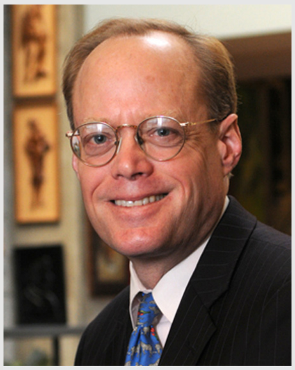
How Fire Victims Are Taxed

by Robert W. Wood



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In this article, Wood surveys many of the key tax issues facing fire victims.

This discussion is not intended as legal advice.

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Fire victims often encounter complex tax issues, along with a host of other difficult issues. They may face damage to 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 a great deal on their circumstances, what they ultimately collect, and what they claim on their taxes.

Here are some of the variables that can affect their taxes in a big way. Initial important variables are the value of the home and improvements as well as what was damaged or destroyed. Also important is the property's tax basis, including improvements. What type and amount of insurance coverage the victims have is always important, as is whether and when they receive payments from their insurance carriers.

If there are physical injuries or medical expenses, those claims raise other tax issues. Some fire victims may have health claims from smoke inhalation, exacerbation of preexisting medical problems, or post-traumatic stress disorder. The list of important variables goes on. Of course, the actions of the fire victims are relevant to taxes: For example, are they repairing or rebuilding their property, or selling their lot and moving away? Did they claim a casualty loss tax deduction on their property, and if so, when and in what amount? In California, another big variable is whether they sue Pacific Gas and Electric Co. (PG&E) and may eventually recover. If so, the interaction of those payments, and the increasingly strange ways that legal fees can be taxed, can create a complex tax picture.

In addition to the myriad facts and variations, multiple tax years are typically involved. In fact, it would be unusual for everything to be wrapped up in a single tax year. The norm would be for a series of tax years to be peppered with fire items. But remember, the IRS (and California's notoriously tough Franchise Tax Board) require annual tax return filings. Thus, fire victims can sometimes be whipsawed with gains and losses (and confusion), depending on the order of events and how they address the tax issues.

There are many misconceptions with taxes in this context. For example, it is common for fire victims to assume that if they are just being made whole for a loss, no taxes could be due. Unfortunately, it is rarely that simple. For example, suppose that you lose a $1 million home, but collect $1 million from your insurance carrier or from PG&E to build somewhere else. It might sound like there is nothing to tax, since you lost a $1 million home but got $1 million back.

Tax Basis Is Important

Before you can address whether there is really no tax issue, you would first need to know 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

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use property like a home, the basis matters. The property might have been worth $1 million when it was destroyed, but if the original purchase price, adjusted for 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 sell the *replacement* home.

Of course, you may not want to replace your home, so you might have to pay tax. To defer casualty gain by reinvesting insurance or litigation proceeds into replacement property, 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. Note the word "any."

For casualty gains resulting from a federally declared disaster, the period is extended to four years. But it is notable that 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. Again, "any" actually means any, and can start your reinvestment timeframe ticking toward the deadline.

Suppose that you engage in prolonged litigation with your insurance company for more insurance proceeds, perhaps alleging bad faith. Alternatively, or in addition, suppose that you are litigating with PG&E about its responsibilities. In either case, the two- or four-year clock to be able to reinvest could run out before the litigation concludes and you are able to purchase your replacement home.

Casualty Losses

Another big issue can be claiming a casualty loss. Some homeowners might assume that this tax write-off is worth a lot, so they should claim it. Up until 2018, many more 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 there were major changes made by the tax reform law passed in late 2017.

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.

How to handle expenses for temporary housing and similar expenses can also 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 include replacement housing and food. Some people might assume that payments for such items are not taxable, not even in part. That would seem only fair.

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 your temporary housing, food, and other living expenses, that surplus can be taxable, too. All in all, you might feel that you need a full-time CPA, and that is before we even broach the topic of fire litigation.

Fire Litigation?

For victims who eventually get a legal settlement or judgment, is it clear how it will be taxed? You probably already know the answer. First, as with most litigation, from a pure tax viewpoint it is almost always better to settle a case rather than have a judgment rendered. With a judgment, you often cannot control the tax language, whether the payment can be attributed to specific items that might help on taxes, or how Form 1099 reporting will be handled, for example.

With a judgment, you have no control over allocations to particular types of damages. You cannot even allocate between compensatory and

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punitive damages. Punitive damages are always taxed as ordinary income, and there is generally no offset or deduction for legal fees under the new tax law. With a settlement, you can often mitigate the punitive damage point, even after trial.

