

10 Tax-Related Steps for Wildfire Victims

By Robert W. Wood

If you suffered a wildfire loss, you probably have a long and difficult road ahead of you to address numerous issues, financial and otherwise. They may include where you will live, what you can afford to replace, and many legal, insurance and tax issues too. I am a tax lawyer, so I see the issues through that lens. But here are some topics to consider.

Make an Insurance Claim

If you have insurance, contact your insurance company right away and make a claim.

Some types of insurance payments are treated as tax-free by the IRS. The tax code allows taxpayers to exclude from their income amounts received from insurance for the temporary additional living expenses created by the wildfire resulting from the loss of the taxpayer's principal residence, if those expenses are reasonable and necessary, such as rental payments for temporary replacement housing or replacement transportation. If the wildfire that destroyed your home was a federally declared disaster (more about that below), the tax code also generally allows you to treat insurance proceeds that compensate you for your personal property, such as clothing, furniture, and household goods, as tax free, if the home was your primary residence.

But most insurance proceeds have tax implications. Under the normal tax rules, amounts received for damage to property, including property insurance payments, are treated as sales proceeds for tax purposes.

Check Federal Disaster Status

Determine if your wildfire was a federal disaster. This usually should be easy. On FEMA's website, you can search for disaster declarations for your location, the year of your fire, and other information. A wildfire with a disaster declaration will have its own declaration number and webpage on the FEMA website.

Some wildfires are group together and included in the same disaster declaration under a more generic name, like "California Wildfires." Therefore, your wildfire may be a federally declared disaster even if there is not a federal declaration that uses your wildfire's specific name. If the federal disaster declaration covers wildfires in your county and the date of your fire, your fire should be covered by the disaster declaration. A federally declared disaster brings various tax and nontax benefits.

Consider a Casualty Loss on Your Taxes

If your fire was not a federal disaster, you cannot claim a casualty loss. If your wildfire was a federal disaster, determine if you want to claim a casualty loss. Individuals and businesses in a federally declared disaster area who suffered *uninsured or unreimbursed* disaster-related losses can choose to claim them on either the return for the year the loss occurred or on the tax return for the *prior year*.

Plus, taxpayers have extra time — up to six months after the due date of the taxpayer's federal income tax return for the disaster year to make the election to claim the disaster loss. A casualty loss deduction is generally measured by your *tax basis* in the home, not by its fair market value. That is consistent with the tax law's view that what you have lost in a

disaster is what you have *invested* in the home, not what it was worth. The tax law does not allow you to claim a casualty loss deduction for more than the decrease in value of your home from the fire. In that way, a change in fair market value can *limit* the size of your casualty loss deduction, but it cannot increase it.

Claiming a casualty loss deduction is attractive in the short term because it allows you to claim a refund, or reduce your tax liability, to help keep much-needed funds in your bank account. However, the amount and whether it is advisable to claim it is tricky when you expect to receive additional insurance proceeds or litigation proceeds in the future. Receiving a reimbursement for an amount that you already deducted on your taxes triggers the "tax benefit rule," which can mean more tax owed on the later insurance or litigation proceeds. Some fire victims who claim a casualty loss end up regretting it later.

Tax on Insurance Proceeds

Some coverage such as extra temporary housing costs are not taxed. But most insurance money to compensate you for damage to your home is treated as sales proceeds. If your tax basis in your home is \$1M, and you receive \$1M from insurance, there's no tax. But if your basis was only \$100k, you have \$900k of "casualty gain."

This is so, even if the home was worth \$1M before the fire. As with any other sales proceeds, your profit or loss from sales proceeds is measured against your tax basis in the property sold. That is what you paid for it and the cost of any improvements you made, *not* its fair market value.

Principal Residence Tax Exclusion

If you have a gain from insurance or a lawsuit, and if you owned and used the home as your main residence for at least two of the last five years, you can exclude up to \$250,000 of casualty gain from the sale of your principal residence. Married couples filing jointly can exclude up to \$500,000 of casualty gain from their gross income.

