

Are False Imprisonment Recoveries Taxable?

By Robert W. Wood

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News stories about prisoners released from custody following the discovery of exculpatory evidence have been cropping up with increasing frequency. As *CSI* fans will attest, one path that can lead to this result involves DNA evidence, a relatively recent scientific phenomenon.¹ A more disturbing path involves the discovery of prosecutorial misconduct.² Still another involves evidence or witnesses that somehow escaped everyone's attention.

However the evidence comes about, we cannot help but notice an uptick in these stories. Given the generally litigious nature of our society (and the corollary theory that for every wrong there is a right), it is hardly surprising that the number and size of settlements from claims for wrongful conviction and imprisonment have blossomed.³

¹See <http://www.innocenceproject.org/Content/351.php> (statistics show that 145 of the 208 postconviction DNA exonerations have been since 2000).

²See <http://www.innocenceproject.org> (profiles of exonerated individuals whose conviction was partially or completely overturned based on prosecutorial misconduct: Billy Wardell, Marvin Anderson, and Jeff Deskovic); Edwin M. Borchard, *A Long Legacy of Error*, excerpted from *Convicting the Innocent: Errors in Criminal Justice* (New Haven, Yale University Press, 1932) (discussing the inherent flaw in our prosecutorial system in which a conviction is regarded as a personal victory for the prosecutor).

³See *Martinez v. Brink's, Inc.*, No. CL0103469AH (S.D. Fla. Oct. 2, 2003) (the plaintiff won an \$8.26 million verdict for malicious prosecution after spending six months in pretrial detention); *Bravo v. Giblin*, No. B125242, 2002 WL 31547001, at 24 (Cal. Ct. App. Nov. 18, 2002) (approving an award of \$3,925,976, including \$3,537,000 to compensate for three years of incarceration).

As such, it seems inevitable that the income tax affects of these increasingly large recoveries will bubble to the surface. When someone who has been in jail is vindicated and released, and receives money from the state, county, or federal government on account of their unlawful incarceration, is that recovery taxable? It would seem there would be a clear answer.

After all, despite the increase in volume, this is not a new phenomenon. Although large recoveries may represent a recent trend, recoveries for wrongful imprisonment have occurred for generations.⁴ Before embarking on a tour of the pertinent federal income tax law, the paucity of tax authority on these issues, and the reasons I believe these recoveries should be tax free, we should review the types of causes of action that may be brought.

I. Types of Recoveries

Claims for false imprisonment may be brought in myriad guises. However, all of the legal bases of suing for unlawful incarceration have more similarities than differences. Someone who has claims for a wrongful incarceration may seek to recover in one or more ways.

A wrongfully convicted individual can attempt to recover under several common-law tort theories, including false imprisonment, malicious prosecution, and abuse of process.⁵ This individual could also bring an action under 42 U.S.C. section 1983 for violation of his constitutional rights. A section 1983 action allows a lawsuit for damages against any official acting under color of state law who deprives the plaintiff of a constitutional right.⁶ Some individuals seek to have a private bill enacted by their state legislature entitling them to compensation for wrongful incarceration.

Finally, state statutes may expressly allow claims for false imprisonment. In fact, 22 states, the District of Columbia, and even the federal government have enacted compensation statutes through which an individual can seek redress for false imprisonment. The sections that follow briefly review each of these avenues of recovery. These sections are not intended as an authoritative legal discussion, but only as an overview to set the stage for an examination of the tax authorities.

A. Common Law

The common-law tort of false imprisonment requires an individual to prove that he was knowingly and intentionally confined, against his will and without his consent, and that the confinement was not privileged.⁷ A

⁴See Borchard, *supra* note 2.

⁵See *Restatement (Second) of Torts* section 35 (1965), section 653 (1977), section 682 (1977).

⁶42 U.S.C. 1983 (1996).

⁷*Restatement (Second) of Torts* section 35 (1965).

false imprisonment claim can be brought against any individual, not merely against the state. For example, a bank robber may be guilty of false imprisonment for taking a bank's customers and employees hostage, physically preventing their escape.

Of course, we are not concerned here with the actions of civilians, but rather with government action leading to false imprisonment. Suits against the government and against government officials have their own problems. The most difficult obstacle for an exonerated person in bringing such a claim is proving that the actor was not "privileged" to arrest or imprison the individual.⁸

At common law, an action for confinement resulting from an arrest under valid process was brought as a claim for either malicious prosecution or abuse of process. Malicious prosecution is related to, but distinct from, false imprisonment. To prove malicious prosecution, a wrongfully convicted person must generally show that:

- a prosecutor initiated a proceeding against him;
- the proceeding terminated in favor of the wrongfully convicted person;
- the prosecutor initiated the case without probable cause;
- the primary purpose of the prosecution involved malice (or something other than bringing the individual to justice); and
- damage resulted from the prosecution.

Thus, to recover for malicious prosecution, an exonerated individual would need to show that the prosecutor brought criminal charges without probable cause, resulting in the plaintiff's wrongful conviction and incarceration, as evidenced by his later exoneration.⁹

Abuse of process is another common-law tort. It is related to (but distinct from) malicious prosecution and false imprisonment. To prove abuse of process, an individual must show that the legal process was used "primarily" to accomplish a purpose for which it was not designed.¹⁰ An abuse of process claim does not focus on the procurement of process or the wrongful initiation of proceedings. Rather, the claim focuses on the use of the process for an improper purpose.¹¹

To recover under any one of these tort theories, the claimant must prove all of the elements of the offense, and must overcome any obstacles to recovery, such as a privilege defense. Precisely who can be sued is a delicate matter. Notably, sovereign immunity generally insulates the government from intentional tort claims.¹²

Likewise, prosecutors and judges have absolute immunity for acts in their official capacities, regardless of their motives or intent to wrongfully convict the individual.¹³ Finally, police officers are generally immune from liability for an arrest, provided it was made within the scope of their authority.¹⁴ For this reason, unless

immunity is waived, the wrongfully convicted individual will often have to turn elsewhere for compensation.¹⁵

B. Section 1983

Section 1983 was originally enacted as part of the Civil Rights Act of 1871.¹⁶ The statute was amended in 1996 as part of the Federal Courts Improvement Act of 1996. Before the 1871 enactment of section 1983, states and those acting with state imprimatur were not liable for violations of the U.S. Constitution. Section 1983 allows an action against any person, acting under color of any statute, for a violation of an individual's constitutional rights.¹⁷

