

# Trial Attorney Tax Summary for Taxation of Settlements and Damages – Part 4: Damages for False Imprisonment

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## Overview

Part 4 of this series focuses on the payment of damages for false imprisonment. We all have all heard the story that the “Big House” is full of innocent men. It turns out that there could be some truth to that statement. It seems that since the advent and availability of DNA testing that chants of “You have the wrong man, “have greatly increased. As a result, these former inmates are bringing claims of false imprisonment and seeking compensation for their incarceration.

As a practical matter, the loss of personal freedom for a crime that you did not commit seems like the worst indignity a person could suffer. Another indignity on top of the indignity, but perhaps not nearly as bad (but under the category of adding salt to the wounds) is the taxation of those settlement damages. The impact of current tax rates could impose a 40-50

percent “haircut” on the settlement. What the Government gives in one hand, it takes back in the other hand.

This article is designed to outline the tax treatment of false imprisonment damages for plaintiffs.

### **What is False Imprisonment?**

The common law tort of false imprisonment requires an individual to prove that he was knowingly and intentionally confined against his will and without his consent. At common law, an action of confinement under valid process was brought as a claim of malicious prosecution or abuse of process. Under common law, a plaintiff needed to prove all of the elements of the claim while overcoming any of the obstacles of recovery such as a privilege defense.

Twenty two states including the District of Columbia and the federal government have statutes providing plaintiffs with redress for false imprisonment. Additionally, Section 1893 of the Civil Rights Act provides a statutory framework for a wrongfully convicted person to seek compensation from the police, prosecutors and municipalities for violation of constitutional rights. A typical claim deals with a violation of the Fifth Amendment right to due process

As previously mentioned, a number of states have compensation statutes that provide compensation for false imprisonment damages. The range itself is pretty spectacular with a lot of requirements as well. Some states only compensate felonies. Other states preclude recovery where the defendant entered a guilty plea. For example, Wisconsin allows \$5,000 per year with a maximum of \$25,000. New York has no cap on compensation.

Montana provides no compensation but provides a small contribution towards education.

The federal government provides \$50,000 for each year of incarceration and \$100,000 for each year on death row. The plaintiff would also be able to file ancillary claims for items such as loss of consortium; invasion of privacy; and battery in addition to the false imprisonment claims

### **A Review of IRC Sec 104(a)(2)**

The Small Business Protection Act of 1996 added IRC Sec 104(a)(2) to the Internal Revenue Code changing the landscape for the taxation of settlements and damages. The new section made a small but significant change by limiting tax-free treatment as a result of personal “physical” injuries and “physical” sickness.

*IRC Sec 104(a)(2)* excludes from gross income the amount of any damages (other than punitive damages) received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal **physical** injuries or **physical** sickness

Emotional distress is generally not considered a physical injury or physical sickness. However, damages for emotional distress attributable to a physical injury or physical sickness are excluded from income under section 104(a)(2).

Internal Revenue Bulletin 2012-12 added final regulations which had been pending since 1996 and substantial amounts of litigation regarding the “on account of physical injury and physical sickness” test of IRC Sec 104(a)(2).

The final regulations adopt the provision under the proposed regulations that delete the requirement that to qualify for exclusion from gross income, damages received from a legal suit, action, or settlement agreement must be based upon “tort or tort type rights

## **The Tax Treatment of False Imprisonment**

Between 1918 and 1996 a judgment or settlement granted on account of personal injury or sickness received tax-free treatment. After the addition of IRC Sec 104(a)(2) the IRS position on damages has been “Show me the bruises and broken bones”, .i.e. observable bodily harm, in order to establish damages on account of personal physical sickness and injury. Recently, the IRS has been more conciliatory in the area of sexual abuse settlements.

The U.S. Supreme Court case *Commissioner v. Schleir*, 515 U.S. 323, (1995) preceded the adoption of IRC Sec 104(a)(2) but continues to be relied on for the “physical” modifier component of IRC Sec 104(a)(2). The case adopted a two prong approach for analyzing a case. The first prong requires the plaintiff to establish that damages were received through a tort or tort-like action. The second prong requires the plaintiff to establish that damages were received “on account” of personal (physical) injury or sickness.

