Tax Myths About Wildfire Settlements

by Robert W. Wood and Alex Z. Brown

Robert W. Wood

Alex Z. Brown

Robert W. Wood (Wood@WoodLLP.com) and Alex Z. Brown (Brown@WoodLLP.com) are tax lawyers with Wood LLP in San Francisco.

In this article, Wood and Brown examine some common myths regarding the tax treatment of fire settlements.

If you suffer damage or loss in a fire and later collect insurance or legal settlement money, is it taxed? It depends. Not all insurance money or legal recoveries are tax free. You can't rely on IRS Forms 1099, either. You may or may not receive Forms 1099 from insurance companies or defendants. In fact, in the case of the Pacific Gas & Electric Co. (PG&E) Fire Victims Trust, claimants generally don't receive a Form 1099 for their settlements. The same is generally also true for wildfire settlements from Southern California Edison.

But the tax law is clear that there are *still* reporting duties because numerous kinds of payments are taxable as income, regardless of whether you get a Form 1099. Here are some tax myths about fire settlements.

Myth No. 1: All fire recoveries are the same.

It might seem like multiple families who have had their homes destroyed in the same fire might have all the same tax issues. But their tax issues and treatment can vary considerably. They may face damage to or destruction of a home or their business, loss of personal property, and loss of fences, barns, trees, and landscaping. They may have health problems stemming from smoke inhalation or worsened medical conditions. They may have temporary living expenses. Some have insurance, but some don't — or not enough.

How they are taxed depends a great deal on their circumstances, what they ultimately collect, and what they claim on their taxes. The IRS says that legal recoveries are taxed based on the origin of your claim. But in the case of a fire recovery, there are often multiple kinds of claims — and tax positions that vary — even if the claims might seem to be exactly the same. Someone who just bought a $1 million house is in a different tax position than someone who bought their house 30 years ago for $100,000, even if both houses were worth $1 million when they were destroyed.

The tax treatment of a payment can vary based on multiple factors — for example, whether the property is a primary residence or an investment property, whether you already received insurance proceeds before receiving a legal recovery, whether you previously claimed a casualty loss for the property on your tax returns, or whether any personal property destroyed was separately scheduled on your property insurance. With so many variables to consider, it's unlikely that any two homeowners will face the exact same tax situation.

The tax code does contain some provisions to make reporting a little more streamlined. However, those provisions are generally limited to victims who had their primary residences destroyed in federally declared disasters. If your facts don't fall within that narrow subset, you don't get to enjoy the benefits of the more streamlined reporting.

Myth No. 2: Fire recoveries reimburse you, so they aren't income.

Not really. Let's take the same example. Say you bought your home 30 years ago for $100,000, and it's worth $1 million today when it burns down. If PG&E pays you $1 million, you've just been made whole, right?

That's not how the IRS sees it. The IRS says you just "sold" your home, even if you don't actually sell your land and move away. It's still a deemed sale of your house — the part that burned down. If you receive $1 million of insurance or litigation proceeds for a house you've only invested $100,000 into, from the IRS's perspective, you've profited by $900,000.

From your perspective, you've only broken even because what you received in settlement doesn't exceed the value of what you lost. However, capital gains tax isn't measured against the *value* of what you've sold but against what you paid for it.

The formal name for what you've paid for your home is your adjusted tax basis (often shortened to just basis). Your basis in your home is your purchase price plus the costs of any improvements you've made to the home. Improvements can include additions to the home, renovations, or the cost of replacing key equipment in the home like the roof, HVAC system, or plumbing. Maintenance — say a new coat of paint on your house or new wallpaper — doesn't usually add to your basis since it's not considered an improvement. Keeping track of your basis is smart, although often homeowners don't calculate their basis in their home until it comes time to sell it.

Ultimately, it is a taxpayer's responsibility to prove they have the basis they claim to have in their property. This means providing the IRS copies of documents that prove how much you've invested in your home. That is, documents that were likely in your home when it burned. If you can't prove your basis in a property, the default is to treat the basis as $0.

