Federal Legislation Makes Wildfire Settlements Retroactively Tax Free

by Robert W. Wood and Alex Z. Brown

Robert W. Wood

Alex Z. Brown

Robert W. Wood and Alex Z. Brown practice law with Wood LLP (www.WoodLLP.com), and Wood is the author of *Taxation of Damage Awards and Settlement Payments* (www.TaxInstitute.com).

In this article, Wood and Brown examine the Federal Disaster Tax Relief Act of 2023 and how it can help those affected by recent wildfires.

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Tax relief for wildfire victims has been a hot topic. In 2024, when a larger tax bill with wildfire tax relief seemed poised to fail in the Senate (as it eventually did),[1] the House passed in May a stand-alone bill, H.R. 5863, the Federal Disaster Tax Relief Act of 2023, that contained only the disaster relief provisions. As its name suggests, H.R. 5863 was first introduced in October 2023.

However, its disaster relief provisions were amalgamated into the larger omnibus tax legislation in 2024, and H.R. 5863 was moved to the back burner while Congress focused on trying to pass the larger tax bill. That started to change when it became clearer in April and May that the larger tax bill contained provisions that seriously threatened its chances of making it through the Senate, and the change was effectively made permanent when the larger omnibus bill failed to overcome a cloture vote in August.

Presumably to give the Senate a different avenue for providing disaster tax relief should the larger tax bill fail, H.R. 5863 passed the House in May by a large margin, 382 in favor and only seven against. Consequently, the Senate had H.R. 5863 teed up for passage once the fate of the larger tax bill and then the competing priorities created by the federal elections had been resolved. With those competing concerns behind it, the Senate finally passed H.R. 5863 as well on December 4, 2024, by unanimous voice vote. On December 12, 2024, President Biden signed the bill into law.

California's devastating wildfires have included the 2015 Butte Fire, the 2017 North Bay Fires, the 2017 Thomas Fire, the 2018 Mendocino Complex Fire, the 2018 Woolsey Fire, the 2019 Kincade Fire, the 2018 Camp Fire, the 2020 Zogg Fire, the 2020 August Complex Fire, the 2021 Dixie Fire, and the recent fires in Los Angeles. There have also been large wildfires recently in Washington, Kansas, Oklahoma, Tennessee, Montana, Arizona, Wyoming, Oregon, New Mexico, Hawaii, and Virginia.

In many cases, federal tax law provisions meant to help victims of disasters have been unhelpful or incomplete. This is especially true for taxpayers whose recoveries consist of two or more sources: for example, insurance payouts plus

[1] *See* H.R. 7024, Tax Relief for American Families and Workers Act of 2024.

litigation proceeds from a utility alleged to have caused the wildfires. The core provision in the tax code's disaster relief rules is arguably section 1033, which allows taxpayers to defer gain on casualty recoveries by reinvesting the gain into the repair or replacement of the damaged property.

However, there are strict time limits on when proceeds must be reinvested to qualify for deferral. The longest replacement period under section 1033, which applies to principal residences destroyed in federally declared disasters, requires that the taxpayer reinvest the deferred gain by the end of the four-year period that begins on December 31 of the first year the taxpayer recognized casualty gain from the disaster.[2]

What that means for many wildfire victims is that any insurance proceeds they received in the years immediately following their wildfires could trigger the end of their replacement periods under section 1033 before they receive a penny of their litigation recoveries from the utility companies. For example, a victim of the 2015 Butte Fire in California (a federally declared disaster[3]) may have received insurance proceeds in 2016 that first triggered casualty gain from the wildfire. Therefore, if the destroyed property was their principal residence, their replacement period under section 1033 ended December 31, 2020.

That same wildfire victim may have also sought reimbursement from their utility company, PG&E in this hypothetical, for the damage caused by the fire that was not covered by insurance. For victims of the 2015 Butte Fire, the claims against PG&E would be resolved through the Fire Victim Trust (FVT) established as part of PG&E's bankruptcy proceedings. However, by December 31, 2020, the FVT had not yet made any distributions to wildfire claimants regarding their claims against PG&E.[4]

Indeed, the special master who oversees the FVT was not appointed until December 2, 2020.[5] The first pro rata distribution from the FVT, which would pay claimants only 30 percent of the amounts they had been awarded, was not announced until March 12, 2021. Even now, claimants have only been paid 70 percent of their awards, meaning 30 percent of each award has not yet been paid.[6] For a wildfire victim in this situation, the section 1033 election provisions in the federal tax code were entirely inadequate to help them to avoid owing tax on the wildfire recovery payments eventually received from the FVT that they would need for repairing or replacing their damaged property.

