Taxing Wildfire Lawsuit and Insurance Recoveries

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In this article, Wood and Brown examine the tax issues that arise when dealing with fire disasters and offer suggestions on how to navigate them.

This discussion is not intended as legal advice.

If you have lost loved ones in a fire or other disaster, taxes are the least of your worries. If your loss is limited to your house and personal possessions, you may not think about taxes until tax time. Even businesses that always have taxes in mind have so much to try to reconstruct or replace that tax considerations usually come much later.

There are more immediate concerns in the weeks and months following a fire. But tax issues eventually arise, and it is good to be prepared for them. Insurance proceeds can raise tax issues, as can other recoveries such as lawsuit settlements.

Hawaii fire victims may be a long way from receiving any lawsuit compensation, but when they do, they may look to the experience of Californians who also experienced devastating wildfires in the last decade. Thousands of Californians have had to sort out — and are still sorting out — the complicated tax interactions between insurance payments, casualty loss deductions, legal recoveries from defendants such as utility companies, and rebuilding expenses. As lawsuits and insurance claims are filed, it is important to think of the tax man, too.

Most legal settlements are taxable, even for a devastating fire loss. A federal tax bill was introduced by U.S. Reps. Doug LaMalfa, R-Calif., and Mike Thompson, D-Calif., that would exempt compensation from federally declared wildfires from federal income tax.[1] This legislation was folded into a broader disaster relief tax bill that recently cleared a committee and moved to the House floor.[2] It has a long path ahead to enactment, though many — including the trustee of the PG&E Fire Victim Trust — have written letters in support to Congress.

California Exclusions for Fire Victims

California lawmakers have passed four exclusions to the Revenue and Taxation Code for certain fire recoveries. First, A.B. 1249, authored by Assembly member James Gallagher (R), created an exemption for Fire Victim Trust recoveries. California also enacted S.B. 1246 to exempt settlement payments from Southern California Edison for the Thomas and Woolsey fires.

[1] Protect Innocent Victims of Taxation After Fire Act, H.R. 4970 (2023).

[2] Federal Disaster Tax Relief Act of 2023, H.R. 5863 (2023).

Two further California income tax exclusions — for the 2019 Kincaid fire and the 2020 Zogg fire — were enacted as part of an omnibus bill, S.B. 131. The somewhat piecemeal method by which the state has added these exclusions can make it difficult for fire victims to keep up with which fires qualify for this tax relief. Thankfully, the four new Revenue and Taxation Code sections (sections 17138.5, 17138.6, 17139.2, and 17139.3) added to establish the exclusions were placed directly next to each other in the California code. Corresponding corporation tax provisions were also added with sections 24309.1, 24309.3, 24309.6, and 24309.7.

Of course, the Legislature can only create state income tax exclusions, not federal. Therefore, victims of the Thomas, Woolsey, Kincaid, and Zogg fires, as well as fire victims receiving recoveries from the PG&E Fire Victim Trust or residing in other states, must consider their fire recoveries when filing their federal taxes.

Federal Taxes and Legal Fees

Most fire victim plaintiffs hire contingent-fee lawyers. Contingent legal fees may be separately paid to the plaintiff lawyers, but they are still attributed to the plaintiff for tax purposes.[3] Thus, after reporting a gross settlement amount including legal fees, plaintiffs need a way to deduct the legal fees.

Until 2018, legal fees were usually tax deductible as miscellaneous itemized deductions.[4] Taxpayers often tried to qualify for better, above-the-line deductions for their fees and expenses,[5] but the below-the-line deduction was essentially always a safe and reliable contingency option. However, under the federal Tax Cuts and Jobs Act enacted in late 2017, miscellaneous itemized deductions were suspended for tax years 2018 through 2025.[6] 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.

