Why False Imprisonment Recoveries Should Not Be Taxable

By Robert W. Wood

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Claims for false imprisonment may be brought in various ways under federal or state law. An individual who has been wrongfully incarcerated may sue under 42 U.S.C. section 1983 for a violation of his constitutional rights. The individual may also sue under state tort law, making claims for the traditional torts of false imprisonment, malicious prosecution, or abuse of process. Also, many states now provide a statutory scheme for addressing false imprisonment claims.

At the root of all these causes of action is a fairly common fact pattern: A plaintiff is arrested or convicted, spends time behind bars, is later exonerated, and then seeks redress for his injuries. There may or may not be prosecutorial misconduct. Although there may well be nuances between the differing legal bases on which a claim may be brought, I have argued that the commonality of this fact pattern should mean that those recoveries should be excludable from income under section 104.[1] I will not restate all of those arguments here, but will summarize them.

Section 104 Authorities

The Internal Revenue Code has excluded personal injury damages from income for 80 years. For most of this time, damages for any personal injury (or for sickness) could be excluded from income, whether or not the injury or sickness was physical. In 1996 the statute was narrowed, with the new requirement that the personal injuries or sickness must be physical to give rise to an exclusion.

Since 1996, section 104 has excluded from gross income damages paid on account of physical injuries or physical sickness. The IRS has interpreted this rule as requiring observable bodily harm for an exclusion to be available.[2] In appropriate cases, however, the IRS is willing to presume the existence of observable bodily harm.

Thus, in CCA 200809001[3] the IRS considered the tax treatment of a settlement with an institution for sex abuse. The abuse had occurred while the plaintiff was a minor, and the settlement was paid years later, by which time the abuse victim had reached the age of majority. Not surprisingly, by that time there were no physical signs of any abuse, injury, or sickness.

However, the IRS ruled that the entire settlement was excludable under section 104. Although the taxpayer failed to demonstrate any signs of physical injury, the IRS found it reasonable to presume that at some point there had been observable signs of physical injuries.[4] It is unclear how important it was to the reasoning of the ruling that the victim was a minor at the time of the abuse, and had reached the age of majority when he received a settlement. It should be irrelevant, as the situation could be just as compelling without the age factor. Yet one suspects the IRS was trying to eke out a narrow exception from its ''we must see it'' mantra.

The IRS didn't back off on its insistence that section 104 requires an outward sign of injuries, but it still gave the taxpayer relief in unquestionably sympathetic circumstances. In essence, the IRS ruled that under at least some circumstances, while it would not dispense with its view that one must be able to observe the bodily harm, one could occasionally *presume* the injuries. That is clever. It may appear to be a tiny step, but it is also a significant step.

Is False Imprisonment Physical?

It is hard to imagine a more obvious degree of physicality than being imprisoned. Even if no bruises or broken bones befall the plaintiff, it seems axiomatically physical to be physically confined. But is it a physical injury or physical sickness?

I argue that it is. First, it is almost a certainty that there will be ancillary claims in any long-term false imprisonment case. Most long-term inmates have had altercations that, whether characterized as assault, battery, or medical

[1] *See* Robert W. Wood, ''Are False Imprisonment Recoveries Taxable?'' *Tax Notes*, Apr. 21, 2008, p. 279, *Doc 2008-7149*, or *2008 TNT 78-28*.

[2] Perhaps the best illustration of the IRS's view on this point is the so-called bruise ruling, LTR 200041022 (July 17, 2000), *Doc 2000-26382*, *2000 TNT 201-10*.

[3] *Doc 2008-4372*, *2008 TNT 42-21*.

[4] *See* further discussion in Wood, ''IRS Allows Damages Exclusion Without Proof of Physical Harm,'' *Tax Notes*, Mar. 31, 2008, p. 1388, *Doc 2008-5734*, or *2008 TNT 63-31*.

malpractice, can provide the proverbial physical hook on which to hang the more general deprivation of liberty claim. Invariably, the presence of such ancillary claims makes the case easier for treating the recovery as excludable under section 104.

Yet even in the hypothetical case of someone who is wrongfully incarcerated and claims no abuse, battery, or medical malpractice, in my opinion, section 104 should apply. If a taxpayer is raped, that physical trauma may or may not be visible. Even if tears or bruising do not appear, a recovery for that rape should be excludable under section 104. The act itself manifests injury. False imprisonment — at least serious and long-term cases of it — should be the same.

Helpful authority can be found concerning the tax treatment of payments made to Japanese-Americans placed in internment camps during World War II. There are also authorities regarding payments made to survivors of Nazi persecution and to U.S. prisoners of war in Korea. At one time or another, all of these types of recoveries were held to be nontaxable as payments for a deprivation of liberty.[5]

In all of those historic cases, the persons were treated as receiving damages for a loss of personal liberty. The payments in each case were therefore held to be nontaxable. There was no wage loss claim or anything else to make the payment even appear to be taxable. The IRS can be forgiven for being skeptical of personal physical injury allocations in many employment cases, in which the nature, severity, and consequences of the physical contact and resulting physical injuries are often modest. Long-term false imprisonment is entirely different.

