

Forum

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A 'Get Out of Jail' Card That's Far From Free

By Robert W. Wood

The news is full of stories about wrongfully convicted prisoners released from custody after years of incarceration. Often, they receive some kind of compensation. Whether the payment is large or small, it can rarely make up for what sometimes turns out to be a ruined life. Most such unfortunates are shocked to learn they may have tax problems too. When a person is vindicated and receives compensation for unlawful incarceration, recent IRS releases suggest it may be taxable. That is indefensible.

Claims for false imprisonment or wrongful conviction can invoke the common law torts of false imprisonment, malicious prosecution or abuse of process. Alternatively, 42 U.S.C. Section 1983 allows suits for violation of constitutional rights. Plus, 22 states, the District of Columbia, and the federal government now have compensation statutes for false imprisonment.

The Internal Revenue Code has provided an exclusion for personal injury damages for more than 80 years. In 1996, it was narrowed to cover only damages paid on account of personal *physical* injuries or *physical* sickness. This 1996 amendment, with its emphasis on the word "physical," was designed to make emotional distress recoveries taxable. Yet, it has led to a chicken or egg game of enormous consequences.

Damages for physical injuries are still tax-free, while damages for emotional distress — even if that emotional distress produces physical symptoms such as headaches, stomachaches and insomnia — are taxable. Confused? Inexcusably, there is little guidance on the line between symptoms of emotional distress (taxable), and physical injuries or physical sickness (tax-free). And, most of the case law has been decidedly anti-taxpayer, giving an unduly narrow focus to the exclusion.

The IRS has suggested you need a physical battery to produce physical injuries, and

that the physical injuries must be observable. Yet, the statute excludes damages for *physical sickness* as well as for physical injuries. Since most physical sickness does not arise from a battery, physical touching should arguably be irrelevant where a person receives money for physical sickness rather than physical injuries.

Whether false imprisonment recoveries are more analogous to recoveries for physical injury or physical sickness may be debatable, and often the exonerated individual has a host of physical and emotional problems upon release that can blur the line even further. Although the tax authorities are not clear about false imprisonment, some basic principles should be helpful. Being deprived of one's personal liberty by being unlawfully confined behind bars seems by its very nature physical. As such, it should not matter whether the state statutory scheme (or any other basis of recovery) includes damages for loss of income, emotional distress, etc.

Interestingly, a little tax history is helpful, despite the lack of *current* tax authorities on false imprisonment recoveries. We can look to guidance on the federal income 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 expressly address the tax treatment of these payments. In the other cases, the IRS issued Revenue Rulings to exclude such payments from income.

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 (which provided for their relocation and internment). These amounts were considered damages for "human suffering" and were expressly excluded from taxable income. Similarly, Revenue Ruling 56-462, 1956-2 C.B. 20 dealt with payments by the U.S. government

to U.S. citizens who were captured and held by the enemy during the Korean War. The IRS treated these payments as compensation for the loss of personal rights excludable from income for federal tax purposes.

Similarly, in Revenue Rulings 58-370, 1958-2 C.B. 14 and 56-518, 1956-2 C.B. 25, the IRS allowed tax-free treatment for payments made by Germany and Austria to victims of Nazi persecution. In all of these historic cases, individuals were not being compensated for lost wages or some other economic claim. Instead, the IRS recognized that these persons were receiving payments for the loss of their liberty and the simple pleasures of life that go with it.

Unfortunately, these authorities predate the "physical" requirement added in 1996. How big an impact that timing should have is not clear. Arguably, it should have no impact, since being wrongfully put behind bars (even if one escapes the physical trauma that so often goes with it) seems "physical" to its core. Nevertheless, disturbingly, the IRS recently announced that all these rulings about compensation for incarceration are now "obsolete." The IRS has even gone so far as to informally suggest that its reason



for slapping these rulings with the obsolete label is the Tax Code's current requirement of a physical act.

Plainly, being wrongfully incarcerated should be viewed as inherently physical. Indeed, this should not be a tough tax question. It is clear that emotional distress damages that flow from physical injuries or physical sickness are excludable from income. Wrongful imprisonment should be classified as physical *by its very nature*.

Society has recognized that victims of false imprisonment and wrongful conviction

deserve compensation. It is difficult to think of a decent argument for taxing these recoveries. By declaring its prior rulings on related subjects obsolete, the IRS has inappropriately suggested these recoveries are taxable, adding one more gotcha to the odyssey of exonerated prisoners.

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