

Tax-Free Wrongful Imprisonment Recoveries

By Robert W. Wood

Robert W. Wood practices law with Wood & Porter in San Francisco (<http://www.woodporter.com>) and is the author of *Taxation of Damage Awards and Settlement Payments* (4th ed. 2009), *Qualified Settlement Funds and Section 468B* (2009), and *Legal Guide to Independent Contractor Status* (5th ed. 2010), all available at <http://www.taxinstitute.com>. This discussion is not intended as legal advice and cannot be relied on for any purpose without the services of a qualified professional.

Although wrongful incarceration and similar recoveries are becoming common and can proceed under several different legal theories, their tax treatment has received relatively little attention. In ILM 201045023, the IRS treated a recovery as excludable from income based on personal physical injuries, prompting many in the popular press to suggest that the tax issues surrounding those recoveries are resolved.

Copyright 2011 Robert W. Wood.
All rights reserved.

Call it false imprisonment, wrongful conviction, wrongful incarceration, or another name. Sue in state court under a state wrongful incarceration statute, or for the torts of false imprisonment or malicious prosecution, or in federal court for violation of civil rights. Claims for false imprisonment are being brought in these and other forms with increasing frequency.¹

However, all of the legal bases for unlawful incarceration lawsuits are fundamentally similar. All seek damages for being unfairly and illegally locked up. Often, of course, a lawsuit advances multiple theories, including the common law torts of false imprisonment, malicious prosecution, and abuse of process.²

¹See, e.g., Sean Gardiner, "A Solitary Jailhouse Lawyer Argues His Way Out of Prison," *The Wall Street Journal* (Dec. 24, 2010), at A1.

²See Restatement (Second) of Torts section 35 (1965), sections 653 and 682 (1977).

Another common claim uses the federal civil rights statute that allows a suit for damages against any official acting under color of state law who deprives the plaintiff of a constitutional right.³ Moreover, state statutes increasingly allow claims for false imprisonment. In fact, 27 states, the District of Columbia, and even the federal government have enacted compensation statutes through which an individual can seek redress for false imprisonment.⁴

These statutes vary widely in their mechanics and requirements and in the amount and measure of compensation they allow. For example, California's maximum payout is \$100 per day of incarceration, while Wisconsin allows \$5,000 per year up to a maximum of \$25,000.⁵ New York has no ceiling on recovery.⁶ Tennessee sets a \$1 million maximum.⁷ Montana does not provide monetary compensation but only educational aid to those exonerated by post-conviction DNA evidence.⁸

The states vary not only in the maximum amount of their payout, but also in the means used to measure the amount of compensation. New Jersey and Virginia base the compensation amount on a measurement of the exoneree's earning capacity. In New Jersey, the individual is entitled to twice his yearly income in the year before incarceration, or \$20,000, whichever is greater.⁹

Virginia's compensation statute varies slightly in that the compensation is based not on the individual's previous earning, but rather on the per capita income of the Virginia population.¹⁰ Some states include lost wages as a component, although they typically do not constitute the majority of the total award and are not used as a measuring tool. In Iowa and Ohio, lost wages are paid in addition to the compensation otherwise provided by the statute.¹¹

³42 U.S.C. section 1983.

⁴For a comprehensive list, see the database provided by the Innocence Project, available at <http://www.innocenceproject.org/news/LawView1.php>.

⁵Cal. Pen. Code section 4904; Wis. Stat. section 775.05.

⁶NY CLS Ct C Act section 8-b.

⁷Tenn. Code Ann. section 9-8-108.

⁸Mont. Code Ann. section 53-1-214.

⁹N.J. Stat. section 52:4C-5.

¹⁰Va. Code Ann. section 8.01-195.11.

¹¹Iowa Code section 663A.1; ORC Ann. 2743.48.

Apart from state statutes, there is a federal statute¹² originally enacted in 1948 and substantially revised by the Innocence Protection Act of 2004 (part of the Justice for All Act of 2004).¹³ This federal law allows \$50,000 for each year of incarceration or \$100,000 for each year of incarceration spent on death row.

In addition to state and federal statutes of general application, some exonerations have involved sufficiently high profile cases that state legislatures pass targeted laws to compensate a particular wronged person.¹⁴ Also, some individuals seek enactment of a private bill entitling them to compensation for wrongful incarceration. Some of these bills even specify that the amount is tax free for state income tax purposes.