Section 1983 provides a statutory framework by which a wrongfully convicted individual can seek compensation from police officers, prosecutors, and municipalities for violating his constitutional rights. The underlying purposes of section 1983 are to compensate victims for past abuses and to serve as a deterrent against future constitutional abuses.¹⁸

A section 1983 action can be based on the notion that a lawsuit for damages against an official, acting under color of state law, is proper when the official deprives the individual of a constitutional right.¹⁹ A typical claim would assert violation of the Fourth Amendment's prohibition on illegal search and seizure, or a violation of the Fifth Amendment's guarantee of due process of law.²⁰

For example, in one case, the police withheld exculpatory information from the prosecutor and encouraged witnesses to pick the defendant out of a police lineup, contributing to a guilty verdict. After spending 15 years in prison, the wrongfully convicted individual was found innocent and pardoned by the governor. The individual then brought a successful action under section 1983 for a violation of his due process rights.²¹

One problem with the viability of many section 1983 claims is that the individual must prove a constitutional violation. Furthermore, even assuming that this initial burden is met, the individual must contend with the probable cause barrier. In the case of a police officer, if the officer had probable cause (a very low standard), he is generally immune from prosecution.²²

An alternative (although still within the rubric of section 1983) is to bring an action against the prosecutor for violating the individual's Fifth Amendment right to liberty.²³ Such an action against the prosecutor will likely fail, as prosecutors have absolute immunity from suits arising out of their prosecutorial duties.²⁴ The origin of

¹⁵See Adele Bernhard, "When Justice Fails: Indemnification for Unjust Conviction," 6 *U. Chi. L. Sch. Roundtable* 73, 86-92 (1999).

¹⁶See generally 42 U.S.C. 1983 (1996).

¹⁷*Id.*

¹⁸*Owen v. City of Independence*, 445 U.S. 622, 651 (1980).

¹⁹*St. Louis v. Praprotnik*, 485 U.S. 112, 121-131 (1988).

²⁰*Elkins v. United States*, 364 U.S. 206 (1960).

²¹*Newcome v. McCabe*, 256 F.3d 747, 752 (7th Cir. 2001), *aff'd*, 319 F.3d 301 (7th Cir. 2003), *cert. denied*, 539 U.S. 543 (2003).

²²*Illinois v. Gates*, 462 U.S. 213, 238 (1983).

²³*Imbler v. Pachtman*, 424 U.S. 409, 420-429 (1976).

²⁴*Id.* at 424.

⁸*Restatement (Second) of Torts* sections 10, 118, 121-132 (1965).

⁹*Restatement (Second) of Torts* section 653 (1977).

¹⁰*Restatement (Second) of Torts* section 682 (1977).

¹¹*Id.*

¹²28 U.S.C. 2680(h) (2000).

¹³*Restatement (Second) of Torts* section 656 (1977).

¹⁴*Restatement (Second) of Torts* sections 118, 121-132 (1965).

that immunity is the concern that “harassment by unfounded litigation would cause a deflection of the prosecutor’s energies . . . and the possibility that he would shade his decisions instead of exercising the independence of judgment required by his public trust.”²⁵

C. State Legislative Remedies

Although it has not occurred frequently, some individuals (particularly those who have received good press coverage of their plight) may turn to their state legislature to seek redress for false imprisonment. The victim may be able to influence the state legislature to pass a private bill to award compensation directly from the state treasury.²⁶ This avenue has a couple of major limitations.

The first is that many courts have viewed a private compensatory bill as potentially violating the U.S. Constitution. Indeed, the 14th Amendment states that a legislature cannot pass a bill for the benefit of one person without passing legislation for all similarly situated people.²⁷ The second stumbling block is the reality that not all wrongful conviction cases garner significant — or even favorable — press.

Moreover, few exonerated individuals have the resources necessary to influence the state legislative bodies to act on their behalf. For these reasons, a private bill is a remedy available for very few cases.

D. State Compensation Statutes

State compensation statutes are another avenue for a wrongfully convicted individual to seek compensation for years spent behind bars. Twenty-two states and the District of Columbia have enacted general compensation statutes, allowing an individual to pursue a claim against the state for wrongful conviction. These statutes all provide some type of compensation for wrongful imprisonment, but they vary greatly in their requirements, as well as in their compensation levels.

Some of the state statutes require an official pardon from the governor before an individual can file a claim.²⁸ Some states only allow a recovery if the conviction was for a felony.²⁹ Almost half of the statutes preclude a recovery when the individual entered a guilty plea. The idea of disqualifying an individual who has pleaded

guilty appears to be that compensation should be unavailable to an individual who played a part in his own conviction.³⁰ Of course, some defendants are coerced into confessing, or face such bleak circumstances that a plea bargain (and confession) may be the only way to avoid the death penalty or a life sentence.

The states also vary in the amount and measure of compensation. For example, California’s maximum payout is \$100 per day of incarceration, whereas Wisconsin allows a recovery of only \$5,000 per year, up to a maximum of \$25,000.³¹ Some states, notably including New York, have no ceiling on the allowable recovery.³² Other states, such as Tennessee, have a \$1 million maximum.³³ Another variation is Montana, which does not provide for any monetary compensation. Instead, Montana provides only educational aid to those exonerated by postconviction DNA evidence.³⁴

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 exonerate’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. Virginia’s compensation statute varies slightly, in that the compensation is based not on the individual’s prior earning, but rather on the per capita income of the Virginia population.³⁵

There are also states that include lost wages as a component of the total compensation amount. In these states, lost wages do not make up the majority of the compensation and are not used as the measure from which to pay out compensation. In Iowa, Ohio, and Texas, lost wages are paid in addition to the compensation otherwise provided by the statute.

E. Federal Compensation Statute

An individual may also choose to sue under the federal compensation statute for unjust conviction and imprisonment.³⁶ This statute was originally enacted in 1948.³⁷ To succeed, the plaintiff must prove that:

- his conviction has been reversed or set aside on the ground that he is not guilty of the offense of which he was convicted, or on new trial or rehearing he

²⁵*Id.*

²⁶See, e.g., *An Act Compensating James C. Tillman for His Wrongful Conviction and Incarceration*, Connecticut H.B. 6673, Special Act No. 07-5 (May 21, 2007), available at <http://www.cga.ct.gov/2007/ACT/SA/2007SA-00005-R00HB-06673-SA.htm>.