In *Schleir*, damages received before the occurrence of the First Pain Incident are not received on account of a personal physical injury or sickness and are not exempt from taxation under IRC Sec 104(a)(2). Damages as a result of injury on occurrence of or after the First Pain Incident for pain and suffering, emotional distress and reimbursement of medical expenses are properly allocable to personal physical injury and receive tax-free treatment under IRC Sec 104(a)(2). PLR 200041022

established that where there is visible harm such as a case of battery, all damages flowing from it including emotional are tax-free.

Stadnyk v. Comm'r 96 T.C.M.475 (2008) was a false imprisonment case in which the Tax Court ruled that the damages received for false imprisonment were taxable. The Sixth Circuit court of Appeal affirmed the ruling. The Court reasoned the mental anguish and humiliation suffered were non-physical injuries and therefore not excluded from income. .

Rob Wood, the pre-eminent attorney in the taxation of settlements and damages has argued that there is nothing "mental" about false imprisonment and that personal confinement must always be seen as "physical." The loss of personal liberty and confinement is as much physical as it is mental. We are all familiar with stories of rape and battery not only at the hands of other inmates but also prison personnel.

This logic has a strong historical basis in the treatment of prisoners. Settlements involving compensation for loss of constitutional rights received tax-free treatment prior to the passage of IRC Sec 104(a)(2). The Civil Liberties Act of 1988 provided tax-free compensation for Japanese-Americans for their relocation and internment in prison camps during World War II.

Rev. Rul. 56-462 provided tax-free treatment for payments by the U.S. Government to Americans held as prisoners by the enemy during the Korean War. American citizens received similar treatment in World War II. See Rev. Ruls 55-132; Rev. Rul. 58-370 and Rev. Rul 56-518. The rulings state that payment for deprivation of civil and personal rights is excluded from income. Similarly, Rev. Rul. 56-518 provided for tax-free treatment for payments related to persecution relating to damage to life, body and health.

## **Some Movement in the IRS Position**

In Part 3 of this series, I examined the tax treatment of damages for sexual abuse. The IRS in the area of sexual abuse is moving away from its bright line test that all damages “on account of personal physical sickness and injury” must be readily observable. The IRS Tax Payer Advocate has addressed Congress on this issue. In an IRS Chief Counsel Advice Memoranda (CCA 200809001), the Office of Chief Counsel cited a sexual abuse fact pattern. In the fact pattern, the plaintiff suffered physical injury as a result of sexual abuse as a child.

A significant amount of time had passed since the events making it difficult to establish the extent of the physical injuries suffered as a result of the abuse. Nevertheless, the IRS conceded that it was reasonable to presume that all damages were the result of physical injuries and that the emotional distress suffered was attributable to the physical injuries suffered years before. Interestingly, the author of CCA 200809001 was also the author of PLR200041002 that concluded that any damages received for unwanted physical contact without any readily observable bodily contact were not received on account of personal physical sickness or injury. These more recent pronouncements seem to indicate a new trend in the IRS position on sexual abuse.

There are several learning points to consider. First, the IRS viewpoint on damages and settlements that are not inherently physical in nature is developing. In the area of false imprisonment there is a lot of historical precedent to establish favorable tax-free treatment using the loss of civil liberties as a basis for damages.

Undoubtedly, in most incarcerations there is a physical component to the false imprisonment. It is important to consider ancillary charges as well as

part of the litigation. In positioning the case, focus on the physical component as well as the loss of constitutional rights as the best strategy to obtain favorable treatment for the settlement.

## **Summary**

Personally I can't imagine many things worse than being incarcerated for a crime that you did not commit. In the era of high tech forensic science, this has become a common occurrence. A number of states have adopted legislation providing compensation for false imprisonment. Adverse tax treatment on the settlement can add insult to injury by treating the settlement damages treated as taxable income. As a matter of policy, it would seem that the least we should be able to do for someone who was falsely incarcerated is to allow them to receive tax-free treatment on any compensation received.