Moreover, the four-year replacement period in this example is the longest replacement period under section 1033. What if the wildfire was *not* a federally declared disaster (and was, for example, merely a state-declared disaster), or if the property was not the taxpayer's principal residence but was instead their farm, business, or vacation home? In either case, the replacement period under section 1033 ends two years (not four) from December 31 of the first year in which the taxpayer recognizes a single dollar of casualty gain related to the same casualty.[7]

Therefore, our hypothetical 2015 Butte Fire victim would only have had until December 31, 2018, nearly two years before the FVT was even formed, to defer gain related to any portion of their property not used as their principal residence (for example, the portion they use for their family's farming activities).

In states with an income tax, victims must deal with state and federal taxes. In response to the gaps and failures in federal tax relief highlighted by recent wildfire victims, California added four temporary provisions to the California Revenue and Taxation Code that exclude from California income tax amounts received in connection with *seven* of the California wildfires (the 2015 Butte Fire (if the recovery is received from the FVT),[8] the 2017 North Bay Fires (if the recovery is received from the FVT),[9] the 2017 Thomas Fire,[10] the 2018

[2] Section 1033(h)(1)(B).

[3] FEMA, "DR-4240-CA, California Valley Fire and Butte Fire" (Sept. 22, 2015).

[4] *See* Fire Victim Trust, "Timeline."

[5] *See id.*

[6] *See id.*

[7] *See* section 1033(a)(2)(B)(i).

[8] Cal. Rev. & Tax. Code section 17138.5.

[9] *Id.*

[10] Cal. Rev. & Tax. Code section 17138.6.

Camp Fire (if the recovery is received from the FVT),[11] the 2018 Woolsey Fire,[12] the 2019 Kincade Fire,[13] and the 2020 Zogg Fire[14]). Four corresponding exclusions were added to California's corporate tax provisions.[15] This state-level relief is limited to the specific fires covered by the legislation and applies only for California income tax, not for federal income tax or any income tax of another state.

Federal Tax Law Finally Passes

But, at last, a new federal tax bill provides its own temporary exclusion for many wildfire recoveries. The new temporary provision excludes from *individuals'* gross income for federal income tax purposes all amounts received "as compensation for losses, expenses, or damages" in connection with a qualified wildfire disaster.[16] Damages can include, but are not limited to, amounts received "by or on behalf of an individual" for additional living expenses, lost wages (except when paid by the employer), personal injury, death, or emotional distress.[17]

A qualified wildfire disaster is any "federally declared disaster" declared after December 31, 2014, resulting from "any forest or range fire."[18] The only major carveout of the exclusion is that an amount cannot be excluded "to the extent" the taxpayer has already been compensated for the loss or expense by another source, say through insurance.[19] In most wildfire recoveries the authors have seen involving litigation or other claims against an insurer, utility company, or the FVT, the calculation of the claimed damages by the plaintiffs accounted for any previously received insurance proceeds for the same damages.

Thus, the victim reduced the amount claimed against the utility company by the amount of insurance proceeds they already received. Indeed, the claims questionnaires required to be used by the FVT for the purpose of determining a claimant's award require claimants to identify and offset their claimed damages by any previously received insurance proceeds for the same claim. Wildfire victims whose claims take into account previously received insurance proceeds did not receive a double recovery.

Therefore, we would not expect wildfire victims who have accounted for insurance proceeds to lose their tax exclusion on account of the "to the extent" language in section 3(b)(1) of H.R. 5863, a topic we address below. However, if a wildfire claimant did *not* clearly factor their previously received insurance proceeds into the calculation of their claimed damages against a later defendant, the claimant may be at risk for not being able to exclude all of their subsequent recovery to the extent the IRS or a court concludes that the subsequent recovery compensates the wildfire claimant for the same portion of their damages for which they had already been reimbursed via insurance proceeds.

The new law includes a few technical provisions that are designed to prevent taxpayers from getting a double tax benefit from the exclusion.[20] One provision is analogous to the section 1033 election rules — chiefly, that if the taxpayer reinvests the excluded payment into the repair or replacement of the damaged property (or into the purchase of any other property), the taxpayer doesn't get to add the excluded amount to their tax basis of the property that was repaired or purchased.[21] The taxpayer also can't claim a tax credit or deduction to the extent the expense generating the credit or deduction was made using funds that were excluded from the taxpayer's income under the new wildfire exclusion.[22]

[11] Cal. Rev. & Tax. Code section 17138.5.

[12] Cal. Rev. & Tax. Code section 17138.6.

[13] Cal. Rev. & Tax. Code section 17139.2.

