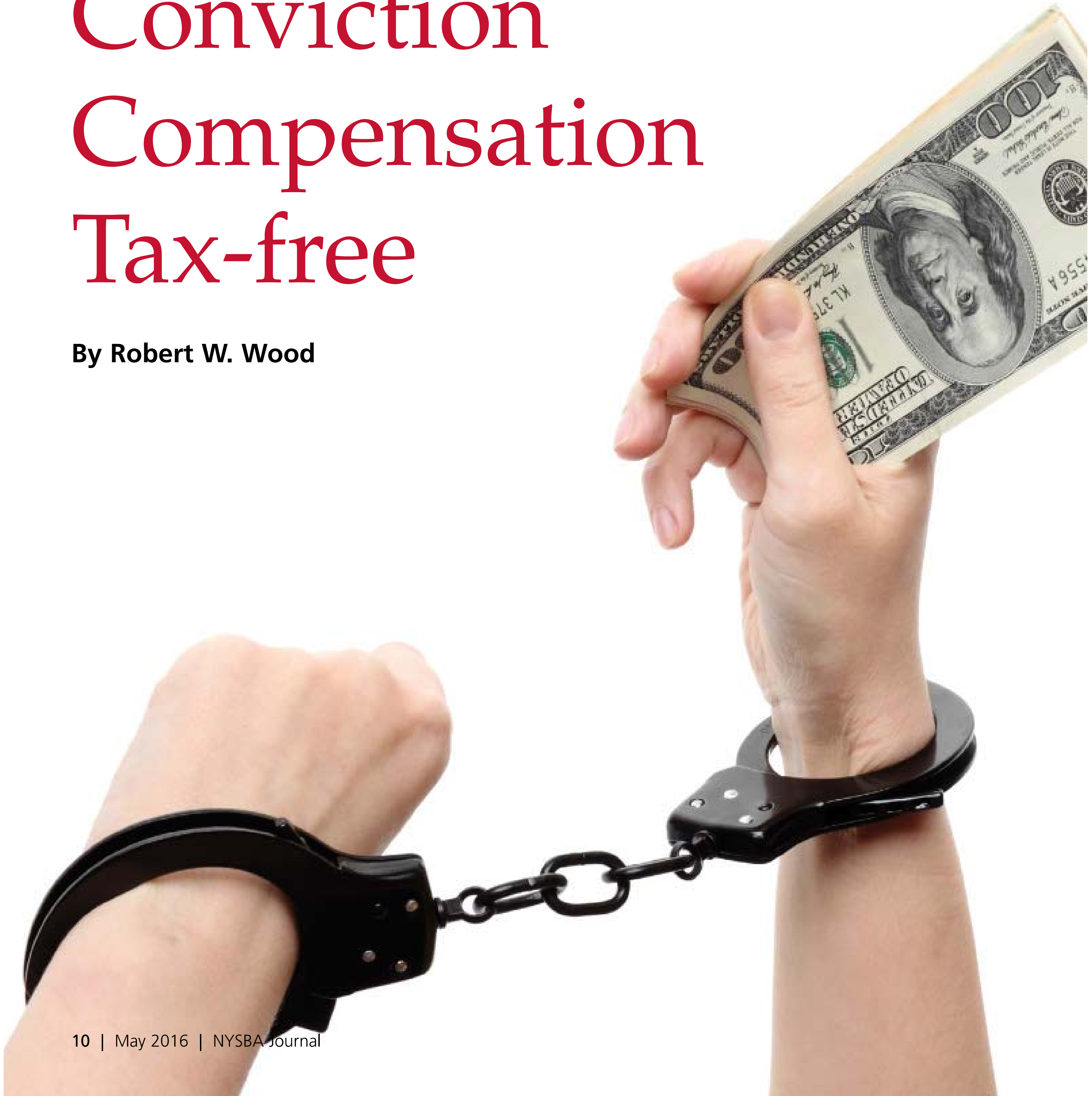
Retroactive Law Makes Wrongful Conviction Compensation Tax-free

By Robert W. Wood



Arguably one of the best and brightest changes to the tax code in the massive tax bill passed at the end of 2015 is something that for years was proposed as the stand-alone "Wrongful Convictions Tax Relief Act."[1] Unlike many other tax changes, you do not want this to apply to you. After all, if it does, you were wrongfully convicted and wrongfully behind bars, probably for many years.

Few of us can imagine what it would be like to be convicted and imprisoned for crimes we did not commit. In the U.S., individuals who were wrongfully convicted and exonerated by DNA evidence spent an average of 13.5 years wrongfully incarcerated. Their actual prison terms range up to 35 years.

Since the first DNA exoneration in 1989, wrongfully convicted persons have collectively served more than 3,809 years in prison before being exonerated. Whether you look at an individual case or at the averages, these are some astounding numbers. The new law amends the Internal Revenue Code so that a wrongfully incarcerated individual can exclude his or her recovery.

