PERSPECTIVE

Los Angeles | Daily Journal

MONDAY, OCTOBER 31, 2022

# California Gives PG&E & Edison Fire Victims Tax Breaks

**By Robert W. Wood**

Most legal settlements are taxable, even for a devastating fire loss. But California has passed two laws to shield wildfire victims from state tax on their fire legal settlements. One applies to PG&E recoveries, the other to Edison. Both laws provide tax relief from California's high—up to 13.3%--income tax. But the IRS still treats lawsuit settlements as taxable. Proposed federal bills, essentially identical to each other, have been introduced in both the House and Senate. H.R. 7305 was introduced by Congressmen Doug LaMalfa (R – 1st District) and Mike Thompson (D – 5th District) this last March, and S. 4666 was introduced by Senator Dianne Feinstein more recently in July, but their prospects remain unclear.

The two California laws, AB-1249 and SB-1246 exclude only certain fires, but both laws are retroactive in scope. For someone who paid tax on their settlement in past years, it's not clear how refund claims will be handled, but the Franchise Tax Board should presumably issue refunds to someone who applies. AB-1249 excludes from income for California income tax purposes any amounts received from the PG&E Fire Victim Trust in connection with the 2015 Butte Fire, the 2017 North Bay Fires, or the 2018 Camp Fire.

The exclusion seems broad for qualifying taxpayers and appears to exclude the entirety of any qualifying settlement, including any awards made for property claims, lost income, emotional distress, interest, legal fees, and so on. Of course, because AB-1249 is limited to recoveries from the Fire Victim Trust, it does not affect the tax treatment of recoveries from other fires, against other defendants, or settlements with PG&E that were not awarded through the Fire Victim Trust. However, that's where SB-1246 comes into play.

It excludes from income for California income tax purposes any amounts received in settlement from Southern California Edison by a Qualified Taxpayer for claims relating to the 2017 Thomas Fire or the 2018 Woolsey Fire. The term Qualified Taxpayer is defined and generally includes anyone who owned property in, who resided in, or who operated a business located in Ventura or Santa Barbara counties, with regard to the Thomas Fire, or Ventura or Los Angeles counties, with regard to the Woolsey Fire. Both of these welcome laws do not address money from other defendants, such as insurance companies.

In that sense, fire victims still have tax reporting to address even for California taxes. Even if your recovery qualifies for the exclusion, you likely will need to address the fire as part of your California tax return. Because your recovery is currently taxable under federal law, the exclusion likely would need to be reported on your California return as a negative adjustment to your federal income on your California return's Schedule CA. And then there is the IRS.

The tax issues are not limited to their victims' net money. The tax issues start with legal fees, which are attributed to the plaintiff for tax purposes. Up until 2018, it was clear that legal fees were virtually always tax deductible. Under the Tax Cuts and Jobs Act passed in late 2017, however, many legal fees are no longer deductible. Miscellaneous itemized deductions, which accounted for most legal fees, were suspended for 2018 through 2025 tax years.

Fortunately, there is usually a good path to deduct or offset the legal fees. If the fire recovery can be treated as capital gain—which it usually can—the legal fees can be treated as additional basis in the home, or as a selling expense. Of course, that still leaves plenty of tax issues to address. Suppose that you lose a $1 million home, but collect $1 million from your insurance carrier or from PG&E. It might sound like there is nothing to tax, since you lost a $1 million home, and simply got $1 million back.

However, you need to know about your tax basis in the property. That generally means the purchase price, plus the cost of subsequent improvements. If it was commercial property, you factor in depreciation (and depreciation recapture). Even with personal use property like a home, your basis matters. The property might be worth $1 million when it was destroyed, but if the original purchase price plus improvements was only $100,000, there is a $900,000 gain.

Does that mean our fire victim has to pay tax on the $900,000 gain? Fortunately, subject to requirements and limits, the tax law may treat this as an involuntary conversion. If you qualify, you can apply your old $100,000 tax basis to a replacement home. That means you should not need to pay tax on that $900,000 gain until you eventually sell the replacement home.

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 for replacing your primary residence is extended to four years. However, watch out for insurance recoveries, which may come in long before a lawsuit settlement. Insurance proceeds can complicate when your replacement period begins.

If your insurance company has paid you enough money to create even $1 of taxable 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. But starting in 2018 and continuing through 2025, casualty losses are allowed only if your loss was the result of a Federal Declared Disaster.

Many fire victims in California qualify, since most major California wildfires are a Federal Declared Disaster. Even so, there can still be some careful planning and projections in determining whether claiming a loss is a good move. If you claim a casualty loss in one year and then later receive a litigation or insurance recovery for the same loss, that can trigger the tax benefit rule, codified in Section 111 of the tax code, which can make the tax on your insurance and litigation proceeds much less favorable than if you never claimed the casualty loss in the first place.

Fire recoveries are intensely factual. Some victims experience physical injuries or physical sickness, either caused by the fire or exacerbated by it. But the damages must be physical, not merely emotional, for money to be tax free. Most emotional distress damages are fully taxable, but emotional distress triggered by physical injuries or physical sickness is tax free. Of course, the big item in most fire cases is property damage or destruction, which may involve a house, outbuildings, trees and shrubs, or crops. If you do not reinvest, you may have a big capital gain, subject to claiming the up to $500,000 primary residence tax benefit if you qualify.

If you are selling a primary residence and qualify, the first $500,000 in gain for a married couple filing jointly should be free of tax. The balance should be taxed as capital gain. If plaintiffs are rolling over their proceeds into purchasing a new home or rebuilding, they may end up with a low basis in the new home, but that would mean paying tax much later when they eventually sell their home.

The pair of California tax laws provide welcome relief to impacted fire victims. Some say that the federal legislation is unlikely to pass without something similar for other disaster victims, such as hurricanes. But not having to worry about California taxes (at least on most of the legal settlement monies from PG&E and Edison) is a big win for victims in the state.

**Robert W. Wood** *is a tax lawyer with www.WoodLLP.com, and the author of "Taxation of Damage Awards & Settlement Payments" (www.TaxInstitute.com). This is not legal advice.*