

Accounting for Medicare, Social Security Benefits and Payroll Taxes in Federal Cases:
Federal Case Law and Errors by Many Forensic Economists

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Introduction

Since *Norfolk and Western Railway Company v. Liepelt*,¹ it has been clear that income taxes should be deducted from personal injury losses in federal cases. This was strongly affirmed in *Jones & Laughlin Steel Corp. v. Pfeifer*,² and is no longer an issue in either FELA (Federal Employers Liability Act) or Jones Act maritime cases. While these U.S. Supreme Court decisions are explicit that "income taxes" include both federal and state income taxes, the Court has left the interpretation of what that term constitutes to the lower courts. What is not explicit in those cases is the appropriate treatment of municipal income taxes and payroll taxes that are also levied against personal incomes of individuals. In *Pfeifer*, the Court was also explicit that lost fringe benefits should be considered, but not which "lost" fringe benefits. However, there are federal cases in which the lower courts have been quite explicit about both the inclusion of payroll taxes and the proper way to consider certain federally mandated fringe benefits. We have found that many forensic economists are not aware of this body of case law and are, correspondingly, making major errors in federal case reports of loss that include the elements of payroll taxes and lost fringe benefits.

In this paper, we provide description of published court decisions that have addressed both payroll taxes and the impact of death or injury on diminution of Social Security and Railroad Retirement benefits. In a number of maritime cases, federal circuit courts have ruled that all payroll taxes are income taxes within the meaning of *Liepelt* and *Pfeifer*. A second group of cases, including three cases by the United States Supreme Court, have stated that reductions in Social Security Benefits are noncontractual and should not be included as a part of lost income. We also discuss one FELA case suggesting that there may be a different requirement for Railroad Retirement benefits, but still held that it is specifically invalid to use employer tax payments to the Railroad Retirement Board as a proxy for lost benefits by an injured worker.

In our practices, we frequently see reports by forensic economists that do not make deductions for employee paid payroll taxes, and that treat employer paid payroll taxes as a lost fringe benefit. Such treatments fly in the face of the case law we describe. Further, the one FELA case we discuss introduces the "doctrine of curative admissibility." That doctrine suggests, in Missouri at least, that a forensic economist who commits the error of using employer Social Security or Railroad Retirement tax payments as a proxy for lost fringe benefits, may allow the defense to introduce Social Security or RRB disability payments into evidence to "cure" the earlier inappropriate admission of invalid claims of loss. In other words, the economist's mistake may create an exception to the collateral source rule, allowing the jury to be informed about disability payments received by the injured party.

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¹ 444 US 490, 62 L. 2d Ed 689, 100 S. Ct. 755 (1980).

² 462 US 523, 76 L. Ed 2d 768, 103 S.Ct. 2541 (1983).

This paper consists of four parts: (1) A brief discussion of payroll taxes; (2) A review of federal case law suggesting that payroll taxes should be deducted from loss estimates; (3) A review of federal case law suggesting that social security benefits are too speculative to be considered in loss estimates; and (4) A discussion of *Adams v. Burlington Northern Railroad Co.*³, suggesting that the standards in FELA and Jones Act cases involving Railroad Retirement Board taxes and Social Security taxes, respectively, may differ. *Adams* also introduces the legal doctrine of "Curative Admissibility," which may be important in the consideration of fringe benefits.

The Meaning of Payroll Taxes

Virtually all working individuals pay some form of payroll tax on "earned" as opposed to "unearned" income. The most common forms are OASDHI (Social Security and Medicare) and Tier I and Tier II Railroad Retirement taxes (by employees of railroads).⁴ Less common types of payroll taxes are "city income taxes" imposed by some municipalities,⁵ and state unemployment and disability taxes imposed by some states. Our specific focus in this paper is on OASDHI and Tier I and Tier II taxes of the Railroad Retirement system. Payroll taxes are defined as a percent of income received from earnings, up to some maximum, except for Medicare and some city income taxes, which have no annual limit. The term "payroll tax" should be understood as an income tax that exempts all forms of "passive income." Passive income exempted from taxation includes interest, royalties, rents, dividends, capital gains, and so forth. Payroll taxes, unlike other income taxes, typically do not start with a basic exemption, so that their percentages apply to the first dollar of income. Because payroll taxes reach a maximum, they are correctly considered to be quite regressive as taxes although the benefits they fund can be very progressive in nature, thus meeting an apparent overall goal of income redistribution. In fact, this overall progressivity is one of the primary reasons why the courts have ruled that employer contributions are not a valid proxy for lost employee benefits, as will be discussed below.