²⁷Barry Scheck et al., *Actual Innocence: Five Days to Execution and Other Dispatches From the Wrongly Convicted* (Doubleday, 2000).

²⁸See Cal. Penal Code section 4900; 505 Ill. Comp. Stat. Ann. 505/8(C); Me. Rev. Stat. Ann. Tit. 14, section 8241(4); Md. Code Ann. State Fin. & Proc. section 10-501(b); N.C. Gen. Stat. section 148-82.

²⁹See Ala. Code section 29-2-156; Cal. Penal Code section 4900; Mass. Gen. Laws Ann. Ch. 258D, section 1(C)(ii); Mo. Ann. Stat. section 650.055(9)(I); Mont. Code Ann. section 53-1-214(1); N.C. Gen. Stat. section 148-82; Ohio Rev. Code Ann. section 2743.48(A); Okla. Stat. Ann. Tit. 51, section 154(B)(1); Va. Code Ann. section 8.01-195.10(B).

³⁰See Cal. Penal Code section 4903; D.C. Code section 2-422(2) (2001); Iowa Code Ann. section 663A.1(b) (West 1998); N.J. Stat. Ann. section 52.4C-3(C) (West 2001); N.Y. Cr. Cl. Act section 8-b(5)(d) (McKinney 1989); Ohio Rev. Code Ann. section 2743.48(A)(2) (LexisNexis Supp. 2006); Okla. Stat. Ann. Tit. 51, section 154(B)(2)(b) (West Supp. 2006); Va. Code Ann. section 8.01-195.10(B) (Supp. 2006); W. Va. Code Ann. section 14-2-13a(e) (LexisNexis Supp. 2006).

³¹See generally <http://www.innocenceproject.org/fix/National-View1.php> (gives state by state breakdown of the compensation statutes, their requirements, and their payouts).

³²*Id.*

³³*Id.*

³⁴*Id.*

³⁵*Id.*

³⁶28 U.S.C. section 1495 (2000); 28 U.S.C.A. section 2513 (West Supp. 2006).

³⁷*Id.*

was found not guilty of such offense . . . or that he has been pardoned upon the stated ground of innocence and unjust conviction; and

- he did not commit any of the acts charged . . . and he did not, by misconduct or neglect, cause or bring about his own prosecution.³⁸

If adequate proof is established, the individual can recover \$50,000 for each year of incarceration, or \$100,000 for each year of incarceration spent on death row.³⁹

The Innocence Protection Act of 2004 was enacted as a part of the Justice for All Act of 2004 (JFAA).⁴⁰ Signed into law by President Bush on October 30, 2004, the JFAA was designed to provide additional victim's rights, additional funds and protocol for DNA testing, postconviction testing to prove innocence, and additional compensation for persons wrongfully convicted.⁴¹ The JFAA increased compensation to wrongfully convicted persons under the federal wrongful conviction statute from \$5,000 to \$50,000 per year (\$100,000 in the case of a year spent on death row).⁴² The JFAA also expressed Congress's belief that states should provide compensation to any person wrongfully convicted and sentenced to death.⁴³

II. Ancillary Claims

As this brief review of the types of causes of action arising out of false imprisonment makes clear, there is significant variety in those claims. Nevertheless, there is an overwhelming level of consistency in the pertinent fact patterns and in what must be proven. There are more similarities than differences.

Moreover, regardless of the precise manner and forum in which those claims are pursued, there is another virtual constant. Often, there are ancillary claims expressly or implicitly made in the context of that litigation.⁴⁴

For example, in addition to false imprisonment, the plaintiff may have a claim for poor medical care during the plaintiff's time in prison, which may constitute medical malpractice under prevailing standards. Other ancillary claims may involve loss of consortium by spouses and loved ones, rape claims against government employees and institutions (for which the state may bear some responsibility), battery, invasion of privacy, and so on. Many of these ancillary claims are indisputably tort claims (such as medical malpractice), and under tradi-

tional federal income tax principles, they should presumably yield a tax-free recovery to the injured party.⁴⁵

Moreover, if one family member is seriously injured in an accident, another family member may have a loss of consortium claim against the tortfeasor. Traditionally, a loss of consortium claim is regarded as physical, and so is tax free to the spouse (or other family member), based on the assumption that the injury giving rise to the loss of consortium is also tax free.⁴⁶ Such loss of consortium claims have a kind of piggyback status, deriving their tax-free character from the underlying tort claim involving the injured party that gave rise to the loss of consortium.⁴⁷

It is difficult to address all such ancillary causes of action within the more standard model of a false imprisonment claim. Generally speaking, however, these ancillary causes of action will make the case for a tax-free recovery to the falsely imprisoned individual much better.

Example: Gideon is sent to prison for five years for a crime he did not commit. While in prison, he receives medical care that is grossly inadequate and causes him permanent physical injuries. If Gideon later recovers for these various harms, there is a better case for his recovery being fully excludable from his income than if he had the same fact pattern but without the medical malpractice.

One likely reason there is little discussion of the tax treatment of wrongful imprisonment recoveries is the frequent interaction between the underlying false imprisonment claim and the all-too-frequent ancillary claims. Sometimes the ancillary claims may rise to a primacy of seriousness (such as medical malpractice in the prison hospital), in which the causes of action for such ancillary claims are quite meritorious in their own right. In those cases, neither taxpayers nor the IRS may be focusing too clearly on precisely how the wrongful imprisonment recovery, by itself, should be taxed.

In any event, because of both the variation in these ancillary claims and the extent to which they cloud (and frankly make easier) the underlying question whether false imprisonment claims *by themselves* should give rise to damage awards that are fully excludable from the exonerated individual's income, I focus here not on any of the ancillary claims, but simply on false imprisonment itself.

³⁸*Id.*

³⁹*Id.*

⁴⁰Justice for All Act of 2004, P.L. 108-405, section 431-432, 118 Stat. 2260, 2260-2261 (2004).

⁴¹*Id.* at 2293.

