



Dollars and Sense

How a recent federal law makes wrongful conviction compensation tax-free.

BY ROBERT W. WOOD

Few of us can imagine being convicted and imprisoned for crimes we did not commit. However, our justice system is not perfect, and errors and even misconduct occur. Statistics show that individuals who were wrongfully convicted and exonerated have spent an average of more than 14 years wrongfully incarcerated,¹ some imprisoned for up to 35 years.²

For those who receive damages for their ordeal, the tax treatment of their awards has been surprisingly cloudy. Fortunately, a new federal tax law,³ introduced by U.S. Reps. Sam Johnson, R-Texas, and John Larson, D-Conn., and signed into law in 2015, makes clear that a wrongfully incarcerated individual can receive damages tax-free. The exclusion applies to the civil damages, restitution, or other monetary awards an exoneree receives as compensation for a wrongful incarceration.⁴

The law covers people who were convicted of a covered offense, served all or part of a sentence of imprisonment relating to the covered offense, and meet any one of the following three requirements: (1) the individual was pardoned, granted clemency, or granted amnesty for that covered offense because the individual was innocent of that covered offense; (2) the judgment of conviction for the individual for that covered offense was reversed or vacated and the indictment, information, or other accusatory instrument for that covered offense was dismissed; or (3) the judgment of conviction for the individual for that covered offense was reversed or vacated and the individual was found not guilty at a new trial after the judgment of conviction for that covered offense was reversed or vacated. The recovery may come under a wrongful incarceration statute, the torts of false imprisonment or malicious prosecution, or for violation of civil rights. The states vary in their payouts,⁵ and there is a federal statute dating back to 1948⁶ and revised in 2004.⁷

From a policy perspective, it seems hard to argue that these recoveries should be taxed, and even the Internal Revenue Service has seemed skittish about the topic. However, there has been no clear tax exemption. And not every exoneree is well advised or equipped to handle a query from the IRS about a legal settlement. The IRS issued a series of rulings in the 1950s and 1960s involving prisoners of war, civilian internees, and Holocaust survivors.⁸ The IRS ruled that their compensation was tax-free irrespective of whether they suffered physical injuries. Then the agency “obsoleted”⁹ these rulings in 2007, suggesting that the landscape had changed.¹⁰ In the meantime, section 104 of the Internal Revenue Code was amended in 1996 to say that recoveries had to be for “physical” injuries to be tax-free.¹¹ If an inmate was seriously injured in prison, section 104 might exclude the entire recovery. Yet even then, normal IRS rules would require allocating the recovery between tax-free and taxable portions. A payment for emotional distress *not* arising from physical injuries or physical sickness is taxed.¹²

There was no clear rule for wrongful imprisonment where damages are for loss of freedom, loss of career, loss of consortium, emotional distress, or other harm. The exoneree may have been beaten or subjected to inadequate medical treatment,

which becomes the basis for tax-free treatment. A loss of liberty and physical confinement is arguably *itself* a physical injury, but this was never clear.

Indeed, in *Stadnyk v. Commissioner of Internal Revenue*,¹³ the U.S. Tax Court and 6th Circuit Court of Appeals found a false imprisonment recovery to be taxable because there was no physical injury.¹⁴ Then, in 2010, the IRS published Chief Counsel Advice 201045023,¹⁵ which said only a victim of wrongful imprisonment who “suffered physical injuries and physical sickness while incarcerated” can exclude his or her recovery from taxes. There are usually physical injuries and sickness in long-term wrongful imprisonment cases, but that was rarely the reason the victim was getting most of the money. And the allocation question for all the rest of the damages was serious.

With the new legislation, the ambiguity is gone and these recoveries are tax-free, even retroactively. Exonerees will no longer have to prove that they were physically injured in prison. Their advisers will no longer have to skew the allocation of the money to 100 percent physical injuries where most of the money is really for loss of freedom and civil rights. Still, there are some technical issues. Section 139F of the tax code now provides that:

In the case of any wrongfully incarcerated individual, gross income shall not include any civil damages, restitution, or other monetary award (including compensatory or statutory damages and restitution imposed in a criminal matter) relating to the incarceration of such individual for the covered offense for which such individual was convicted.

