

Office of Chief Counsel
Internal Revenue Service
memorandum

Number: **201045023**

Release Date: 11/12/2010

CC:ITA:B04:SAIskow
PRES-140001-10

Third Party Communication: None
Date of Communication: Not Applicable

UICL: 104.03-00

date: November 04, 2010

to: David Alito
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Internal Revenue Service

from: Donna Welsh
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(Income Tax and Accounting)

subject: Tax Treatment of Compensation to Exonerated Prisoners

Issue:

Whether an individual, under the facts described below, may exclude from gross income the compensation that the individual receives from a state for wrongful conviction and incarceration.

Facts:

An individual was wrongfully convicted of a crime and was wrongfully incarcerated for several years before the state exonerated the individual of the crime. The individual suffered physical injuries and physical sickness while incarcerated. The state enacted legislation to compensate individuals who were wrongfully convicted and incarcerated for their injuries, sickness, and economic losses flowing from the physical injuries and physical sickness (e.g., lost wages, future medical bills, etc.). The individuals may receive the compensation in a lump sum and/or in periodic payments.

Law:

Section 61(a) of the Internal Revenue Code provides that, except as otherwise provided by law, gross income means all income from whatever source derived.

Section 104(a)(2) provides, in general, that gross income does not include the amount of any damages (other than punitive damages) received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal physical injuries or physical sickness.

If an action has its origin in a physical injury or physical sickness, then all damages flowing therefrom are received on account of the physical injury or physical sickness under § 104(a)(2). See H.R. No. 104-737, at 301 (1996) (Conf. Rep.). Thus, damages received for economic losses flowing from a physical injury or physical sickness are excludable from income under § 104(a)(2). See *Commissioner v. Schleier*, 515 U.S. 323, 329 (1995) (“on account of” requirement in § 104(a)(2) is met for lost wages resulting from the time a taxpayer is out of work due to the physical injuries), and Rev. Rul. 85-97, 1985-2 C.B. 50.

Analysis:

Compensatory damages for physical injuries and physical sickness (including damages received for economic losses flowing from the physical injury or physical sickness) that an individual receives from a state for wrongful conviction and incarceration are excluded from gross income under § 104(a)(2). The compensatory damages that the individual receives are excluded from gross income whether the individual receives the compensation in a lump sum, periodic payments, or a factoring transaction. However, if an individual receives title to, constructive receipt of, or economic benefit of the corpus or assets used to fund future periodic payments, then some portion of the future periodic payments may not be excludable. Compare Rev. Rul. 79-220, 1979-2 C.B. 74, and Rev. Rul. 2003-115, 2003-2 C.B. 1052. Punitive damages and interest are included in gross income.

Conclusion:

An individual may exclude from gross income the compensation that the individual receives from the state for wrongful conviction and incarceration consistent with this analysis.

Please call Sheldon Iskow or me at (202) 622-4920 if you have any further questions.