⁴²*Id.*

⁴³*Id.*

⁴⁴Although I use the term "litigation" here, some disputes of this nature are resolved far more amicably, with the state seemingly recognizing, long before any lawsuit is filed, that it made a mistake and that it should pay for that mistake. See, e.g., Azrael Sky, "Man Receives \$5 Million for Rape He Didn't Commit," available at http://www.associatedcontent.com/article/248548/man_receives_5_milli_on_for_rape_he.html.

⁴⁵See generally section 104(a)(2); *Commissioner v. Schleier*, 515 U.S. 323, 115 S. Ct. 2159, Doc 95-5972, 95 TNT 116-8 (1995).

⁴⁶*Id.*; *Francisco v. United States*, 54 F. Supp.2d 427, 435, Doc 1999-20985, 1999 TNT 128-8 (E.D. Pa. 1999), *aff'd*, *Francisco v. United States*, 267 F.3d 303, Doc 2001-27013, 2001 TNT 208-8 (3d Cir. 2001).

⁴⁷LTR 200121031, Doc 2001-15011, 2001 TNT 103-10.

III. Tax Authorities

A. Section 104 Authorities

The Internal Revenue Code has provided an exclusion for personal injury damages for more than 80 years.⁴⁸ Most states follow suit. For the bulk of this long history, the exclusion from income applied to any damages received (by judgment or settlement) for personal injuries or personal sickness. That meant emotional distress damages were also excludable from income.

In 1996, however, the statute was amended to narrow the exclusion to cover only damages for personal *physical* injuries and *physical* sickness.⁴⁹ This simple but far-reaching statutory change was made primarily in response to what both Congress and the IRS viewed as abuses by lawyers and their plaintiff clients in employment lawsuits.⁵⁰ Although many employees sue for discrimination or wrongful termination, and a portion of damages received for such claims is almost invariably for lost wages, some plaintiffs and their counsel became aggressive in seeking to allocate the bulk of their recoveries from such claims to “emotional distress.” The 1996 amendment to section 104 was expressly designed to stem that tide and to make emotional distress recoveries taxable.

Surprisingly, the IRS has failed to update its regulations since 1996, and has provided no official guidance on the meaning of the term “physical.”⁵¹ Private letter rulings suggest that the IRS believes not only that there must be a physical striking of the plaintiff, but that the plaintiff must also experience observable bodily harm (broken bones, bruising, and so on).⁵² The legislative history to the 1996 amendment to section 104 indicates Congress’s view that mere symptoms of emotional distress do not result in excludable awards. Thus, headaches, stomachaches, and insomnia, commonly

experienced by those in stressful situations, are not sufficiently “physical” to give rise to an exclusion from income.⁵³

Unfortunately, there is little authority from which to divine the line between mere symptoms of emotional distress on one hand, and physical injuries or physical sickness on the other. Is a stroke a mere headache? Are bleeding ulcers mere stomachaches?⁵⁴

Perhaps more significantly, is the IRS correct that there must be a striking for an exclusion to be available? I believe the answer must be no, and that some physical consequences must be viewed as serious enough to constitute physical injury or physical sickness, and thus to give rise to an exclusion from income, despite the absence of a physical battery.⁵⁵ Yet the issue remains controversial.

1. *Schleier* test. The U.S. Supreme Court in *Commissioner v. Schleier*⁵⁶ established a two-part test for determining whether a payment is excludable from income under section 104. The test came before the 1996 amendments to section 104, but the case continues to be relied on, now with the “physical” modifier. The first prong of this test requires a taxpayer to establish that damages were received through a tort or tortlike action.⁵⁷ The second prong requires a taxpayer to establish that the damages received were “on account of” personal (physical) injury.⁵⁸

Despite this seemingly simple test, the courts have struggled to apply it. Most of the case law has been decidedly antitaxpayer, giving an unduly narrow focus to section 104. The cases are legion in which taxpayers fail to carry their burden of proving a recovery to be excludable under the *Schleier* standard. For example, in *Reid v. Commissioner*, the Tax Court held a tort recovery for wrongful discharge not to be excludable because it was not received “on account of” personal physical injuries or physical sickness.⁵⁹

Reid, a cashier at a Florida Chevron station, alleged he was injured lifting a bucket of ice and filed for workers’ compensation benefits. When his claim was denied and he was fired, he sued Chevron for wrongful discharge. The case settled for \$5,000.

Reid excluded the settlement from his income, and the matter ended up in Tax Court. Noting that the settlement agreement failed to allocate any portion of the recovery to personal physical injuries or physical sickness, the court held for the IRS. Even if there was an ancillary

⁴⁸Section 104(a)(2) originates from the Revenue Act of 1918, ch. 18, 40 Stat. 1057, section 213(b)(6). See H.R. Rep. No. 767 65th Cong., 2d Sess. 9-10 (1918) (1939-1 C.B. (Pt. 2) 86, 92). Major revisions of the Internal Revenue Code in 1939 and 1954 altered the wording only slightly and made no substantive changes to the provision. Section 22(b)(5) (1939); section 104(a)(2) (1954). In 1982, Congress amended section 104(a)(2) to exclude deferred payments explicitly by adding the language that “periodic payments as personal injury damages are excludable from gross income of the recipient.” S. Rep. No. 97-646, at 4 (1982), *reprinted in* 1982 U.S.C.C.A.N. 4580, 4583.

⁴⁹Small Business Job Protection Act of 1996, P.L. 104-188, section 1605, 110 Stat. 1755, 1838 (1996); H.R. Conf. Rep. No. 104-737, 104th Cong., 2d Sess., 301 (1996).

⁵⁰*Id.*

⁵¹See Robert W. Wood, “Tax Treatment of Settlements and Judgments: Post-1996 Act Section 104 Cases: Where Are We Eight Years Later?” *Tax Notes*, Oct. 4, 2004, p. 68, *Doc 2004-18582*, 2004 TNT 189-27. See also Wood, “Recent Damage Awards Decisions,” *Tax Notes*, Sept. 5, 2005, p. 1129, *Doc 2005-18117*, 2005 TNT 169-15.

⁵²LTR 200041022, *Doc 2000-26382*, 2000 TNT 201-10.

⁵³H.R. Conf. Rep. No. 104-737, 104th Cong., 2d Sess., 301 (1996).