Through county records, you can probably prove your original purchase price for the property and avoid having $0 basis. But it might be more difficult to prove how much you paid to renovate the kitchen, to add on the sunroom, or to replace the water heater if those records were in the home when it burned. Some homeowners contact their contractors from past remodels for records, and there are other workarounds, too. But even so, the amount of basis you can prove may be significantly less than your true basis in the property.

It's not just your home that has a basis but also each piece of property in the home. If you receive compensation for your damaged personal property, you would normally also need to establish your basis in each asset. Here, the tax code provides some relief. If your primary residence was destroyed in a federally declared disaster area, any compensation you receive *from insurance* for personal property located in the home is tax free, *unless* the property was separately identified and scheduled in your property insurance policy.

That means you don't have to try to calculate the taxable gain on every sock, pillow, fork, and Blu-ray Disc (assuming you didn't have them separately scheduled in your property insurance policy). It also means that you don't have to prove how much you paid for each item of property in your home to establish your basis in those items. However, this relief only applies to (unscheduled) personal property located in your primary residence, and it applies only to insurance proceeds. For furniture and other personal property located in your rental property, business property, or vacation home, or if you received compensation for the personal property through litigation proceeds from the electric utility rather than through insurance, hopefully you have kept receipts for each item in a reliable fireproof safe.

Of course, your settlement money could be for a range of claims, not all about the house. As this simple example shows, even if you are truly just getting reimbursed for the economic loss you suffered, the IRS (and the state tax authorities) still sees taxable income. After all, just about everything is taxable.

Myth No. 3: The law now makes all fire settlements nontaxable.

Unfortunately, it isn't true that all fire settlements are nontaxable. Many fire victims are shocked to hear that they might be taxed on money they receive after a devastating loss. Given the thousands of fire victims, they have pushed on their legislators too. But the law hasn't been changed. It is true that there is one federal tax bill and one California tax bill pending that, if passed, could make some fire lawsuit recoveries nontaxable.

It is unclear how either of those bills will fare, but many tax bills are introduced that never pass. In that sense, the statistics alone don't bode well. The federal bill is backed by Rep. Josh Harder, D-Calif., and would exempt thousands of fire victims who are receiving compensation from the PG&E Fire Victim Trust from having to pay federal income tax on their settlements.

There is also a California bill, A.B. 1249, authored by State Assembly member James Gallagher, that would add a similar exemption from California state taxes. But until both provisions pass into law, fire victims must consider their fire recoveries when they do their taxes.

Myth No. 4: Insurance settlements are never taxable.

Most people assume that if you collect insurance money, it can't be taxed, but that's not true. Even handling expenses for temporary housing and similar expenses can be tricky. If your primary residence is damaged or destroyed, the insurance proceeds intended to compensate you for your living expenses may be partially tax free. Examples are replacement housing and food. However, that is supposed to be only for the *additional* living expenses you incur because of the fire.

However, if the insurance proceeds pay you for living expenses you would have *normally* incurred if your home hadn't 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.

And if insurance compensates you for the damage to your property, as discussed in Myth 2, that can result in a *reduction* of your tax basis or even taxable gain. Even if you avoid tax because you have sufficient basis to absorb the insurance proceeds, you will be left with lower basis in your property. That means that any future litigation proceeds or any future sales proceeds relating to the property you receive are more likely to result in taxable gain and more tax owed. In that sense, you aren't really avoiding a tax now, you are just deferring the tax until later.

Myth No. 5: If your attorney fees are paid separately, no need to report them.

Most plaintiffs (in fire cases and just about any other sort of legal case) use contingent fee lawyers, and most assume that they are only responsible for the *net* money they collect after contingent legal fees. If you settle for $1 million, and your lawyer takes $400,000 off the top, isn't your tax problem always limited to $600,000? Unfortunately, no. Just because a portion of your recovery is paid to your attorney doesn't mean you don't owe tax on that portion.

