FAQs on Taxes for Natural Disaster Victims

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In this article, Wood and Brown provide answers to tax questions frequently asked by taxpayers affected by natural disasters.

For many taxpayers, the loss of their home or other property in a wildfire or other disaster is devastating in a host of ways. One might imagine that when they receive a hefty payout from a combination of their insurance carrier and the utility that allegedly caused the loss, their problems would be solved. But as they rebuild their lives with that money, they would surely not have a tax problem, would they?

The answer, of course, is that tax issues can seem to bring another layer of devastation. A litigation recovery may present the most complex tax issues victims have ever had to face. That complexity can be exacerbated when the litigation recovery involves multiple claims with different tax treatments, potentially affecting multiple tax years. There are often payments from insurance companies too, some without prodding from the taxpayers and their lawyers, some after litigation.

In the case of wildfires, although other states have been affected, none have been more terribly hit than California, which has seen destruction over vast swaths across all its regions. Thousands of California property owners face tax issues in connection with recoveries concerning the last decade's wildfires.

What follows is not an answer key to the factual and difficult tax questions victims face as they eventually start to collect following their losses. But because many questions are similar, we have assembled some questions and answers that we encounter most frequently.

I. General Questions

Q1. What does an IRS Form 1099 mean, and who issues it?

A1. Forms 1099 document different types of payments and are issued by the payer, but not usually in fire cases since most claims involve types of recoveries that are not generally subject to Form 1099 reporting. Some recoveries could constitute a return of your tax basis in your property; some could be reimbursed expenses, such as income, capital gain, or expenses for physical injuries and sickness. Both the PG&E Fire Victims Trust and Southern California Edison determined not to use Forms 1099 in most cases.

Q2. What is the section 121 exclusion?

A2. Section 121 allows a taxpayer to exclude up to $250,000 ($500,000 for taxpayers who file a joint return) of the gain from the sale (or exchange) of property owned and used as a principal residence for at least two of the five years before the sale.

If a surviving spouse sells a property within two years from the date of death of their deceased spouse, they can claim an exclusion up to $500,000 so long as the property was owned and used as their principal residence for at least two of the previous five years before the deceased spouse's date of death. If the sale of the principal residence occurs more than two years from that date, then the exclusion is reduced to $250,000.

Section 121 can be claimed in casualty cases (for example, cases in which property is destroyed or damaged) only when the damage results in "complete destruction" of the property. Damage that falls short of complete destruction is not sufficient to claim an exclusion under section 121.

Q3. What is an asset-by-asset gain calculation, and does this always apply?

A3. This is a calculation of each damaged item's individual value, your basis in it (which can be significantly reduced by insurance funds), and the net gain of each item through the settlement proceeds. These amounts are usually taxed as long-term capital gains. Asset-by-asset gain calculation can be burdensome because it requires the taxpayer to identify the acquisition date and tax basis for each item of property that was destroyed or damaged in the fire.

Section 1033 provides some relief from the asset-by-asset method of gain calculation.

When insurance proceeds are received for a primary residence destroyed in a federally declared disaster area, all property related to the primary residence other than unscheduled personal property is treated as a common fund. Therefore, the land, trees, improvements, and scheduled personal property would be grouped together for basis allocation.

Thus, even under section 1033, you would generally not be permitted to combine your basis in your primary residence and a separate house you own, unless, perhaps, the separate house is a guest house located on the same site as your primary residence.

Q4. What is depreciation recapture?

A4. For assets used in a trade or business, you can often deduct part of your tax basis in business assets each year to offset your income. This deduction of your tax basis is called depreciation. Depreciation decreases the basis of the depreciated property. Moreover, when depreciated property is sold, taxpayers must reimburse the IRS for any depreciation claimed by treating a portion of the gain as ordinary income. This obligation to reimburse the government for previously claimed depreciation is called depreciation recapture.

To the extent insurance proceeds or a legal recovery compensates you for damage to a depreciated asset, these recoveries can also trigger depreciation recapture. If the amount paid out through insurance and settlement proceeds exceeds your adjusted tax basis in the property, any gain may be taxed at depreciation recapture tax rates (usually 25 percent) until all previously claimed depreciation has been reimbursed.

Q5. Can I claim a casualty deduction for the destruction of my property?

