the following:
>
> Any bodily injury sustained by [Plaintiff] and any resulting pain and suffering experienced in the past. There is no exact standard for measuring such damage. The amount should be fair and just in the light of the evidence.
>
> The reasonable expense of hospitalization and medical care and treatment necessary or reasonably obtained by [Plaintiff] in the past.
>
> Any earnings lost on account of the injury.

As noted above, for our experiment, we tested five groups. Some of the instructions we tested are less clear than they might have been, in part because of latent ambiguities, and some are less informative. But except for the last instruction, which we developed to misstate current tax law, we chose instructions that courts actually use. Part of the object of our experiment is to test the effects of instructions in use, with all their flaws. Some of our conclusions suggest that refining tax instructions to be clearer, less ambiguous, or more informative would have no effect on awards. In other cases, a refined instruction might produce more accurate results, but for manageability, we have confined this experiment to one set of common instructions.

The first group did not receive any instructions about tax consequences. In Tables 2 and 4 below, we label this group "None," referring to the absence of taxation jury instructions. As noted, this group did receive general compensation instructions. For the closing arguments summary, this group was told that the plaintiff's attorney emphasized the pain and suffering the plaintiff had endured while the defendant's attorney emphasized the plaintiff's full recovery.

The second group received not only the general compensation jury instructions, but also an instruction stating:

> Any compensatory damages awarded to [Plaintiff] are not income within the meaning of federal and state income tax laws, and [Plaintiff] will not owe or have to pay any income tax on the amount awarded as damages.

We label this group "Law" in Tables 2 and 4, suggesting the instruction merely provides a declarative statement of current tax law. For the closing arguments summary, the members of this group were told the plaintiff's attorney emphasized the pain and suffering the plaintiff endured. The defendant's attorney emphasized that the plaintiff had fully recovered, but also noted that any damages that the jury awarded to the plaintiff would not be subject to federal or state income tax.

The third group, which we label "Net," received the instruction the Law jurors received as well as a charge instructing them to return awards net of income taxes. The instruction stated:

> If you find that [Plaintiff] is entitled to an award of damages for loss of past earnings, there are two particular factors you must consider. First you should consider loss after income taxes; that is you should determine the actual or net income that [Plaintiff] has lost, taking into consideration that any past earnings would be subject to income taxes. You must award [Plaintiff] only his net earnings after tax. This is so because any award you may make here is not subject to income tax. The federal or state government will not tax any amount that you award on this basis.

For the closing arguments summary, the members of this group were told that the plaintiff's attorney emphasized the pain and suffering that the plaintiff endured. The defendant's attorney emphasized that the plaintiff had fully recovered, noted that any damages that the jury awarded to the plaintiff would not be subject to federal or state income tax, and informed the jury that they should determine the plaintiff's lost earnings on a net (that is, after-tax) basis.

The fourth group received, in addition to the general compensation jury instructions, an instruction stating that damages would not be included in income but also that the juror should ignore the tax ramifications of the award when determining the appropriate amount. We label this group "Gross" because the import of the instruction is that jurors should return gross damages, not reduced by taxes. Specifically, the instructions stated:

> When determining damages, you should ignore the effect that state and federal taxes would have. While any compensatory damages awarded to [Plaintiff] are not income within the meaning of federal and state income tax laws, and [Plaintiff] will not owe or have to pay any income tax on the amount awarded as damages, this fact should not have any effect on the amount that you award to [Plaintiff].

This group's summary of the closing arguments was exactly the same as that given to the "None" group. That is, the juror was informed that neither attorney said anything about the tax consequences in their closing arguments.

The fifth group was given, along with general compensatory jury instructions, instructions stating that any award the plaintiff received would be considered income to the plaintiff and therefore the plaintiff would be required to pay income tax on the award. We label this group "Taxed," referring to the tax treatment of awards. This counter-factual instruction was designed to provide stark evidence of the effect of jury instructions on damage awards. Thus, for example, if awards are statistically identical whether jurors are told that awards are not taxable or that awards are taxable, the inference would be strong that jurors do not consider tax instructions in reaching verdicts. The instruction specifically stated:

> Any compensatory damages awarded to [Plaintiff] are income within the meaning of federal and state income tax laws, and [Plaintiff] will owe or have to pay income tax on the amount awarded as damages.