⁵⁴See *Vincent v. Commissioner*, T.C. Memo. 2005-95, *Doc 2005-9343*, 2005 TNT 85-6. See also Wood, “Ulcers and the Physical Injury/Physical Sickness Exclusion,” *Tax Notes*, June 20, 2005, p. 1529, *Doc 2005-13042*, 2005 TNT 115-33.

⁵⁵See, e.g., LTR 200121031, *supra* note 47, in which the IRS ruled that an asbestos claim resulting from inhalation of fibers was excludable (despite the lack of physical touching).

⁵⁶515 U.S. 323, 336-337 (1995).

⁵⁷*Id.* at 335.

⁵⁸*Id.* at 336.

⁵⁹T.C. Summ. Op. 2002-55, *Doc 2002-12459*, 2002 TNT 100-12.

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cause of action based on tort or tort-type rights, the settlement agreement did not ascribe any amount to personal physical injuries or physical sickness.

Nevertheless, the IRS has recognized that when there is physical touching and resulting physical injuries, recoveries (such as for sexual harassment) can be excluded. In what is generally regarded as a seminal private letter ruling,⁶⁰ the IRS bifurcated a sexual harassment recovery into damages for the period leading up to a physical battery (what the IRS called the First Pain Incident), and damages thereafter.⁶¹ The physical battery and its consequences became a threshold beyond which all damages were tax free.

LTR 200041022 clearly indicates that in the IRS's view, when there is a battery that causes visible harm, all damages flowing therefrom (including emotional distress) are excludable. In the real world, however, there is often no clear event from which both physical and nonphysical damages flow. The IRS's desire for bright lines has probably caused it to virtually ignore the "physical sickness" wing of section 104. Nevertheless, the statute is clear that physical sickness recoveries are fully excludable, and physical sickness is not generally triggered by a battery.

There is often simply too little proof from which such a watershed can be observed. For example, in *Prasil*, the Tax Court found a sexual harassment settlement fully taxable.⁶² The court dismissed *Prasil's* uncorroborated testimony that the harassment caused or exacerbated various illnesses. Proving that express tax language in settlement agreements does matter, the court noted that the settlement documents failed to allocate any portion of the payment to physical injury or physical sickness.

2. Physical 'sickness' recoveries. One whole wing of the section 104 exclusion has rarely been explicated.⁶³ The statute excludes damages for physical injuries or physical sickness. That physical sickness has almost never been discussed in rulings, in the tax literature, or in case law is disturbing. In our common experience, most physical sickness does not arise from a battery. Thus, physical touching should arguably be irrelevant.

A few authorities expressly touch on the physical sickness wing of section 104. In *Vincent v. Commissioner*,⁶⁴ the plaintiff claimed her employer's conduct exacerbated her ulcers. She claimed that supported the exclusion of 50 percent of her settlement, which she attributed to her ulcers and emotional distress arising therefrom. Unfortu-

nately for the taxpayer, this was a case that had settled after a jury verdict, and the Tax Court reviewed the jury verdict. Finding no mention whatsoever that the jury had considered the ulcers, the Tax Court found the entire recovery to be taxable.

Proving a physical sickness may sometimes be easy, but proving its cause often will not be. Moreover, when the sickness itself is mental, the courts have thus far not addressed the excludability of recoveries attributable to that sickness.⁶⁵

In at least one letter ruling involving a serious physical sickness (cancer) that led to the person's death, the IRS did not expressly comment whether this was "physical sickness," presumably because it was so obvious that it was.⁶⁶ The ruling involved a widow whose husband died from cancer after being exposed to asbestos. The ruling concludes that the widow's recovery for wrongful death and her recovery for loss of consortium were both excludable under section 104. The IRS does note that there was a direct causal link between the deceased's inhalation of asbestos and the widow's claims for wrongful death and loss of consortium.

This letter ruling involving cancer from asbestos may be an obvious case. Yet it illustrates what is at the root of many of the Tax Court cases that seem to ignore physical sickness and even many physical injuries: the problems of proof. As in many of the cases I've noted, the taxpayer is unable to show much of anything in the way of medical documentation.

Even when the plaintiff has medical documentation, plaintiffs often fail to show a causal connection between the defendant's conduct and the sickness or injury. Of course, in some cases, as in *Vincent*, there is even a failure to show that the malady was attributed to the defendant and argued as part of the case. Given such failings, it is hardly surprising that most of the authority interpreting section 104, particularly in the post-1996 era, has found that this exclusion does not apply.

Given the express purpose of the 1996 tightening of section 104 (to prevent abuses that Congress thought were occurring in allocations of damages in employment lawsuits), one should expect that result. Thus, in *Tritz v. Commissioner*,⁶⁷ the Tax Court found settlement payments for a termination of employment to be fully taxable. The settlement payment was made under a reduction in force of many employees, and the taxpayer signed a release that provided for wage treatment for the entire severance payment. The taxpayer argued that because he had been treated for carpal tunnel syndrome, a portion of the settlement had to be attributed to that, and therefore was nontaxable.

Predictably, the Tax Court concluded that the entire severance payment was properly treated as severance, as

⁶⁰Private letter rulings are not technically authority, and can be used only by the taxpayer to whom they are issued. However, practitioners routinely read them and rely on them as indications of the position of the IRS National Office. Moreover, even the U.S. Supreme Court has cited letter rulings. See *Rowan Cos. v. United States*, 452 U.S. 247 (1981).

⁶¹See *supra* note 52.

⁶²*Prasil v. Commissioner*, T.C. Memo. 2003-100, Doc 2003-9085, 2003 TNT 69-39.

⁶³See Wood, "Ulcers and the Physical Injury/Physical Sickness Exclusion," *supra* note 54. See also Wood, "Physical Sickness and the Section 104 Exclusion," *Tax Notes*, Jan. 3, 2005, p. 121, Doc 2004-24100, 2005 TNT 2-41.

⁶⁴T.C. Memo. 2005-95, Doc 2005-9343, 2005 TNT 85-6.

⁶⁵See *Tamberella v. Commissioner*, 139 Fed. Appx. 319, 322, Doc 2005-15534, 2005 TNT 140-11 (2d Cir. 2005). ("We expressly do not decide whether a serious mental illness, such as schizophrenia or bipolar disorder, constitutes a 'physical' injury or sickness within the meaning of 26 U.S.C. [section] 104(a)(2).")

⁶⁶See *supra* note 47.

