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Wildfire Legal Settlements In 2020–2025 Could Soon Be Free Of IRS Tax

The last decade has seen many large and destructive wildfires in California. There have been wildfires in many other states too, including Washington, Kansas, Oklahoma, Tennessee, Montana, Arizona, Wyoming, Oregon, New Mexico, and Virginia. There was also the catastrophic fire in Maui. With loss of life and property, taxes may be far down the list of worries. Yet on top of all the other miseries of a wildfire, taxes have emerged as unpleasant for many fire victims.

There's long been talk that Congress should change that, and it could finally happen—albeit only on a temporary basis that would cover 2020 through 2025 tax years under the Tax Relief for American Families and Workers Act of 2024. The version of the bill that passed the House would help a great deal if passed, and the progress of the bill is worth tracking. The provision is not yet law, but fire victims are eying the Senate and hoping that the long-awaited relief from federal taxes will be passed into law. How fire victims can be taxed in the first place often comes as a surprise. Yet most legal settlements are taxable, even for a devastating fire loss. That grim fact can be an unpleasant surprise to fire victims and seems particularly unfair.

How fire victims are taxed depends on their circumstances, what they ultimately collect, and what they claim on their taxes. But a "tax free" law would be a huge relief. Some states have offered help with state income tax. California, for example, added *four* temporary provisions to the California Revenue & Taxation Code that exclude from California income tax amounts received in connection with *six* of the California wildfires (the Butte Fire (if the recovery is received from the Fire Victim Trust), the North Bay Fires (if the recovery is received from the Fire Victim Trust), the Thomas Fire, the Woolsey Fire, the Kincade Fire, and the Zogg Fire.

If passed, the federal tax bill could obviate most of the technical problems that taxpayers faced relying on the usual disaster relief provisions with the IRS. The new temporary provision will exclude from individuals' gross income for federal income tax purposes all amounts received "as compensation for losses, expenses, or damages" in connection with a Qualified Wildfire Disaster.

Damages can include, but are not limited to, additional living expenses, lost wages (except when paid by the employer), personal injury, death, or emotional distress.

A Qualified Wildfire Disaster is any federally declared disaster declared after December 31, 2014, as a result of “any forest or range fire.” The only major carve-out of the exclusion is that an amount cannot be excluded if it compensates the taxpayer for a loss or expense that has already been reimbursed by another source, which in most cases would be through insurance. There are also a few technical provisions designed to prevent taxpayers from getting a double tax benefit from the exclusion.

One provision is analogous to the rules that apply to a Section 1033 election (to roll proceeds into rebuilding or a new home). The new law would clarify that if the taxpayer reinvests the *excluded* payment into the repair or replacement of the damaged property (or into the purchase of any other property), the taxpayer doesn’t get to add the excluded amount to their tax basis of the property. The taxpayer also can’t claim a tax credit or deduction to the extent the expense generating the credit or deduction was made by a payment excludible under the new wildfire exclusion.

The exclusion applies to tax years beginning after December 31, 2019, and before January 1, 2026. It is reasonable to assume these dates were chosen to allow taxpayers to file amended returns to claim a tax refund in connection with their reporting as income any amounts that are retroactively excludible under the new legislation. Because taxpayers only have three years to file an amended return and claim a tax refund, the period for amending a taxpayer’s tax return for 2019 and earlier years has already expired.

Any tax return filed before the original filing due date (usually April 15, unless it falls on a weekend) is considered filed on the filing due date. Although one might expect that means that taxpayers wanting to amend their 2020 returns now only have until April 15, 2024, to amend their 2020 returns and claim a refund, taxpayers may recall that the federal government *postponed* the 2020 filing deadline because of COVID until May 17, 2021. Therefore, taxpayers who filed their 2020 returns without going on extension should have until May 17, 2024 to file an amended return for 2020.

The new provision may also streamline states' efforts to provide relief to wildfire victims. Rather than add exclusions on a fire-by-fire basis, as California has done, ostensibly a state could choose to simply conform its rules to the new federal exclusion, which is not limited to any particular wildfire. This would avoid the state having to repeatedly add new exclusions every time there is a new wildfire, as California currently faces, leaving the victims of those wildfires in a tax limbo waiting to see if their wildfire makes the list.

