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Tax Alert

Robert W. Wood
THE TAX LAWYER

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How IRS Taxes Fire Victims

Do wildfire victims worry about their taxes? You bet. How fire victims are taxed depends on what they collect, what they claim on their taxes, if they are rebuilding their property, their insurance and more. Another big variable is whether they sue PG&E. It can build out a complex tax picture, especially now that there is a new tax on litigation settlements, as many legal fees can no longer be deducted.

The IRS (and California's notoriously tough Franchise Tax Board) require annual tax filings, so several years may be peppered with fire items. Say you lose a $1M home, but collect $1M from your insurance company or PG&E. There's no tax, right? Not so fast. You need to know about the tax basis of the property, usually purchase price, plus improvements. Your property might be worth $1M when it was destroyed, but if the original purchase price plus improvements was only $100K, there is a $900K gain.

Does that mean a fire victim must pay tax on $900K? Not necessarily. If you qualify and replace your home, you can apply your old $100K tax basis to a replacement. That means you should not need to pay tax on that $900K gain until you eventually sell the *replacement* home. The replacement must generally be purchased within two years after the close of the *first* year in which *any* part of the casualty gain is realized. For Federal Declared Disasters,you get four years. However, if your insurance company has paid you enough to create even $1 of gain on your destroyed property, the clock for acquiring replacement property may already have started.

Another big issue is claiming a casualty loss. Up until 2018, many taxpayers could claim casualty losses on their tax returns. For 2018 through 2025, casualty losses are allowed only if your loss was the result of a Federal

Declared Disaster. Most major California wildfires are a Federal Declared Disaster, but determining whether claiming a loss is a good move can be complex.

How to handle expenses for temporary housing and similar expenses can also be tricky. If your primary residence is damaged or destroyed, insurance proceeds intended to compensate you for living expenses like housing and food may be partially tax-free. However, if the insurance proceeds pay you for living expenses you would have *normally* incurred if your home had not been damaged, say your mortgage payment or your typical food expenses, that portion may be taxable *income* to you. If the insurance proceeds exceed the actual amount you spend on temporary housing, food, and other living expenses, that surplus can be taxable.

This is not legal advice. For tax alerts or tax advice, email me at Wood@WoodLLP.com.