

Tax on Wrongful Imprisonment Damages Should Be Eliminated

By Robert W. Wood

The movie “*Conviction*” stars Hillary Swank in the true-life story of Betty Anne Waters who was in her late 20s when her brother Kenny was wrongly convicted of murder and sentenced to life in prison. Committed to exonerating him, she spent the next 18 years getting a community college degree, completing college, earning a law degree, and then tirelessly working to free her brother. Uncovering police misconduct, perjured testimony, lying witnesses, and with conclusive DNA evidence, she finally freed him.

Every such story is dramatic and gut wrenching, and this one is no exception. Few lawyers, even those quite familiar with the criminal justice system, can imagine the ordeal of being unjustly accused, tried, convicted, and imprisoned. Even in these days of DNA evidence, prisoners and their loved ones face an arduous task on the road to exoneration.

Once freed, many exonerees seek recompense from the government, particularly where laws were broken to convict them. Although some recoveries for long-term wrongful imprisonment are in the millions of dollars, many are smaller and can hardly be called generous. Some states have statutory schemes, such as \$50,000 per year of wrongful incarceration. The biggest payouts usually involve prosecutors who have unlawfully buried witnesses and destroyed evidence.

Exonerees may receive payment under federal or state civil rights or compensation statutes or under the common law of false imprisonment. As a tax lawyer, I believe such damages should be free of tax, and the precise nature of the suit or statute should not be important. Yet oddly, these tax issues have become quite controversial. Federal legislation to exempt such recoveries from tax has repeatedly failed to become law.

There used to be no debate. A longstanding series of Internal Revenue Service rulings issued more than 40 years ago accorded tax-free treatment to survivors of Nazi persecution, prisoners of war, and Japanese-American internees. Then, in 2007 the IRS abruptly cancelled these rulings, ostensibly because the tax law requires injuries to be “physical” before a recovery is tax-free.

Some exonerees have been forced to pay taxes on their awards, presumably because there is nothing “physical” about being locked up. In one case, the U.S. Tax Court, affirmed by the 6th U.S. Circuit Court of Appeals, ruled that “[p]hysical restraint and physical detention are not ‘physical injuries’.... Nor is the deprivation of personal freedom a physical injury.” This is wrong and dangerously so. Even if a victim of wrongful imprisonment is never beaten or mistreated, he suffers a deprivation of liberty that is manifestly physical.

The IRS recently took a positive step (albeit a small one) in IRS Chief Counsel Advice 201045023 (Nov. 4, 2010). This IRS ruling considers the tax treatment of a recovery for wrongful conviction, ruling it to be tax-free. It has caused some advisers to proclaim broadly that “all wrongful conviction recoveries are now tax free!”

I wish I could agree, but that’s not (at all) what the IRS ruling says.

In fact, this IRS ruling only considers one person and is not precedential in nature. More important, the ruling is explicit that the victim of wrongful imprisonment whose facts are considered “suffered physical injuries and physical sickness while incarcerated.” For that reason, the ruling concludes he can exclude his recovery from taxes and can structure it just like other physical injury victims.

That hardly signals a change in the law. The debate over the tax treatment of such recoveries has long focused on the factual question whether the wrongfully imprisoned person experienced physical injuries or physical sickness while incarcerated. If so, the damages are tax-free, just like more garden variety personal physical injury recoveries. But if not, then what?

Exonerees often have significant physical injuries and sickness attributable to their time in prison. But the dangerous corollary is that if they cannot prove such injuries, the recovery may be taxed. It is wrong as a matter of social policy and as a matter of tax law to require this awkward dance. It may be difficult or impossible to separate out all of the multiple levels of horror, all the losses that can never be made up. Yet a payment for a loss of freedom should be tax-free in its own right. One should not have to disguise it under the rubric of physical injuries.

I commend the IRS for saying what it did say in IRS Chief Counsel Advice 201045023. But the IRS has still not addressed whether being unlawfully locked up is *itself* tax-free. This is worrisome and portends continuing adherence to the IRS canard that “there must be physical injury.” As an administrative matter, it also suggests that IRS agents in the field will still seek to verify the requisite level of physical injuries. This generally requires that they be manifest, such as bruising and broken bones.

It is wrong to leave this area of the tax law to develop piecemeal while some exonerees are paying tax. The IRS’ continuing myopic focus on accompanying injuries or sickness will simply foment more tax disputes. It’s time for the IRS to say clearly and unequivocally that recoveries for wrongful imprisonment are tax-free.

This discussion is not intended as legal advice, and cannot be relied upon for any purpose without the services of a qualified professional.



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