The above-the-line deductions taxpayers tried to claim before the TCJA still exist, but the tax treatment of the legal fees has become a major tax problem associated with many types of litigation.[7]

Fortunately for fire victims, there is usually a good path to deduct or offset the legal fees. Under IRC section 1033, insurance and other proceeds received that compensate you for damage to your property in a fire or other involuntary conversion are generally treated for tax purposes as a capital recovery, like sales proceeds. Typically, the bulk of insurance proceeds and legal recoveries received for a fire are for damage to property. In addition to the other benefits that section 1033 and capital gain treatment may provide, this treatment helps to mitigate the legal fee problem.

To the extent the fire recovery can be treated as a capital recovery,[8] the legal fees can be treated as additional basis in the home or other property damaged by the fire, or as a selling expense.[9] Capitalizing the legal fees reduces the resulting capital gain on the recovery,[10] thus having a similar offsetting effect on capital gains that deductions have on ordinary income. However, capitalization is not affected by the suspension of miscellaneous itemized deductions. Of course, that still leaves plenty of tax issues to address.

Untangling Basis, Gain, and Income

How fire victims are taxed depends on their circumstances, what they collect, and what they claim on their taxes. Suppose that you lose a $1 million home but collect $1 million from your insurance carrier or as lawsuit proceeds. Since you lost a $1 million home and simply got $1 million back, it might sound like there is nothing to tax. You have only broken even.

However, that is not how tax law views it. To determine whether you've made a profit, tax law looks at how much you paid for and have invested into your home. If you only paid $400,000 for the home (the original purchase price plus the cost of renovations and other

[3] *See Commissioner v. Banks*, 543 U.S. 426 (2005).

[4] *See* IRC sections 162, 212.

[5] *See* IRC section 62(a)(1), (2), (20), and (21).

[6] IRC section 67(g).

[7] *See* Robert W. Wood, "12 Ways to Deduct Legal Fees Under New Tax Laws," *Tax Notes Federal*, Oct. 7, 2019, p. 111.

[8] *See* Wood, "Legal Settlements as Capital Gain: A Playbook to Avoid Ordinary Income," *Tax Notes Federal*, Sept. 28, 2020, p. 2407.

[9] *See* IRC section 263.

[10] *See* IRC section 1001.

improvements) and now you've received a $1 million check, then for tax purposes, you've made a $600,000 profit on a $400,000 investment. For tax purposes, it's the total amount that you've invested in your home, not its value before the fire, that determines whether you've incurred a loss, broken even, or recognized a casualty gain.

In tax parlance, the amount you have invested in your home — increased by anything spent to improve the property and decreased by any events that reimburse you for your investment — is called its adjusted tax basis. As one might expect, there is a robust set of rules, regulations, and cases elaborating on what counts toward your adjusted tax basis,[11] what doesn't, and what transactions require you to reduce your adjusted tax basis.

Many taxpayers do not worry about the adjusted tax basis in their home or other property unless they decide to sell it. Compounding things, many of the documents needed to reconstruct a taxpayer's adjusted tax basis may have been damaged or destroyed in the fire. As a result, for many fire victims, one early, often frustrating step for beginning to consider their taxes is working with an accountant to begin reconstructing their adjusted tax basis to determine how much insurance and legal recovery can be considered a tax-free reimbursement of that basis (that is, a return of basis).

If it was commercial property, you would need to factor in depreciation (and depreciation recapture).[12] But even with personal use property like a home, your basis matters. The tax consequences of the same $1 million insurance check for two homeowners can be vastly different depending on how much adjusted tax basis each taxpayer and their tax preparers can reconstruct. The more basis a taxpayer has in their property, the less they may need to concern themselves with other, often more complicated methods to deal with casualty gains.

Does that mean fire victims must pay tax on any resulting casualty gain? Not necessarily. For many taxpayers, determining basis and identifying how much of a recovery can be treated as a tax-free return of basis is only the starting point of the analysis. Once you have determined how much casualty gain you have, you can then figure out how to mitigate tax on it.

If the damaged or destroyed property is your primary residence, IRC section 121 can provide assistance. Under section 121, a wildfire or other involuntary conversion under section 1033 can qualify for the partial exclusion of gain — $250,000 for unmarried taxpayers or for each spouse if you file separate returns and $500,000 for spouses that file jointly — that generally applies to sales of primary residences.[13] Taxpayers have to remember to claim the section 121 exclusion on their tax returns, but if a taxpayer qualifies, it can be a convenient way to shave a few hundred thousand dollars off the top of the casualty gain.

