PERSPECTIVE

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Finally, Wrongful Conviction Damages Are Tax Free

By Robert W. Wood

Many of us are discovering surprises in the massive so-called tax extenders package. For years, Congress could never seem to agree on tax laws. There have been some amazing examples of bad governing, including the flip flop over estate taxes a few years ago that ended up with no estate tax at all in 2010. That was the year Walter Shorenstein, George Steinbrenner and a number of other billionaires died!

In the fights over which tax provisions would be extended for one more year, Congress would often put on a tax law band aid at year end. Usually, these quick fixes were done after nearly 12 months of the law being expired, so there was no opportunity for businesses to plan. Then, this year in mid-December, as if all the stops were pulled out, Congress quickly passed a massive tax and spending law, seemingly with extraordinary ease.

With more than six hundred billion tax dollars at stake, it is easy to get overwhelmed with all of the hundreds of tax changes. Arguably one of the least noticed and yet most defensible changes to the tax code in this sausage-filled bill is actually long overdue. It is something that for years was proposed as the stand-alone, "Wrongful Convictions Tax Relief Act."

Unlike many other tax changes, you do not want this one to apply to you. Because if it does apply to you, you were wrongfully convicted and wrongfully behind bars. Now, recoveries for wrongful conviction are tax free, at last. This has not been the law up to now.

In the U.S., individuals who have been wrongfully convicted and exonerated by DNA evidence spent on average over 13 years wrongfully incarcerated. Since the first DNA exoneration in 1989, wrongfully convicted persons have served more than 3,809 years in prisons across 35 states before being exonerated. Hundreds of DNA exonerees have served an average of 13.5 years in prison, ranging from less than one year to 35 years.

Whether you look at an individual case or at the averages, these are some astounding numbers, as Congressmen Sam Johnson (R-TX) and John Larson (D-CT) have noted. *See* Press Release, *available at* http://samjohnson.house.gov/news/documentsingle.aspx?DocumentID=397844. Injustices happen, and when they do and are eventually rectified, the person is never the same. This includes re-entry needs that are hard to comprehend. For the few who end up with money for their ordeal, adding IRS collectors into the mix was always a bad idea. Yet until now, the tax issues have been surprisingly cloudy.

The new law amends the Internal Revenue Code so a wrongfully incarcerated individual can exclude from his taxes the civil damages, restitution, or other monetary awards he receives as compensation for a wrongful incarceration. Congressmen Johnson and Larson introduced their bill repeatedly, and the bill languished, but they did not give up.

In 2015, they re-introduced the Wrongful Convictions Tax Relief Act, H.R. 3086. Several members of the Senate, including Charles Schumer (D-NY) and John Cornyn (R-TX), joined in. And eventually, it has become law. Thirty states, the District of Columbia, and the federal government provide some form of statutory compensation for wrongful conviction and incarceration.

But the only thing the tax law has allowed up to now is that if you are physically injured while in prison and get money for your injuries, *that amount* is tax free. That is the same tax rule applicable if you were injured outside prison in a car wreck, a slip and fall, or skiing accident. Compensatory damages for personal physical injury are tax-free. Interest and punitive damages are taxed.

Up until now, the only way to argue for a tax-free wrongful imprisonment recovery was to say it was for physical injuries. Fortunately, the new law says you no longer have to prove that you were physically injured in prison to get tax-free treatment. You also no longer have to fudge the allocation of the money.

For years, the norm was to look for—and try to emphasize—any incidents of physical injury or sickness. If there was an injury in a prison fight, an incidence of medical malpractice from inadequate health care, or something of that sort, the lawyers and tax professionals would stress it. But now, one no longer needs to suggest that the plaintiff is receiving millions for getting stabbed or beaten up while in prison, and nothing for spending 15 years wrongfully behind bars.

Finally, the tax law makes it clear that recoveries of this sort are tax free. The law is even retroactive in effect, which rarely happens with a tax law. But it is fixing some wrongs. In the 1950s and 1960s, the IRS ruled that prisoners of war, civilian internees and holocaust survivors received tax-free money for their loss of liberty.

In 2007, the IRS "obsoleted" these rulings suggesting the landscape had changed. The IRS thereafter asked whether a wrongfully jailed person was physically injured/sick while unlawfully jailed. If so, the damages were tax free, just like more garden variety personal physical injury recoveries.

In IRS Chief Counsel Advice 201045023, the IRS sidestepped whether being unlawfully incarcerated is itself tax free. The Tax Court and Sixth Circuit in *Stadnyk*, 367 Fed. Appx. 586 (6th Cir. 2010), suggested that persons who aren't physical injured during their imprisonment should be taxed. The situation has become a hodgepodge, with some tax auditors looking the other way, and some insisting on voluminous proof of physical injury to support an allocation of damages.

Finally, though, the Wrongful Convictions Tax Relief Act allows exonerees to keep their awards tax-free. According to Congressman Larson, "Though we can never give the wrongfully convicted the time back that they've had taken from them, they certainly shouldn't have to pay Uncle Sam a share of any compensation they're awarded. This bill will make sure they don't have to suffer that insult on top of their injury."

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