A ‘wrongfully incarcerated individual’ means an individual who was convicted of a covered offense, who served all or part of a sentence of imprisonment relating to that covered offense, and:

(A) who was pardoned, granted clemency, or granted amnesty for that covered offense because that individual was innocent of that covered offense, or

(B) (i) for whom the judgment of conviction for that covered offense was reversed or vacated, and (ii) for whom the indictment, information, or other accusatory instrument for that covered offense was dismissed or who was found not guilty at a new trial after the judgment of conviction for that covered offense was reversed or vacated.

A “covered offense” means any criminal offense under federal or state law. It includes any criminal offense arising from the same course of conduct as that criminal offense. The law has an unusual effective date, almost unheard of with tax laws. It is retroactive, and tax refunds are even possible.

Notably, new section 139F of the tax code does *not* say that punitive damages are taxed. That is a contrast from section 104, which makes that point explicit. Perhaps that means that section 139F excludes any punitive damages too. It appears that some people are reading the law in this way.¹⁶ However,

there is nothing in section 139F that expressly states punitive damages are tax-free. The IRS’s position is that punitive damages are never tax-free because they are never to compensate the plaintiff; rather they are to punish. As the U.S. Supreme Court held in *O’Gilvie v. United States*,¹⁷ punitive damages are not compensating for an injury and therefore *cannot* be tax-free. Exonerees are unlikely to receive punitive damages. In that sense, the ambiguity in section 139F may never be called into question. But if an exoneree does receive punitive damages, the taxpayer and the IRS may disagree.

There are also some questions about how structured settlements will be handled. With many physical injury cases, the plaintiff may want to “structure” all or a part of his or her recovery, receiving a stream of payments over time. Section 104 clearly contemplates this, stating that the damages are tax-free in a lump sum or in periodic payments. With periodic payments, 100 percent of each payment is tax-free, even though a portion could be viewed as investment return. The mechanics are complex. Defendants want to pay a lump sum, and no plaintiff wants to rely upon the defendant to pay like clockwork over time. Accordingly, insurance companies fill the void with structured settlement annuities. The structured settlement industry allows defendants to pay a lump sum for a release and plaintiffs to receive payments over time. Under new section 139F, however, it is unclear how wrongful conviction recoveries will be structured.

Up until now, the agreement and structure documents in a wrongful conviction settlement would refer to physical injury recoveries. Now, unless one continues to use personal physical injury language and to rely on section 104, there will be a mismatch. This may be a mere technical glitch that can be overcome in one of several ways; but it may be causing some worries. One approach would be to use non-qualified structured annuities, of the same type one would employ for taxable periodic payments.

But this is not a perfect solution. First, it will dramatically limit the number of companies that can write the annuities. There are numerous big life insurance companies that write tax-qualified annuities. Only a few write non-qualified ones. Even worse, the non-qualified annuity approach will set up the protocol for taxable payments, with an IRS Form 1099 being issued every year to the exoneree. That means the IRS will assume that each payment is taxable income—even though it should not be under the new law.

If the IRS later tries to tax the payments, presumably section 139F would be sufficiently clear that the agency should go away. However, this could lead to administrative tax problems. It seems like an unfortunate train to set off down the tracks, particularly with insurance products and companies that are not used to altering their Form 1099 protocols. These companies issue Forms 1099 in non-qualified cases, and that is likely to be that.

The tax code does not always make sense and is not always clear. The origin of the claim doctrine is the hallmark of taxing litigation recoveries, but it is often more thematic than conclusive. For many litigants who receive damages, there is ambiguity. There may be disputes about the facts,

pleadings, and resolution of the case and about the application of the tax law as well. Sometimes, tax returns must be examined, litigation documents must be exhumed, and tax disputes initiated. The tax law and the IRS may apply their own imprint on the conflict.

