

Taxing Condemnation Recoveries

By Robert W. Wood

From a tax viewpoint, an involuntary conversion occurs if your property is destroyed, stolen, condemned, or disposed of under the threat of condemnation, and if you receive money or other property in payment. The money may come from insurance, a condemnation award, or a lawsuit settlement. Fire and other disaster recoveries often trigger these rules. The tax rules are contained in Section 1033 of the Internal Revenue Code and parallel provisions of California tax law.

Fundamentally, the tax law generally treats these funds as the proceeds of settling your property. Depending on your tax basis in your property, that can trigger gain, as would occur with any other sale. If the property is your primary residence, a married couple may qualify to exclude up to \$500,000 of gain, subject to certain requirements. But beyond that, there would be taxes to pay, which is where Section 1033 comes into play.

Section 1033 of the tax code allows taxpayers who experience an involuntary conversion to roll over their gain into similar property. It is somewhat analogous to a Section 1031 exchange of real estate, although Section 1033 is decidedly different.

Section 1033 and the IRS regulations interpreting it are chock full of special rules, timing constraints, and more. If a sale occurs under *threat* of condemnation, there are special rules for that too. Generally, to withstand IRS scrutiny under the threat of condemnation doctrine, the taxpayer must be informed that the acquiring entity has decided to condemn the property. You do not necessarily have to wait until the actual condemnation process reaches its conclusion. You could sell voluntarily in the face of the threat, but you must have reasonable grounds to believe, based on all the available information, that the entity *will* condemn the property unless the owner sells it voluntarily.

Section 1033 of the tax code comes up more frequently than you might think. Wildfire recoveries are probably the most common context for it to be relevant, and many fire victims end up needing to learn the rudiments of these rules. Whether the property is a primary residence is relevant, as is whether the loss occurred as a result of a federally declared disaster. As you might predict, there are more liberal rules under Section 1033 for losses that occur as a result of a federally declared disaster.

How could any of this relate to Cuba? The Supreme Court appears to be easing the way for people and companies to make claims over the confiscation of Cuban property when Fidel Castro seized power in 1959. Recently, the U.S. Supreme Court revived claims filed by a U.S. company, Havana Docks, that operated docks in the Cuban capital. See *Havana Docks Corp. v. Royal Caribbean Cruises, Ltd.*, 598 U.S. ____ (2026).

The suit targets four cruise lines that brought tourists to Cuba during a brief reopening of Cuban relations that occurred during the Obama administration, using confiscated property claimed by Havana Docks. The pivotal law is the Helms-Burton Act, which Congress passed in 1996. Among other things, it allows Americans to sue almost any company

that engages in commercial activity or that benefits from property confiscated by Cuba's government.

The law allows U.S. nationals with claims to confiscated property to file suit in U.S. courts. But for decades, every U.S. president since 1996 suspended the law in view of broader international implications. Then, in 2019, President Trump reactivated the law to allow lawsuits. He also imposed travel restrictions that stopped the cruise ships that were in issue in the Havana Docks case. The trial court in the case awarded Havana Docks more than \$400 million in damages, but a federal appeals court reversed.

The Supreme Court has sent the case back for further argument. Numerous law firms have filed lawsuits under the law and some plaintiffs are collecting. When plaintiffs collect damages for property that was confiscated many years ago, it is often the descendants of property owners who are the recipients. And while it might seem that they are just getting back something that was taken from them, they are paid in cash, not with actual property.

To the IRS, that means taxes, as the IRS taxes most lawsuit settlements. However, some settlements can be positioned as capital gain. A suit about damage to or conversion of property is a prime example.

Ordinary income is taxed at up to 37%, while capital gain can be taxed as low as 0% and as high as 23.8%. Apart from lower tax rates, capital gain can involve recouping basis too. If you spent \$1 million in costs that you have not deducted, that is basis that can be repaid without tax before you start reporting gain. The IRS can push back and tends to argue for ordinary income, it is one of the IRS rules about legal settlements.

However, a successful Helms-Burton Act plaintiff is likely to have a good argument that settlement proceeds should qualify for long term capital gain treatment. After all, having property confiscated should mean that a later settlement is effectively paying you for your property. Selective settlement agreement wording could make that argument even better.

But will a taxpayer have a significant tax basis? Probably not after a 1959 confiscation. But there is one other significant tax impact of reporting as capital gain. Nearly all Helms-Burton Act plaintiffs use contingent fee lawyers. When their ship comes in, the IRS will treat them as receiving not only their net recovery, but the share of the funds that goes to their contingent fee lawyers as well. That means most plaintiffs must look for a way to claim a legal fee tax deduction.

That can be tricky in some cases. However, if you recover capital gain, the tax case law says you can capitalize your legal fees and offset them to reduce your gain. That is an added benefit of lawsuit settlements that are taxed as capital gain. Still, not every plaintiff who reports capital gain for a legal settlement has an easy time convincing the IRS.

Settlement Agreement Wording

In NCA Argyle LP, Newport Capital Advisors, LLC, the IRS and the taxpayer faced off over the treatment of a \$23 million legal settlement. The taxpayer claimed that the money was capital gain for its interests in the failed joint ventures.

The IRS said the money was really future fees the joint ventures would reap, plus punitive damages, both of which are clearly taxed as ordinary income.

While the case was on appeal, the parties settled for \$23 million. The settlement agreement stated that NCA received all \$23 million in exchange for its interests in the joint ventures. Although settlement agreement wording does not bind the IRS, the Tax Court relied heavily on the express allocation in the settlement agreement. The court agreed with the taxpayer that these were sale proceeds and capital gain.

Tax Deferral

Finally, we come back to Section 1033, which is another tax benefit for Cuban confiscation damages. Section 1033 allows you to put your gain into repairing or replacing the damaged or destroyed property. There are time limits and requirements, but it is used frequently in property damage and construction defect cases. Of course, descendants of Cuban property owners paid nearly 70 years after the confiscation may be unlikely to want to reinvest their lawsuit proceeds into other property, even if it saves them taxes.

No one wants to go through a protracted legal dispute. After enduring that process, no one wants to go through *another* dispute about taxes on the money they recovered, or the money they had to pay. When possible, getting some tax advice to avoid the numerous landmines in the tax rules can help you sleep easier.

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