⁶⁷T.C. Summ. Op. 2001-76, Doc 2001-15770, 2001 TNT 108-12.

it had clearly been intended by the employer. Those cases, however understandable they are, arguably trivialize the section 104 exclusion.

3. Cases on constitutional rights. Although much of our learning about the current scope of section 104 comes from employment litigation, there has been some litigation over the tax treatment of recoveries for violations of constitutional rights. Moreover, several courts have held compensatory payments in this circumstance to be excludable from income.

For example, in *Bent v. Commissioner*,⁶⁸ the taxpayer was a schoolteacher whose contract was not renewed after he publicly criticized the school administration. The plaintiff had a reputation for outspokenness, and at a teachers' meeting, made several highly critical remarks about a school administrator. Shortly thereafter, he received an evaluation by the same administrator concluding that he would not be employed the following year.

When Bent's contract was not renewed, he sued for breach of contract and violation of his right to freedom of speech, suing under section 1983. The court rejected all claims except that for free speech. However, before the court reached a decision on damages, the taxpayer and the defendant settled.

In the subsequent tax dispute, the Tax Court determined that claims for constitutional rights violations under section 1983 are tort-type claims. Accordingly, the Tax Court held the recovery to be excludable because the free speech violation was the only claim on which the school board was liable. The IRS appealed to the Third Circuit Court of Appeals, but the appellate court affirmed.

Bent stands for the view that personal injuries include mental pain and suffering, and not simply physical trauma. Of course, this view was disapproved by statute for recoveries after August 20, 1996, which may make *Bent* and other constitutional violation cases irrelevant after 1996. At the very least, they must be read with the current gloss of required physical (sickness or injury) consequences.

However, there is an interesting point regarding the calculation of damages in *Bent*. Although the settlement amount in *Bent* was calculated by reference to the plaintiff's wages, the court did not treat this fact as significant. The *reference* to wages did not make this settlement wages. Wages were a measuring device for determining the tort damages.

4. Sex Abuse Ruling. Up until now, arguably the most important IRS statement on how the IRS views section 104 came in LTR 200041022, which is now often simply dubbed "the bruise ruling," among tax aficionados.⁶⁹ Broadly stated, this letter ruling indicates that for an exclusion to be available under section 104, one must show evidence of physical injuries we can see. Bruises or broken bones would certainly qualify, but how much less would qualify is unclear. This ruling also makes crystal

clear the watershed nature of those physical manifestations. Once one crosses the threshold of physicality, all damages flowing from the physical event, including emotional distress damages, also become excludable.

Recently, there are signs the IRS is ameliorating its rigid need to see demonstrable physical harm to recognize exclusions under section 104. In ILM 200809001,⁷⁰ the IRS determined that a settlement with an institution for sex abuse that occurred many years previously was fully excludable under section 104. The IRS reached this conclusion despite the taxpayer's failure to be able to demonstrate any signs of physical injury. While any other tax result on such a recovery would be indefensible, this is nevertheless an important stride in section 104 interpretation that should not go unnoticed.⁷¹

The IRS does not do away with its demonstrable physical injury talisman. Instead, the IRS says that in this case, given what occurred, it is reasonable to *presume* that the injuries were physical in nature. That is a momentous step in the right direction. The IRS does not say that one is not required to *have* observable bodily harm in some situations, but rather that one need not demonstrate it. To me, the reasoning goes something like this: Some things are inherently and incontrovertibly physical, whether or not they leave lasting outward scars. Sex abuse surely fits this category, as does rape or other sexual assault. I think wrongful imprisonment does too.

If one can criticize the recent ILM (which I'm certainly not doing, since I think it is a hugely important ruling) it would be only in potentially creating ambiguity about the importance of the plaintiff being a minor at the time of the abuse, and an adult when the case settled. The ruling does not emphasize this, and surely the rationale for not needing to prove observable bodily harm in some cases does not rest on the minority of the plaintiff. Nevertheless, one cannot help but wonder whether the IRS is implicitly restricting its view to such circumstances, or perhaps to more general circumstances in which the failure to be able to show observable bodily harm is somehow especially excusable.⁷² Regardless, ILM 200809001 shows that in at least some cases, proof of physical harm is not required.

B. Evaluating False Imprisonment

In an archetypal false imprisonment case, how do the tax authorities suggest that a recovery should be taxed? If one is deprived of one's personal liberty, if one is confined unlawfully behind bars, is that not by its very nature physical? The answer must surely be yes. It is difficult to see how it could be otherwise. Perhaps one might review civil rights law and find cases in which bona fide deprivations of civil rights might not in all senses be physical. However, wouldn't being confined in a jail cell (unlawfully) *always* be physical?

⁷⁰*Doc 2008-4372, 2008 TNT 42-21.* Interestingly, this legal memorandum was written by the IRS's Michael Montemurro, who also authored the bruise ruling.

⁷¹See Wood, "IRS Allows Damages Exclusion Without Proof of Physical Harm," *Tax Notes*, Mar. 31, 2008, p. 1388, *Doc 2008-5734, 2008 TNT 13-31.*

⁷²*Id.*

⁶⁸87 T.C. 236 (1986), *aff'd*, 835 F.2d 67, 88-1 U.S. Tax Cas. (CCH) para. 9101, 61 AFTR2d (P-H) para. 88-301 (3d Cir. 1987).

⁶⁹See discussion accompanying notes 60-62 above.

In determining whether damages or settlement payments paid on account of wrongful conviction should qualify under section 104 (as paid on account of personal physical injuries or personal physical sickness), the statutory scheme under which the exonerated person recovers is clearly relevant. Some state statutes limit recoveries to circumstances in which there has been an actual imprisonment (as opposed to merely a wrongful conviction in which the person remains free on bail or is otherwise not incarcerated).⁷³

If one accepts the notion that incarceration is itself physical, such restrictions in the underlying statute would seem to help rather than hurt the case for excludability under section 104. Moreover, if one accepts the notion that the wrongful incarceration is itself physical, it should not matter whether the state statutory scheme (or any other basis of recovery) includes damages for loss of income, emotional distress, and so on.

Consider an automobile accident case in which there is physical injury. Plainly, the tools that may be used to help measure damages (loss of income, pain and suffering, and so on) do not make the recovery for injuries in the accident taxable. In other words, despite the origin of the claim test that governs the tax treatment of litigation recoveries, wage loss is not income if it is awarded because of physical injuries or physical sickness.