Answering the Tax Question

There are differences of opinion regarding whether all of these recoveries are or should be tax free. Most discussion seems to center on section 104, which excludes recoveries on account of personal physical injuries, physical sickness, and emotional distress arising from either. To a lesser extent, some discussion may explore the general welfare exception from gross income. After all, these payments in almost all cases are made by the government for depriving someone of freedom and welfare.

I have argued the general welfare point elsewhere and will not repeat the details here.¹⁵ I believe the argument for applying the general welfare exception to those recoveries is usually strong, whatever one thinks about section 104. Unfortunately, little attention is usually given to the general welfare exception, bringing us back to section 104.

As the voluminous section 104 authorities make clear, this statute in its post-1996 iteration requires that the payment be made on account of the physical injuries, sickness, or related emotional distress. If a payment is for emotional distress not arising out of the physical injuries or physical sickness, income tax is applicable.¹⁶ This invites discussion over *why*

the payment is being made, or in the language of the statute, “on account of” what the payment is made.

This strained verbiage isn’t exactly but-for causation.¹⁷ It is meant to be something a little more, but what? Many of us in the workaday world aren’t exactly sure what “on account of” means. Why was the payment made? What happened to the plaintiff and what is the intent of the payer?

Often, what happened to the plaintiff may not correlate exactly with the defendant’s reason for making the payment. After all, a defendant may care only about avoiding publicity or about covering up the actions of an employee. The “what happened to the plaintiff” inquiry may seem incidental. All of this is arguably true in any putative application of section 104, but it seems especially so in many wrongful incarceration cases.

Allocating the Damages

Even more frequently, the payment seems to be made for a mix of damages, including loss of freedom, loss of career, loss of consortium, familial association, reputation, and emotional distress. Often the exoneratee has been beaten, subjected to inadequate medical treatment, and more. These circumstances often become the basis for tax-free treatment.

Positions vary on whether monies should be allocated between these purely physical elements and the more generic wrongful imprisonment damages. If the exclusion of an award is based on physical injuries or sickness, it may seem appropriate to make an allocation. In some ways, however, that may depend on how one views the entire situation.

In an employment case, the payment would almost invariably be allocated even if there is a serious physical injury. In the famous IRS “bruise” ruling, the Service said that all the damages in a sexual harassment case leading up to the “first pain incident” are taxable.¹⁸ Thus, all the damages (including those for emotional distress) accruing after the first pain incident are tax free.

¹²28 U.S.C. sections 1495 and 2513.

¹³P.L. 108-405.

¹⁴See, e.g., Cal. Rev. & Tax Code section 17156, providing for exclusion from income for the \$620,000 paid by the state of California to Kevin Lee Green as compensation for 17 years of wrongful imprisonment.

¹⁵Robert W. Wood, “Are False Imprisonment Recoveries Taxable?” *Tax Notes*, Apr. 21, 2008, p. 279, *Doc 2008-7149*, 2008 *TNT* 78-28. For more information on the general welfare exception, see Wood, “The Evergreen General Welfare Exception,” *Tax Notes*, Mar. 8, 2010, p. 1271, *Doc 2010-3440*, or 2010 *TNT* 47-11; Wood, “Updating General Welfare Exception Authorities,” *Tax Notes*, June 22, 2009, p. 1443, *Doc 2009-11813*, or 2009 *TNT* 118-6.

¹⁶See H.R. Conf. No. 104-737, 301 (1996).

¹⁷See *O’Gilvie v. United States*, 519 U.S. 79, 82-83 (1996):

And the phrase ‘on account of’ does not unambiguously define itself. On one linguistic interpretation of those words . . . they require no more than a ‘but-for’ connection between any damages and a lawsuit for personal injuries. . . . On the Government’s alternative interpretation, however, those words impose a stronger causal connection, making the provision applicable only to those personal injury lawsuit damages that were awarded by reason of, or because of, the personal injuries. . . . We agree with the Government’s interpretation of the statute.

¹⁸LTR 200041022, *Doc 2000-26382*, 2000 *TNT* 201-10.

If the sexual harassment case considered in the bruise ruling has a wrongful imprisonment analogue, it would perhaps be a case in which a person is wrongfully arrested, convicted, and imprisoned for perhaps 10 years before being exonerated and released. Suppose that five years into the wrongfully imprisoned individual's sentence he is assaulted and beaten, hurt in a botched operation in the prison hospital, or otherwise subjected to some first pain incident. Does that mean all of his recovery attributable to the time before the first pain incident is taxable?

