Why the *Stadnyk* Case on False Imprisonment Is a Lemon

By Robert W. Wood

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In this article, Wood considers *Stadnyk*, in which the Tax Court and Sixth Circuit held that a settlement payment for a few hours of incarceration was not excludable under section 104. Wood contends that the Sixth Circuit did a better job than the Tax Court, but he believes long-term incarceration cases are qualitatively and quantitatively different.

In *Stadnyk v. Commissioner*,[1] the Sixth Circuit Court of Appeals affirmed the Tax Court,[2] ruling that a recovery for false imprisonment was fully taxable. The *Stadnyk* case is unfortunate but doesn't come as a surprise.[3] It is hard to make lemonade out of this lemon.

Lemon Law?

With all the talk of auto company bailouts and vehicle recalls, it is no surprise that not every car works perfectly. *Stadnyk* is a tax case, but it arose out of Mrs. Stadnyk's purchase of a used Geo Storm. The car quite literally broke down on the way home from the dealership.

Mrs. Stadnyk attempted to get satisfaction from the dealer, but left multiple phone messages and no call was returned. Consequently, Mrs. Stadnyk stopped payment on her check. Bank One complied with her wishes and listed the reason for the stop payment order as ''dissatisfied purchase.''

However, Bank One incorrectly stamped the check ''NSF'' for insufficient funds. When the auto dealership received the dishonored check, it filed a criminal complaint against her for passing a worthless $1,100 check. The Fayette County Sheriff's Department arrested Mrs. Stadnyk at her home at 6 p.m. in the presence of her husband, daughter, and a family friend. On arrival at the detention center, she was handcuffed, photographed, and put in a holding area.

At approximately 11 p.m., she was transferred to the county jail, where she was patted down and searched with an electronic scanning wand. She had to undress to her undergarments, remove her brassiere in the presence of officers, and don an orange jumpsuit. At approximately 2 a.m., she was released on bail.

Several months later, she was indicted for theft by deception. The charges were later dropped. Understandably, Mrs. Stadnyk hired a lawyer and sued for malicious prosecution, false imprisonment, breach of fiduciary duty, and more. After a mediation, she received a generic $49,000 settlement from the bank.

The settlement agreement included no language indicating the purpose for which the settlement was paid. However, Mrs. Stadnyk testified that her attorney, the mediator, and the attorney for Bank One all advised that the settlement proceeds would be excludable from income tax under section 104. Still, the bank issued a Form 1099.

Mrs. Stadnyk was audited and her case came before the Tax Court. To her credit, she acknowledged that she was never physically harmed in any way and suffered no physical injuries. Given that admission, the Tax Court determined that the settlement was taxable. While the court's opinion is understandable and may even have been correct, Judge Goeke suggests that *all* such recoveries are taxable. Balderdash!

Of course, this was a false *arrest* case, not a false *imprisonment* or wrongful conviction case. In fact, the bank had only mishandled a stop payment order, so it was really just a case of breach of fiduciary duty. Although there was some embarrassment and some mental distress, no physical injuries were claimed. Further, there was also only a de minimis loss of liberty — a matter of hours. Any person should know instinctively that long-term incarceration is qualitatively and quantitatively different.[4]

The Tax Court in *Stadnyk* lamented the fact that there was no record of the mediation to show the parties' focus during that process. The taxpayer had relied heavily on the false imprisonment claim to support her argument for the excludability of the settlement proceeds. Yet the release was a general one (surely a critical mistake), and the complaint, like so many others, contained multiple claims.

[1]2010 U.S. App. LEXIS 4209 (6th Cir. 2010), *Doc 2010-4364*, *2010 TNT 40-9*.

[2]T.C. Memo. 2008-289 (Dec. 22, 2008), *Doc 2008-27001*, *2008 TNT 247-10*.

[3]*See* Robert W. Wood, ''Why False Imprisonment Recoveries Should Not Be Taxable,'' *Tax Notes*, June 8, 2009, p. 1217, *Doc 2009-10767*, or *2009 TNT 108-10*.