Although the new exclusion is likely to be profoundly helpful to wildfire victims, there are a few provisions that it would be helpful to see if the IRS can address or refine. First, given the short time 2020 amendments have to be filed before the three-year statute of limitations for 2020 returns expires, it would be good to see if any relief can be offered regarding a grace period for taxpayers to amend their 2020 returns.

Second, it would be helpful if the IRS could clarify who is considered an "individual" for the purpose of the exclusion. Typically, the tax law says that an individual is considered a natural person, a human being, rather than an entity of some kind. Nevertheless, some entity types are treated as *entirely* transparent and disregarded from their owners, so it should be uncontroversial that amounts paid to these types of entirely transparent entities should qualify for exclusion because they are treated as received by the individuals who own them. These entirely transparent entities include grantor trusts (typically including the usual estate planning “living” trust), and “disregarded” business entities (often, single-member LLCs).

However, many types of properties are owned through entities that are not quite so transparent for tax purposes. Families may own their homes through family limited partnerships or non-grantor trusts. Are these partners and beneficiaries allowed to claim the exclusion on their individual returns for the income that they recognize on behalf of the entity, even though the entity presumably cannot claim it on its tax return?

Does this mean non-grantor trusts must distribute their recoveries in the year received so that the individual beneficiaries can claim the exclusion the trust itself cannot claim? If so, how does that money then get back into the trust so it can be used to rebuild or replace the damaged property? Even with these issues to iron out, the new provision is a lot better than the chaos wildfire victims were previously addressing. After so many years of loss, stress, and bureaucracy, this relief is sorely needed.

Unless and Until the Law Passes. Unless the bill passes, here are just a few of the tax issues fire victims face. It can take considerable ingenuity to turn the gross settlement figure into a viable tax reporting strategy that is defensible to the IRS and state tax authorities. Fire victims even need to address the tax treatment of their attorney fees. Most fire victim plaintiffs use contingent fee lawyers. Even if contingent legal fees are separately paid to the lawyers without the plaintiffs’ having ever received them, they are attributed to the plaintiff for tax purposes as part of their gross recoveries. It is how legal fees are treated under tax law.

A tax deduction for legal fees would help the plaintiff to avoid owing tax on the legal fees, but starting in 2018, many legal fees paid before 2026 are no longer deductible. Miscellaneous itemized deductions, which accounted for most legal fees, were "suspended" for 2018 through 2025 tax years. Accordingly, in some cases, plaintiffs may not be able to deduct the fees, even though 40 percent or more of their recoveries are paid to their lawyers. The tax treatment of the legal fees has become a major tax problem associated with many types of litigation, but there are 12 ways to deduct legal fees under new tax laws.

The IRS requires annual tax return filings, but a whole series of tax years may be peppered with fire items, including insurance recoveries, and then later lawsuit proceeds. Suppose that a fire victim loses a $1 million home, but collect $1 million from her insurance carrier or from PG&E. It might sound like there is nothing to tax, since she lost a $1 million home, and simply got $1 million back.

However, when you lose property and get cash, tax law generally treats that as a *sale* of the property, which can trigger capital gains tax. To calculate whether you are considered as profiting from the sale, the relevant question isn't how much the property was *worth* when you sold it, but rather how much you paid for it. If you invested $250,000 into a property, and later sell it for $1 million, then for tax purposes you have gain on the sale. The fact that the property is presumably *worth* $1 million when you sold it, so you only got what it was worth, is not relevant for determining your gain.

Suppose that you've invested $250,000 in your property, and then you receive $1 million in insurance and/or litigation proceeds to compensate you for the damage to the property when it burned. For tax purposes, you have profited from the proceeds, a tax concept called "casualty gain." To know whether you've experienced a casualty gain, and the amount of the casualty gain, you need to calculate how much you've invested into your damaged property over time, which in tax parlance is called your *adjusted tax basis*.