Payroll taxes are treated as income taxes in all Public Finance textbooks⁶ and all analysis made of the impact of payroll taxes treat them as a special type of income tax. Thus, while payroll taxes were not specifically mentioned in *Liepelt* or *Pfeifer*, we argue that their inclusion was clearly implied by the reference to income taxes. And, as we will show, that is how the courts, following *Liepelt* and *Pfeifer*, have ruled.

³ 865 S.W.2d 748 (Mo.App.W.D. 1993).

⁴ Tier I of Railroad Retirement tax is designed as a perfect analog to FICA. It includes Medicare taxes of railroad workers and retirement/disability taxes that are identical to Social Security taxes. The percentages allocated for Medicare, disability insurance and retirement insurance and the income maximums on which these taxes are levied are identical to those in FICA taxes, which combine Social Security and Medicare taxes.

⁵ St. Louis, Missouri, is one example of a "city income tax" that is a payroll tax, but we have not surveyed cities to determine the frequency of this type of tax.

⁶ See Edgar G. Browning and Jacqueline M. Browning, *Public Finance and the Price System*, MacMillan Publishing Company (1994) and Randall G. Holcombe, West Publishing Company (1996). In models analyzing incentive effects of payroll taxes, income is normally the dependent variable, as is the case with analysis of other income taxes.

Federal Cases Requiring Subtraction of Employee Payroll Taxes

This section offers a series of citations to federal decisions (two appellate and one trial) in which the courts have ruled explicitly that payroll taxes should be subtracted in economic loss computations:

In *Madore v. Ingram Tank Ships, Inc.*, 732 F.2d 475 (1984), the U.S. Court of Appeals, 5th Circuit at 478 said:

In computing the loss of future earnings, gross earnings should not be used. Unless the amounts the worker would have been required to pay in income taxes and social security taxes is negligible or should, for some articulated reason, be disregarded, the lost income stream must be computed after deducting the income taxes and social security taxes the worker would have paid had he continued to work, for he is entitled only to be made whole for what he has lost, his net income. *Culver I*, 688 F.2d at 302.

In *Pickle v. International Oilfield Divers, Inc.*, 791 F.2d 1237 (1986), the Court of the Fifth Circuit, again dealt specifically with omission of a reduction for social security taxes by the plaintiff's economic expert and at 1241 wrote:

...IOD correctly argues that the district court erred in not deducting social security taxes from its estimate of Pickle's future income.

In *Purdy v. Belcher Refining Company*, 781 F. Supp. 1559 (S.D.Ala. 1992), the Southern District, Alabama, U.S. District Court at 1562 noted:

The Purdys agree that from base earnings federal, state and social security taxes amounting to 16.3% should be deducted.

We also cite Thomas J. Schoenbaum's *Admiralty and Maritime Law*, 2nd ed. West Publishing 1994 (p. 205) as follows:

Social Security taxes which would have been paid on wages are also properly deducted from the award.

There are two important elements in these citations. First, all three cases and Thomas J. Schoenbaum's legal treatise fall within the realm of admiralty law, whose economic damage calculations flow directly from *Pfeifer*. Second, we could find no published decision from any federal court dealing with any form of admiralty or other federal law that explicitly considered the question of payroll taxes and ruled that payroll taxes should not be subtracted. We found no FELA cases which specifically addressed payroll taxes paid by employees, but since the Jones Act is essentially FELA applied to seamen, it is reasonable to surmise that appellate courts applying FELA standards would react in the same manner described here for Jones Act cases. We also note one important instance

(*Trevino v. U.S.*'), where a circuit court found the Supreme Court's economic directives in *Pfeiffer* compelling enough to broaden its applicability to include FTCA (Federal Tort Claims Act) actions.

Cases Disallowing Claims to Future Social Security Benefits

This section lists both federal and state decisions that suggest that social security benefits, particularly including those stemming from employer paid Social Security taxes, should not be treated as a compensable lost fringe benefit.

In *Fleming v. Nestor*,⁷ the United States Supreme Court discusses Social Security at length and wrote:⁸

Of special importance in this case is the fact that eligibility for benefits, and the amount of such benefits, do not in any true sense depend on contribution to the program through payment of taxes...

The Social Security system may be accurately described as a form of social insurance, enacted pursuant to Congress' power to "spend money in aid of the 'general welfare,'"...whereby persons gainfully employed, and those who employ them, are taxed to permit the payment of benefits to the retired and disabled, and their dependents...