[4]*Id.*

This was clearly a suit over a single incident and one set of damages precipitated by Bank One's erroneous marking of Mrs. Stadnyk's check. The case simply didn't involve a serious loss of liberty. If anything, it was a mere technical violation, not unlike a technical battery or nonconsensual touching, whether or not it caused any damage.

Lemon Appeal

Courts can only decide the cases before them, and the Sixth Circuit's opinion is entirely predictable. Mrs. Stadnyk advanced three arguments in her appeal:

- there was no enrichment or accession to wealth, so the $49,000 was not income under *Glenshaw Glass*;[5]
- because her liberty was taken away, by definition there was a physical injury leading to the section 104 exclusion; and
- even if section 104 would otherwise tax such a recovery, it was unconstitutional.

On the facts presented, all three arguments were losers. The *Glenshaw Glass* argument is incorrect, no matter how appealing it might have sounded to the taxpayer. As the Sixth Circuit noted, if recoveries were not income based on the lack of enrichment theory, there would be no need for section 104.

The section 104 argument was also resolved as expected. Mrs. Stadnyk had already agreed she was not physically injured in any way. The Sixth Circuit examined the (now presumably irrelevant[6]) first prong of the "tort or tort-type right" rule from *Commissioner v. Schleier*.[7] The court then went on to address the second "on account of personal physical injuries" element. The court could not get past the fact that Mrs. Stadnyk had admitted she did not suffer any physical injuries. Of course, the settlement agreement said nothing about any physical injuries — or any deprivation of physical liberty for that matter.

The Tax Court suggested in dicta (inappropriately, in my view) that there should be a per se rule under which recoveries like Mrs. Stadnyk's would be taxable. The Sixth Circuit said Mrs. Stadnyk essentially wanted the appellate court to do the opposite — adopt a per se rule that every false imprisonment claim necessarily would involve a physical injury.

The Sixth Circuit acknowledged that in this kind of action a person *could* be injured. So the facts matter. Moreover, the court seems to set a low threshold for physical injury. For example, the court suggested that a physical injury might include "an injured wrist as a result of being handcuffed,"[8] but the mere fact that there was a physical loss of liberty is not necessarily physical.

Conversely, a loss of liberty *can* be physical. Relying on Mrs. Stadnyk's testimony that she "suffered no physical injuries as a result of her physical restraint,"[9] the Sixth Circuit said section 104 requires a direct causal link between the physical injury and the recovery. This "but for" analysis creates a high threshold of causation for plaintiffs seeking the shelter of section 104.[10] Again, the Sixth Circuit noted that the nature of the damages was not mentioned in the settlement agreement, which the court found dispositive.

Murphy's Law

Our old friend the *Murphy* case comes up again in the constitutional part of the case. Mrs. Stadnyk asserted that the Sixteenth Amendment only permits "direct taxes on incomes," and that a personal injury recovery like the one she received was simply not income. This is a little different from the *Glenshaw Glass* argument, but not much. The court's discussion is brief and to the point. The constitutional claim, of course, is a losing one. Among other cases cited by the appellate court is the D.C. Circuit's *Murphy* opinion.[11]

Where Are We Now?

The Sixth Circuit's decision was not recommended for publication and is only an appellate court review of a Tax Court memorandum opinion. Yet the case is getting more press and interest than the underlying Tax Court case did.

That is both good and bad. The decision is clearly more carefully thought out than the Tax Court's opinion. The Sixth Circuit avoids blanket rules and suggests that the facts need to be examined. Should there be a per se rule that any physical confinement of significant duration is excludable from income? Should that line be drawn at six months? At one year? At five?