Section 1033 Involuntary Conversion Deferral

If there is any casualty gain left over, the next option is to consider an election to defer paying tax on the gain under IRC section 1033. By making a valid section 1033 election, taxpayers do not have to pay income tax on any casualty gain in the year the gain is generated to the extent that they reinvest the deferred gain into the repair, reconstruction, or replacement of their damaged property within the required period. The catch is that they can't consider any gain deferred under section 1033 as an addition to their adjusted tax basis in the property.[14]

Thus, the intended result is that the taxpayer will have a lower adjusted tax basis — hence more taxable gain — in the later year the property is sold than she would have if she had used post-tax funds to rebuild, repair, or replace her property. In this intended situation, the section 1033 election only serves to defer gain. However, if the fire victim never sells her property, and continues to own it until her death, then she and her heirs may get an even better result.

When the fire victim's heirs inherit their property, IRC section 1014 provides that the heirs receive the property with a new adjusted tax basis equal to the property's fair market value. The

[11] *See, e.g.*, IRC section 1016; reg. sections 1.1016-1-5.

[12] IRC sections 167-169, 1250.

[13] *See* IRC section 121(d)(5).

[14] *See* IRC section 1033(b)(2).

heirs do not inherit the fire victim's adjusted tax basis affected by section 1033. In many cases, this could mean that the deferred gain may never be paid back, effectively making the section 1033 election a permanent exclusion rather than a deferral.

To defer a casualty gain by reinvesting insurance or litigation proceeds, the replacement property must generally be purchased within two years after the close (typically, December 31 since most taxpayers report using the calendar year) of the first year when any part of the casualty gain is realized.[15] For a federally declared disaster, the period is extended to four years for principal residences.[16] Other types of properties — commercial, rental, or vacation — are still subject to the standard two-year replacement period in most cases.

Indeed, that is even true in a federally declared disaster, in which the extra two years of time only applied to principal residences.[17] This is yet another point on which establishing a high adjusted tax basis can be crucial. The higher an adjusted tax basis you can support, the more insurance and litigation proceeds you can receive as a return of basis before you generate any casualty gain.

To paint a clearer picture, imagine there are two neighbors whose homes (their primary residences) are each worth $1 million and are destroyed in a wildfire in 2023, which is a federally declared disaster. One taxpayer, perhaps daunted by the idea of reconstructing decades of investment history, decides to report under the conservative assumption that his adjusted tax basis is only the $100,000 he originally paid for the home decades ago. The other works with a CPA to account for all his investments in the property over the years and is able to support having a $500,000 adjusted tax basis in his property. Each taxpayer receives a $750,000 insurance payment for his home in 2023, and each receives a second insurance payment of $250,000 in 2024.

[15] IRC section 1033(a)(2)(B).

[16] IRC section 1033(h)(1)(B).

[17] *See* IRC section 1033(h)(2) (providing relief for trade or business and investment property destroyed in a federally declared disaster, which does not include an extension of the replacement period).

The first taxpayer can treat $100,000 of the 2023 payment as a tax-free return of basis and can exclude an additional $250,000 under IRC section 121, but he would still have $400,000 of casualty gain remaining in 2023 and $250,000 of additional casualty gain in 2024. The first taxpayer timely files section 1033 elections for the remaining casualty gain in 2023 and 2024. Because this taxpayer first recognized casualty gain in 2023, he would have until December 31, 2027, to reinvest the gain to satisfy the requirements of section 1033.

He would have to reinvest $650,000 total ($400,000 from 2023 and $250,000 from 2024) to defer all the tax on the casualty gain. However, as a result of the section 1033 election, the $650,000 deferred would not be added back into his adjusted tax basis, creating the possibility of higher taxes on any subsequent sale of his home.