It is apparent that the noncontractual interest of an employee covered by the Act cannot be soundly analogized to that of the holder of an annuity, whose right to benefits is bottomed on his contractual premium payments.

... (the Social Security) program was designed to function into the indefinite future, and its specific provisions rest on predictions as to expected economic conditions which must inevitably prove less than wholly accurate, and on judgements and preferences as to the proper allocation of the Nation's resources which evolving economic and social conditions will of necessity in some degree modify.

To engraft upon the Social Security system a concept of "accrued property rights" would deprive it of the flexibility and boldness in adjustment to ever-changing conditions which it demands.

In *Richardson v. Belcher*,¹⁰ citing *Fleming v. Nestor*, the Court wrote:¹¹

⁷ 804 F. 2d 1512 9th Cir. 1986.

⁸ 363 US 603, 4 L. ed 2d 1435, 80 S Ct 1367 (1960).

⁹ at 4 L Ed 2d 1443-1444.

¹⁰ 404 US 78, 30 L. Ed 2d 231, 92 S Ct 254 (1971).

In our last consideration of a challenge to the constitutionality of a classification created under the Social Security Act, we held that "a person covered by the Act has not such a right in benefit payments as would make every defeasance of 'accrued' interests violative of the Due Process Clause of the 5th Amendment." The fact that social security benefits are financed in part by taxes on an employee's wages does not in itself limit the power of Congress to fix the levels of benefits under the Act or the conditions upon which they may be paid. *Nor does an expectation of public benefits confer a contractual right to receive the expected amounts* (emphasis added).

In *Weinberger v. Wiesenfeld*, the Court restated:¹²

We held in *Fleming* that the interest of a covered employee in future social security benefits is "noncontractual," because "each worker's benefits, though flowing from the contributions he made to the national economy while actively employed, are not dependent on the degree to which he was called upon to support the system by taxation."

Drawing upon these three Supreme Court decisions, the California Court of Appeal, First District, Division 2, in *In re Marriage of Nizenkoff*,¹³ reasoned (135 Cal.Rptr. at 191):

...Further, Congress, which has recognized the need for vested pension rights in the private sector, has, in the intervening 26 years since *Fleming*, retained section 1304 of the Social Security Act. This inaction, in the face of legal trends toward vested rights, only serves to confirm the court's view that the social security system is essentially different from other benefit and insurance programs and still needs the flexibility provided by section 1304.

In *Farquharson v. Travelers Insurance Company*,¹⁴ the Court of Appeals of Michigan ruled (at 488) that:

...plaintiff seeks compensation because his employer's federal Social Security tax payment on his wages was terminated after he left work. An employee's interest in such payments is too speculative for it to be considered "income." Despite our recognition that plaintiff's inability to work probably affected his eventual entitlement to Social Security

¹¹ 30 L Ed 2d at 234.

¹² 420 US 636, 43 L. Ed 2d 514, 95 S Ct 1225 (1975) at 43 L. Ed 2d 523.

¹³ 65 Cal.App 3d 136, 135 Cal.Rptr.189 (1976).

¹⁴ Mich.App., 329 N.W.2d 484 (1982).

benefits, we conclude that the employer's tax is not "income" to the employee under section 3107(b).

The Alaska Supreme Court in *Mann v. Mann*¹⁵ cited *Nizenkoff* and wrote:

Unlike social security, an employee has an absolute contractual right to receive SBS benefits... (social security is a scheme of social insurance which significantly differs from ordinary deferred compensation plans).

In *Jenkins v. Kerr-McGee Corporation*,¹⁶ the Court of Appeal of Louisiana, Third Circuit at 1103 wrote:

The trial court correctly deducted income taxes from the gross past lost wages amount. It is well settled that an award for lost wages under general maritime law should be based on after tax earnings... The trial court erred, however, in adding employer FICA contributions to the net past lost wages amount. The worker is entitled to be made whole for what he has lost, i.e., his net income--what he would have received had he continued to work. *Madore v. Ingram Tank Ships, Inc.*, 732 F. 2d 475 (5th Cir. 1984). In other words, the lost income stream must be computed after deducting income taxes and social security taxes the worker would have paid had he continued to work. It is erroneous to thereafter add back the employer FICA contributions, which essentially represent the employer's half of contributions to the social security fund in the name of the worker. These payments, based upon a percentage of the gross amount paid to the worker, go directly from the employer to the federal government. The worker has no right to receive the resulting benefits until retirement or disability. Jenkins would not have directly received these payments as part of his income had he continued to work. Therefore, the employer contributions were not "lost" to him.