[14] Cal. Rev. & Tax. Code section 17139.3.

[15] Cal. Rev. & Tax. Code sections 24309.1, 24309.2, 24309.6, and 24309.7.

[16] Section 3(a) and (b)(1), H.R. 5863.

[17] Section 3(b)(1), H.R. 5863.

[18] Section 3(b)(2), H.R. 5863.

[19] Section 3(b)(1), H.R. 5863.

[20] Section 3(c), H.R. 5863.

[21] Section 3(c)(2), H.R. 5863.

[22] Section 3(c)(1), H.R. 5863.

Not All Fires Qualify

The new exclusion does not apply to all fire victims, nor does it apply to all fires. For example, the exclusion applies only to federally declared disasters that are wildfires.[23] Whether a wildfire is a federally declared disaster is usually decided by the Federal Emergency Management Agency, and generally it is rather cut-and-dry whether a wildfire has been formally declared a federal disaster. Plainly, any fire is devastating to the victim whose home is destroyed by it, regardless of whether the fire was a wildfire, as opposed to an electrical or grease fire, or whether the wildfire was a federally declared disaster.

However, a wildfire or other disaster is only supposed to be designated as a federal disaster if the damage is severe enough that it is beyond the combined capabilities of the state and local authorities and disaster relief organizations to respond to the disaster without federal assistance.[24] Thus, many wildfires that destroy tens or hundreds of properties (rather than *thousands* of properties) do not qualify to be designated as federal disasters. For example, the Mountain View Fire of 2020 in California burned for nearly a month over more than 32 square miles, destroying 80 buildings (damaging many more), and killing at least one person.[25]

As devastating as the Mountain View Fire surely was to the people who lived there, the wildfire was not large enough for FEMA to consider it outside of the combined capability of the California state and local governments and relief organizations to address without federal involvement. Thus, the Mountain View Fire was designated by California as a state disaster[26] but was never designated as a federal disaster.

It is typical for any law to have some provisions that are ambiguous, but the requirement that the wildfire be a federally declared disaster designated on or after December 31, 2014, seems difficult to avoid if the wildfire at issue was not declared a federal disaster. Wildfire victims who do not satisfy that requirement for the exclusion likely must rely on the existing methods under the tax law for minimizing or deferring their federal income tax on wildfire recoveries.

Limited Number of Tax Years

The exclusion is not a permanent addition to the tax code and applies only to payments received in tax years beginning after December 31, 2019, and before January 1, 2026.[27] Because most individuals report their tax using the calendar year, that effectively means any qualifying payments received in 2020-2025.

Taxpayers who are still in litigation over their wildfire damages or mired in settlement negotiations could lose out on the exclusion if these disputes are not resolved, and the recovery paid, by the end of 2026. Wildfire victims who are being paid in installments, such as FVT claimants in California who have to date only been paid 70 percent of their awards, may also lose out on the exemption for any distributions made in 2026 or later. Because this limitation originates from the text of the legislation, it would take another act of Congress to extend the exclusion beyond payments received in 2025 or to make the exclusion permanent.

Deadlines for Amending Tax Returns

Taxpayers may amend their previously filed tax returns affected by the new legislation to claim a refund on federal tax they paid on recoveries that are now retroactively excludable. Under the standard rule for claiming a tax refund, taxpayers have only three years from the date their original tax return was filed to claim a refund by filing an amended return.[28]

Any tax return filed before the original filing due date (usually April 15, unless it falls on a weekend) is considered filed on the filing due date.[29] Tax returns filed after the standard due date, on account of an extension or on account of simply being filed late, are considered as filed on

[23] Section 3(b)(2), H.R. 5863.

[24] *See* FEMA, "How a Disaster Gets Declared" (last updated July 22, 2024). *See also* 42 U.S.C. section 5122.

[25] *See* Mono County Office of Emergency Management, "Mono County Mountain View Fire."

[26] *See* Gov. Gavin Newsom, "Proclamation of a State of Emergency" (Nov. 18, 2020).

[27] Section 3(d), H.R. 5863.

[28] Section 6511(a).

[29] Section 6513(a).

the date they were actually filed.[30] Applying those rules, it might appear that tax relief is not possible for 2020 because 2020 tax returns were due to be filed in 2021, so the three-year statute of limitations for claiming a refund already passed.

Applying the standard three-year rule, it would also appear that taxpayers will need to rush to amend their 2021 tax returns in the coming months. Under the regular three-year rule, the statute of limitations for claiming a tax refund for 2021 would expire as early as April 18, 2025, just a few months from now. However, we appear to avoid this rather chaotic situation for both 2020 and 2021 amendments.