The second taxpayer has it a little easier because he substantiated a higher adjusted tax basis. For the 2023 payment of $750,000, he can treat $500,000 as a tax-free return of his basis and can exclude the remaining $250,000 under section 121. This taxpayer has no casualty gain remaining in 2023 and no need to make a section 1033 election yet.

The second taxpayer would not generate casualty gain until 2024, when he receives the $250,000 second insurance payment. Not to introduce even more complexity, but the second taxpayer could reinvest $250,000 of his 2023 payment back into his home in 2023 and 2024. Because he is investing post-tax funds, not section 1033 deferred funds, these payments could be added to his adjusted tax basis, meaning that his 2024 insurance payment could also be treated as a tax-free return of this newly created basis. The second taxpayer may avoid having to ever make a section 1033 election.

But even if we ignore that possibility and assume the 2024 payment of $250,000 generates casualty gain to the second taxpayer, he could make a section 1033 election. In that case, because he was able to avoid recognizing casualty gain until 2024, the second taxpayer would have until December 31, 2028, one year longer than the first taxpayer, to reinvest the casualty gain under section 1033. And he would only have to reinvest $250,000 — less than half of what the first taxpayer would have to invest — to satisfy section 1033's requirements.

Because only $250,000 of what the second taxpayer spends to rebuild, repair, or replace his home cannot be added to his adjusted tax basis under section 1033's rules, the second taxpayer — all other things being equal — would likely end up with a higher adjusted tax basis in his home after repairs are completed than the first taxpayer. Not getting credit for $650,000 of out-of-pocket reconstruction expenses can have a large impact on your resulting tax basis. Thus, as a final insult, the first taxpayer may have more gain and may owe significantly more tax later when he sells his home than the second taxpayer.

The moral of the story is that reconstructing tax basis, though frustrating, is not something it pays to ignore. It can result in having to spend more money in less time for a section 1033 election, not to mention a potentially higher tax bill when you later sell the property. The CPA fees to substantiate your basis can pay for themselves.

Claiming a Casualty Loss?

Another big issue is a casualty loss,[18] which many taxpayers could once claim on their tax returns. But from 2018 to 2025 (another suspended deduction), casualty losses are allowed only if your loss was the result of a federally declared disaster.[19] Many fire victims in California and Hawaii qualify, since most major wildfires are federally declared disasters.

The amount of casualty loss you can claim is based on — wait for it — your adjusted tax basis.[20] This goes back to the earlier point about how the IRS views profit and loss in a casualty. When your property is destroyed, the amount you are considered to have lost is not the value of your home, but your adjusted tax basis, or the monetary amount you had invested in it. FMV only factors into the calculation of your casualty loss deduction in some circumstances if the disaster-related reduction in your property's FMV is less than your adjusted tax basis.[21]

Critically, you are supposed to claim a casualty loss only to the extent you do not expect to be reimbursed for the loss through insurance or other recovery.[22] To claim a casualty loss, you generally must file a Form 4684 with your tax return. To calculate your casualty loss on the Form 4684, you are required to subtract from your adjusted tax basis the amount of any "insurance or other reimbursement."[23] As tax law and IRS guidance confirms, this amount is not just the amount of insurance and other reimbursement you have already received, but also the amount you anticipate you will receive.[24]

If you do not expect to receive any insurance proceeds or other reimbursement, then claiming a casualty loss can mitigate the financial burden of having to rebuild or replace your property out of pocket. And if you know how much compensation you will receive from insurance or litigation for the loss of your property, and you still have excess basis remaining, there is nothing wrong with claiming a casualty loss for that excess basis you do not expect to be reimbursed for to the extent tax law allows.

It is important to be careful here, however, because things can get sticky if you overaggressively calculate your casualty loss and end up getting more insurance or litigation proceeds than you had factored into your Form 4684 calculations. In a perfectly calculated casualty loss, you should never have casualty gain. A casualty loss is only supposed to be claimed when a taxpayer's basis is more than what she anticipates receiving, so there would be no casualty gain. If you know you are going to receive more than your adjusted tax basis from insurance or a litigation recovery, you are not supposed to claim any casualty loss.