I don't know. I think it would be reasonable and appropriate to draw a line beyond which a recovery would be presumed attributable to physical injuries. If ever there was a case for taxing such recoveries, *Stadnyk* was it. There simply was no injury of any sort, except for embarrassment, humiliation, and very brief confinement. I suppose per se rules are meant for cases at the extreme, so one need not analyze the facts. I would favor a per se rule in any significant incarceration.[12]

Public Comment on Incarceration

It seems entirely possible that the same day Sixth Circuit Judge Eric Clay was putting the finishing touches on his *Stadnyk* opinion in Cincinnati, Mike Montemurro and other members of the IRS and Treasury were holding a public hearing in Washington to discuss the proposed regulations under section 104(a)(2). As it turned out, a big topic was wrongful imprisonment.[13] Only in tax law do the stars align so perfectly.

Of course, the proposed changes to the section 104(a)(2) regulations have nothing to do with wrongful

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[5]*Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426 (1955).

[6]*See* prop. reg. section 1.104-1(c), REG-127270-06 (Sept. 14, 2009), *Doc 2009-20411*, *2009 TNT 176-6*.

[7]515 U.S. 323 (1995).

[8]*See Stadnyk v. Commissioner* at p. 12.

[9]*Id.*

[10]*See O'Gilvie v. United States*, 519 U.S. 79, 82 (1996), *Doc 96-31894*, *96 TNT 240-1*.

[11]*See Murphy v. IRS*, 493 F.3d 170 (D.C. Cir. 2007), *Doc 2007-15777*, *2007 TNT 129-4*.

[12]*See* Wood, "Are False Imprisonment Recoveries Taxable?" *Tax Notes*, Apr. 21, 2008, p. 279, *Doc 2008-7149*, or *2008 TNT 78-28*; Wood, *supra* note 3.

[13]For the unofficial transcript, see *Doc 2010-4501* or *2010 TNT 41-15*.

imprisonment, or even the broader question of what constitutes a personal physical injury. That's a shame. These proposed regulations merely discard the first prong of the so-called *Schleier* test, which had provided that a plaintiff's action for damages must be based on a ''tort or tort-type right.'' However, there was hardly a mention of tort or tort-type rights at the public hearing.

Instead, members of the public, the IRS, and Treasury discussed, among other topics, whether new section 104(a)(2) regulations were the appropriate means to announce a rule that unlawful incarceration for a long time (as opposed to a brief period like in *Stadnyk*) constitutes a physical injury per se, with or without observable bodily harm.[14]

The panelists did not entirely discount the possibility that section 104(a)(2) could create per se exclusions for unlawfully imprisoned individuals or victims of sex abuse, but they raised interesting questions about such a rule. Where, for example, would the Service draw the line beyond which the length of wrongful imprisonment would be a personal physical injury?

If the IRS chose one year, what would that mean for an unlawfully imprisoned individual who spent 11 months behind bars? What about a kidnapping victim or hostage who is wrongfully imprisoned not by the state, but by another individual?

The IRS and Treasury appear to have been considering the application of section 104(a)(2) to wrongful imprisonment, just as the judges in the Sixth Circuit recently did. It would be nice if the proposed regulations addressed what constitutes personal physical injuries for purposes of section 104(a)(2) and whether cases of long-term wrongful imprisonment are per se excludable. Treasury was urged to adopt per se carveouts for individuals who receive damage awards based on their wrongful imprisonment or sexual abuse.[15] Yet they appear concerned that any per se rule will cause someone just beyond the per se threshold to cry foul.[16] The implicit assumption seems to be that it is better to have chaos than rules with arguably arbitrary demarcations.

In some cases, observable bodily harm can be presumed,[17] which under the Service's current administrative formulation[18] is the ticket to excludability. At the hearing on the proposed section 104 regulations, witnesses discussed the chilling effect created by the lack of guidance. If life insurance companies won't write structured settlement annuities for sex abuse or wrongful imprisonment cases, is that fair to the victims who may want and need structures? Is the IRS allowing or even encouraging this *in terrorem* effect?