The exclusion applies to the civil damages, restitution, or other monetary awards an exoneree receives as compensation for a wrongful incarceration. Several points are notable, and may not be obvious. First, it may even cover punitive damages, a topic discussed below.

Second, it covers only exonerees. Thus, it does not apply to a false imprisonment recovery – or any other claim – by a person who may have been mistreated but is not later found to actually be innocent. The exoneration is a legal requirement for the tax exclusion to apply.

Thirty states, the District of Columbia, and the federal government provide some form of statutory compensation for wrongful conviction and incarceration. Some plaintiffs sue in state court under a state wrongful incarceration statute, in federal court for violation of civil rights, or in state court for the torts of false imprisonment or malicious prosecution. The states vary in the maximum amount of their payout, and in the means used to measure the awards.[2]

Some states include lost wages in addition to the compensation otherwise provided by the statute.[3] Apart from state statutes, there is also a federal statute.[4] The federal statute was originally enacted in 1948 and was later substantially revised by the Innocence Protection Act of 2004, part of the Justice for All Act of 2004 (JFAA).[5] In addition to state and federal statutes of general application, some state legislatures have weighed in with targeted legislation to compensate a particular wronged person.[6]

Robert W. Wood is a tax lawyer with www.WoodLLP.com, and the author of numerous tax books including *Taxation of Damage Awards & Settlement Payments* (www.TaxInstitute.com). This discussion is not intended as legal advice.

Tax Questions

Few people have argued that these recoveries should be taxed, but there has been no clear exemption. Our justice system is complex, and sometimes gross injustices occur. When they do and are eventually rectified, the person is never the same. This includes re-entry needs that are hard to comprehend.

For those who do end up with money to help pay for their ordeal, adding IRS collectors into the mix can be salt in the wounds. And not every exoneree is well advised or equipped to handle a query from the IRS about a legal settlement. Yet until now, the tax issues have been surprisingly cloudy.

The IRS issued a series of rulings in the 1950s and 1960s involving prisoners of war, civilian internees and holocaust survivors.[7] Sensibly, the IRS ruled that their compensation was tax-free irrespective of whether they suffered physical injuries. Then the IRS "obsoleted" these rulings in 2007, suggesting that the landscape had changed.[8]

Section 104 was amended in 1996, but these 1950s and 1960s rulings were not based on § 104. Meanwhile, the Tax Court and the Sixth Circuit found a false imprisonment recovery to be taxable in *Stadnyk.*[9] It was a very short term incarceration case, but suggested continuing adherence to the canard that "there must *also* be physical injury."[10]

If so, the damages are tax-free as with more garden variety personal physical injury recoveries. If an inmate was seriously injured in prison, § 104 might exclude the entire recovery. Yet even then, normal IRS rules would suggest allocating the recovery between amounts that are tax-free and those that are not.

Indeed, in some cases the plaintiff is never physically injured despite physical confinement. If the § 104 model was not too helpful in excluding an entire recovery, perhaps one could rely on the non-statutory general welfare exception? After all, the government is typically paying the money.

Moreover, the government is paying someone for depriving him or her of his or her freedom and welfare.[11] Unfortunately, little attention is usually given to the general welfare exception. That brings us back to the uneasy topic of § 104.

As the voluminous § 104 authorities make clear, the statute's post-1996 iteration requires that the payment be made on account of physical injuries, sickness or related emotional distress. If a payment is for emotional distress *not* arising out the physical injuries or physical sickness, then tax applies.[12] This invites discussion over just *why* the payment is being made, or more exactly in the language of the statute, "on account of" what the payment is made.

The payment may be for a mix of damages, including loss of freedom, loss of career, loss of consortium, familial association, reputation, emotional distress and more. The

exoneree may have been beaten, roughed up, subjected to inadequate medical treatment and more. These latter items often become the hook on which we hang tax-free treatment.

Positions vary on whether one should allocate monies between these pure physical elements and the more generic wrongful imprisonment damages. Tax lawyers are inclined to allocate. In the IRS "bruise" ruling, the IRS says that all of the damages in a sex harassment case leading up to the "First Pain Incident" are taxable.[13]

All of the damages (including emotional distress damages) accruing after the First Pain Incident are tax-free. Does the sex harassment case discussed in the bruise ruling have a wrongful imprisonment analog? If so, it would perhaps be a case in which a person is wrongfully arrested, convicted and imprisoned for say 10 years before being exonerated and released.

This IRS ruling said only that a victim of wrongful imprisonment who "suffered physical injuries and physical sickness while incarcerated" can exclude his recovery from taxes. If the exoneree had physical injuries, the damages are tax-free, just like personal physical injury recoveries. If not . . . well, we don't like to talk about that one.