Nonetheless, some taxpayers and their tax advisers aggressively claim large casualty losses even when large insurance and litigation proceeds

[18] IRC section 165(c)(3).

[19] IRC section 165(h)(5).

[20] IRC section 165(b).

[21] *See* reg. section 1.165-7(b).

[22] *See* reg. section 1.165-1(c)(4).

[23] IRS Form 4684, section A, line 3 (2022).

[24] *See, e.g.*, IRS Public Notice 547, "Casualties, Disasters, and Thefts," at 8 (2022) ("If in the year of the casualty there is a claim for reimbursement with a reasonable prospect of recovery, the loss isn't sustained until you know with reasonable certainty whether such reimbursement will be received. If you expect to be reimbursed for part or all of your loss, you must subtract the expected reimbursement when you figure your loss.").

are anticipated. Some taxpayers claim a casualty loss for as close to 100 percent of their adjusted tax basis as tax law allows without any regard for what they anticipate getting paid, effectively wiping out their entire adjusted tax basis before they have received their first insurance check. Given the importance of adjusted basis in fire recoveries and for IRC section 1033 elections, this can be disastrous.

Even worse, if you are too aggressive with your casualty loss deductions, and later receive insurance or litigation proceeds exceeding the amount you estimated on your Form 4684, you do not simply get to treat that as regular casualty gain subject to the usual section 1033 election rules. Rather, under IRC section 111's tax benefit rules, you are required to reimburse the IRS for the amount your previous casualty loss was excessive — to the extent that amount actually resulted in your owing less tax.[25]

Essentially, unless your CPA demonstrates mathematically that your casualty loss did not result in you owing less tax (either in the year the deduction was claimed or in any year any unused portion of the loss was carried as a net operating loss),[26] this means that you have to treat any future casualty gain related to the same property as ordinary income that does not qualify for deferral under IRC section 1033 until you have fully repaid the casualty loss deduction. Only after you have fully repaid the IRS for the casualty loss deduction can you begin to use section 1033 to defer any remaining casualty gain. So if you are expecting insurance proceeds or litigation proceeds in the future, plan carefully with casualty losses, because the prospect of having to pay the IRS back later can make future payments you receive significantly less tax efficient.

Temporary Housing

Handling expenses for temporary housing and related issues is also tricky. If your primary residence is damaged or destroyed, your insurance proceeds intended to compensate you for your living expenses — such as replacement housing and food — may be partially tax free.[27] But if the insurance proceeds pay for living expenses you would normally have incurred if your home had not been damaged — say, your mortgage payment or typical food expenses — that portion may be taxable income.[28]

If the insurance proceeds exceed the amount you spend on temporary housing, food, and other living expenses, that surplus can also be taxable.[29] The IRC doesn't say whether additional living expenses received from anyone other than an insurance company are taxable. Therefore, taxpayers being reimbursed for additional living expenses by non-insurance payers would need to look to IRS and judicial decisions to determine whether such a payment constitutes a taxable reimbursement of the taxpayer's personal expenses[30] — or is sufficiently factually analogous to a situation in which the IRS or a court has held that the reimbursement was tax free because it was not an accession to wealth.[31] For example, is an award of additional living expenses from the PG&E Fire Victim Trust or a defendant who is not an insurance company tax free? On these and other issues, there is uncertainty as to their appropriate treatment.

In short, even insurance proceeds raise nuanced tax issues, and the tax stakes increase with a lawsuit recovery. Fire recoveries are intensely factual, so the issues are complex in assessing how they will be taxed.[32]

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[25] *See* reg. section 1.111-1(b).

[26] *See* IRC section 172(d)(4)(C).

[27] *See* IRC section 123.

[28] IRC section 123(b).

[29] IRC section 123(b)(1) (referring to "actual living expenses incurred").

[30] *See, e.g., Old Colony Trust Co. v. Commissioner*, 279 U.S. 716 (1929); *Commissioner v. Jacobson*, 336 U.S. 28 (1949).