After all, we ended up with the 1996 changes to section 104 precisely because of abuses in employment cases, when the wage versus nonwage dichotomy was patent. In employment cases preceding the 1996 amendments, the emotional distress moniker was added to every situation. It was no secret that most damages seemed to be labeled as ''emotional distress'' in view of the obvious tax advantages that nomenclature imported.

The IRS's rigidity in its view today may be explained by taxpayer sins of the past. That is unfortunate, for there is nothing abusive about a recovery for long-term wrongful incarceration being afforded tax-free treatment. Taxable or not, no amount of money can ever make those victims whole.

Nevertheless, the IRS appears to have concluded that the authorities dealing with recoveries by civilian internees or prisoners of war (which we might collectively call the internment authorities) should no longer be relied on. In the Service's view, the ''physical'' requirement interposed into section 104 in 1996 undercuts those internment authorities. In Rev. Rul. 2007-14[6] the IRS obsoleted all of these revenue rulings, ostensibly because of the 1996 statutory change to section 104, although it doesn't publicly say why.

However, my off-the-record understanding is that the IRS believed the 1996 legislation said ''physical'' and meant ''physical.'' To the IRS, being wrongfully locked up isn't physical — at least not by itself. Yet I believe wrongful imprisonment is by its nature physical. That the internment rulings predate the 1996 statutory change should be irrelevant.

General Welfare Exception

It could be argued that the general welfare exception (GWE) should apply to false imprisonment recoveries. The GWE exempts from taxation payments that are:

- made from a governmental general welfare fund;
- for the promotion of the general welfare (that is, issued on the basis of need rather than to all residents); and
- not made as a payment for services.[7]

The GWE is intended to exempt from taxation amounts the government pays for general welfare. The IRS has applied the GWE to various government payments, ranging from those for housing and education to adoption and crime victim restitution.[8] It is reasonable to believe that payments from the government to make a victim of false imprisonment whole should be within the scope, purpose, and terms of the GWE.

Recent Case

Despite my arguments, there has been no tax case discussing the application of either section 104 or the GWE to a significant false imprisonment case in which the plaintiff spent years wrongfully behind bars. However, there is a recent case involving a type of false imprisonment that could well skew the law in an inappropriate direction: *Daniel J. and Brenda J. Stadnyk v. Commissioner*.[9]

In *Stadnyk* the taxpayer received a settlement of $49,000 in 2002, and the question was whether that settlement was excludable from her income. The settlement resulted from an involved set of facts relating to the purchase of a used car. When the taxpayer was unhappy with the car and could not obtain satisfaction from the dealership, she placed a stop payment order on the check she tendered to pay for the car.

Although the stop payment order listed the reason for the stop payment as ''dissatisfied purchase,'' the bank (Bank One, which later would become a defendant)

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[5]*See* Civil Liberties Act of 1988, sections 101-109, 102 stat. 903, 903-911 (1988). *See also* Rev. Rul. 56-462, 1956-2 C.B. 20 (concerning Korean War payments); Rev. Rul. 55-132, 1955-1 C.B. 213 (exempting from tax payments made to U.S. citizens who were prisoners of war during World War II). *See also* Rev. Rul. 58-370, 1958-2 C.B. 14, and Rev. Rul. 56-518, 1956-2 C.B. 25 (providing tax-free treatment for payments by Germany and Austria for persecution by the Nazis).

[6]2007-1 C.B. 747 (Feb. 16, 2007), *Doc 2007-4230, 2007 TNT 34-15*.

[7]*See* ITA 200021036 (May 26, 2000), *Doc 2000-14946*, *2000 TNT 104-74*. *See also* Wood and Richard C. Morris, ''The General Welfare Exception to Gross Income,'' *Tax Notes*, Oct. 10, 2005, p. 203, *Doc 2005-20172*, or *2005 TNT 191-34*.

[8]*See* 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 (Nov. 24, 2003), *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.

[9]T.C. Memo. 2008-289, *Doc 2008-27001*, *2008 TNT 247-10*.

incorrectly stamped the check ''NSF'' — the customary label for a check with insufficient funds — and returned it to the car dealer. The dealership filed a criminal complaint against the taxpayer for passing a worthless check. At 6 p.m. one day several weeks later, officers of the Fayette County, Ky., Sheriff's Department arrested the taxpayer at her home, in the presence of her husband, her daughter, and a family friend. She was taken to the Fayette County detention center and was handcuffed, photographed, and confined to a holding area.

Several hours later, she was handcuffed and transferred to the Jessamine County Jail, where she was searched via patdown and with the use of an electric wand. She was required to undress to her undergarments, to remove her brassiere in the presence of police officers, and to don an orange jumpsuit. At approximately 2 a.m. the next day, she was released on bail. Several months later, she was indicted for theft by deception as a result of the check, but the charges were later dropped.

Most of us would be pretty upset by such a course of events. Not surprisingly, the taxpayer eventually filed suit against the dealership and its owners for breach of fiduciary duty. She also sued the bank. She sought compensatory damages and special damages, including damages for lost time and earnings, mortification and humiliation, inconvenience, damage to reputation, emotional distress, mental anguish, and loss of consortium. She also sought punitive damages and alleged counts for malicious prosecution, abuse of process, false imprisonment, defamation, and outrageous conduct.

After a mediation, the taxpayer settled her case. At the mediation, everyone seemed to agree that the modest $49,000 settlement would not represent income to the plaintiff and would not be subject to tax. Indeed, the attorney for the taxpayer, the mediator, and the attorney for the defendant, Bank One, all stated definitively at the time that the settlement proceeds would not be taxed. Nevertheless, the taxpayer received a Form 1099 for the payment. She did not report the payment on her 2002 tax return, and she eventually landed in Tax Court.

Pure Confinement

In considering the appropriate tax treatment of the payment, Judge Joseph Robert Goeke of the Tax Court noted that the plaintiff suffered no physical injuries as a result of her arrest or detention, save that she was physically restrained against her will and subjected to police arrest procedures. The taxpayer stated that she was not grabbed, jerked around, bruised, or physically harmed as a result of her arrest or detention. She did visit a psychologist approximately eight times over two months as a result of the incident. The costs of those visits were covered by her insurance. She had no out-of-pocket medical expenses for physical injury or mental distress suffered as a result of her arrest and detention.

In analyzing the applicability of section 104, the Tax Court recited the usual authorities and the nature of the claims that had to be reviewed. An inevitable discussion was about *Schleier*,[10] which imposed two requirements to bring an amount within the exclusion provided by section 104: First, the payment must be made to satisfy a claim for tort or tort-type rights. Second, the payment must be made on account of personal physical injuries or physical sickness. Despite its Supreme Court provenance, this test has proven to be more tautological than helpful.

The Tax Court in *Stadnyk* lamented that although there had been a mediation, there was no record of the mediation to show what the parties were focusing on during the process. The court looked primarily to the complaint and to the fact that in Tax Court, the taxpayer was relying heavily on the false imprisonment claim as a way to support her claim of excludability under section 104. Yet this complaint — like so many others in the real world — contained multiple claims.

The Tax Court pointed out that the taxpayer had also alleged the torts of negligence and breach of fiduciary duty against Bank One. The IRS argued that those claims were based on contract and were not tort claims. The Tax Court seemed to be favoring the taxpayer, noting that it was not as clear as the IRS postulated that a lawsuit relating to a bank and customer relationship was based on contract alone. Admitting the possibility of tort claims, the Tax Court even noted that the bank's actions regarding the check could have proximately caused her arrest.

To the Tax Court, that made it incorrect to view the woman's complaint against Bank One as solely a contract claim. The Tax Court also didn't view it solely as a claim over the wrongful dishonor of a check. In fact, the Tax Court pointed out that the taxpayer was suing Bank One not merely because of the alleged mishandling of her check, but because of the ordeal she suffered as a result of her arrest and detention.

This kind of approach sounds rooted in common sense. It seems to recognize that, cutting through the formalities of multiple causes of action, this was a suit over one incident and one set of damages. Although Bank One did not initiate the criminal proceedings against Stadnyk, its erroneous marking of her check precipitated her arrest. Moreover, the Tax Court found that when Bank One settled the case, it entered into a settlement agreement with an intent to resolve her claims for tort or tort-type rights. The Tax Court therefore concluded that the first prong of the *Schleier* test was met.

Physical Injury or Physical Sickness?

Unfortunately, Stadnyk was not so lucky regarding the physical injury or physical sickness requirement enunciated by *Schleier*. The Tax Court began its analysis with a discussion of the legislative history to the 1996 statutory change. The terms ''physical injuries'' and ''physical sickness'' do not include emotional distress (except for damages not in excess of the cost of medical care attributable to that emotional distress).

Stadnyk admitted that she had suffered no physical harm during her arrest or detention. She is to be commended for her honesty, because she did not try to spin

[10] *Commissioner v. Schleier*, 515 U.S. 323 (1995), *Doc 95-5972*, *95 TNT 116-8*.

her story as involving even a technical battery. She was not grabbed, jerked around, or bruised. Although she argued that physical restraint and detention by itself constitutes a physical injury, the Tax Court disagreed. It stated that:

> Physical restraint and physical detention are not ''physical injuries'' for purposes of Section 104(a)(2). Being subjected to police arrest procedures may cause physical discomfort. However, being handcuffed or searched is not a physical injury for purposes of Section 104(a)(2). Nor is the deprivation of personal freedom a physical injury for purposes of Section 104(a)(2).[11]

The Tax Court found language from a Kentucky state court case to the effect that the tort of false imprisonment protects one's personal interest in freedom from physical restraint.[12] The same Kentucky court wrote that the injury from false imprisonment is ''in large part a mental one'' and that the plaintiff can recover for mental suffering and humiliation. The Tax Court therefore concluded that the alleged false imprisonment of Stadnyk did not cause her to suffer any physical injury, which a section 104 exclusion would require.

The court nevertheless found that Stadnyk was not liable for section 6662 penalties. The Tax Court acknowledged that the Stadnyks had not sought tax advice concerning the recovery. It nevertheless seemed reasonable to rely on the parties to the mediation and the lawyers, all of whom said with little equivocation that they expected the recovery to be tax free. Thus, although Stadnyk had to pay the tax and the interest, she paid no penalties.

Bad Case, Bad Law

Stadnyk is an unfortunate case, whether or not one views it as correct. It can be argued that the Tax Court was right to analyze this particular recovery as taxable. I do not agree, but reasonable minds can differ. But are the Tax Court's platitudes about false imprisonment correct?

I believe one must answer that question with a resounding no. Whatever a Kentucky state court may have said about the nature of a false imprisonment claim, there is nothing mental about being subjected to the physical confinement of imprisonment/incarceration. Put another way, the primary thrust of a false imprisonment claim — although that claim may well lead to mental damages —- is not mental. Even if you are handled with kid gloves, confinement is physical.

Yet even if we acknowledge that Stadnyk's recovery is not physical enough to be tax free, one must be able to draw lines. Clearly, no one would want to spend eight hours in jail as Stadnyk did. Nevertheless, that period (during some part of which she was being processed and transported and thus apparently was not confined in a cell) hardly compares with spending months or years locked up.

Can anyone seriously compare Stadnyk's experience to that of an exonoree who is wrongfully convicted and wrongfully imprisoned in a penitentiary for, say, 10 years? I think not. I recognize that qualitative decisions are not easy.

Arguing that serious false imprisonment cases should be treated differently than nonserious ones is analytically difficult and perhaps impracticable. Where you draw the line between trivial and serious false imprisonment is subjective. One could reasonably conclude that Stadnyk's recovery too should be tax free.

Yet I do not think it is silly to agree that Stadnyk's recovery can be taxable while arguing that a serious and long-term exonoree should receive tax-free treatment. Line drawing may not be easy, but even if one agrees that Stadnyk's recovery should be taxed, it does not follow that *all* false imprisonment recoveries should be taxed. The Tax Court's broad and unnecessary dicta in *Stadnyk*, blathering on about all false imprisonment recoveries is, to my mind, simply wrong.

One way to distinguish the serious false imprisonment case involving a long period in prison from a case such as Stadnyk's relates to ancillary claims. Stadnyk herself indicated that she experienced no roughing-up and no physical injuries, and that she filed no medical claims. She suffered indignities, but she was not bruised, pushed, or manhandled.

In my experience, a true long-term incarceration case is vastly different. There are almost always incidents of physical trauma, often leaving permanent scars. There are often battery claims, medical malpractice claims, and more. Yet as a matter of analytical purity, it is worthwhile to ask what would happen if the tax consequences of a payment in settlement of a wrongful long-term incarceration case were considered in isolation.

Consider the rare — and perhaps even unimaginable — case in which a person is wrongfully incarcerated for 10 years, but is fortunate enough to be able to state, as Stadnyk did, that he endured no pushing, no shoving, no bruising, no rapes, no assaults, no batteries, and no medical malpractice. In my view — even without the presence of the customary ancillary claims for separate torts, and even without the customary damages usually accompanying those torts — such a false imprisonment recovery should itself be tax free.

Stadnyk is an unfortunate and probably an incorrect decision, even on its facts. As a technical matter, of course, a Tax Court memo decision is nonprecedential.[13] Apart from that, neither taxpayers nor the government should put too much stock in the broad statements made by Judge Goeke in *Stadnyk*.

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[11]*Stadnyk*, T.C. Memo. 2008-289, at p. 17.

[12]*See Banks v. Fritsch*, 39 S.W. 3d 474 (Ky. Ct. App. 2001).

[13]*See Nico v. Commissioner*, 67 T.C. 647, 654 (1977), *aff'd. in part, rev'd. in part on other grounds*, 565 F.2d 1234 (2d Cir. 1977): ''We consider neither Revenue Rulings nor Memorandum Opinions of this Court to be controlling precedent.''