

# Wildfire Settlement Tax Issues Are Tricky

By Robert W. Wood

If you suffer damage or loss in a fire and collect a settlement, is it taxed? Not all insurance money or legal recoveries are tax-free, and there are numerous traps for the unwary. Fire victims may face damage or destruction of a home or a business, loss of personal property, loss of fences, barns, trees, and landscaping. They may have smoke inhalation or worsened medical conditions.

They may have temporary living expenses. Some have insurance, some do not, or not enough. How they are taxed depends on their circumstances, what they ultimately collect, and what they claim on their tax returns. Someone who just bought a \$1M house is in a different position than someone who bought their house for \$100k 30 years ago, even if both houses were worth \$1M when destroyed.

Suppose that you bought your home 30 years ago for \$100k and it's worth a \$1M today when it burns down. If PG&E pays you \$1M, you've been made whole, but you haven't come out ahead, 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. And even though you haven't made any money, the IRS says you *gained* \$900k, the difference between your tax basis and the amount you received. Your settlement money could be for a range of claims, not all about the house.

As this simple example shows, even if you are just getting *reimbursed* for the economic loss you suffered, the IRS and the California FTB see taxable income.

Many fire victims are shocked to hear that they might be taxed on money they receive after a devastating loss. There are federal and California tax bills pending that if passed, could make some fire lawsuit recoveries nontaxable. But unless both provisions pass into law, fire victims must consider their recoveries when they do their taxes.

## Insurance Money

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

If the insurance proceeds pay you for living expenses you would have *normally* incurred if your home had not been damaged (like your mortgage payment or typical food expenses), that portion may be taxable *income*. If the insurance proceeds exceed the actual amount you spend on temporary housing, food, and other living expenses, that surplus can also be taxable.

## Legal Fees

Most plaintiffs use contingent fee lawyers, and many assume that they are only responsible for the *net* money they collect after contingent fees. If you settle for \$1M, and your lawyer takes \$400k off the top, isn't your tax problem *always*

limited to \$600k? Unfortunately, just because a portion of your recovery is paid to your attorney does not mean you do not owe tax on that portion.

In 2005 in *Commissioner v. Banks*, the U.S. Supreme Court ruled that plaintiffs must include contingent fees in their gross income. In most fire cases, legal fees can be dealt with in a way so that victims do not have to pay tax on the fees, but you still should report them on your return.

There are several ways to handle the fees on your tax return. One way is as an addition to your tax basis, capitalizing the fees as part of your proceeds, much the way you would if you sold your house and paid a large sales commission. Legal fees should generally be treated pro rata, along with each element of your recovery, so an accountant or tax lawyer's help may be needed.

## What if You Don't Receive a 1099?

Most people know that if they receive a Form 1099 that reports a payment, they need to report it on their tax return. You can explain if it is not income, but you must deal with the Form 1099 on your return. But what if you do NOT receive a Form 1099? Some people assume that if there is no Form 1099, there is no income, but that's not true. Even if you do not receive the form, you *still* must consider what is income, what is capital gain, etc.

The reason Forms 1099 are usually not issued in fire cases is that the claims are mixed. Some money may be a return of your tax basis in your property. (Your basis is what you paid, plus additions like remodeling costs). Some of your settlement may be reimbursed expenses, some income, some capital gain, some money for inconvenience or even physical injuries.

Both the PGE Fire Victims Trust and Edison generally determined not to issue Forms 1099 in most cases. That maximizes your tax flexibility, but not being alerted with a form could lead you to think that just because you did *not* receive a Form 1099, you have nothing to report.

## Rebuilding

Federal and state tax law recognizes that some sales or dispositions of property were not by choice, so should be subject to more liberal tax rules. Destruction by fire is a prime example. In some cases, Section 1033 of the tax code allows you to treat insurance or lawsuit proceeds as arising from an involuntary conversion that you can reinvest into other property without paying current tax. If you qualify, you can apply your old tax basis to a replacement home, either to rebuilding costs or to a new purchase (even in another state). That means you should not need to pay tax on your gain until you sell the replacement home.

Unfortunately, like so much else in the tax law, there are numerous rules and traps for unwary victims. 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 two years after the close of the first year in which *any part* of the casualty gain is realized. Note the word "any." For casualty

gains resulting from a federally declared disaster, the period is extended to four years.

But even a four-year period can be tight if you are rebuilding in tightly controlled California. Besides, *when* the two or four-year clock starts to run is tricky. Again, note the word “any.” If your insurance company has paid you enough money to create *any* gain, even \$1 of taxable gain on your destroyed property, the clock for acquiring replacement property may already have started to run. Any gain means that your reinvestment clock may be shorter than you thought.

### **\$500,000 Home Sale Exclusion**

If your destroyed property was your primary residence, Section 121 of the tax code can reduce the gain you need to defer under section 1033. Section 121 allows an individual to sell his/her residence and to exclude from tax the first \$250,000 of the gain as an individual, or \$500,000 as a married couple. To be eligible, the home must be held as a primary residence for an aggregate of 2 of the preceding 5 years.

Even if you don’t really sell your home—if it is destroyed by fire and you collect money from insurance or from a utility, you can qualify. But you must *elect* this treatment on your tax return. If you do not make a timely election on your tax return, you are not entitled to this \$250,000 or \$500,000 tax benefit.

### **Emotional Distress**

There is still lots of confusion about the tax treatment of emotional distress damages. Damages for wrongful death or physical injuries are tax free under Section 104 of the tax code. Moreover, if you have emotional distress from one of these events, your emotional distress damages can *also* be tax free. Some fire victims had smoke inhalation or the exacerbation of a pre-existing medical condition that may qualify as tax-free damages. But plain old emotional distress—even with physical consequences such as headaches, stomachaches, etc., is not enough.

What is a physical enough injury or sickness to qualify for tax-free damages? Health problems from smoke inhalation or from the exacerbation of preexisting medical problems can be enough. Diagnosed PTSD claims may too, as there is medical evidence that PTSD is physical, not merely emotional.

### **Casualty Losses and Taxes**

Up until 2018, many 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 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. However, there can still be some careful planning and projections involved in determining whether claiming a loss is a good move. Claiming a casualty loss can backfire, requiring that you take back into ordinary income in the year of your recovery the deduction you previously claimed.

### **Conclusion**

The tax treatment of wildfire recoveries is harder to predict and more varied than most other types of litigation recoveries. Fire victims encounter complex tax issues, along

with a host of other difficult issues. They may face damage or loss of a home or business, loss of personal property, and numerous other challenges as they try to rebuild their lives.

How they are taxed depends on their circumstances and what they collect. It depends on what they do with their proceeds, what insurance money they received, and what they claim on their taxes. There are often multiple tax choices to discuss, so building in the necessary time is important.

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