For this group, we added that the plaintiff's attorney, in her closing arguments, informed the jury that any damages received by the plaintiff would be subject to taxation.

B. Expected Results

Assuming jurors attempt to follow the instruction that damage awards should be compensatory, what should we expect juries to award if they consider the effect of taxation? There are three possibilities. First, juries may gross up an award if they believe that the award will be taxed and they want to ensure that the plaintiff receives a specific amount after tax. That is, the award will exceed the objective assessment of what the plaintiff should recover for compensation to account for the expected reduction on account of taxation. After paying taxes on the award, the plaintiff will receive the appropriate objective compensatory amount. Second, jurors may reduce or gross down an award if they believe that the award is nontaxable and compensates the plaintiff for something that normally would have been taxed. In this scenario, the juror's award is less than his or her objective assessment to account for the expected non-taxation, where the relevant amount would have been taxed had it been earned. This reduction again leads to the appropriate compensatory award since it puts the plaintiff in the position he or she would have occupied absent the injury. Third, jurors may remain "neutral" and neither gross up nor down. The award purports to be an

objective assessment of the relevant category of damages without an adjustment to account for tax consequences.

Assuming, alternatively, jurors are told the award is taxable, told the award is not taxable, or not told anything about taxation, Table 1 summarizes predicted awards:

TABLE 1
PREDICTED AWARDS

	Award: Medical Expenses	**Award: Lost Income**	**Award: Pain and Suffering**
Instruction: Award Taxed	Gross Up	Neutral	Gross Up
Instruction: Award Not Taxed	Neutral	Gross Down	Neutral
No Tax Instruction	Slightly Above Neutral	Between Neutral and Gross Down	Between Neutral and Gross Up

A simple example may help explain. Assume that plaintiff has $100,000 in medical expenses that were incurred on account of the defendant's negligence. The jury desires to make the plaintiff whole by ensuring that, after taxation, the plaintiff ends up with $100,000 to place the plaintiff in the position he or she would have occupied but for the injury. That objective is consistent with the compensatory damages instruction they would have received. If the jury is informed that the award is taxable, they will gross up. Grossing up makes sense, since the jury's goal is to ensure the plaintiff has $100,000 after he or she pays the tax due on the award. If the jury is told that the award is not subject to taxation, then the award will be neutral—that is, they will award exactly $100,000. They will not need to gross up or down to achieve adequate compensation.

What if the jury is not told anything about taxation? We surmise most jurors will assume an award for medical expenses is not taxable because it does not replace an amount that would have been taxed (that is, it is not replacing something that would have been "income" to the plaintiff). Therefore, most jurors will award the neutral amount for medical expenses. Some jurors, however, will mistakenly believe that the amount is taxable. After all, jurors might believe that the government has nearly unlimited power to define "income" and might declare amounts received as effective

reimbursement for medical expenses paid to be income. These jurors, consequently, will gross up the award. But we assume a relatively small proportion of jurors would be mistaken about the tax treatment of medical expenses, and therefore we predict awards slightly above neutral when no instruction on the tax treatment of the award is given.

For lost income awards, we expect the opposite. Many jurors may assume that an award for lost income is taxable because the calculated objective amount would have been taxed had it been earned. This group will award a neutral amount. However, without any tax instructions, some jurors will assume (correctly under current law) that the award is not taxable, and they will gross down to achieve accurate compensation. When comparing the medical expense and lost income categories, we predict that the award for medical expenses will be closer to neutral than the award for lost income. Fewer jurors are likely to assume the medical expense award is taxable than an award for lost income is tax free.

An award for pain and suffering differs from awards for both medical expenses and lost income because it is inherently more difficult to determine objectively. Otherwise, the results should be similar to the awards for medical expenses since, like the medical expense category, it is compensating for something that would not have been income if the plaintiff had not been injured. Even with that similarity, our prediction is more jurors believe that pain and suffering awards are taxable than jurors believe medical expense awards are taxable. While both are awards for something that wouldn't otherwise be taxed, jurors can more easily make the non-taxation connection for the medical expense category, since the jury is reimbursing the plaintiff for an expenditure. This reimbursement of an outlay further supports the non-taxation treatment.

