

Retroactive Tax Law Provides Tax Benefits for Victims of Wrongful Incarceration

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At the end of 2015, Congress eliminated some of the uncertainty regarding the tax treatment of damages for wrongful imprisonment. Newly enacted Internal Revenue Code section 139F provides that gross income does not include compensation received by an individual as a result of incarceration relating to the individual's wrongful conviction of a crime. Moreover, individuals who paid tax on such compensation in years that normally are closed under the statute of limitations can get tax refunds as long as they file amended returns by December 18, 2016.

Nonetheless, there continues to be unanswered questions about the tax treatment of damages for wrongful imprisonment, including wrongful incarceration damages to which section 139F applies. Following is a summary of the areas in which further clarity would be helpful:

Treatment of Punitive Damages

Although section 104(a)(2) generally excludes from gross income damages received on account of personal physical injuries or physical sickness, it expressly does not apply to punitive damages. In contrast, section 139F contains no reference to punitive damages, and a literal reading of section 139F suggests that punitive damages in wrongful incarceration cases are excluded by the new law ("... 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 ..."). Guidance from the Internal Revenue Service (IRS) on this point would be helpful.

Treatment of Damages Paid to Family Members

In some cases, relatives of a wrongfully incarcerated individual receive payments on account of the wrongful incarceration. A literal reading of section 139F suggests that such payments are covered by the exclusion. Guidance from the IRS on this point would be helpful.

Structured Settlements

In high-dollar settlements of personal injury cases, claimants sometimes prefer to receive periodic payments (a "structured settlement") rather than a lump sum. In structured settlement transactions, the defendant typically makes a single payment (an "assignment payment") to a third party (an "assignment company"), which assumes the defendant's obligation to make the periodic payments. The assignment company typically uses the assignment payment to purchase an annuity and arranges for the claimant to receive the annuity payments, retaining a portion of the assignment payment as compensation for its services.

Section 130 permits the assignment company to exclude from its gross income the portion of the assignment payment that is used to purchase the annuity. Section 130, however, applies only in structured settlement transactions in which the periodic payments to the claimant will be excludable under section 104(a)(2). Thus, in cases to which section 139F applies, settlement companies can rely on section 130 to help facilitate structured settlements only if section 104(a)(2) applies as well.

There is little clarity, however, about the application of section 104(a)(2) to damages received on account of wrongful

incarceration. Section 104(a)(2) excludes from gross income “damages received ... on account of personal physical injuries or physical sickness.” Bodily injuries suffered during incarceration are clearly “physical injuries.” However, there is no clear authority on whether involuntary physical confinement in a prison itself constitutes a physical injury.

In a judicial decision, considering the application of section 104(a)(2) to damages received on account of the tort of wrongful imprisonment, the U.S. Tax Court and the Sixth Circuit Court of Appeals determined that wrongful imprisonment did not constitute a physical injury where (1) the taxpayer was detained for eight hours, (2) she alleged only nonphysical injuries (e.g., emotional distress), and (3) she conceded that she suffered no physical injuries. See *Stadnyk v. Commissioner*, T.C. Memo 2008-289, *aff’d*, 367 Fed. App’x 586 (6th Cir. 2010). There are no other reported decisions involving the tort of wrongful imprisonment, and there are no reported decisions involving the application of section 104(a)(2) to damages received on account of actual incarceration in a prison.

If the IRS determined, by regulation or other administrative action, that all monetary awards to which section 139F applies are also excludable under section 104(a)(2), section 130 would apply to structured settlements in wrongful incarceration cases and assignment companies could help facilitate such structured settlements without fear of prohibitive taxation.



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