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Wrongful Imprisonment Tax Ruling Stirs Controversy

As a tax lawyer, I believe exonerated prisoners who receive damages for wrongful imprisonment should not have to pay tax on their awards. See [Tax On Wrongful Imprisonment Needs Reform](#). Perhaps for that reason, people have been gleefully emailing me the IRS's latest: IRS [Chief Counsel Advice 201045023](#). Everyone *seems* to be reading it by the headline the tax press is (inappropriately) giving it, proclaiming “wrongful conviction recoveries are now tax free!”

Since I've long argued for this view, I hate to be a killjoy. Unfortunately, that's not what it says—not by a long shot. In fact, this IRS ruling 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 (probably incorrectly) on the factual question whether the wrongfully jailed person experienced physical injuries or physical sickness while unlawfully incarcerated. If so, the damages are tax free, just like more garden variety personal physical injury recoveries. If not . . . well, we don't like to talk about that one.

Admittedly, there are usually significant levels of physical injuries and sickness, especially in long term wrongful imprisonment cases. For that reason, as a practical matter, we tend to use the hook for tax free

treatment 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. It may be difficult or even impossible to separate out all of the multiple levels of horror, all the losses that can never be made up. But in many cases, 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.

I commend the IRS for saying what it did say in IRS [Chief Counsel Advice 201045023](#). But 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. Sensibly, the IRS ruled their compensation was tax free irrespective of whether they suffered physical injuries. Then the IRS "obsoleted" these rulings in 2007, suggesting the landscape has changed.

The IRS has still not addressed whether being unlawfully locked up is *itself* tax free. This is a worry, since the Tax Court (affirmed by the [Sixth Circuit](#)) dangerously held in [Stadnyk](#) that persons who step forward saying they *didn't* experience physical injuries or physical sickness will have a taxable recovery. *Stadnyk* was a very short term incarceration case, but it may portend continuing adherence to the IRS canard that "there must *also* be physical injury."

It is wrong as a matter of tax policy and as a matter of social justice to tax these recoveries. It is also wrong to leave this area of the tax law to develop piecemeal so some people are paying tax. The continuing myopic focus on the accompanying injuries or sickness will foment tax disputes about these issues.

It's time for the IRS to say it clearly and unequivocally. That's a headline I'll underscore.

For more reading, see:

[Tax On Wrongful Imprisonment Needs Reform](#)

[Why the *Stadnyk* Case on False Imprisonment Is a Lemon](#)

Should False Imprisonment Damages Be Taxable?

Why False Imprisonment Recoveries Should Not Be Taxable

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