A5. For tax years 2018 through 2025, casualty losses are allowed only if the loss was the result of a federally declared disaster. Casualty losses that don't result from a federally declared disaster can be claimed to offset only casualty gains from the same year that are connected to a federally declared disaster. You can determine whether the event that destroyed your property is a federally declared disaster at the Federal Emergency Management Agency website.

However, we generally suggest caution about claiming a casualty loss deduction if you expect to receive a legal recovery for the same property. Claiming a casualty loss depletes your tax basis, resulting in more of any future recovery being taxable. Further, claiming a casualty loss may make any future recovery taxable as ordinary income, rather than capital gain, under the tax benefit rule. This is because you are being reimbursed for the previously claimed casualty loss deduction. Thus, you are generally required to reimburse the IRS for the tax you did not pay as a result of the earlier claimed casualty loss deduction.

Q6. What is my (adjusted) tax basis in my property?

A6. The adjusted tax basis (commonly referred to informally as just "tax basis" or "basis") in real property is generally the purchase price plus the cost of subsequent improvements. If the property is commercial property, you will need to factor in depreciation explained above. If you have received insurance proceeds for the property or claimed a casualty loss deduction, that can also decrease your adjusted tax basis.

Q7. How do insurance payments affect the tax treatment of my recovery?

A7. If the insurance payments you receive for damage to your property exceed the adjusted basis in the property, then you may have a taxable gain. This gain may trigger depreciation recapture if you previously depreciated the property or may trigger the tax benefit rule on account of any previously claimed casualty loss deductions.

Insurance proceeds received for your living expenses could be taxable to you if the additional living expenses exceed your actual expenses for the year. If the residence is still being rebuilt or if you are still looking for a house, your temporary living costs could continue to be charged against these funds, and thus, there could be no limit to your time to use the additional living expenses funds for living tax free.

Because insurance proceeds refund your basis to you, they may also result in your having more taxable gain if you later sell the property or receive litigation proceeds for damage to the property. Because insurance payments may result in your recognizing gain, they can trigger the end of your replacement period under section 1033, discussed in more detail in Section II, below.

Q8. Does section 139 apply to my recovery?

A8. Section 139 excludes from taxable income any "disaster relief payments." Today, section 139 is only applicable to payouts from government entities and employers for reimbursement of necessary living expenses. We do not believe it applies to payouts from a Fire Victim Trust or utility company unless the IRS or Congress publishes guidance on this topic.

II. Involuntary Conversions Under Section 1033

Section 1033 is important for most natural disaster victims, allowing taxpayers to defer taxes when reinvesting their proceeds into the repair or replacement of the damaged property.

Q9. How does section 1033 operate?

A9. Section 1033 allows taxpayers to defer capital gain realized from the involuntary conversion of their property, provided that they use the proceeds received to purchase qualified replacement property.

Q10. What is qualified replacement property?

A10. Qualified replacement property is property that is similar or related in service or use to the destroyed property. For example, you could use the proceeds from the destruction of your vacation home to buy another vacation home or to rebuild the destroyed vacation home.

Q11. How long do I have to find replacement property?

A11. Your replacement period begins when the property is damaged or destroyed (even though you won't have insurance or litigation proceeds yet). Normally, the replacement period continues until two years from December 31 of the first year in which you would first recognize taxable gain. That is, the deadline for the end of the replacement period does not begin when your property is damaged or destroyed, but when you first receive enough compensation (from insurance or litigation proceeds, typically) to make you owe tax. If your primary residence was destroyed by a federally declared disaster, the replacement period ends four years (not two years) from December 31 of the first year you would recognize taxable gain, subject to extension for good reason. These time limits also apply if you choose to rebuild your property. The property must be completely rebuilt within these time limits.

Q12. How do I report the proceeds for my destroyed residence?

A12. If you want to defer income using section 1033, you should affirmatively elect section 1033 deferral on your tax return when you receive the proceeds for the destruction of your house. You would report the election on a statement attached to your tax return. If gain is not reported on a tax return, the IRS can consider the election constructively made, but it is better to affirmatively include an election statement with the return.

Q13. How does section 121 affect section 1033?

