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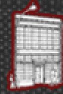
Tax Alert

Victims of California Wildfires Have Complex Tax Issues to Consider

By Robert W. Wood

How fire victims are taxed depends on their circumstances, what they ultimately collect, and what they claim on their taxes. Are they repairing or rebuilding their property, or selling and moving away, and what does their insurance cover? Another big variable is whether they sue PG&E and may eventually recover. It can all build out a complex tax picture.

The IRS (and California's notoriously tough Franchise Tax Board) require annual tax return filings, but a whole series of tax years may be peppered with fire items. Suppose that you lose a $1 million home, but collect $1 million from your insurance carrier or from PG&E. It might sound like there is nothing to tax, since you lost a $1 million home, but only got $1 million back.

However, you need to know about your tax basis in the property. That generally means the purchase price, plus the cost of subsequent improvements. If it was commercial property, you would need to factor in depreciation (and depreciation recapture). But even with personal use property like a home, your basis matters. The property might be worth $1 million when it was destroyed, but if the original purchase price plus improvements was only $100,000, there is a $900,000 gain.

Does that mean our fire victim has to pay tax on the $900,000 gain? Not necessarily. Fortunately, subject to requirements and limits, the tax law may treat this as an involuntary conversion despite the $900,000 gain. If you qualify, you can apply your old $100,000 tax basis to a replacement home. That means you should not need to pay tax on that $900,000 gain until you eventually sell the *replacement* home.

In order to defer casualty gain by reinvesting insurance or litigation proceeds, the replacement property 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 a Federal Declared Disaster, the period is extended to four years. However, if your insurance company has paid you enough money to create even $1 of taxable gain on your destroyed property, the clock for acquiring replacement property may already have started.

Another big issue is claiming a casualty loss. Up until 2018, many more taxpayers could claim casualty losses on their tax returns. However, starting in 2018 and continuing through 2025, casualty losses are allowed only if your loss was the result of a Federal Declared Disaster. Many fire victims in California qualify, since most major California wildfires are a Federal Declared Disaster. However, there can still be some careful planning and projections in determining whether claiming a loss is a good move.

How to handle expenses for temporary housing and similar expenses can be tricky. If your primary residence is damaged or destroyed, then insurance proceeds intended to compensate you for your living expenses may be partially tax-free. Examples are replacement housing and food. However, if the insurance proceeds pay you for living expenses you would have *normally* incurred if your home had not 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 be taxable.

For victims who eventually get a legal settlement or judgment, is it clear how it will be taxed? Section 104 of the tax code excludes damages for personal physical injuries or physical sickness. Health problems from smoke inhalation or from the exacerbation of pre-existing medical problems can be enough for tax-free damages. The damages must be physical, not merely emotional for money to be tax free.

If you do not reinvest, you may have a big capital gain, subject to claiming the up to $500,000 primary residence tax benefit if you qualify. If you are selling a home and qualify, the first $500,000 in gain may be tax free for a married couple filing jointly. The balance should be taxed as capital gain. When it comes to California taxes, though, remember that all income is taxed at up to 13.3 percent, so even capital gain is no bargain.

Many fire victim plaintiffs use contingent fee lawyers. Up until 2018, it was clear that legal fees were virtually always tax deductible, either above or below the line. Under the Tax Cuts and Jobs Act passed in late 2017, however, many legal fees are no longer deductible. Miscellaneous itemized deductions, which accounted for most legal fees, were repealed for 2018 through 2025 tax years.

Accordingly, in fire litigation and many other types of cases, some plaintiffs may have to pay taxes on their gross recoveries, even though 40 percent or more of their recoveries are paid to their lawyers. Of course, the lawyers must also pay tax on the fees. The tax treatment of the legal fees has become a major tax problem associated with many types of litigation.

Fortunately, though, for both federal and California income tax purposes, a capital gain reporting position can help with legal fee deductions. That is, if the litigation recovery can be treated as capital gain, the legal fees can often be treated as additional basis in the home, or as a selling expense. This can mitigate the new tax law's treatment of legal fees. In effect, it can mean paying tax only on the net recovery.

Understandably, though, most fire victims hope for a far better tax result, optimally one in which they face no tax hit at all. That is certainly possible in some cases. But it is rarely easy, and can involve some scrupulous attention to timing and details. When it comes to taxes, just as with fire, be careful out there.

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