To address that timing issue, H.R. 5863 contains language providing that the statute of limitations for filing a refund related to H.R. 5863 will not end any earlier than one year from the date H.R. 5863 is enacted.[31] Taxpayers should have until December 2025 to claim refunds in connection with the new exclusion related to their 2020 and 2021 reporting, even though they ordinarily would not be able to wait so long under the regular three-year rule.

The regular three-year deadline for claiming a refund for 2022-2025 will already fall after the end of the one-year grace period in December 2025. It therefore seems likely that the deadline for filing amended returns for the later years will be governed by the regular three-year rule. Taxpayers and their tax advisers should be mindful of these deadlines for claiming refunds. Delaying preparing and submitting amended reporting, especially for 2020 and 2021, could easily put a taxpayer beyond the statute of limitations for claiming a refund.

State Conformity?

Most states with income tax provisions piggyback on federal tax law for their own state income tax laws, subject to modifications the states may make to the federal provisions for the purposes of their state income tax rules. Whether and how states conform to changes in federal tax law varies by state. Therefore, taxpayers should not assume that the new law necessarily means their previous recoveries are now tax free for state law purposes, too. Some states will likely clarify whether they intend to conform to the new federal exclusion.

The new provision may also streamline state efforts to provide relief to wildfire victims. Rather than add exclusions on a fire-by-fire basis as California did, a state could simply conform to the new federal exclusion, which is not limited to any specific wildfire. That would avoid the state having to repeatedly add new exclusions every time there is a new wildfire, as California currently faces, leaving the victims of those wildfires in a tax limbo waiting to see if their wildfire makes the list.

The streamlined approach would still require that the wildfire be a federally declared disaster to qualify. States would still need to find a mechanism to address this potential mismatch, assuming they would also want the exclusion to apply to state-designated disasters for state income tax purposes, but that seems relatively easily done. For example, the state could conform to the new federal exclusion, but provide that for the state's income tax purposes, the exclusion also includes state-designated disasters.

Tax Questions Remain

Without question, the new exclusion is profoundly helpful to many wildfire victims. However, there are a few terms and provisions in the legislation on which taxpayers could significantly benefit from IRS guidance. It would be helpful if the IRS could clarify who is considered an "individual" for the purpose of the exclusion.[32]

Typically, for tax purposes, an individual is considered a natural person rather than an entity.[33] However, some entity types are disregarded from their owners for tax purposes, so payments to the disregarded entities are treated for tax purposes as if they were paid to the

[30] *Id.* ("For purposes of this subsection, the last day prescribed for filing the return or paying the tax shall be determined without regard to any extension of time granted the taxpayer.").

[31] Section 3(e)(1), H.R. 5863.

[32] *See* section 3(a), H.R. 5863 ("For purposes of the Internal Revenue Code of 1986, gross income shall not include any amount received *by an individual*, as a qualified wildfire relief payment" (emphasis added).).

[33] *See, e.g.*, sections 1(a) (imposing income tax on married "individuals") and 7701(a)(1) (defining "person" for income tax purposes to include "an individual, a trust, estate, partnership, association, company or corporation").

entities' owners directly. One example is a single-member LLC (unless electing otherwise).[34] Another is a grantor trust.[35]

Amounts paid to those types of entirely transparent entities should qualify for exclusion to the extent the entity is owned by one or more individuals. The exclusion would be claimed on the individual income tax returns of the owner, who is treated as directly receiving the recovery for income tax purposes.

Property Owned Through Tax Partnerships

However, many properties are owned through entities that are not quite so transparent for tax purposes, even though their income may flow through to individual owners or beneficiaries. For example, families might own their homes and properties through family partnerships, especially when the properties are used for farming and other family-run agricultural businesses whose profits are split among multiple family members.

A partnership is not an individual, but many individuals are partners. Of course, income tax is not imposed on a partnership but rather on its partners: "A partnership as such shall not be subject to the income tax imposed by this chapter. Persons carrying on business as partners shall be liable for income tax only in their separate *or individual* capacities" (emphasis added).[36] The tax code specifically imposes tax on partnership income on individual partners in their individual capacities.

That might suggest that partners can claim the exclusion under H.R. 5863 in connection with their tax allocations of an otherwise qualifying wildfire relief payment received by their partnerships. However, there are possible counterarguments that suggest individual partners fall outside of the exclusion vis-à-vis their allocations of wildfire recovery payments received by their partnerships. The quoted language above from section 701 provides that the individual partners will be liable for the income tax on the partnership's income.