There are suggestions that in calculating the damages to which a plaintiff in a false imprisonment case should be entitled, the number of days, months, or years in confinement serve as a kind of litmus test for the amount of appropriate damages.⁷⁴ This does not make the payment wages. Wage loss is often used as a measure of damages in auto accident (and other tort) cases, but this does not make the damage payments taxable.⁷⁵ If the amounts paid to compensate the individual are tax free under section 104(a)(2), the amounts paid for wages lost as a result of the injury are tax free as well.⁷⁶

There is another way in which unlawful imprisonment should be evaluated in the context of existing section 104 authority. Before the 1996 statutory change to section 104, it became common practice in resolving employment cases to denominate some portion of the damages as "emotional distress damages." The goal, of course, was to achieve tax-free treatment for those damages.⁷⁷

In almost every employment case (whether employment discrimination, sexual harassment, wrongful termination, and so on), there was a natural dichotomy

between wages, on one hand, and nonwage damages, on the other. For that reason, perhaps it was inevitable that the IRS and Congress would eventually act to narrow the section 104 exclusion. In the false imprisonment context, there is (quite obviously) no dichotomy between payments for loss of liberty and payments of wages.

Plainly, there is no employment relationship between the prisoner and the state.⁷⁸ It is also odd to think of emotional distress damages here. The IRS could perhaps argue that a recovery for false imprisonment represents a payment for emotional distress, and as such, is taxable. To do so, however, it would seem that the IRS would have to contend that the emotional distress was not caused by the physical confinement. This seems counterintuitive, if not downright impossible.

In any event, recall that the legislative history to the 1996 amendment to section 104 makes eminently clear that the section 104 exclusion applies to damages for emotional distress triggered by (or emanating from) physical injuries or physical sickness.⁷⁹ It is hard to imagine that a false imprisonment plaintiff would *not* have emotional distress. It is equally hard to imagine that the emotional distress will not be unequivocally caused by his confinement.

C. False Imprisonment Authorities

Despite the lack of authorities on the tax treatment of false imprisonment recoveries, there is some history on unlawful imprisonment recoveries and the tax issues they raise. Helpful analogies can be found in the tax treatment of payments made to: survivors of Nazi persecution; U.S. prisoners of war during World War II and the Korean War; and Japanese-Americans placed in internment camps. In the case of interned Japanese-Americans, Congress enacted legislation to clarify the tax treatment of those payments. In the other cases, the IRS issued revenue rulings providing exclusions from income tax for the payments.

The Civil Liberties Act of 1988 provided compensation for Japanese-Americans who were relocated and placed in internment camps, as well as those wrongfully convicted under Executive Order Number 9066 (the order providing for their relocation and internment).⁸⁰ This law established a fund for compensating those individuals. For tax purposes, those amounts were considered damages for "human suffering" and were expressly excluded

⁷³See New York State Court of Claims Act, section 8-B.

⁷⁴See Cal. Penal Code section 4900-4906; Iowa Code Ann. section 663A.1 (West 1998); Wis. Stat. section 775.05 (2006).

⁷⁵See IRS Publication 525, *Taxable and Nontaxable Income*.

⁷⁶*O'Gilvie v. United States*, 519 U.S. 79, Doc 96-31894, 96 TNT 240-1 (1996); *Francisco v. Commissioner*, 267 F.3d 393, 315, Doc 2001-27013, 2001 TNT 208-8 (3d Cir. 2001); *Commissioner v. Schleier*, 515 U.S. 323, 329 (1995); *Ervin v. Commissioner*, T.C. Memo. 2002-134, Doc 2002-13101, 2002 TNT 105-5; Rev. Rul. 85-97, 1985-2 C.B. 50; Rev. Rul. 61-1, 1961-1 C.B. 14.

⁷⁷See Wood, "New Law Radically Changes Tax Rules in Employment Litigation," *Tax Notes*, Aug. 19, 1996, p. 1045, Doc 96-23171, 96 TNT 176-75.

⁷⁸I ignore here the possibility that the prisoner may perform menial tasks for menial pay, such as Michael Vick's reported 12 cents per hour kitchen job. See Holtzclaw, "Michael Vick's New Salary: 12 cents an Hour," *New York Daily News*, April 7, 2008; see also <http://www.dailypress.com/news/dp-now-vick.a7,0,6509.story>. Any such "employment" should not invoke the dichotomy between wages and tort payments. Plus, if a prisoner's recovery were taxable, it would presumably not mean his attorney fees would be deductible under the above-the-line deduction for legal fees in employment cases now provided by section 62.

⁷⁹See Small Business Job Protection Act of 1996, P.L. 104-188, section 1605, 110 Stat. 1755, 1838 (1996); H.R. Conf. Rep. No. 104-737, 104th Cong., 2d Sess., 301 (1996).

⁸⁰Civil Liberties Act of 1988, P.L. 100-383, section 101-109, 102 Stat. 903, 903-911 (1988).

from income.⁸¹ Moreover, the payments were also not considered resources for purposes of determining Social Security eligibility.

Similarly, Rev. Rul. 56-462⁸² dealt with payments by the U.S. government to U.S. citizens who were captured and held by the enemy during the Korean War. This ruling cited Rev. Rul. 55-132,⁸³ which provided a tax exemption for payments made to U.S. citizens who were prisoners of war during World War II. In both rulings, these payments were treated as compensation for the loss of personal rights during imprisonment and were excluded from income for federal income tax purposes.

Rev. Rul. 58-370⁸⁴ and Rev. Rul. 56-518⁸⁵ provided tax-free treatment for payments by Germany or Austria for persecution by the Nazis. Rev. Rul. 58-370 states that the payments represent reimbursement for the deprivation of civil or personal rights, and as such, are not includable in income. Similarly, Rev. Rul. 56-518 states that the payments were made on account of persecution, resulting in damage to life, body, health, liberty, or to professional or economic advancement. Thus, they were excluded from income for tax purposes.

Being incarcerated has dramatic effects on one's ability to work and earn a living. Yet, plainly, the consequences of incarceration are more of a measuring tool, much the way wage loss is used as a measuring tool for damages in auto accidents and other more traditional personal physical injury cases. That a wrongfully incarcerated person experiences wage loss does not ascribe the character of wages to a payment for unlawful incarceration.

