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Fire Victims Wait Years For PG&E & Edison To Settle Then Face IRS Taxes

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. There are federal tax bill pending that if passed, could make certain fire lawsuit recoveries nontaxable. The proposed federal bill was introduced in

2022 by Congressmen Doug LaMalfa (R – Calif.) and Mike Thompson (D – Calif.) and would exempt thousands of fire victims who are receiving compensation from the PG&E Fire Victims Trust from having to pay federal income tax on their settlements.

However, the Congressional session ended, and a new Congress was sworn in, before it passed, making the federal bill effectively dead. A new, substantially identical, bill, H.R.176, was quickly introduced in the new Congress by Representative LaMalfa (along with other co-sponsors, including Representative Thompson) in January 2023. It too has not seen any significant movement since its (re-)introduction.

Unless the new bill passes, fire victims must consider their settlements when they do their federal income taxes. As to state taxes, at least many wildfire settlements are free of California tax. The golden state passed two laws to shield certain wildfire victims from state tax on their legal settlements in wildfire cases. One law applies to PG&E recoveries, the other to Edison suits, AB-1249 and SB-1246.

Even under the federal income tax, in some cases the recovery will not actually be subject to current tax, provided that the fire victim is careful, has tax help, and plans ahead. But it can take considerable ingenuity to turn the gross settlement figure into a viable tax reporting strategy that is defensible to the IRS. Fire victims should account for it all, including the attorney fees. Most fire victim plaintiffs use contingent fee lawyers.

Contingent legal fees may be separately paid to the plaintiff lawyers, but it is still attributed to the plaintiff for tax purposes. It is how legal fees are treated under tax law. 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 Miscellaneous itemized deductions, which accounted for most legal fees, were repealed for 2018 through 2025 tax years.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. Of course, the lawyers must also pay tax on the fees, so some argue that it is a form of double taxation. In any event, 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].

Even so, there is usually a viable 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. This can mitigate the new tax law's treatment of legal fees. In effect, it can mean paying tax only on the net recovery. Of course, that still leaves plenty of tax issues to address. How fire victims are taxed depends on their circumstances, what they ultimately collect, and what they claim on their taxes.

The IRS requires annual tax return filings, but a whole series of tax years may be peppered with fire items, including insurance recoveries. 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 would need to factor in depreciation (and depreciation recapture). But 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. The $500,000 exclusion for married couples for the sale of a primary residence doesn't cover *all* of that gain, leaving some gain exposed to tax.

Does that mean our fire victim has to pay tax on the $900,000 gain (or $400,000 if they qualify for the full primary residence exclusion)? Not necessarily. Fortunately, subject to requirements and limits, the tax law may treat this as an involuntary conversion despite the $900,000 gain. 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 is extended to four years, under the involuntary conversion tax relief provision.

However, watch 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 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.

Another tricky issue is how to handle expenses for temporary housing and similar expenses. If your primary residence is damaged or destroyed, your insurance proceeds intended to compensate you for your living expenses may be partially tax-free. Examples are replacement housing and food. But, if the insurance proceeds pay you for living expenses you would have no*rmally* incurred if your home had not been damaged, say your mortgage payment or your typical food expenses, that portion may be taxable *income* to you. If the insurance proceeds exceed the actual amount you spend on temporary housing, food, and other living expenses, that surplus can also be taxable.

As these examples illustrate, even dealing with insurance proceeds raises numerous nuanced tax issues. Plainly, though, the tax stakes and issues can grow larger with a lawsuit recovery. For victims who eventually collect a legal settlement or judgment, how it will be taxed? Fire recoveries are intensely factual, so the issues are complex in assessing how a fire recovery is going to be taxed. Some fire cases involve wrongful death, and compensatory wrongful death damages are tax free. Punitive damages are always taxable.

Some victims experience physical injuries or physical sickness, either caused by the fire or exacerbated by it. Fortunately, Section 104 of the tax code excludes from income damages for personal physical injuries or physical sickness. The damages must be physical, not merely emotional, for money to be tax free. Health problems from smoke inhalation or from the exacerbation of pre-existing medical problems can be enough for tax-free damages.

Some of the line drawing that the tax law seems to require can seem artificial. Most emotional distress damages are fully taxable, but emotional distress triggered by physical injuries or physical sickness is tax free. It can make taxing emotional distress and physical sickness damages can seem like chicken or egg issues.

The big item in most fire cases is property damage or destruction. This may be a multi-faceted item, with a house, outbuildings, trees and shrubs, crops and more. The taxpayer's actions are also important to consider. Are you rebuilding or moving away? It will all play into how the IRS will tax the fire victim. 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.

Understandably, fire victims hope to minimize taxes when they collect money from their insurance company or PG&E or Edison. If they 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. But there can be some surprising gotchas in fire cases that are important to avoid. With any fire recovery, give attention to timing and details or you could get burned by the IRS.

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