Even with sophisticated damages studies, such precision is rarely possible. However, if wrongful imprisonment is not considered to be physical by itself, that result may make some sense. Even if the compensation is bifurcated, of course, damages after the first pain incident might account for 80 or 90 percent of the total award. Alternatively, it might be 50 percent.

To me, this is a silly inquiry. A payment received for wrongful imprisonment is quite unlike the payment in the bruise ruling in which some of the award was clearly taxable. In an employment setting such as in the bruise ruling, some amount is always taxable (and probably attributable to wages).¹⁹ As I have previously asserted, I believe the loss of liberty and physical confinement is itself a physical injury within the meaning of section 104.

Of course, the only judicial guidance available on wrongful imprisonment recoveries does not say this. In *Stadnyk v. Commissioner*,²⁰ the Tax Court ruled that physical restraint and physical detention are not "physical injuries" for purposes of section 104(a)(2). However, *Stadnyk* involved facts unlike those in a typical wrongful imprisonment case.

Mrs. Stadnyk was held at a local sheriff's office for approximately eight hours, during which time she was handcuffed, photographed, confined to a holding area, and frisked. She suffered no observable bodily harm, and she admitted she was never injured or even roughed up. Given these facts, the Tax Court concluded, without much explanation, that the deprivation of personal freedom is not a physical injury for purposes of section 104(a)(2).

¹⁹It bears noting that the 1996 change to section 104(a)(2) adding the "physical" requirement appears to have arisen out of congressional concern about the application of the exclusion in the employment context. Indeed, the legislative history to the 1996 change appears to show that Congress added the "physical" requirement to ensure that section 104 reflected the U.S. Supreme Court's holding in *Schleier*: that an employment claim under the Age Discrimination Act could not be excluded under section 104(a)(2). See H.R. Conf. Rep. No. 104-737, at 300.

²⁰T.C. Memo. 2008-289 (2008), *Doc 2008-27001*, 2008 TNT 247-10.

On appeal, the Sixth Circuit tempered the Tax Court's analysis, noting that false imprisonment may indeed cause a physical injury, such as an injured wrist as a result of being handcuffed.²¹ However, the appeals court acknowledged that while false imprisonment involves a physical act — restraining the victim's freedom — it "does not mean that the victim is *necessarily* physically injured as a result of that physical act."²² Importantly, the Sixth Circuit does not foreclose the possibility that false imprisonment by itself could create a personal physical injury within the meaning of section 104(a)(2).

However, many people may read the Sixth Circuit's unpublished opinion less optimistically than I do, observing simply that the Tax Court was affirmed. All of this does little to comfort exonerees receiving recoveries after long-term wrongful imprisonment.

New Chief Counsel Advice

It seems clear that the IRS has been thinking about some of these issues, which were noted at the hearing on the section 104 regulations in February 2010.²³ The IRS recently published a legal memorandum²⁴ on which I have received numerous e-mails expressing approval that the federal income tax issues for exonerees and others who receive wrongful imprisonment recoveries are at an end. After several conversations on this point, I'm feeling self-conscious at being such a perceived nay-sayer.

Many advisers seem to be judging the legal memorandum by the headlines some members of the tax press have (inappropriately) given it, to the effect that "wrongful conviction recoveries are now tax free!" I hate to be a killjoy, but that's not what the IRS says — not by a long shot.

I've long argued for this view, and I wish the memorandum affirmed it. However, the IRS says only that a victim of wrongful imprisonment who "suffered physical injuries and physical sickness while incarcerated" can exclude his recovery from taxes and can structure it just like other physical injury victims. We already knew that.

After all, the debate over these recoveries has focused (perhaps incorrectly) on whether the

²¹*Stadnyk v. Commissioner*, 367 Fed. Appx. 586, 593 (6th Cir. 2010), *Doc 2010-4364*, 2010 TNT 40-9.

²²*Id.* Emphasis in original. For more on *Stadnyk*, see Wood, "Why the *Stadnyk* Case on False Imprisonment Is a Lemon," *Tax Notes*, Apr. 5, 2010, p. 115, *Doc 2010-5747*, or 2010 TNT 67-3.

²³See *infra* note 26.