Though not presented here, the *Jenkins* court cited *Culver v. Slater Boat Co.* (*Culver II*):

722 F.2d 115 (5th Cir. 1983) (en banc) cert. denied 467 US 1252, 82 L. Ed.2d 842, 104 S. Ct. 3537 (1984) for its authority and reiterated at 1104 in its discussion of lost future wages that including employer FICA contributions in the computation of fringe benefits was "clearly erroneous."

The cases cited here all concern Social Security and represent a variety of types of federal litigation, as well as state litigation that applies principles set down by the federal

¹⁵ 778 P.2d 590 (1989) at 592.

¹⁶ 613 So.2d 1097 (1993).

courts relating to Social Security. The last case we cite in this section *Adams v. Burlington Northern*¹⁷ is one that does not involve Social Security, but rather the Railroad Retirement System. In one sense, *Adams* appears to go against the cases previously cited in that it states a method by which economic experts should proceed to properly value the reduction in employer railroad retirement payroll taxes made by an employer on behalf of an employee because of an injury. In another sense, however, it may be partially or fully confirming a distinction made in the cited cases between private pensions and Social Security benefits. Tier II of the Railroad Retirement System is much more like a true private pension program than is Tier I or Social Security. It may be that the existence of Tier II is what explains the difference between *Adams* and the cases previously cited.

Railroad employers and employees make payments into two "Tiers" of the Railroad Retirement System. Tier I is exactly identical to OADSHI (Social Security and Medicare). The rates are the same, the maximum amounts of income on which taxes are paid are the same, and the benefit formulas are the same. This concurrence of systems is a result of federal legislation designed to bring about this symmetry of programs. But Tier II is a system in which the amounts of employer tax payments contributed on a worker's behalf have a more direct impact on the benefit amount that the worker eventually receives, in a manner similar to a private pension program. The formula is different. Employers pay 16.1 percent, while employees pay 4.9 percent. The maximum amount of income on which the tax is paid is different from Tier I and Social Security. At the same time, Tier II has, like Social Security, functioned largely as a "pay as you go" system and, like Social Security, the Railroad Retirement System, with respect to both Tier I and Tier II, is not subject to the pension requirements of ERISA for private pensions.

Whether this explanation is valid, or is simply speculation on our parts, the Court, in *Adams*, at 751 wrote:

The plaintiff, through the expert testimony, added all the tax payments defendant would have made to the Railroad Retirement Account if plaintiff had continued working until retirement. Plaintiff claims this is the correct measure of damages due to the "actuarial nature" of the railroad retirement system, arguing that because the Railroad Retirement Board must fund benefits with revenues, there is a correlation between revenues and benefits. Any link between the taxes paid and the benefits is too tenuous to provide a true measure of plaintiffs loss.

The statute describes the method for computing retirement benefits. The formula is set out in 45 U.S.C. § 231b(b). To determine the plaintiffs lost retirement benefits, one should simply apply the formula in order to arrive at two numbers: (1) the amount plaintiff would have been entitled to if he had continued to work until age 66; and (2) the amount plaintiff will actually be entitled to. The difference between the two amounts, discounted to present value, represents plaintiffs lost benefits. Plaintiffs evidence, upon proper objection, would not have been admissible.

¹⁷ 865 S.W.2d 748 (Mo.App.W.D. 1993).

Therefore, this requirement of the *the curative admissibility doctrine* is satisfied (italics added).

Adams v. Burlington Northern and the "Doctrine of Curative Admissibility"

The *Adams* case is also very interesting from another perspective. *Adams* carries an implication that, at least in Missouri, an error in how a plaintiff's economist computes losses of an injured employee may create a damaging admissibility to a jury of evidence that an injured employee is receiving disability payments from either Social Security or from the Railroad Retirement System. This is the meaning of the last two sentences in the Court's opinion in the above citation. The *Adams* court was saying three things that are important: (1) that employer payroll tax payments to the Railroad Retirement Board on behalf of the plaintiff are not a valid measure of benefits lost to the plaintiff; (2) that, unlike the court rulings involving Social Security discussed above, the Court did not believe that the estimate of the impact on benefits was too noncontractual to be included, and could be calculated from the formulas existing in current law; and, (3) the court at 751 specifically stated that the doctrine of curative admissibility could have been validly invoked by the defendant, had the defendant done so correctly.