With wrongful conviction recoveries, though, it is now clear that lump sums or periodic payments are tax-free. A few definitional issues may arise in the future, and it seems conceivable that punitive damages may become a bone of contention. Furthermore, there may be some changes in the structured settlement field. **TBJ**

Originally published in the New York State Bar Association Journal, May 2016, Vol. 88, No. 4, One Elk Street, Albany, NY 12207. This article has been edited and reprinted with permission.

NOTES

1. See Innocence Project, *Compensating The Wrongly Convicted*, available at <https://www.innocenceproject.org/compensating-wrongly-convicted/>.
2. See Michael Hall, *The Exonerated*, Texas Monthly (November 2008), available at <http://www.texasmonthly.com/articles/the-exonerated/>.
3. 26 USC § 139F.
4. Under Texas Civ. Prac. & Rem. Code § 103.001(d), an exoneree is eligible to receive group health benefit plan coverage through the Texas Department of Criminal Justice as if the person were an employee of the department. See Texas Civ. Prac. & Rem. Code § 103.001(d).
5. For a comprehensive list, see the database provided by the Innocence Project, available at <http://www.innocenceproject.org/how-is-your-state-doing>.
6. 28 USC §§ 1495 and 2513.
7. P.L. 108-405, 118 Stat. 2293.
8. Rev. Rul. 55-132, 1955-1 C.B. 213; Rev. Rul. 56-462, 1956-2 C.B. 20; Rev. Rul. 56-518, 1956-2 C.B. 25; Rev. Rul. 58-370, 1958-2 C.B. 14.

9. "Obsoleted" describes a previously published ruling that is not considered determinative with respect to future transactions. This term is most commonly used in a ruling that lists previously published rulings that are obsoleted because of changes in laws or regulations. A ruling may also be obsoleted because the substance has been included in regulations subsequently adopted. See I.R.B. 2016-33 (August 15, 2016).
10. Rev. Rul. 2007-14, 2007-12 I.R.B. 747, Doc 2007-4230, 2007 TNT 34-15.
11. In 1996, Congress amended this formerly simple and straightforward personal injury exclusion by inserting the word "physical" in two key places. Since that amendment, to get tax-free damages or tax-free settlement payments, the payment must be on account of personal *physical* injuries or *physical* sickness.
12. See H.R. Conf. Rep. No. 104-737, 104th Cong., 2d Sess., 301 (1996).
13. T.C. Memo 2008-289, *aff'd* without published opinion (6th Cir. 2010).
14. *But see* comments of Mike Montemurro, branch chief of the IRS's Office of Associate Chief Counsel for Income Tax and Accounting, Public Hearing on Proposed Regulations, 26 CFR Part 301 "Damages Received on Account of Personal Physical Injuries or Physical Sickness" [Reg-127270-06], Feb. 23, 2010: "I mean I don't know that the Service has ever gone to court on litigation, you know, I know the Service doesn't ever go to court on litigation, [regarding] anybody who's been falsely imprisoned or anyone who's suffered any sex abuse, as far as asserted in a courtroom that those kinds of damages are taxable, I mean whatever the pure technical answers may be." at p.10, Doc 2010-4501, or 2010 TNT 41-15.
15. Nov. 4, 2010.
16. RIA's Complete Analysis of the Protecting Americans From Tax Hikes Act of 2015, Other Tax Provisions of the Consolidated Appropriations Act, 2016, and Earlier 2015 Tax and Pension Acts, Chapter 100 at ¶ 120 Damages for wrongful incarceration are excluded from gross income, available on Checkpoint.
17. 519 U.S. 79 (1996).



ROBERT W. WOOD

is a tax lawyer and the author of numerous tax books including Taxation of Damage Awards & Settlement Payments. He can be reached at woodllp.com. This discussion is not intended as legal advice.



Fastest smartest malpractice insurance. Period.

800.906.9654
GilsbarPRO.com