A13. Section 121 can reduce the gain you would need to defer under section 1033. This would apply only to a primary residence and not a vacation home or rental property that was destroyed. You must make an election on your tax return to claim the section 121 exclusion.

Q14. How does insurance affect this?

A14. Insurance can have a significant effect on section 1033 elections, particularly if you receive both insurance proceeds and a litigation recovery. This is because insurance proceeds can reduce your tax basis in your assets, which will make any future litigation recovery have more gain that may need to be deferred under a valid section 1033 election, or vice versa.

Also, you may receive insurance proceeds that exceed your tax basis and produce gain. This can start the clock at the end of your replacement period, giving you less time to acquire replacement property if you later receive a legal settlement.

III. Taxation of Your Settlement or Judgment

Q15. How can I have my settlement payment excluded from my income?

A15. For California income tax purposes, your settlement can be excluded from your income if it qualifies for exclusion under legislation passed in 2022: A.B. 1249 and S.B. 1246. These pieces of legislation generally exclude from California income all PG&E recoveries received from the Fire Victim Trust and Southern California Edison settlements regarding the Thomas and Woolsey fires.

Federal tax law does not provide these same broad exclusions. The most common way to exclude some or all of a fire recovery from income for federal income tax purposes is section 104(a)(2). That code section excludes from income compensation received on account of physical injuries and physical sickness.

"On account of" is not well defined in tax law. If the recovery is too attenuated from a personal physical injury or physical sickness to be considered on account of the injury or sickness, then the recovery does not qualify for exclusion. Punitive damages are never considered to be on account of a physical injury or physical sickness, and they are always taxable.

Q16. What constitutes physical injury damages for my fire case?

A16. This is generally any type of physical damage to your body, but it is not limited solely to serious or fatal physical damage. The IRS often expects there to be "observable bodily harm," such as broken bones, cuts, or bruises.

Q17. What constitutes physical sickness?

A17. For fire cases, the IRS has said that physical complications from the inhalation of smoke from a fire can be considered physical sickness. This can be substantiated with medical records to show that, for example, returning to the damaged property to live or losing your property exacerbated or caused your physical sickness.

There is also a growing consensus that post-traumatic stress disorder may qualify as physical sickness under section 104. To substantiate this, you should have a diagnosis of post-traumatic stress disorder by a licensed healthcare professional and supporting records. However, the IRS has not issued a formal opinion on this yet, and it may assert that post-traumatic stress disorder is not sufficiently physical.

Q18. Are emotional distress damages or similar damages taxable?

A18. Generally, emotional distress is taxable because it is not considered a physical injury or physical sickness. However, emotional distress damages that are connected to physical injuries or physical sickness damages can be entitled to tax-free treatment. Thus, once you have a qualifying physical injury or sickness, all the resulting damages may be tax free, even though most of the damages may formally be for emotional distress.

Q19. What if only my spouse suffered a physical injury and I am not injured? How does this affect my recovery?

A19. The IRS has concluded in multiple letter rulings that a taxpayer who suffered no personal physical injuries can claim section 104 treatment for their emotional distress damages if those damages are "on account of" their spouse's physical injury. Consequently, damages for loss of companionship, loss of consortium, and similar emotional distress claims can qualify for exclusion because the emotional distress was caused by, and therefore on account of, the death or serious injury of another person. Of course, the IRS can challenge whether your emotional distress was on account of a physical injury or physical sickness, so it is helpful and important to have documents, including declarations from medical providers, that can help document the causes of your emotional distress.

Q20. What kind of substantiation is needed to claim section 104 for my settlement or judgment?

A20. It is helpful to have specific tax language and allocations in the settlement agreement including specific dollar amounts for physical injuries or physical sickness. The tax language in a settlement agreement is not binding on the IRS or the courts. The IRS can look beyond the settlement agreement to determine the intent of the payer. But it can go a long way toward helping the taxpayer achieve the desired tax treatment.

If you suffered any physical sickness or injury, maintaining copies of medical records, court documents describing the injury, and any other reports detailing the injury or sickness can help.

For a judgment, the IRS will generally look to the complaint, mediation brief, and any judgments, jury verdict form, or other relevant court pleading to determine the nature of the claim. While there may not be any specific tax language in these documents, there may be helpful language to help identify the intent of the payer to help support section 104 treatment.