C. Actual Results

Our experiment was not designed to test all of the predictions described above. Those predictions apply to a theoretical but logically comprehensive set of conditions. Notably, our experiment was designed to test the effect of actual approaches to taxation instructions on only two kinds of awards; we examined awards for pain and suffering and for lost earnings, using awards for medical expenses only as a control variable. Nevertheless, we predicted that compensation-driven jurors would award three different amounts for pain and suffering based on the tax instructions they received. As we report below, however, the experiment yielded awards that were statistically indistinguishable regardless of the tax instructions given.

We also predicted three different awards for lost income depending on tax instructions. We expected the award for lost income to equal gross income

if jurors were told counter-factually that awards are taxed, the award to be somewhat lower if no tax instruction were given, and the award to be even lower if jurors were told that awards are not taxed. By contrast, the median award was identical regardless of the tax instruction given and equal to gross lost earnings. We found a statistically significant reduction in mean awards only between the amount awarded by the "Net" tax instruction group and the "Law," "Gross," and "Taxed" groups; the "Net" group mean award was lower than that of the "None" group, but not significantly so. Only our prediction that an instruction that awards are not taxed would be lower than they would be under either other approach to instructions was borne out by the experiment. And surprisingly, the mean awards for all categories of test groups except "Net" were *above* "neutral," or the unadjusted amounts of lost income. Even the "Net" group returned a mean award that implied a tax rate of only 4.47%. Jury awards appear to be less sensitive to instructions and assumptions than we had expected.

Since the data that we received are "non-normal" (that is, they do not follow a traditional bell curve), we used an alternative to the traditional approach of linear regression. We performed a non-parametric test to analyze our data. This was more helpful than the traditional approach as this test does not assume anything about the underlying data distribution. The trade-off, however, is that the test is less powerful and sensitive than linear regression.

We used this approach on both our pain and suffering awards and our lost earnings awards.[204] The median and mean amounts awarded for pain and suffering for each instruction group are presented in Table 2:

TABLE 2
PAIN AND SUFFERING AWARDS

Group	Median	Mean
None	$20,000	$40,287.10
Law	$19,100	$32,319.64
Net	$17,100	$43,107.50

204. As noted above, we used the medical expense damage awards as a marker to determine whether the participant's responses should be included in the survey.

TABLE 2
PAIN AND SUFFERING AWARDS

Group	Median	Mean
Gross	$55,000	$56,157.69
Taxed	$30,000	$54,488.89

While the differences in median and mean damages awarded between the groups seem large, the non-parametric test reveals no statistically significant differences. The results are summarized in Table 3, which reports results of pairs of awards based on instruction group:[205]

TABLE 3
PAIRWISE COMPARISONS OF INSTRUCTIONS FOR PAIN AND SUFFERING AWARDS

Sample 1 – Sample 2	Test Statistic	Standard Error	Standard Test Statistic
Law-Net	−1.778	10.762	−.165
Law-None	5.911	10.995	.538
Law-Taxed	−16.522	11.375	−1.452
Law-Gross	−23.507	11.486	−2.047
Net-None	4.132	10.473	.395
Net-Taxed	−14.743	10.871	−1.356

205. Each row tests the null hypothesis that the Sample 1 and Sample 2 distributions are the same. The significance values have been adjusted by the Bonferroni correction for multiple tests.

TABLE 3
PAIRWISE COMPARISONS OF INSTRUCTIONS FOR PAIN AND SUFFERING AWARDS

Sample 1 – Sample 2	Test Statistic	Standard Error	Standard Test Statistic
Net-Gross	21.729	10.987	1.978
None-Taxed	−10.611	11.101	−.956
None-Gross	−17.596	11.215	−1.569
Taxed-Gross	6.985	11.588	.603

At the significance level of 0.050, the test, perhaps surprisingly, indicates no significant difference between any of the jury instructions.

The median and mean amounts awarded for lost earnings for each jury instruction group are summarized in Table 4:

TABLE 4
LOST EARNINGS AWARDS

Group	Median	Mean
None	$20,000	$23,518.52
Law	$20,000	$25,342.86
Net	$20,000	$19,105.88
Gross	$20,000	$24,915.38
Taxed	$20,000	$26,066.67

The data demonstrate statistically significant differences between pairs of instructions for the lost earnings damages award. Specifically, there were statistically significant differences between the awards made by jurors that were given the "Net" instructions (that is, the group that was informed both that the award was nontaxable, and jurors should award net earnings only) and

the awards made by all the other groups except the group that received no tax instructions. There was no statistically significant difference in lost earnings awards between the "Net" group and the "None" group. The results of the test are summarized in Table 5:[206]

