Robert W. Wood
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With PG&E $13.5 Billion Fire Settlement, How Much Is Left After Taxes?

The news that PG&E agreed to a $13.5 billion fire settlement with lawyers for victims means that plaintiffs are a step closer to getting compensated. But there are conditions, including approval from the Bankruptcy Court. Even assuming that court approval comes, there are big mechanics to work out too. Most big settlements of this nature first go into a trust known as a Qualified Settlement Fund, also known as a QSF. That is a separate trust that can resolve claims from litigants and lawyers, with PG&E out of the picture. From there, individual claims need to be evaluated, and funds need to be allocated based on the claims made, their relative merit, etc. It is a complicated process. Some claims involve purely property loss, and others involve personal physical injuries or even death. Of course, there a multiple lawyer claims for fees as well.

One helpful feature of a QSF is that the money is in suspense for tax purposes. It will be beyond PG&E's control. In fact, PG&E can actually treat the payment as made to the *plaintiffs* for tax purposes at the time the money goes *into* the QSF. Yet it is not treated as *received* by the plaintiffs or their lawyers until the money is actually paid *out* of the QSF. Think of it a tax-free holding pattern. Another nice feature of a QSF is the ability to structure payments. If a lawyer or client wants money paid out over time, that can be arranged as a structured settlement. The tax treatment of the underlying award and the legal fees can be complex, and that can be helped by a QSF too. The tax picture can be complex, especially now that there is a new tax on litigation settlements. That is, many legal fees can no longer be deducted.

Some fire victims may have physical injury damages that they can exclude from their taxes. But a majority of claimants primarily have reimbursement and property damage claims. Those can involve surprisingly complex tax issues. If you lose a $1M home, but collect $1M from your insurance company or PG&E, there's no tax, right? Actually, before you can answer, you need to know about the tax basis of the property, which is usually the purchase price, plus the cost of improvements. Your property might be worth $1M when it was destroyed, but if the original purchase price plus improvements was only $100K, there is a $900K gain.

Does that mean a fire victim must pay tax on $900K? Not necessarily. If you qualify and replace your home, you can apply your old $100K tax basis to a replacement. That means you should not need to pay tax on that $900K gain until you eventually sell the *replacement* home. The replacement 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 Federal Declared Disasters, you get four years. However, if your insurance company has paid you enough to create even $1 of gain on your destroyed property, the clock for acquiring replacement property may already have started.

For victims getting a legal settlement, health problems from smoke inhalation or from the exacerbation of pre-existing medical problems can be enough for tax-free damages. Section 104 of the tax code excludes damages for personal physical injuries or physical sickness. But the damages must be physical, not merely emotional, and that can be a chicken or egg issue. For taxable proceeds, if you do not reinvest in time, you may have a big capital gain. However, up to $500K from a primary residence may be tax free for a married couple filing jointly. It isn't only the IRS that collects tax. States do too, notably California, where all income is taxed at up to 13.3%, even capital gain.

Many fire victim plaintiffs use contingent fee lawyers. Up until 2018, it was clear that legal fees were virtually always tax deductible. Now, however, many legal fees are no longer deductible. Thus, some plaintiffs may have to pay taxes on their gross recoveries, even though 40% or more is paid to their lawyer, who *also* must pay tax on the same fees. The tax treatment of the legal fees has become a major tax problem associated with many types of litigation. Fortunately, if the money can be treated as capital gain, the legal fees can often be treated as additional basis or as a selling expense. In effect, it can mean paying tax only on the net recovery. How fire victims are taxed can be confusing and nuanced, so allow time to work out the details, and be careful.

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