



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. § 1983 for a violation of his or her 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. Furthermore, many states now expressly 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 these injuries. Prosecutorial misconduct may or may not be involved. Although there may well be nuances between the differing legal bases upon which such a claim may be brought, I have argued that the commonality of this fact pattern should mean that such recoveries should be excludable from income under Section 104 of the Code.¹ I will not re-state all of those arguments here, but will endeavor to summarize them briefly.

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Should False Imprisonment Damages Be Taxable?

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 Internal Revenue Service (IRS or the “Service”) has interpreted this rule as requiring observable bodily harm in order 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 Chief Counsel Advice Memorandum 200809001,³ the IRS considered the tax treatment of a settlement for sex abuse. The abuse had occurred while the plaintiff was a minor, and the settlement was paid by the institution many 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.

Nevertheless, the IRS ruled that the entire settlement was excludable under Section 104. Although the taxpayer had failed to demonstrate any signs of physical injury, the IRS found it reasonable to *presume* there had (at some point) been observable signs of physi-

cal injuries in such case.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. Arguably, it should be irrelevant, as the situation could be just as compelling without the age factor. Yet one senses that the Service was trying to eke out a narrow exception from its “we must see it” mantra.

Significantly, the Service failed to back off on the notion that Section 104 requires an outward sign of injuries. Nevertheless, it still gave the taxpayer relief on an unquestionably sympathetic fact pattern. In essence, the IRS ruled that at least under *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 physically confined behind bars. Even if no bruises or broken bones befall the plaintiff while behind bars, it seems axiomatically physical to be physically confined. But is it a physical injury or physical sickness?

I argue yes. First, I note that it is almost a certainty that there will be ancillary claims in any long-term false imprisonment case. Whether characterized as assault, battery, medical mal-

practice, etc., most long-term inmates have had altercations that can provide the proverbial physical hook on which one can 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 clearly apply. If a taxpayer is raped, that physical trauma may or may not be visible. Even if tears or bruising do not appear, in my opinion 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 thereof, should be the same.

Historically, 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, to U.S. prisoners of war in Korea, and so on. At one time or another, all these types of recoveries were held to be nontaxable as payments for a deprivation of liberty.⁵

In all of these historic cases, these 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 in such circumstances appear even arguably to be taxable. The IRS can be forgiven for being skeptical of personal physical injury allocations in many employment cases, where 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, where the wage versus non-wage dichotomy was patent. In employment cases preceding the 1996 amendments, the emotional distress moniker was added

to virtually every situation. It was no secret that most damages seemed to be labeled as “emotional distress” in view of the obvious tax advantages such nomenclature imported.

The Service’s rigidity in its view today may be explained by taxpayer sins of the past. That is unfortunate, for there is nothing whatsoever abusive about a recovery for long-term wrongful incarceration being afforded tax-free treatment. Taxable or not, no amount of money can ever make such 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 upon. Indeed, in the Service’s view, the “physical” requirement interposed into Section 104 in 1996 undercuts these internment authorities. In Revenue Ruling 2007-14, 2007-12 IRB 747, the IRS “obsoleted” all of these revenue rulings, ostensibly due to the 1996 statutory change to Section 104. The IRS does not state publicly exactly why it obsoleted these internment rulings.

My off-the-record understanding, however, is that the Service felt that the 1996 legislation said “physical” and meant “physical.” Being wrongfully locked up – without more anyway – just isn’t physical. Yet I believe wrongful imprisonment is *by its very nature* physical. The fact that the internment rulings pre-date the 1996 statutory change should be irrelevant.

General Welfare Exception

Quite apart from Section 104 of the Code, it is independently arguable that the general welfare exception (GWE) shall apply to false imprisonment recoveries. The GWE exempts from taxation payments that are

- made from a governmental general welfare fund;
- made for the promotion of the general welfare (that is, on the basis of need rather than to all residents); and

- not made as a payment for services.⁶

The GWE is intended to exempt from taxation amounts the government pays for the general welfare. The IRS has applied the GWE to various government payments, ranging from housing and education to adoption and crime victim restitution.⁷ 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 general welfare exception to a significant false imprisonment case in which the plaintiff spent years wrongfully behind bars. There is, however, a recent case involving a type of false imprisonment that could well skew the law in an inappropriate direction. The case is *Daniel J. and Brenda J. Stadnyk v. Commissioner*.⁸

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 a rather 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) incorrectly stamped the check “NSF” – the customary label for a check with insufficient funds – and returned it to the used car dealer. The dealership filed a criminal complaint against the taxpayer for passing a worthless check. Several weeks later, at 6:00 p.m. one evening, officers of the Fayette County, Kentucky, Sheriff’s Department arrested the taxpayer at her home. They did so in the presence of her husband, her daughter and a

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family friend. She was taken to the Fayette County detention center, 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 pat down 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

She did not report the payment on her 2002 tax return, and eventually landed in Tax Court.

Pure Confinement

In considering the appropriate tax treatment of the payment, Judge Goeke of the Tax Court noted that the plaintiff did not suffer any physical injuries as a result of her arrest or detention, save that she was physically restrained against her will and subjected to police

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.