TABLE 5
PAIRWISE COMPARISONS OF INSTRUCTIONS FOR LOST EARNINGS AWARDS

Sample 1 – Sample 2	Test Statistic	Std. Err.	Std. Test Statistic	Sig.	Adj. Sig.
Net-None	13.634	8.525	1.599	.110	1.000
Net-Law	24.957	8.760	2.849	.004	.044
Net-Gross	25.252	8.943	2.824	.005	.047
Net-Taxed	-29.414	8.849	-3.324	<.001	.009
None-Law	-11.323	8.950	-1.265	.206	1.000
None-Gross	-11.618	9.129	-1.273	.203	1.000
None-Taxed	-15.780	9.036	-1.746	.081	.808
Law-Gross	-.295	9.349	-.032	.975	1.000
Law-Taxed	-4.457	9.259	-.481	.630	1.000
Gross-Taxed	-4.162	9.432	-.441	.659	1.000

VI. EXPERIMENT IMPLICATIONS

What does this experiment tell us about the issue of whether to inform the jury of the income tax consequences of damage awards? Since there is no statistically significant difference for pain and suffering awards regardless of whether instructions are given at all or the content of any instructions given, the answer is simple for those damages: tax instructions should not be provided. The purpose of instructions is to achieve damage awards that

206. Each row tests the null hypothesis that the Sample 1 and Sample 2 distributions are the same. The significance values have been adjusted by the Bonferroni correction for multiple tests.

correspond to the damage rule as closely as possible. If an instruction makes no difference to the jury, omitting it has the benefit of reducing instruction clutter without imposing a marginal cost of inaccuracy. Given the limits of human cognitive capacity, the omission of unproductive instructions frees up cognitive energy that can be devoted to instructions that matter. This conclusion holds whether the damage rule adopts a gross harm or net harm standard. We found no statistically significant difference between awards made by jurors instructed that awards are not taxable and awards are taxable.

The experiment's implications for lost earnings awards are less straightforward, for different instructions can produce statistically significant differences in awards. We have argued that the efficient rule of damages for lost earnings is the gross amount, recognizing that the harm caused by the tortfeasor includes that portion the government would have taken through taxation. That is a social loss. Optimal deterrence requires that the tortfeasor internalize the entire loss he or she causes.[207]

The efficient damages rule is also consistent with the intent of Congress. Congress is aware that people are awarded lost earnings for physical injuries. Congress is also aware such awards are replacing dollars that would have been subject to tax if the plaintiff had not been injured. Yet, despite this substitution for something that would have been taxed, Congress provides an exemption for such awards.[208] Congress apparently is willing to provide special treatment to this group of taxpayers—that is, those that have been physically injured. This appears to be implicit approval that these taxpayers will receive what might be considered a windfall.

Our experiment implies that under current tax law, the best rule on instructions is that no tax instruction be given. A net earnings instruction would conflict with the efficient damages rule and so should not be given. An instruction that awards are taxable would misinform the jury, and it would not produce results different from no instruction, an accurate law instruction, or a gross instruction. As for the latter three approaches, each would yield the same results. But providing no instruction is preferable because it minimizes the cognitive costs imposed on jurors. It is the simplest approach. And because no instruction on tax would be given, no evidence or closing arguments directed to taxation should be allowed, conserving trial resources.

Importantly, the correct instruction rule would not change if tax law changed to treat damage awards as taxable income. The optimal damage rule would remain: damages should equal gross lost earnings.[209] Under the new, hypothetical tax rule, the "Law" instruction would be incorrect, and the "Taxed" instruction would be correct. The "Net" instruction would still

207. *See* Coase, *supra* note 119.
208. *See* I.R.C. § 104(a)(2).
209. *See supra* notes 150-151 and accompanying text.

conflict with the efficient damages rule, and the simplest approach to obtaining gross awards is to give no tax instruction.

If a state were to choose the inefficient damage rule, attempting to achieve perfect compensation for the immediate victim at the expense of optimal deterrence,[210] the appropriate approach to jury instructions is to require a net lost income charge under current tax law. That charge does yield lower awards than any other instruction or silence, and the awards are closer to the net lost earnings. If that charge is given, presumably evidence would have to be allowed on the taxes that would have been due on earnings and argument on the evidence would have to be allowed, adding to the cost of trial.