The IRS has not yet issued guidance on how much weight it will give to determination letters from the Fire Victim Trust for determining the tax treatment of recoveries from the trust. We expect that significant weight will be given to the determination letters because they represent the Fire Victim Trust's description of why it is awarding you the payment. It would be difficult to successfully argue that the Fire Victim Trust did not intend to compensate you for the claims and amounts it described in its own determination letter.

Q21. How is the legal fees portion of my settlement payment or judgment treated for tax purposes?

A21. The portion of your gross settlement payment or award that is retained by your counsel is considered a part of your recovery and income for tax purposes. Thus, you must include the legal fees in your income, and then separately deduct them or capitalize them to avoid having to pay tax on them.

For example, legal fees allocable to your capital recovery portion of the settlement can increase your tax basis and reduce the resulting gain. Legal fees related to the section 104 portion of the settlement or award can be excluded from gross income. The tax treatment of legal fees depends on the allocation of the recovery and will need to be reviewed by either a CPA or a lawyer.

Q22. What part of my settlement or judgment is taxable as ordinary income?

A22. Lost profits, lost revenue, and lost rental income, as well as taxable emotional distress discussed above, could be taxable. For judgments, punitive damages are always taxed as ordinary income. Interest will also be treated as taxable ordinary income. There is significant case law and authority to support the tax treatment of this type of income in your recovery.

IV. Capital Gain Treatment

Q23. Can I treat my recovery for my damaged house (or other property) as a capital gain since my house (or other property) was destroyed and it was a capital asset?

A23. Amounts you receive for the damage or destruction of a capital asset are generally taxed as capital recoveries. Capital recoveries are generally tax free to the extent they reimburse you for your tax basis in the capital asset. To the extent your recovery exceeds your basis, capital recoveries are taxed as capital gain. If you owned the damaged property for more than one year, the capital gain is generally taxed as long-term capital gain. As discussed in sections I and II above, previously claimed casualty losses and section 1033 elections can change this outcome.

Q24. What about the property I own surrounding my house, such as a guest house in the backyard?

A24. As discussed in Section I, capital gain must generally be calculated on an asset-by-asset basis. It is possible (or likely) that the guest house may also be treated as a capital asset, and any recovery for damages to it may be treated as a capital recovery. Still, the determination whether an asset is a capital asset must be done on an asset-by-asset basis.

Q25. How can I have my settlement treated as a capital recovery?

A25. To determine the tax treatment of your recovery, we would have to examine the origin of your claim. This determination requires a careful review of the complaint, mediation brief, settlement agreement, and any other relevant documents. Most fire recoveries involve claims for property damage, so a tax adviser's analysis would likely involve determining how much of your recovery should be treated as compensation for your damaged property, and how much should be allocated to your other claims (for example, emotional distress, physical injuries or physical sickness, interest).

Q26. How do I treat the legal fees if I have a capital recovery?

A26. Legal fees and costs incurred in acquiring or disposing of a capital asset, or in defending or perfecting a claim to ownership, should be treated as capital expenditures that increase your tax basis in the property. Therefore, the legal fees allocable to your capital claims can usually be capitalized (that is, added to your basis in your destroyed property). This would reduce your capital gain, and as a result, you would not owe tax on the portion of your recovery that was paid to your counsel as legal fees. You could also capitalize the legal fees and add them to the basis in the property you are rebuilding instead.

V. Conclusion

Fire (and other disaster) victims often encounter complex tax issues along with a host of other difficult issues. They may face damage to or loss of a home (or business), loss of personal property, and many other challenges as they try to rebuild their lives. How they are taxed depends a great deal on their circumstances, what they ultimately collect, and what they claim on their returns.

To make things worse for victims, there are many misconceptions about taxes in this context. For example, it is common for fire victims to assume that if they are just being made whole for a loss, no taxes could be due. Unfortunately, it is rarely that simple. For example, suppose that you lose a $1 million home but collect $1 million from your insurance carrier or from a utility to build somewhere else. It might sound like there is nothing to tax because you lost a $1 million home but got $1 million back. But you must know your tax basis and much more.

We hope these FAQs help to demystify the rules, but caution is in order. These are general statements, and even little changes in the facts can make the taxes spin out of control — like a forest fire. ■