Indeed, 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

Although Bank One did not initiate the criminal proceedings against her, its erroneous marking of her check had actually precipitated her arrest.

jumpsuit. At approximately 2:00 a.m. the next morning, 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 subsequently 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 rather definitively at the time that the settlement proceeds would not be taxed. Nevertheless, the taxpayer received a Form 1099 for the payment.

arrest procedures. Indeed, 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 these visits were covered by her insurance. She did not have any 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. One of the inevitable discussions was over the two-tier requirement of *Commissioner of Internal Revenue v. Schleier*,⁹ which imposed two thresholds in order 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 the fact that although there had been a mediation, there was no record of the mediation to show precisely what the parties were focusing on during the mediation process. Indeed, the court

argued that those claims were based on contract and were simply 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 of the possibility of tort claims, the Tax Court even noted that it was possible that the bank's actions with respect to the check had 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; rather, she sued Bank One 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 her, its erroneous marking of her check had actually 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, Mrs. Stadnyk was not so lucky with respect to the physical injury or physical sickness requirement enunciated by *Schleier*. The Tax Court commenced its analysis with a discussion of the legislative history of 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).

In fact, Mrs. Stadnyk had admitted that she did not suffer any physical harm during her arrest or detention. She is to be commended for her honesty. She did not try to spin her story as involving even a technical battery; she was not grabbed, jerked around, or bruised. She did argue that physical restraint and detention by itself constitutes a physical injury, but the Tax Court disagreed. It said baldly that

[p]hysical 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).¹⁰

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.¹¹ The same Kentucky court went on to say 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 against Mrs. Stadnyk did not cause her to suffer any physical injury, which a Section 104 exclusion would require.

The court nevertheless found that Mrs. Stadnyk was not liable for Section 6662 penalties. The Tax Court acknowledged that Mr. and Mrs. Stadnyk had not sought tax advice concerning the recovery. It nevertheless seemed reasonable to rely upon the parties to the mediation and the various lawyers. All of them said with little equivocation that they expected the recovery to be tax free. Thus, although Mrs. Stadnyk had to pay the tax and the interest, there were no penalties.

Bad Case; Bad Law

Stadnyk is an unfortunate case, whether or not one views it as correct. It can certainly be argued that the Tax Court was right to analyze *this particular*

recovery as taxable. I do not agree with this argument, 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 locked behind bars and subjected to the physical confinement it entails. Put another way, although it may well lead to mental damages, the primary thrust of a false imprisonment claim is not mental. Even if you are handled with kid gloves, confinement is physical.

Yet even if we acknowledge that Mrs. 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 from 6:00 p.m.

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to 2:00 a.m. in jail as Mrs. Stadnyk did. Nevertheless, that period of eight hours (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 behind bars.

Can anyone seriously compare Mrs. Stadnyk's experience to that of an exonoree who was 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 non-serious ones is analytically difficult and perhaps impracticable. Exactly where one draws the line between trivial and serious false imprisonment is subjective. Indeed, one could reasonably conclude that Mrs. Stadnyk's recovery too should be tax-free.

I do not think it is inconsistent to agree that Mrs. Stadnyk's recovery can be taxable and yet to argue forcefully that a serious and long-term exonoree should receive tax-free treatment. Line-drawing may not be easy, but even if one agrees that Mrs. Stadnyk's recov-

ery 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*, going on about *all* false imprisonment recoveries is, to my mind, simply wrong.

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

A true long-term incarceration case is vastly different. Almost always there are 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.

That is, 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 Mrs. Stadnyk did) that she endured no pushing, no shoving, no bruising, no rapes, no assaults, no batteries, no medical malpractice, and so on. 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, in my opinion, an unfortunate and probably an incorrect decision, even on its facts. As a technical matter, of course, a Tax Court memo decision is non-precedential.¹² Quite apart from that, neither taxpayers nor the government should put too much stock in the broad statements made by Judge Goeke in *Stadnyk*. ■

1. See Robert W. Wood, *Are False Imprisonment Recoveries Taxable?*, Tax Notes, Apr. 21, 2008, p. 279.

2. Perhaps the best illustration of the IRS's view on this point is the so-called "bruise" ruling, Private Letter Ruling 200041022 (PLR), Oct. 13, 2000.

3. Issued Nov. 27, 2007; available at 2008 WL 543985 (IRS CCA) (Feb. 29, 2008).

4. See further discussion in Robert W. Wood, "IRS Allows Damages Exclusion Without Proof of Physical Harm," *Tax Notes*, March 31, 2008, p. 1388.

5. See Civil Liberties Act of 1988, Pub. L. No. 100-383, 102 Stat. 903. See also Rev. Rul. 56-462, 1956-2 C.B. 20 (dealing with 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); Rev. Rul. 58-370, 1958-2 C.B. 14; 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. See ITA 200021036. See also Robert W. Wood & Richard C. Morris, *The General Welfare Exception to Gross Income*, Tax Notes, Oct. 10, 2005, p. 203.

7. 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; PLR 200409033 (Nov. 23, 2004); Rev. Rul. 74-153, 1974-1 C.B. 20; Rev. Rul. 74-74, 1974-1 C.B. 18.

8. T.C. Memo 2008-289, 2008 WL 5330828 (U.S. Tax Ct. 2008).

9. 515 U.S. 323 (1995).

10. *Stadnyk*, T.C. Memo 2008-289 at p. 17.

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

12. See *Nico v. C.I.R.*, 67 T.C. 647, 654, *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").

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