Life insurance companies don't need the excludability section 104 provides, but they do need to satisfy themselves that it applies. The companies rely on that excludability when transferring an annuity contract via section 130, which works only in tandem with section 104.[19]

Life insurance companies may be reluctant to stick their necks out to offer structures when tax questions remain. Currently, most life insurance companies presented with opportunities to structure wrongful imprisonment settlements look for ancillary claims involving observable bodily harm. They may be unwilling to structure if they do not find such claims. Moreover, the insurance companies may even expect a putative allocation of the settlement amount between pure incarceration damages and an amount for the personal physical injuries.

Obviously, one way to distinguish serious false imprisonment cases involving a long period in prison from a case like *Stadnyk* is ancillary claims. Mrs. Stadnyk experienced no physical injuries and filed no medical claims. A true long-term incarceration case is vastly different, because there are almost always incidents of physical trauma, often leaving permanent scars.

There are also often battery claims, medical malpractice claims, and more — but not always. Besides, one should not have to look for these physical injury/sickness signposts as a hook for the monumental emotional distress that can be expected from years of wrongful imprisonment.

If the ''observable bodily harm'' model makes any sense, it is understandable that the Service and Treasury are loath to draw lines. Who can say where the long-term versus short-term incarceration line should be drawn? Nevertheless, the difficulty of drawing any line should not be an excuse to provide no guidance whatsoever. That is particularly so when the failure to provide any guidance has a chilling effect on taxpayers and on the structured settlement industry.

Sometime we may see a case involving a wrongfully imprisoned taxpayer who is receiving payment for a gross deprivation of his civil rights and freedom, but who like Mrs. Stadnyk has somehow never been physically harmed or worse. Whether the IRS issues guidance or a court is forced to address it, someone is going to have to confront the excludability question.

What if a person is wrongfully incarcerated for 10 years but somehow endures no pushing, no shoving, no bruising, no rapes, no assaults, no batteries, and no medical malpractice? The purist's fact pattern involving a deprivation of civil liberties without physical injury or physical sickness may be more academic than real. Yet even without the presence of these customary ancillary claims, and even without the customary damages usually accompanying them, such a false imprisonment recovery should itself be tax free.

Like Prof. Erik Jensen in his recent article (''The Receipt of Cash for Losses of Personal Rights,'' *Tax Notes*,

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[14]Among the guidance on what constitutes ''personal physical injuries'' within the meaning of section 104(a)(2) is LTR 200041022 (July 17, 2000), *Doc 2000-26382*, *2000 TNT 201-10*, which requires bruises, cuts, swelling, and bleeding, or ''observable bodily harm.'' For more on this ruling, see Wood, ''IRS Allows Damages Exclusion Without Proof of Physical Harm,'' *Tax Notes*, Mar. 31, 2008, p. 1388, *Doc 2008-5734*, or *2008 TNT 63-31*.

[15]*See* LTR 200041022, *supra* note 14, at 7.

[16]*Id*. at 8.

[17]*See* ILM 200809001 (Nov. 27, 2007), *Doc 2008-4372*, *2008 TNT 42-21*. For more information, see Wood, *supra* note 14.

[18]*See* LTR 200041022, *supra* note 14.

[19]*See* section 130(c)(2)(D).

Jan. 4, 2010, p. 103, *Doc 2009-27321, 2010 TNT 4-9*), I was disappointed that the Service saw fit in 2007 to obsolete its confinement rulings.[20] They had confirmed tax-free treatment to recoveries for violation of civil or personal rights. (I would have thought Mrs. Stadnyk would have trumpeted those rulings because her settlement was in her 2002 tax year, and it was not until 2007 that the Service yanked them.) To me, those rulings all made — and still make — sense. Even if the jailers leave no bruises, to be deprived of your right to move about is physical — and observably so — by its very nature.

[20]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; all obsoleted by Rev. Rul. 2007-14, 2007-12 IRB 747, *Doc 2007-4230, 2007 TNT 34-15*.