Unlike the instruction rule implementing the optimal damages rule, the appropriate instruction rule implementing a compensation-driven damages rule would change if damage awards became taxable. The best trial practice rule would be to provide no instructions. If awards are not taxed, the jury would be instructed to take tax ramifications into account in arriving at a net award, reducing gross lost earnings by the amount of taxes that would have been paid on those earnings. If awards are taxed, however, the simplest way to lead the jury to award gross lost earnings is to provide no tax instruction, as explained above. That gross amount would be taxed, and the plaintiff would be left with a net amount. True, the amount of an *award* net of taxes is not necessarily the same as the amount of *earnings* net of taxes. The tax rates might be different, either because of different bases or changes in tax rates over time. But small changes in the amount of taxes due on the award and the amount that would have been due on future earnings are not likely to have a significant impact on awards.

VII. CONCLUSION

Tax law does not treat compensatory damage awards for physical injuries as income.[211] But these awards compensate victims both for expenses they otherwise would not have incurred and income they otherwise would have earned. That income would have been taxed had it been earned. Courts are split on whether damage awards should reflect taxes avoided.[212] A rule that requires tax consequences to be taken into account, in part by allowing the recovery only of net lost earnings, is justified on the ground of compensation: recovery of gross lost earnings over-compensates the victim. The Supreme Court in *Liepelt* focused on perfect compensation as the objective specified in a federal statute.[213] We have argued for the alternative rule on grounds of

210. *See supra* notes 145-146 and accompanying text.
211. *See* I.R.C. § 104(a)(2).
212. *See supra* Part IV.
213. *See* Norfolk & W. Ry. Co. v. Liepelt, 444 U.S. 490, 493–94, 498 (1980).

efficiency. Optimal deterrence requires that the full cost of tortious conduct be imposed on the tortfeasor,[214] and part of that cost is the tax revenue the government would have received had the victim not been injured.[215] Efficiency requires the recovery of gross lost earnings, even if the victim is over-compensated.[216] The margin of over-compensation is a benefit Congress intended to bestow on tort victims.

The damage rule selected affects a set of trial practice rules, including the admissibility of evidence on taxation and the propriety of closing arguments directed to taxation. Most importantly, courts do not agree on whether juries should be instructed on tax ramifications of their awards, or the content of any instructions given.[217] Even when the optimal damages rule is adopted, the appropriate approach to jury instructions is uncertain.

We examined the theoretical arguments relating to tax jury instructions and conducted an experiment to determine whether jury instructions matter. We concluded that to best implement the efficient rule of damages, no jury instruction on taxation should be given. That rule on instructions implies that evidence and argument on taxation should not be allowed. Surprisingly, our experiment implies that the optimal approach to tax instructions is invariant to a change in tax law: tax instructions should not be given even if authorities began to tax awards for lost earnings. The efficient damages rule would still require the recovery of gross lost earnings, and the tax change would merely align the victim's damage award with the net earnings he or she would have received absent the injury. Our experiment also indicated that if a state adopted a compensation-driven damages rule under the current rules of taxation, it should require a net lost earnings instruction. But if awards were made taxable as income, no tax instruction should be given.

214. *See* Coase, *supra* note 119.
215. *See supra* notes 147-151 and accompanying text.
216. *See supra* Part III.
217. *See supra* notes 183-197 and accompanying text.

APPENDIX 1
(FULL SCENARIO)

This portion of the scenario was given to every testing group.

INTRODUCTION TO JURIES

In a civil trial, one party ("plaintiff") sues another party ("defendant") for an injury done to the plaintiff. Both sides will present evidence to the jury and the jury will decide whether the defendant is liable (has to pay damages to the plaintiff) or not liable (does not have to pay damages to the plaintiff).

In this survey, we ask you to think of yourself as a member of a jury in a civil case. The next page will describe the evidence that you should consider. In this case, we are not asking you to decide whether the defendant is liable or not (the defendant has conceded that it is liable). Instead, after receiving jury instructions from the judge, we will ask you to determine the appropriate amount of damages (that is, money) that the defendant will be required to pay to the plaintiff to compensate for the plaintiff's injury.