Section 1033 Election

If you have casualty gain from insurance or a lawsuit, you can often elect to defer it under Section 1033. You do not need to make a Section 1033 election on your taxes until you have *gain* to report. What rules apply under Section 1033 depend on whether the involuntary conversion occurred in a Federally declared disaster. With a Federally declared disaster, you can:

1. Exclude from your income most insurance proceeds received for personal property damaged or destroyed in the disaster if that property was located at your primary residence;
2. Treat all other insurance proceeds for damage to your primary residence as a single asset to get the full benefit of your adjusted tax bases in all the affected property before any casualty gain is produced;

3. Treat the acquisition of any replacement property related to your principal residence as qualifying replacement property for any other property located at your principal residence;
4. Double the replacement period for damaged property under a Section 1033 election from two years to four years; and
5. Treat the acquisition of any tangible property to be held for productive use in a trade or business as qualifying replacement property for any other damaged property that was held for productive use in a trade or business or held for investment.

If you have casualty gain for the *first* time in a given tax year from a federally declared disaster that damaged your principal residence, you have until four years from December 31 of that year to reinvest the proceeds into qualifying replacement property under Section 1033. Any casualty gain you have in any subsequent tax year must be reinvested by the same deadline, which was based on the first year you had casualty gain.

If your casualty gain is reinvested by the end of your replacement period, your casualty gain is deferred indefinitely until you sell. If you never sell the property or experience other events that are treated as a sale of the property for tax purposes, the Section 1033 election can be, in effect, a tax exclusion.

What if your fire was not a federally declared disaster? Even if your wildfire was not a federally declared disaster, you can still make a Section 1033 election. However, some of the most generous features of a Section 1033 election do not apply if the wildfire is not a federally declared disaster. For example, you generally only have the standard two-year replacement period once you generate casualty gain. Even so, a Section 1033 election can be an effective way to defer tax in wildfires and other disasters that are not federally declared disasters.

Tax on Lawsuit Settlements

Many wildfire victims join lawsuits against utilities. You usually don't have tax issues until you settle or receive an award. Most fire victims hire contingent fee lawyers. For tax purposes, you are treated as receiving 100% of the settlement and *then* paying your lawyer. However, there is usually a way to offset or deduct your legal fees so that you are not actually paying taxes on the legal fees.

The same tax rules discussed above for insurance proceeds apply to lawsuit proceeds as well. However, there are added tax benefits in the form of federal or state tax exclusions that may apply.

Many 2020-2025 Recoveries are Tax Free

For fire victims in federally declared disasters, in late 2024, Congress enacted a broad federal tax exemption to make wildfire settlements tax free if received in 2020 through 2025. Yet that tax relief included puzzling qualifiers that exclude many recoveries, and the federal law expired on 12/31/25.

Federal Law Extension?

Although the federal tax exclusion expired on 12/31/25, The *Protect Innocent Victims of Taxation After Fire Extension Act* would make the exclusion permanent. This proposed law has not yet passed.

State Tax Exclusions

Some states, notably California, have state tax law exclusions. In the past, California passed a handful of tax exclusions that were limited to particular wildfires. More recently, in 2025, California enacted S.B. 132 to add a new section to the California tax code, Section 17138.7. This Section covers most types of California taxpayers. C corporations are covered by a similar exclusion in Section 23409.2.

The exclusion applies to *all* qualifying wildfire recoveries received by a California taxpayer between January 1, 2021, and December 31, 2030. As enacted, to be excludable, the qualifying recovery must be received from a "settlement entity," and that term was defined in such a way that it would cause most California wildfire survivors to fail to qualify for the exclusion. Fortunately, shortly after it was enacted, Section 17138.7 and the corresponding exclusion for C corporations in Section 23409.2 were amended to remove the narrower definition.

Under the current version of the statute, the identity of the payor of a settlement, judgment, or award should not affect a taxpayer's qualification for the exclusion. However, the amended language requires that a qualifying wildfire be *either* (a) a federally declared disaster that is the subject of a federal major disaster declaration or a federal emergency declaration; *or* (b) a wildfire that was the subject of a proclamation of a state of emergency by the California governor. This should cover most significant wildfires.

However, some California wildfires did not receive either a federal major disaster declaration or an emergency declaration, or even a California state disaster declaration. Therefore, taxpayers affected by these wildfires may need to rely on Section 1033 and other relief provisions in the federal and state tax codes when planning around their fire recovery.

Robert W. Wood practices law with www.WoodLLP.com, and is the author of "*Taxation of Damage Awards & Settlement Payments*" (www.TaxInstitute.com). This discussion is not intended as legal advice.