

# Are False Imprisonment Settlements Taxable?

By Robert W. Wood

If you are wrongfully convicted of a crime, exonerated and then receive a legal settlement, the federal tax code provides that your legal settlement will be tax free. There are some definitional niceties that need to be satisfied, as often is the case under the tax code. But in general, if you are convicted of a crime and later exonerated, any settlement money you receive as a result is protected from taxes by federal law.

But what if you were not exonerated, perhaps because you were never even convicted, and therefore are not found to be innocent? The tax code exclusion applies only to exonerees. It does not apply to a false imprisonment recovery—or any other claim—by a person who may have been mistreated. Exoneration is a legal requirement for the tax exclusion to apply.

You might think that false imprisonment claims are rare, but they may be asserted more than you might think, in a variety of settings. In the context of cases against the government by persons who were once criminal defendants, examples include suits over false arrest and pretrial confinement. With no conviction, there can be no exoneration. False imprisonment claims can be raised in other contexts too.

But in whatever context the claims come up, there can be tax issues for plaintiffs. Although the long-confused tax treatment for exonerees was clarified by an amendment to the tax code, the cloudy tax treatment of false imprisonment recoveries remains. There is some interesting tax history that is relevant. 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 that the compensation they received was tax free, irrespective of whether they suffered physical injuries while they were confined.

However, without explanation, the IRS “obsoleted” these rulings in 2007, suggesting that the tax landscape had changed. The tax landscape had changed more generally too. For generations, the tax code said that legal recoveries for *personal* injuries were tax free. However, in 1996, Section 104 of the tax code was amended to require “physical” injuries or physical sickness for an exclusion. Since 1996, merely personal but nonphysical injuries have not been enough for tax-free treatment.

Notably, though, the IRS’s 1950s and 1960s rulings about confinement were not based on Section 104. They appear to have been based more broadly on the notion that physical confinement was a violation of civil rights, and that as a policy matter, such recoveries should not be taxed. That seemed sensible, but when the IRS in 2007 said that these rulings no longer applied, the tax treatment of false imprisonment recoveries grew more uncertain.

Then, in 2008, the U.S. Tax Court decided *Stadnyk v. Commissioner*, T.C. Memo 2008-289, *aff’d* without published opinion (6th Cir. 2010). The Tax Court and Sixth Circuit found a false imprisonment recovery to be taxable. It was a very short-term incarceration case, but it suggested continuing adherence to the concept that there must *also* be physical

injury. As a result, the general consensus is that if there is a physical injury in a false imprisonment case, the damages should be tax free, as with more garden variety personal physical injury recoveries. Indeed, if a person who is confined is physically injured, Section 104 might exclude the entire recovery.

Yet even then, normal IRS rules would suggest allocating the recovery between amounts that are tax free and those that are not. If you are confined, but only injured half-way into your confinement, does that mean only half of your settlement is tax-free? It may depend on how your settlement agreement is written. And in some cases, the plaintiff is never physically injured despite physical confinement.

The latter is the most worrisome type of false imprisonment case, where someone is confined, deprived of their freedom but not physically injured in any way. As voluminous section 104 authorities make clear, to be tax-free, a payment must be made on account of physical injuries, sickness or related emotional distress. If a payment is for emotional distress *not* arising out of physical injuries or physical sickness, it is taxable.

In false imprisonment cases, the payment may be for a mix of damages, including loss of freedom, loss of income, loss of consortium, familial association, reputation, emotional distress and more. Depending on the length of confinement, inadequate medical treatment may also be an issue. I would argue that one’s loss of liberty and physical confinement should *itself* be viewed as a physical injury within the meaning of Section 104.

However, that view seems hard to square with the tax authorities. To return to the *Stadnyk* case, there, the Tax Court and Sixth Circuit ruled that physical restraint and physical detention are *not* “physical injuries” for purposes of section 104(a)(2). But one can arguably explain the tax result by the highly unusual facts. Mrs. Stadnyk was held at a local sheriff’s office for approximately eight hours. She was handcuffed, photographed, confined to a holding area, and searched via pat-down. However, she suffered no observable bodily harm.

Indeed, she *admitted* that she was never injured or even roughed up. That became an important admission in her Tax Court case, something the court specifically noted. The Tax Court concluded that the deprivation of personal freedom is not a physical injury for purposes of section 104(a)(2). The Sixth Circuit affirmed, noting 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.

The topic came up in an IRS Regulation hearing in 2010. Then, in the same year, the IRS published Chief Counsel Advice 201045023. This IRS ruling said only that a victim of wrongful imprisonment who “suffered physical injuries and physical sickness while incarcerated” can exclude his recovery from taxes. If the person has physical injuries, the damages are tax free, just like more garden variety personal physical injury recoveries.

But otherwise, in the IRS view, mere confinement is not enough for an exclusion. Plaintiffs in false arrest and false imprisonment cases should not forget to consider the quirky tax issues, as they are prosecuting their case, and particularly as a case is being settled and documented. It may be possible to help shape and improve the tax treatment.

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