On January 4, 2019, Plaintiff, William White (age 68), was diagnosed by his doctor with chronic gastroesophageal reflux disease, a digestive disorder that affects the muscle between a person's esophagus and stomach. This condition was causing William significant discomfort with both heartburn and acid indigestion.

William's doctor prescribed lansoprazole, a drug designed to alleviate the effects of William's disease. The doctor submitted the prescription to HealthAid Pharmacy. On January 5, 2019, William picked up the prescription from HealthAid Pharmacy. Unfortunately, the pharmacist at HealthAid filled the prescription with the wrong drug. Instead of lansoprazole, the pharmacist filled the prescription with melphalan, a powerful chemotherapy drug used to fight certain cancers.

On that same day that he picked up the drug from the pharmacy, William started taking the drug, unaware that it was the wrong medication. On January 12, 2019 (one week after beginning to take the wrong drug), William began to suffer from nausea and loss of appetite. Believing these were just side effects of lansoprazole, he continued to take the medicine, and he continued to do his job as an independent plumber.

On January 20, 2019 (the fifteenth day after starting the medication), William collapsed at work and was rushed to the hospital, where he was found to be suffering from gastrointestinal bleeding. Following emergency admission, William remained in the hospital for five weeks and received numerous blood transfusions.

During almost his entire stay in the hospital, he suffered severe infections and had both bruising and skin rashes. For two of the five weeks of his hospital stay, he was unable to eat because of bleeding gums and an infection in his mouth. Also, during almost his entire stay, because of his weakened immune system, visitors could not come within ten feet of him.

Near the end of his hospital stay, William's prior health returned. On February 24, 2019, when William was discharged from the hospital, he no longer suffered any pain from taking the wrong drug. Also, his doctor does not expect William to suffer any future consequences on account of taking the wrong drug.

Still, William's medical bills totaled $60,800 and he missed five weeks of work while he was in the hospital. William is an independent plumber and has submitted evidence that he missed a very busy construction period while in the hospital and he would likely have earned approximately $20,000 from performing plumbing jobs over the time he missed.

William sued HealthAid Pharmacy for its mistake in providing him the wrong medication. HealthAid Pharmacy does not dispute that it is at fault for William's injuries and therefore legally liable for William's damages.

The only issue on which the two sides cannot agree and thus is for the jury to determine is the amount of money damages to be awarded William.

GROUP ONE
("NONE")

In his closing argument, William's lawyer emphasized how much pain and suffering William endured during his five weeks in the hospital. In her closing argument, the lawyer for HealthAid did not dispute that William had a difficult stay but emphasized that he has fully recovered.

The judge has provided the following instructions to help you resolve the issue.

A. You should award William White an amount of money that will fairly and adequately compensate him for his loss and injury. This amount should include the following:

1. Any bodily injury sustained by William White and any resulting pain and suffering experienced in the past. There is no exact standard for measuring such damage. The amount should be fair and just in the light of the evidence.

2. The reasonable expense of hospitalization and medical care and treatment necessary or reasonably obtained by William White in the past.

3. Any earnings lost on account of the injury.

The judge has asked you to fill out the following form:

We, the jury, find for William White and against HealthAid Pharmacy. We assess the damages itemized as follows:

The pain and suffering experienced as a result of the injury:

The expenses for medical treatment:

The value of lost earnings:

GROUP TWO
("LAW")

In his closing argument, William's lawyer emphasized how much pain and suffering William endured during his five weeks in the hospital. In her closing argument, the lawyer for HealthAid did not dispute that William had a difficult stay but emphasized that he has fully recovered. HealthAid's lawyers also noted that any damages that the jury awards to William will not be subject to state or federal income tax.

The judge has provided the following instructions to help you resolve the issue.

A. You should award William White an amount of money that will fairly and adequately compensate him for his loss and injury. This amount should include the following:

1. Any bodily injury sustained by William White and any resulting pain and suffering experienced in the past. There is no exact standard for measuring such damage. The amount should be fair and just in the light of the evidence.

2. The reasonable expense of hospitalization and medical care and treatment necessary or reasonably obtained by William White in the past.

3. Any earnings lost on account of the injury.

B. Any compensatory damages awarded to William White are not income within the meaning of federal and state income tax laws, and William White will not owe or have to pay any income tax on the amount awarded as damages.