There are usually significant levels of physical injuries and sickness in long-term wrongful imprisonment cases. For that reason, as a practical matter, we tend to use a hook for tax-free treatment that we know appeals to the IRS. But is that really why the victim is getting most of the money? Usually, no.

It may be difficult or even impossible to separate out all of the multiple levels of horror, all the losses that can never be made up. But in many cases, the loss of physical freedom and civil rights is at the root of the need for reparations. Although I commended the IRS for saying what it did say in IRS Chief Counsel Advice 201045023, it did not solve all the issues.

The new law says you no longer have to prove that you were physically injured in prison to get tax-free treatment.

Suppose it is five years into his sentence before he is assaulted and beaten, hurt in a botched operation in the prison hospital, or experiences some other "First Pain Incident." Does that mean all of his recovery attributable to the time *before* the First Pain Incident is taxable? To me, the loss of liberty and physical confinement is *itself* a physical injury within the meaning of § 104.

However, that view was hard to square with the authorities. Indeed, in *Stadnyk v. Commissioner*,[14] the Tax Court and the Sixth Circuit ruled that physical restraint and physical detention are not "physical injuries" for purposes of § 104(a)(2).

Mrs. Stadnyk was held at a local sheriff's office for approximately eight hours. She was handcuffed, photographed, confined to a holding area, and searched via pat-down. She suffered no observable bodily harm, and she admitted she was never injured or even roughed up. The Tax Court concluded that the deprivation of personal freedom is not a physical injury for purposes of § 104(a)(2).

The Sixth Circuit affirmed, noting that while false imprisonment involves a physical act – restraining the victim's freedom – it does not mean that the victim is *necessarily* physically injured as a result.[15] The issue came up in the Regulation hearing on the § 104 regulations in February 2010. Then, the IRS published Chief Counsel Advice 201045023.[16]

Chief Counsel Advice 201045023 does not attempt to allocate an amount paid under the state statute between the payment for physical injuries and sickness and the other damages. I applaud that treatment, for I don't think the "First Pain Incident" analog made sense in this context. Perhaps the IRS did not either.

The state statute in the Chief Counsel Advice awarded money based on tenure in prison with a kind of *per diem* approach. The fact that the IRS does not broach the allocation point might mean that it views the money as all for the physical injuries and sickness. It might mean that the time-based payment is carried along with the physical injury payment.

It might even mean that the time-based payment on its own would be tax-free, though the latter seems the least likely meaning. In any case, the IRS does not attempt to parse the recovery in Chief Counsel Advice 201045023. Still, what of an exoneree who spends years in prison but, like Mrs. Stadnyk, says he was never roughed up, never beaten, never given inadequate medical care?

New Day

With the new legislation, these recoveries are now tax-free, even retroactively. Congressmen Sam Johnson

(R-TX) and John Larson (D-CT) introduced their bill repeatedly. In 2015, they re-introduced the Wrongful Convictions Tax Relief Act. Several members of the Senate, including Charles Schumer (D-NY) and John Cornyn (R-TX), joined in.

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. You no longer need to suggest that you received millions for getting stabbed or beaten up while in prison, and nothing for spending 15 years wrongfully behind bars.

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."[17]

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.

As you might expect in any tax code section, there are definitions. 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.

Finally, a "covered offense" means any criminal offense under federal or state law, and includes any criminal offense arising from the same course of conduct as that criminal offense.

The law has an unusual effective date. At first, it even seems hard to understand: "The amendments made by this section shall apply to taxable years beginning before, on, or after the date of the enactment of this Act." Then, the provision goes on to include a waiver of the statute of limitations:

> If the credit or refund of any overpayment of tax resulting from the application of this Act to a period before the date of enactment of this Act is prevented as of such date by the operation of any law or rule of law (including res judicata), such credit or refund may nevertheless be allowed or made if the claim therefor is filed before the close of the 1-year period beginning on the date of the enactment of this Act.

Punitive Damages

Does the new law cover punitive damages as well as compensatory ones? That is an interesting question. One might note that new code § 139F itself does not say that punitive damages are taxed. That is a contrast from § 104, which makes that point explicit.

Perhaps that means that § 139F excludes any punitive damages too. It appears that some people are reading the law in this way.[18] On the other hand, there is also nothing in § 139F to expressly state that punitive damages are tax-free.

One can argue – as the IRS has in the past – that punitive damages are by definition not to compensate the plaintiff for anything. Punitive damages are to punish. That would suggest, as the Supreme Court held in *O'Gilvie*,[19] that punitive damages are not compensating for an injury and therefore cannot be tax-free.

This may be an academic point unless and until an exoneree receives punitive damages. But that does not seem out of the realm of possibility. And it seems easy to imagine the taxpayer and the IRS disagreeing over this.