In *Banks*,[1] the Supreme Court held that plaintiffs and claimants must include contingent fees in *gross* income and find a way to offset with deduction or capitalization. In most fire cases, you shouldn't actually have to *pay* taxes on the legal fees your lawyer receives. But you still must report them on your return, or the IRS will think you are shorting them. After all, the *Banks* case on legal fees is from the Supreme Court. There are several ways to handle the fees on your tax return.

One way of handling the legal fees is as tax basis, capitalizing them as part of your proceeds much the same way you would if you sold your house and paid a large sales commission. But legal fees should generally be treated pro rata, along with each element of your recovery, so help from a good accountant or tax lawyer might be needed. That ties into the point that most fire recoveries aren't taxed just in one way — they are generally paying for a whole range of claims. That means the legal fees paid to your lawyer are supposed to be spread for tax purposes across all your different items of recovery.

Myth No. 6: If you don't receive a Form 1099, the payment isn't taxable.

This myth is dangerous. Most people know that if they receive a Form 1099 reporting a

[1] *Commissioner v. Banks*, 543 U.S. 426, 430 (2005).

payment, they must report it on their tax return. It is presumptively income, and that's what the IRS will think. Sometimes you can explain if it isn't income, but you at least must deal with the Form 1099 on your return.

But what if you don't receive a Form 1099? Perhaps it's like a tree falling in the forest with no one there to hear it, but many people seem to think that if there is no Form 1099, there is no income. That's not true. There are hundreds of pages of tax rules regarding when companies must issue Forms 1099 for a wide variety of payments. There are several varieties of those forms, including for legal settlements. But if you don't receive the form, you must still consider what is income or what is capital gain, for example.

Forms 1099 often aren't issued in fire cases because the claims are so mixed. Some money may be a return of your tax basis in your property. Some of your settlement may be reimbursed expenses, some income, some capital gain, even some money for inconvenience or physical injuries.

Both the PG&E Fire Victims Trust and Edison generally determined not to issue the forms in most cases. That is good, maximizing your tax flexibility. But not being alerted with a form could be bad if it leads you to think that just because you didn't receive a Form 1099, you have nothing to report.

Myth No. 7: The money is never taxable if you rebuild.

Not really. It is true that there are ways to put your money into rebuilding, even deferring your tax hit. But you should be very careful about what qualifies, and especially about deadlines. There are compliance requirements, too, and you must make an election on your tax return to qualify.

Fortunately, subject to requirements and limits, section 1033 of the tax code may allow you to treat your proceeds as an involuntary conversion despite your gain. If you qualify, you can apply your old tax basis to a replacement home, either to rebuilding costs or to a new purchase (even one in another state). That means you shouldn't need to pay tax on your gain until you sell the replacement home.

Myth No. 8: In a disaster area, you have four years to replace the property and defer gain.

The default period for replacing property under section 1033 is only two years, not four. This default period is extended to four years for principal residences destroyed or involuntarily converted in a federally declared disaster. However, if the property destroyed is *not* your principal residence but was a vacation home, rental property, business property, or investment property, you are stuck with the default two-year window.

When the replacement window begins also can trip up taxpayers. The two-year (or four-year) clock begins to tick on December 31 of the year in which you first recognize any gain on the property. That means that if you received insurance proceeds that exceeded your basis in your home by even just $1 in 2019 but didn't receive your settlement from the electric company until 2021, you may have first recognized gain on the property in 2019, not 2021. By the time you receive your litigation recovery in 2021, you may already be nearly two years into your replacement window for the property.

Timing matters. To defer gain from a casualty by reinvesting insurance or litigation proceeds into replacement property, the replacement property must generally be rebuilt completely or purchased within the replacement period.

Myth No. 9: You can always exclude the first $500,000.

Not necessarily. It is true that if your destroyed property was your primary residence, section 121 may reduce the amount of gain that needs to be deferred under the involuntary conversion provision, section 1033. Section 121 allows an individual to sell her residence and receive a tax exemption on $250,000 of the gain as an individual and $500,000 if she is married.

