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As Wildfire Federal Tax Relief Expires, Victims Await Extension

In late 2024, wildfire victims got a Christmas present from Congress when it passed a tax law to make many wildfire settlements tax free. The Federal Disaster Relief Act *of 2023* covers many 2020 through 2025 wildfire legal settlements, but the law expires at the end of 2025. That's a worry for many fire victims, including of the LA fires of 2025. After all, litigation usually takes many years to resolve. Besides, survivors of fires usually have tax issues long before any lawsuit recovery, such as whether and how to claim a casualty loss on their taxes, and how various categories of insurance proceeds are taxed.

Limitations On Wildfire Tax Relief

The expiring law doesn't completely cover everyone, but it's still been of enormous benefit to survivors of fires despite its limitations. One big limitation is that the law only applies to exclude payment from individuals' gross income. It covers amounts received "as compensation for losses, expenses, or damages" in connection with a Qualified Wildfire Disaster. A Qualified Wildfire Disaster is any federally declared disaster declared after December 31, 2014, as a result of "any forest or range fire."

Apart from the limitation to individuals, 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*, say through insurance. There are also a few technical provisions to prevent taxpayers from getting a double tax benefit from the exclusion. The rules can make wildfire recovery tax treatment tricky even with the exclusion.

Tax Exclusion Ends on December 31, 2025

The exclusion applies to tax years beginning after December 31, 2019, and before January 1, 2026. But with end of 2025, are fire victims out of luck?

Senators Alex Padilla (D-Calif.), Cynthia Lummis (R-Wyo.), Ron Wyden (D-Ore.), and Tim Sheehy (R-Mont.) introduced the *Protect Innocent Victims of Taxation After Fire Extension Act* to make the tax exclusion permanent. The bill signed into law in December of 2024 is part of the *Federal Disaster Tax Relief Act*. It exempted many payments for living expenses, lost wages, and compensation for injury, death, or emotional distress.

Many survivors of fires are surprised to find that settlement payments are subject to federal income tax unless specifically excluded, and specific exclusion is necessary. The idea is to allow wildfire survivors to put the *full* amount of their settlement money toward recovering from devastating losses. The pending extension bill would:

- Make permanent the exclusion from the gross income of a taxpayer, for income tax purposes, qualified wildfire relief payments, including compensation for losses, expenses, or damages (including compensation for additional living expenses, lost wages, personal injury, death, or emotional distress) paid in connection with a qualifying wildfire disaster.

- Allow victims to claim the exemption in the year they receive payments rather than to amend prior tax returns for a refund.

As Senator Lummis put it, "The *Protect Innocent Victims of Taxation After Fire Extension Act* ensures every dollar of wildfire insurance is used to help people recover and restore what they've lost, not line Washington's pockets." Additionally, the *Protect Innocent Victims of Taxation After Fire Extension Act* would allow victims to claim the exemption in the year they receive payments rather than to amend prior tax returns for a refund.

Only Individuals Are Covered

Hopefully the bill will pass to make the tax relief for wildfire victims permanent. However, there will still be interpretive questions, such as how the IRS will interpret the "individual" requirement. If would be helpful if the IRS could clarify who is considered an "individual" for purposes of the exclusion. Typically, for tax purposes, an individual is considered a natural person, a human being, rather than an entity of some kind. However, some types of legal entities are treated as *entirely* transparent and disregarded from their owners.

In that case, settlement amounts paid to these types of 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 as transparent for tax purposes. They include C corporations, S corporations, partnerships, multi-member LLCs, and irrevocable trusts. Some of these stand a better chance of qualifying than others, but it remains to be seen if they IRS will be rigid about the "individual" requirement.

Last year, Senator Padilla spoke on the Senate floor following the unanimous passage of the *Federal Disaster Tax Relief Act*, which included his *Protect Innocent Victims of Taxation After Fire Act*. After the bill was signed into law, he and others urged the IRS to take immediate actions to implement the legislation to provide critical tax relief and get money back into the hands of wildfire survivors.