The *doctrine of curative admissibility* is an extremely important exception to the collateral source rule that has major implications in the context of this case for calculations of lost fringe benefits. The issue at hand was that the defendant would normally have been prevented from presenting evidence that the plaintiff was receiving disability payments from the Railroad Retirement System by the collateral source rule. However, in this case, the plaintiff's expert economist had introduced invalid evidence by claiming the loss of employer paid Tier I and Tier II taxes in the employee's name as lost income. This meant that the defendant may have been able to introduce evidence of the employee's disability payments for the sole purpose of showing that the employee had not suffered a loss in the amount claimed by the plaintiff. In other words, because the economic expert for the plaintiff had invalidly introduced the amount of the employer's Tier I and Tier II taxes that would have been paid on the employee's behalf, the defense may have had the right to introduce evidence that the employer had been receiving disability payments to "cure" the plaintiff's introduction of invalid evidence.

In *Adams*, the defendant had not made a proper reference to the collateral source rule or the curative admissibility doctrine at the trial court level and the Court of Appeal ruled against the defendant. But the Court of Appeal went out of its way at 751 to state clearly that the doctrine did apply to the circumstances of the case. On this matter the Court wrote:

(The doctrine of curative admissibility) allows a party to answer inadmissible evidence introduced by the opposing party with similar inadmissible evidence if its introduction would remove any unfair prejudice caused by the admission of the earlier inadmissible evidence...In order for the doctrine to come into play, the following requirements must be met: the earlier evidence must have been inadmissible. *Id.*: it must not have been objected to when offered. *Id.*: the rebutting evidence is needed to remove an unfair prejudice which might otherwise ensue from the original evidence...

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The curative evidence, i.e., that plaintiff would receive disability income from the time of the accident until his retirement date, must be of the same type or character as the earlier inadmissible evidence. Phoenix Redevelopment, 812 S.W.2d at 886. Defendant argues that the admission of the disability benefits will show that plaintiff is receiving some benefits from the fund and, therefore, did not lose the entire amount of defendants contribution. Whether this cures the earlier testimony or is of the same type or character and thereby admissible rests to a great extent within the discretion of the trial court. *Elliot v. Mid-Century Ins. Co.*, 701 S.W.2d 462, 466 (Mo.App.1985). We are not prepared to say that the court abused its discretion in denying the offer of proof. It was within the trial courts discretion to refuse the evidence.

The Court went on to make it clear that a big part of the problem was that the defendant had not included the doctrine of curative admissibility at the trial court level and that the burden of proof for making such arguments rests with party offering the evidence to explain the proper grounds for its admission (at 752).

Granting the trial court discretion is particularly significant under the unique rules of evidence argued here. The defendant made alternative arguments to the court, one in which it claimed that the proffered evidence was admissible as an exception to the collateral source rule and the other in which it acknowledged that the offered evidence was inadmissible. Under these circumstances, it is necessary that the court understand not only what evidence was being offered, but also the theory of its evidentiary admissibility. We have carefully reviewed the defendants offer of proof and find no reference to the collateral source rule or the curative admissibility doctrine or any description that comes close to those two theories of admissibility. The only identification made is the argument that exclusion of the evidence of disability payments will result in double damages. This characterization does not sufficiently inform the trial judge. In order to avoid trial court error and to enable the court to rule intelligently, the burden is on the party offering the evidence to explain the proper grounds for its admission...This is particularly so where the proffered evidence, as here, is normally inadmissible.

We want to be careful not to overstate the potential applicability of this doctrine in states other than Missouri, or to imply what tests need to be met in other states for this doctrine to apply. Nevertheless, *Adams* carries the implication that incorrect calculations of a lost fringe benefit by an economist may open a damaging admissibility of evidence of disability payments to an injured worker by the defense. This fact alone suggests that forensic economists need to become more aware of relevant case law.

Conclusion

Since this has been a descriptive paper, there is no need for a summary of the information provided. We will, however, restate our underlying premise that many forensic

reports we have seen in widely differing areas of the United States do not properly account for the legal requirements described in this paper. As economists and not attorneys, we are not ultimately responsible for legal interpretations about what is and what is not permissible under the law. But if we are to hold ourselves out as experts, we need to stay current and be well versed in the structure imposed by statute, case law, and court customs that affect our calculations. Where the law is concerned, the final determination must be left to the employing attorney, but our clients will be better served if we know enough about the law to ask the right questions.