To be eligible for this tax savings, the home must be used as your primary residence for an aggregate of two of the preceding five years. Even if you don't really sell your home — if it is destroyed by fire and you collect money from insurance or from PG&E — you can qualify. But this provision is also elective and doesn't provide any tax benefits unless you elect this treatment on your tax return. If you don't make a timely and proper election on your tax return, you are not entitled to this $250,000 or $500,000 tax benefit.

Myth No. 10: Emotional distress damages are tax free.

Be careful with this one. Damages for wrongful death or physical injuries are tax free. And if you have emotional distress from one of these causes, your emotional distress damages can *also* be tax free. Some fire victims had health problems from smoke inhalation or the exacerbation of a preexisting medical condition. In these cases, there may be a good case for excluding some of the damages.

But plain old emotional distress — even with physical consequences such as headaches or stomachaches — isn't enough. Section 104 excludes damages for personal physical injuries or physical sickness. The damages must be physical — not merely emotional — for the money to be tax free. Many plaintiffs struggle with a chicken-or-egg issue about what comes first.

Emotional distress damages that are connected to physical injuries or physical sickness damages are also entitled to tax-free treatment. Thus, once you have a qualifying physical injury or sickness, all the damages may be tax free, even though most of the damages may really be for emotional distress. What is "physical" enough to qualify? Health problems from smoke inhalation or from the exacerbation of preexisting medical problems can be enough on appropriate facts.

Moreover, a diagnosis of PTSD and the appropriate assertions of PTSD claims might also be enough. There is now reliable medical evidence that PTSD is physical, not merely some kind of emotional distress. In many fire cases, of course, there may be no claims of physical injuries or physical sickness. If you fail to assert damages for physical injuries in your case, it is considerably more difficult to prove to the IRS that the defendant was intending to pay you for those physical injuries or for their associated emotional distress.

Myth No. 11: Claiming a casualty loss is best.

Some homeowners assume that this tax write-off is worth a lot, so they claim it. Up until 2018, many more taxpayers could claim casualty losses on their tax returns for many types of losses. It was essentially a tax write-off for bad fortune. But there were major changes made by the Tax Cuts and Jobs Act, which passed in late 2017. Starting in 2018 and continuing through 2025, casualty losses are effectively 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. Of course, many fire victims in California qualify because most major California wildfires are federally declared disasters. Even so, consider the potential downside of claiming a casualty loss. It can make any future recoveries on the property for insurance or litigation proceeds considerably less tax favorable and a lot more complicated.

For one thing, claiming a casualty loss in one year can complicate the determination of your tax basis. It can also trigger section 111 of the tax code, which embodies the "tax benefit rule." If you claimed a casualty loss for the fire or other loss, what happens if you later recoup the money in litigation or from your insurance company?

The prior loss you claimed will count against you and need to be taken into account when you determine the tax treatment of the insurance money or lawsuit proceeds you receive. Therefore, if you are expecting insurance or litigation proceeds, you may want to consider whether the short-term tax benefit of the casualty loss deduction is outweighed by the tax harm you may face later when your insurance or lawsuit settlement comes in. Having an accountant crunch some numbers for you under various possible scenarios isn't a bad idea.

Conclusion

As anyone who has experienced one can attest, a fire is a devastating experience that affects nearly every part of a victim's life. In some cases, fires destroy literally every tangible thing a person owns. Because so much of your life is affected by a fire, fire recoveries generally compensate you for a wide variety of damages. That complexity creates even more complexity for determining and reporting tax due.

More complexity is added by the interactions between victims' sources of compensation (insurance payments and litigation proceeds) and all the provisions in the tax code that exist to provide some relief to taxpayers. Those include casualty loss deductions, section 121's primary residence exclusion, and section 1033's gain deferral on involuntary conversions. They all have their own sets of rules, regulations, and variables to consider. Determining the appropriate tax treatment of a fire recovery is no small task, and victims are well advised to get professional help. ■