Indeed, in all of those historic cases, the individual was not being compensated for a loss of wages or some other economic claim. Instead, like wrongfully convicted individuals, the IRS recognized that those persons were being compensated for the loss of the simple pleasures of life we may take for granted. These revenue rulings reflect the prevailing view that the ability to take a breath of fresh air, to sleep in one's own bed, to attend a family gathering, is not taxable.

Unfortunately, of course, those authorities predate the 1996 changes to section 104, imposing the "physical" requirement. How big an impact that timing should have is not clear. Yet all of the aforementioned revenue rulings were "obsoleted" by Rev. Rul. 2007-14, issued on March 19, 2007.⁸⁶ That is disturbing.

After all, despite the lack of IRS guidance since 1996, the legislative history to the 1996 act makes clear that all emotional distress damages that flow from physical injuries or physical sickness are still excludable from income. Thus, if one believes, as I do, that wrongful

imprisonment is *by its very nature* physical, the fact that these are pre-1996 revenue rulings does not matter.

D. The General Welfare Exception

Exclusions from income are narrowly construed and generally have been limited to those specified in the code.⁸⁷ There is, however, a little-known administrative exception to gross income that could conceivably apply to false imprisonment recoveries.⁸⁸ To be clear, this is entirely independent from the section 104 exclusion, and one might argue them in the alternative.

Under the general welfare exception (GWE), some government payments do not constitute gross income to the recipients. Under the GWE, the IRS has ruled that payments made under legislatively provided social benefit programs for promotion of the general welfare are excludable from gross income.⁸⁹ In determining whether the GWE applies to payments, the IRS requires the payments to be:

- made from a governmental general welfare fund;
- for the promotion of the general welfare (that is, on the basis of need rather than to all residents); and
- not made as payment for services.⁹⁰

The IRS has applied the GWE to a handful of disparate government payments. Perhaps the most classic example of the GWE's application is a government payment to victims of a natural disaster.⁹¹ The IRS has applied the GWE doctrine to government payments ranging from housing to education to adoption, and even crime victim restitution.⁹² Thus, it is not farfetched to suggest that the GWE could apply to government payments for wrongful imprisonment. Many such payments could arguably satisfy the GWE requirements.

This may particularly be the case when the payment is made under a state or federal compensation statute. However, any payment from the government in this context, even one prompted by a lawsuit for false imprisonment, could arguably qualify. After all, the GWE is intended to exempt from taxation amounts the government pays for the general welfare. Plainly, that is what payments to victims of false imprisonment do.

IV. Conclusion

Perhaps victims of false imprisonment may be no more numerous today than they were 100 years ago. Yet

⁸¹*Id.*

⁸²Rev. Rul. 56-462, 1956-2 C.B. 20.

⁸³Rev. Rul. 55-132, 1955-1 C.B. 213.

⁸⁴Rev. Rul. 58-370, 1958-2 C.B. 14.

⁸⁵Rev. Rul. 56-518, 1956-2 C.B. 25.

⁸⁶See Rev. Rul. 2007-14, 2007-12 IRB 747, *Doc 2007-4230*, 2007 TNT 34-15, obsoleting these and other revenue rulings. Although the IRS does not publish reasons for an obsolescence, I understand from IRS personnel who were involved in this obsolescence that the IRS considered the rulings no longer valid in light of the 1996 changes to section 104.

⁸⁷*O'Gilvie v. United States*, 519 U.S. 79 (1996); *Commissioner v. Schleier*, 515 U.S. 323 (1995).

⁸⁸See Wood and Richard C. Morris, "The General Welfare Exception to Gross Income," *Tax Notes*, Oct. 10, 2005, p. 203, *Doc 2005-20172*, 2005 TNT 191-34.

⁸⁹See ITA 200021036, *Doc 2000-14946*, 2000 TNT 104-74; LTR 200451022, *Doc 2004-23902*, 2004 TNT 244-53 (Dec. 17, 2004).

⁹⁰See ITA 200021036.

⁹¹Many disaster payments have now also been statutorily exempted from income under recently enacted section 139. Rev. Rul. 2003-12, 2003-3 IRB 283, *Doc 2002-27748*, 2002 TNT 245-6, acknowledges that the GWE doctrine overlaps the application of section 139, so both can apply.

⁹²See Rev. Rul. 76-373, 1976-2 C.B. 16; Rev. Rul. 74-205, 1974-1 C.B. 20; Rev. Rul. 76-395, 1976-2 C.B. 16; Rev. Rul. 75-271, 1975-2 C.B. 23; LTR 200409033, *Doc 2004-3963*, 2004 TNT 40-26; Rev. Rul. 74-153, 1974-1 C.B. 20; Rev. Rul. 74-74, 1974-1 C.B. 18.

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they are certainly more easily identified today. Not only that, but society has clearly recognized that they deserve compensation. The compensation may come via a state or federal statute, legislative edict, or an old-fashioned lawsuit.

Whatever triggers the payment, it is appropriate to ask what federal income tax consequences face the victim. Like the tax treatment of victims of clergy sex abuse, this may be the type of tax question we're afraid to ask. Not only should this be a tax question we want to ask, but it should be one we embrace with open arms, seeking tax certainty that helps to bring finality to a painful incident for all parties. Unfortunately, we do not yet have crystal clear answers to this tax conundrum.

Yet I believe there is no question that these recoveries should be tax free, either under section 104 or under the GWE. It should not take congressional action to do it, although clarifying legislation would be appropriate. I

believe being wrongfully incarcerated is manifestly physical, and that a payment for same must therefore be excludable from income.

It is especially easy to reach this conclusion when the victim has ancillary claims, such as medical malpractice, battery, and so on. At least with such ancillary claims, there is existing federal income tax authority speaking more clearly to the excludability of the recoveries from income. Moreover, in the vast majority of cases, there will be ancillary claims. They may vary in type and severity, but they inevitably add to the physicality of it all, as if being locked up by itself was not palpably physical enough.

But to return to my initial assumption, even taking the somewhat unrealistic fact pattern in which there are no ancillary claims — that is, even when there are no such separate tort causes of action — the point seems clear. It is difficult to think of a decent argument based on the existing tax authorities, or for that matter, based on social or tax policy, for taxing these recoveries.

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