More generally, in a settlement, one can often help to position the plaintiff with subtle references that help on taxes, even in recitals. It is often possible to persuade defendants to include specific tax language and allocations as long as there is no cost to them. You may also be able to call out specific dollar amounts (for example, for physical injuries or physical sickness).

If you are not trying to (or are unable to) reinvest all the proceeds in other property, the plaintiff is likely to hope that anything that is taxable is taxed as capital gain, not ordinary income. Capital gain treatment will not save on California taxes, where everything is taxed at ordinary income rates. However, it should save on federal taxes. Thus, language in legal settlement agreements is often used to try to steer a recovery toward tax-free or capital gain treatment. One can also try to minimize adverse Form 1099 reporting.

In fire litigation, as in other contexts, settlement agreement language and how Forms 1099 are handled can be important. Of course, it is important for both lawyers and clients to understand that tax language in settlement agreements does *not* bind the IRS or state tax authorities, no matter how convincing it might sound. Even so, it is surprising how often in an audit the tax authorities do pay attention to settlement agreement language. It can help materially.

Best Tax Treatment?

As this article suggests, it is quite difficult to summarize the tax treatment that fire victims can expect. There are huge variations, and even issue spotting can be hard. Understandably, however, some fire victims — particularly fire victim plaintiffs — ask about the best tax treatment they can hope to achieve.

There is no perfect answer, and many recoveries have multiple elements taxed in different ways. In that sense, the "best" tax treatment, if there is one, is probably a mix of several elements of the case. If there is a decent claim to at least some physical injury or sickness damages, many plaintiffs might say that tax-free treatment would be the ultimate goal. There is no restriction on the use of the money, and tax-free money is hard to beat.

Section 104 excludes damages for personal physical injuries or physical sickness. The damages must be physical — not merely emotional — for the money to be tax free. Many plaintiffs struggle with a chicken-or-egg issue about what comes first.[1] However, emotional distress damages that are connected to physical injuries or physical sickness damages are also entitled to tax-free treatment. Thus, once you have a qualifying physical injury or sickness, all the damages may be tax free, even though most of the damages may really be for emotional distress.

What is physical enough to qualify? Health problems from smoke inhalation or from the exacerbation of preexisting medical problems can be enough on appropriate facts. Moreover, a diagnosis of PTSD and the appropriate assertions of PTSD claims might also be enough. There is now reliable medical evidence that PTSD is physical, not merely some kind of emotional distress.[2]

In many fire cases, of course, there may be no claim of physical injuries or physical sickness. In such cases, a common goal would be to have money for damage or destruction of a home treated as capital gain.

If the building was your personal residence and resulted in a gain, then you may be able to first claim the up to $500,000 primary residence tax benefit if you qualify. Then, you may be able to defer gain recognition on the balance if you reinvest the proceeds and the transaction qualifies as an involuntary conversion. If involuntary conversion treatment is not available, then the balance should be taxed as capital gain. If you pay California taxes, though, remember that all income is taxed at the same rates, so even capital gain is no bargain.

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

[2] *See* Wood, "Taxing Post-Traumatic Stress Disorder," *Tax Notes*, July 7, 2014, p. 89; Wood, "New Tax on Litigation Settlements, No Deduction for Legal Fees," *Tax Notes*, Mar. 6, 2017, p. 1297.

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Attorney Fee Tax Treatment

What about legal fees? Many fire victim plaintiffs use contingent fee lawyers. Up until 2018, it was clear that legal fees were almost always tax deductible, either above or below the line. Under the Tax Cuts and Jobs Act, however, many legal fees are no longer deductible.[3] Miscellaneous itemized deductions, which accounted for most legal fees, were repealed for 2018 through 2025 tax years.

Thus, 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, and we can expect many future tax cases dealing with legal fees.

Fortunately, however, 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. If the gain is deferred because the recovery is treated as an involuntary conversion, then the legal fees might similarly offset the proceeds on the conversion. This can mitigate the new tax law's treatment of legal fees. In effect, it can mean paying tax only on the net recovery (which seems only fair).

This survey has just scratched the surface of the tax issues faced by fire victims. The facts, legal claims, timing, and numbers matter. In a large sense, fire victims deserve our sympathy, and that is also true when it comes to taxes.

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[3] *See* Wood, "New Tax on Litigation Settlements, No Deduction for Legal Fees," *Tax Notes*, Mar. 5, 2018, p. 1387.

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