Adjusted tax basis generally means the purchase price, plus the cost of subsequent improvements. If it was commercial property, you would need to factor in depreciation (and depreciation recapture). But even with personal-use property like a home, your basis matters. If the damaged property was your principal residence and you are married, you and your spouse may be able to claim a $500,000 exclusion to reduce the casualty gain. Unmarried taxpayers and married taxpayers filing separate tax returns can each claim a $250,000 exclusion from their casualty gain for their principal residences.

Does that mean the fire victim has to pay tax on *all* the resulting casualty gain that doesn't get excluded under the principal-residence exclusion? Not necessarily. Fortunately, the tax law may treat this as an involuntary conversion under Section 1033. If you qualify to make a Section 1033 election, you can choose to defer recognizing the gain, and then reinvest the gain into the repair, replacement, or reconstruction of the damaged property.

That means you should not need to pay tax on the casualty gain until you eventually sell the *replacement* home. If you never sell the replacement home, the gain can be effectively deferred forever, essentially making the deferral a permanent exclusion. In order to defer a casualty gain by reinvesting insurance or litigation proceeds, the replacement property 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 a Federal Declared Disaster, the period is extended to four years for most properties constituting part of your principal residence, under the involuntary conversion tax relief provision.

However, under current law, taxpayers had to look out for insurance recoveries that may come in long before a lawsuit settlement. If your insurance company has paid you enough money to create even $1 of taxable casualty gain on your destroyed property, the clock for acquiring replacement property may already have started. In some cases, taxpayers who had their homes destroyed in wildfires in 2016 and 2017 experienced casualty gain with their first insurance checks in 2017 and 2018. As a result, even the generous 4-year replacement period under Section 1033 had already expired *before* they received their litigation recovery for the fire from the utility company, making Section 1033 effectively useless for the deferring the litigation recovery.

Another big issue is claiming casualty losses. Many taxpayers want to claim casualty losses after they receive their insurance checks to recoup any adjusted tax basis remaining that insurance did not cover. At the time the casualty loss deduction is claimed, they may not have initiated their litigation against their utility company, or the uncertainty of the litigation's success makes the casualty loss deduction seem the safer and more immediate path to recovery.

However, taxpayers are generally not allowed to claim a casualty loss deduction for amounts that they are reimbursed for. Therefore, if you claim a casualty loss deduction, and then later receive a litigation recovery, you are required to reimburse the IRS for the previous casualty loss deduction to the extent it has now been reimbursed and to the extent the reimbursed portion of the loss deduction actually reduced your tax liability.

A CPA is often helpful for doing the required math for how much of the casualty loss you need to pay back. Nevertheless, mechanically, you pay back the reimbursed portion of the casualty loss *not* by amending your previous tax return, but instead by treating that portion of the *current* litigation recovery as *ordinary income*. That means you do not get capital gains rates, and you do not get to defer that portion under Section 1033. For taxpayers desperately needing their litigation proceeds to rebuild their homes, the discovery that their previously casualty loss deductions means their losing these benefits and having to treat a significant portion of their recovery as immediately taxable ordinary income can be shocking.

The proposed federal legislation makes many of these tax headaches go away, at least for recoveries before 2026. In particular, Section 1033's mechanics and timing are largely obviated by making the recovery excludible, in most cases leaving no casualty gain needing to be deferred, and the issue of legal fee deductions for any ordinary income portions of the recoveries (e.g., emotional distress, inconvenience, nuisance damages) is also largely rendered moot.

Some complexities will likely still exist, however. At some point, adjusted tax basis will need to be calculated for the property, if not immediately, then when the property is later sold. And, if a casualty loss deduction was previously claimed, it is not unreasonable to expect the IRS to expect reimbursement for it under the general rule, notwithstanding the potential new exclusion. Still, the new legislation, if enacted, *reduces* and *defers* the tax headaches and mazes wildfire victims would need to navigate.

Relief from federal income taxes for fire victims has long been awaited, and even if there are remaining details and interpretive questions to be ironed out with Congress and the IRS, it would dramatically impact the plight of fire victims.

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