²⁴ILM 201045023, *Doc 2010-24317*, 2010 TNT 219-20.

wrongfully jailed person experienced physical injuries or physical sickness while unlawfully incarcerated. If so, the damages are tax free, just like the more garden-variety personal physical injury recoveries. If not, well, we don't like to talk about that.

Most cases of wrongful imprisonment, especially those that are long term, involve significant levels of physical injuries and sickness. For that reason, as a practical matter, we tend to use a justification for tax-free treatment that we know appeals to the IRS. But is this appropriate under the circumstances? Put another way, is that really why the victim is getting most of the money?

Usually, no is the answer. It may be difficult or even impossible to dissect into levels the horror experienced by the wrongfully imprisoned individual. In many cases, however, the loss of physical freedom and civil rights is at the root of the need for reparations. A payment for a loss of freedom should be tax free in its own right. Although I commend the IRS for saying what it did in its recent legal memorandum, that isn't the issue.

The IRS issued a series of rulings in the 1950s and 1960s involving prisoners of war, civilian internees, and holocaust survivors.²⁵ Sensibly, the IRS ruled that their compensation was tax free regardless of whether they suffered physical injuries. The IRS later "obsoleted" these rulings in 2007, suggesting the landscape had changed.²⁶ Yes, section 104 was amended in 1996, but these rulings from the 1950s and 1960s were not based on section 104. Rather, as recoveries for the loss of "personal rights," the amounts were not taxable.

The IRS has still not addressed whether being unlawfully locked up is itself tax free. This is a worry, particularly given *Stadnyk*. While *Stadnyk*

involved a very short-term incarceration, it may portend continuing adherence to the canard that "there must also be physical injury."²⁷

Interestingly, the recent IRS legal memorandum does not attempt to allocate the compensation under the state statute between the payment for physical injuries and sickness and the other damages. I applaud that treatment, since I don't think the first pain incident analogy makes any sense in this context. Perhaps the Service does not, either.

That the IRS does not broach the allocation point might mean that the Service views the money as awarded entirely for physical injuries and sickness. It might also mean that the time-based payment is carried along with the physical injury payment. It might even mean that the time-based payment on its own would be tax free, although the latter seems the least likely.

In any case, it is good that the IRS does not attempt to parse the recovery in its memorandum. Nevertheless, what would happen (however unlikely it may seem) if we had an exoneree who spends years in prison but, like Mrs. Stadnyk, says he was never roughed up, beaten, or given inadequate medical care? Despite the Tax Court's platitudes in *Stadnyk*, such a hypothetical recovery should still be tax free.

I believe it is wrong as a matter of tax policy and as a matter of social justice to tax these recoveries. Although I recognize that the IRS has much on its plate, it also seems wrong to leave this area of the tax law to develop piecemeal. The continuing myopic focus on the accompanying physical injuries or sickness will foment continuing confusion.

²⁷But see comments of Michael Montemurro, branch 1 chief of the IRS Office of Associate Chief Counsel for Income Tax and Accounting, Public Hearing on Proposed Regulations, 26 CFR Part 301, "Damages Received on Account of Personal Physical Injuries or Physical Sickness" (REG-127270-06), Feb. 23, 2010: "I mean I don't know that the Service has ever gone to court on litigation, you know, I know the Service doesn't ever go to court on litigation, [regarding] anybody who's been falsely imprisoned or anyone who's suffered any sex abuse, as far as asserted in a courtroom that those kinds of damages are taxable, I mean whatever the pure technical answers may be," at 10, *Doc 2010-4501*, 2010 *TNT* 41-15.

²⁵Rev. Rul. 55-132, 1955-1 C.B. 213; Rev. Rul. 56-462, 1956-2 C.B. 20; Rev. Rul. 56-518, 1956-2 C.B. 25; Rev. Rul. 58-370, 1958-2 C.B. 14.

²⁶Rev. Rul. 2007-14, 2007-12 IRB 747, *Doc 2007-4230*, 2007 *TNT* 34-15.

SUBMISSIONS TO TAX NOTES

Tax Notes welcomes submissions of commentary and analysis pieces on federal tax matters that may be of interest to the nation's tax policymakers, academics, and practitioners. To be considered for publication,

articles should be sent to the editor's attention at taxnotes@tax.org. A complete list of submission guidelines is available on Tax Analysts' Web site, <http://www.taxanalysts.com/>.