Structured Settlements

With many physical injury cases, the plaintiff may want to "structure" all of a part of his recovery. Section 104 clearly contemplates this. Section 104 says that the damages are tax-free in a lump-sum or in periodic payments.

With periodic payments, 100 percent of each payment will be tax-free. This is so even though a portion of those periodic payments could be viewed as investment return on the lawsuit proceeds. The plaintiff only wants to be sure that he will receive all of the promised payments over time, and that each payment is tax-free.

But the mechanics are complex. Defendants want to pay a lump-sum, and no plaintiff would want to rely upon the defendant to pay like clockwork over time. Accordingly, insurance companies that write structured settlement annuities fill the void.

The defendant or insurer transfers the obligation to an assignment company which will make the payments to the plaintiff. If the assignment qualifies under § 130, the assignment company is sure that the payment it receives is not income for federal income tax purposes. Even with § 139F, however, it is unclear how wrongful conviction recoveries will be structured from now on.

Up until now, the settlement agreement and structure documents in a wrongful conviction settlement would refer to §§ 104 and 130. Now, unless one continues to use personal physical injury language and to rely on §§ 104 and 130, there will be a mismatch. That is, § 139F does not work in tandem with § 130.

This may be a mere technical glitch that can be overcome in one of several ways. But it may be causing some worries. One suggestion I recently heard was to use non-qualified structured annuities, of the same type one would employ for taxable periodic payments.

On first blush, this strikes me as a terrible idea. First, it will dramatically limit the number of companies that can write the annuities. There are approximately 15 big life insurance companies that write qualified (§ 130) annuities. There are approximately two that write non-qualified ones.

Even worse, it sets up the protocol for taxable payments with a Form 1099 every year to the plaintiff. Perhaps there are ways to counteract that. And if the IRS later tries to tax the payments, presumably § 139F would be sufficiently clear that the IRS should go away.

However, this could lead to administrative tax problems galore. 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. They issue Forms 1099 in non-qualified cases, and that is likely to be that.

Conclusion

The tax code does not always make sense. And it 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 often ambiguity.

There may be disputes about the facts, pleadings, 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 there will be tax disputes. The tax law and the IRS may apply their own imprint on the dispute that went before.

With wrongful conviction recoveries, though, it is now clear that lump sums or periodic payments are tax-free. There may be a few definitional issues 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. But this is a very good change in the law. ■

1. Public Law No. 114-113 at § 304 (2015).

2. For a comprehensive list, see the database provided by the Innocence Project, www.innocenceproject.org/how-is-your-state-doing.

3. *See, e.g.*, Iowa Code § 663A.1; Ohio Revised Code Ann. 2743.48.

4. 28 U.S.C. §§ 1495 and 2513.

5. Public Law 108-405, 118 Stat. 2293.

6. *See, e.g.,* Cal. Rev. & Tax Code § 17156, providing for exclusion from income for the $620,000 paid by the state of California to Kevin Lee Green as compensation for 17 years of wrongful imprisonment.

7. 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.

8. Rev. Rul. 2007-14, 2007-12 IRB 747, Doc 2007-4230, 2007 TNT 34-15.

9. T.C. Memo 2008-289, *aff'd without published opinion* (6th Cir. 2010).

10. *But see* comments of Mike Montemurro, branch chief of the IRS Office of Associate Chief Counsel for Income Tax and Accounting, Public Hearing on Proposed Regulations, 26 C.F.R. pt. 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.

11. Wood, *Are False Imprisonment Recoveries Taxable?*, Vol. 119, No. 3, Tax Notes (Apr. 21, 2008), at p. 287. For more general information on the general welfare exception, see Wood, *The Evergreen General Welfare Exception*, Vol. 126, No. 10, Tax Notes (Mar. 8, 2010), p. 1271; Wood, *Updating General Welfare Exception Authorities*, Vol. 123, No. 12, Tax Notes (June 22, 2009), p. 1443.

12. *See* H.R. Conf. Rep. No. 104-737, 104th Cong., 2d Sess., p. 301 (1996).

13. Letter Ruling 200041022 (July 17, 2000).

14. T.C. Memo 2008-289, *aff'd without published opinion* (6th Cir. 2010).

15. *Id.* (italics in original). For more on *Stadnyk*, see Wood, *Why the Stadnyk Case on False Imprisonment Is a Lemon*, Vol. 127, No. 1, Tax Notes (April 5, 2010), p. 115.

16. Nov. 4, 2010.

17. *See* Press Release, "Congressmen Sam Johnson and John Larson introduce legislation to assist those wrongfully convicted" (March 22, 2012), http://samjohnson.house.gov/news/documentsingle.aspx?DocumentID=286340.

18. 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.

19. 519 U.S. 79 (1996).