[31] *See, e.g.,* Rev. Rul. 57-60, 1957-1 C.B. 25, *as modified by* Rev. Rul. 60-280, 1960-2 C.B. 12; Rev. Rul. 67-30, 1967-1 C.B. 9; Rev. Rul. 80-99, 1980-1 C.B. 10; LTR 201035004. *See also Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 431 (1955) (famously defining gross income for tax purposes to include "instances of undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion").

[32] *See* Wood, "How Fire Victims Are Taxed," *Tax Notes Federal*, July 29, 2019, p. 709.

Personal Physical Sickness or Injuries

Some fire cases involve wrongful death, and compensatory wrongful death damages are tax free.[33] Punitive damages are always taxable, except in situations so rare they barely merit reference.[34] Some fire victims experience physical injuries or physical sickness, either caused by the fire or exacerbated by it. Fortunately, IRC section 104 excludes from income damages for personal physical injuries or physical sickness.

However, there is a great deal of line-drawing, as the IRS requires the damages to be physical — not merely emotional — for money to be tax free.[35] There are many disputes between taxpayers and the IRS on this point every year. The U.S. Tax Court often must resolve these disputes, which frequently go in favor of the IRS. Even so, health problems from smoke inhalation[36] or from the exacerbation of preexisting medical conditions[37] can be enough for tax-free damages. Some distinctions that the tax law seems to require appear rather artificial.

Most emotional distress damages are fully taxable, but emotional distress triggered by physical injuries or sickness is tax free.[38] However, some conditions — including headaches, nausea, eating disorders, sleeping disorders, indigestion, and changes to weight and activity level — are generally considered mere symptoms of emotional distress unless a taxpayer can demonstrate an underlying physical injury or sickness to account for them, and symptoms of emotional distress do not generally qualify for exclusion.[39] It can make taxing emotional distress and physical sickness damages seem like chicken-or-egg issues.[40]

Conclusion

The big item in most fire cases is property damage or destruction, which may be a multifaceted 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 all plays into how the IRS taxes the fire victim.[41] If you do not reinvest, you may have a big capital gain — subject to claiming the primary residence tax benefit of up to $500,000 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. California tax law conforms to this $500,000 exclusion,[42] as do most states,[43] although most fire recoveries are now tax free under California's special fire legislation. That is a huge benefit, since when it comes to California taxes, all income is taxed at up to 13.3 percent, even capital gain. Wildfire victims in Hawaii can face state capital gains rates reaching 7.25 percent and state ordinary income rates of up to 11 percent.[44]

Understandably, many fire victims hope to face no taxes when they collect money from their insurance companies, electric utilities, or other defendants. 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 sell their home. The unfortunate bottom line is that there can be some surprising gotchas that are important to avoid in fire cases. ■

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[33] *See* IRC section 104(a)(2); LTR 20121031; H.R. Rep. No. 104-737, at 300 (1996).

[34] *See* IRC section 104(a)(2) and (c).

[35] *See* reg. section 1.104-1(c).

[36] *See* LTR 201311006.

[37] *See Domeny v. Commissioner*, T.C. Memo. 2010-9; *Parkinson v. Commissioner*, T.C. Memo. 2010-142.

[38] *See* reg. section 1.104-1(c).

[39] *See* H.R. Rep. No. 104-737, at 301 n.6 (1996) ("It is intended that the term emotional distress includes symptoms (*e.g.*, insomnia, headaches, stomach disorders) which may result from such emotional distress."). *But see Parkinson v. Commissioner*, T.C. Memo. 2010-142 (holding that "it would seem self-evident that a heart attack and its physical aftereffects constitute physical injury or sickness rather than mere subjective sensations or symptoms of emotional distress.").

[40] *See* Wood, "Taxing Emotional Distress and Physical Sickness: Chicken or Egg?" *Tax Notes*, Dec. 11, 2017, p. 1635.

[41] *See* Wood, "How IRS Taxes Fire Victims," *Forbes*, July 20, 2019.

[42] Cal. Rev. & Tax. Code section 17152.

[43] *See, e.g.*, Haw. Rev. Stat. sections 235-2.3, 235-2.4(g).

[44] Haw. Rev. Stat. section 235-51.