The judge has asked you to fill out the following form:

We, the jury, find for William White and against HealthAid Pharmacy. We assess the damages itemized as follows:

The pain and suffering experienced as a result of the injury:

The expenses for medical treatment:

The value of lost earnings:

GROUP THREE
("NET")

In his closing argument, William's lawyer emphasized how much pain and suffering William endured during his five weeks in the hospital. In her closing argument, the lawyer for HealthAid did not dispute that William had a difficult stay but emphasized that he has fully recovered. HealthAid's lawyer also noted that any damages that the jury awards to William will not be subject to state or federal income tax. So, for example, when the jury determines William's lost earnings, they should do so on a "net" (that is, after-tax) basis.

The judge has provided the following instructions to help you resolve the issue.

A. You should award William White an amount of money that will fairly and adequately compensate him for his loss and injury. This amount should include the following:

1. Any bodily injury sustained by William White and any resulting pain and suffering experienced in the past. There is no exact standard for measuring such damage. The amount should be fair and just in the light of the evidence.

2. The reasonable expense of hospitalization and medical care and treatment necessary or reasonably obtained by William White in the past.

3. Any earnings lost on account of the injury.

B. You should be aware of the tax consequences of any amount that you award to William White.

1. Any compensatory damages awarded to William White are not income within the meaning of federal and state income tax laws, and William White will not owe or have to pay any income tax on the amount awarded as damages.

2. If you find that William White is entitled to an award of damages for loss of past earnings, there are two particular factors you must consider. First you should consider loss after income taxes; that is you should determine the actual or net income that William White has lost, taking into consideration that any past earnings would be subject to income taxes. You must award William White only his net earnings after tax. This is so because any award you may make here is not subject to income tax. The federal or state government will not tax any amount that you award on this basis.

The judge has asked you to fill out the following form:

We, the jury, find for William White and against HealthAid Pharmacy. We assess the damages itemized as follows:

The pain and suffering experienced as a result of the injury:

The expenses for medical treatment:

The value of lost earnings:

GROUP FOUR
("GROSS")

In his closing argument, William's lawyer emphasized how much pain and suffering William endured during his five weeks in the hospital. In her closing argument, the lawyer for HealthAid did not dispute that William had a difficult stay but emphasized that he has fully recovered.

The judge has provided the following instructions to help you resolve the issue.

A. You should award William White an amount of money that will fairly and adequately compensate him for his loss and injury. This amount should include the following:

1. Any bodily injury sustained by William White and any resulting pain and suffering experienced in the past. There is no exact standard for measuring such damage. The amount should be fair and just in the light of the evidence.

2. The reasonable expense of hospitalization and medical care and treatment necessary or reasonably obtained by William White in the past.

3. Any earnings lost on account of the injury.

B. When determining damages, you should ignore the effect that state and federal taxes would have. While any compensatory damages awarded to William White are not income within the meaning of federal and state income tax laws, and William White will not owe or have to pay any income tax on the amount awarded as damages, this fact should not have any effect on the amount that you award to William White.

The judge has asked you to fill out the following form:

We, the jury, find for William White and against HealthAid Pharmacy. We assess the damages itemized as follows:

The pain and suffering experienced as a result of the injury:

The expenses for medical treatment:

The value of lost earnings:

GROUP FIVE
("TAXED")

In his closing argument, William's lawyer emphasized how much pain and suffering William endured during his five weeks in the hospital. William's lawyer also informed the jury that any damages awarded will be subject to taxation. In her closing argument, the lawyer for HealthAid did not dispute that William had a difficult stay but emphasized that he has fully recovered.

The judge has provided the following instructions to help you resolve the issue.

A. You should award William White an amount of money that will fairly and adequately compensate him for his loss and injury. This amount should include the following:

1. Any bodily injury sustained by William White and any resulting pain and suffering experienced in the past. There is no exact standard for measuring such damage. The amount should be fair and just in the light of the evidence.

2. The reasonable expense of hospitalization and medical care and treatment necessary or reasonably obtained by William White in the past.

3. Any earnings lost on account of the injury.

B. Any compensatory damages awarded to William White are income within the meaning of federal and state income tax laws, and William White will owe or have to pay income tax on the amount awarded as damages.

The judge has asked you to fill out the following form:

We, the jury, find for William White and against HealthAid Pharmacy. We assess the damages itemized as follows:

The pain and suffering experienced as a result of the injury:

The expenses for medical treatment:

The value of lost earnings: