

Who Pays for Unlawful Imprisonment?

By Robert W. Wood
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The mere thought of being wrongfully convicted and imprisoned is disturbing. So the dramatic increase in wrongfully convicted persons gaining their freedom is simultaneously comforting and distressing. Often these exonerees bring suit against the cities, states and officials whose actions precipitated their wrongful conviction. Under federal and state civil rights and compensation statutes or the common law of false imprisonment, such individuals are receiving increasingly large settlements. The biggest payouts usually involve burying witnesses and destroying evidence.

For example, in August the city of Long Beach reached a \$7,950,000 settlement with Thomas Lee Goldstein, the largest pretrial settlement for wrongful conviction in California. Similarly, in June New York City agreed to pay \$9,900,000 — the largest settlement in the city's history — to compensate Barry Gibbs for his 19 years behind bars. Even with these large payments, change in the person's life from such a physical and mental ordeal is incalculable.

An important yet often ignored ramification of these awards is their tax treatment. The Internal Revenue Code excludes from income payments received on account of personal physical injuries or physical sickness. Thus, settlements for a serious auto accident or plane crash are tax-free. Puzzlingly, the tax treatment of payments for wrongful imprisonment is in doubt, and some exonerees have been forced to pay taxes on their awards.

As exonerees have often suffered physical injuries while confined, they argue their cases are like an auto accident so the award should be tax-free. Yet if an exoneree is lucky enough never to be beaten, assaulted or mistreated in a prison hospital, his deprivation of liberty is still pronounced. The IRS had a long history of treating unlawful imprisonment recoveries as tax-free. In the 1950s, the IRS issued a series of rulings according tax-free status for payments to survivors of Nazi persecution, U.S. prisoners of war, and Japanese-American internees. Then, in 2007

the IRS abruptly — and without explanation — cancelled these rulings.

More recently, the U.S. Tax Court, affirmed by 6th U.S. Circuit Court of Appeals, ruled that “[p]hysical restraint and physical detention are not ‘physical injuries’....Nor is the deprivation of personal freedom a physical injury.” These broad (and in our view erroneous) platitudes leave exonerees with few options. Congress has

tried repeatedly to ameliorate this disparity, most recently in the Wrongful Convictions Tax Relief Act of 2010, H.R. 4743. This bill would make the first \$50,000 in annual income received by a victim of wrongful imprisonment tax-free.

Even this isn't enough. In any case, this bill, like previous legislative efforts to provide relief to exonerees, failed to become law. (See e.g. the Wrongful Convictions Tax Relief Act of 2007, S. 2421, introduced by Senators Schumer and Brownback.) As more individuals are found to have been unlawfully imprisoned and receive payment for their life-altering ordeal, this tax issue will only become more visible.

It's time for the IRS and Congress to fix this. Justice demands it.

This discussion is not

intended as legal advice, and cannot be relied upon for any purpose without the services of a qualified professional.

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