However, being liable for another taxpayer's income tax is not necessarily the same as actually or constructively receiving funds or assets received by the other taxpayer. Subchapter K generally distinguishes between property held directly by a partner and property held by the partnership itself.[37] If H.R. 5863 had instead provided that the new tax exclusion applies to any amount taxable to an individual, it would be much easier to say that partners qualify to claim the exclusion for their allocations of partnership income. Clearly, the partners are taxable on the partnership income under subchapter K of the tax code.

Instead, however, H.R. 5863 requires that the qualified wildfire relief payment be "received by" an individual.[38] H.R. 5863's definition of a qualified wildfire relief payment is somewhat broader, and it includes both amounts received by an individual and amounts received "on behalf of" an individual.[39]

Perhaps the IRS or a court could come out either way, especially given the humanitarian purposes of H.R. 5863. However, compared with the context of disregarded entities and grantor trusts, it might be a heavier lift to say that an individual partner actually or constructively has "received" a recovery paid to their partnership that is retained by the partnership to repair or replace partnership property.

Section 3(b)(1) might be read to support the position that it may be sufficient if an otherwise qualifying relief payment were received on behalf of an individual, even if the taxpayer receiving the payment on behalf of an individual taxpayer is not an individual. But even under that broader reading of the exclusion, it is not clear that a partnership can necessarily be said to receive a wildfire recovery solely on behalf of its partners. A partnership that pursues its own claims for damage to its own property, and that retains the proceeds to repair or replace its own damaged property, may be considered as pursuing its own claims in its own right, rather than merely acting as an agent for its partners, who do not directly

[34] *See* reg. section 301.7701-2(c)(2).

[35] *See* section 671.

[36] Section 701.

[37] *Compare* section 722 *with* section 723; *see* sections 732-734.

[38] Section 3(a), H.R. 5863.

[39] Section 3(b)(1), H.R. 5863.

own the damaged property. Given the uncertainty in this context, IRS guidance clarifying the application of the new exclusion to individual partners of tax partnerships would be appreciated.

Property Owned Through Non-Grantor Trusts

Some families put their properties in non-grantor trusts for the benefit of their children or other relatives for estate planning (and probate avoidance) purposes. Owning family property through a trust (including a non-grantor trust) can help avoid having to divide a single property among several children for legal ownership or to avoid having to re-record ownership of the property with the county recorder every time there is a change in ownership (for example, every time a family member dies or is added as a beneficiary of the trust).

For tax purposes, a non-grantor trust is not an individual. However, non-grantor trusts are often either required to, or have the discretion to, distribute their "distributable net income" to their beneficiaries in the same year the income is received by the trust. Distributable net income is essentially the new income received by the trust during the year, net of expenses and exemptions that can be claimed by the trust to offset that income.[40]

That usually allows the trust to claim a tax deduction for the income distribution, which is intended to offset the trust's income.[41] That mechanism results in a non-grantor trust usually not owing income tax on any distributable net income it receives that it distributes to its beneficiaries in the same year. The tax rules that apply to non-grantor trusts are complex, so this discussion of the relevant rules should be considered a simplified discussion intended to highlight concepts relevant to H.R. 5863's tax exclusion.

When distributable net income is distributed by a non-grantor trust to its beneficiaries, sections 652 and 662 generally require the beneficiaries to treat the distribution as their income on their tax returns. Moreover, sections 652(b) and 662(b) provide that the income distribution from the trust will have the same character in the hands of the beneficiary as it had in the hands of the trust. Effectively, this mechanism creates a tax result for the trust and its beneficiaries that is similar to the flow-through taxation rules that apply to tax partnerships.

Like individual partners in tax partnerships, the beneficiaries of a non-grantor trust, who are often individuals, may reasonably want to know if they can claim the new exclusion in connection with their receipt of their non-grantor trust's distribution of the net taxable portion of any otherwise qualifying wildfire recovery.

Of course, that would require that the trust timely distribute some or all of the wildfire recovery to its beneficiaries. Because H.R. 5863 is being enacted so late into the 2020-2025 exclusion period it creates, it appears to be too late for a non-grantor trust to retroactively make a distribution of distributable net income in connection with an otherwise qualifying wildfire recovery payment for 2020-2023. If a non-grantor trust does not make a distribution of distributable net income in the same year, the income is taxable on the trust's tax return for the year *without* the offsetting deduction. That means the trust (which is not an individual) would pay tax on the income.

Once the trust has paid tax on the distributable net income, unless an exception applies, any future distribution of the net income (on which the trust has already paid tax) should be tax free to the beneficiaries.[42] Therefore, distributing income in a subsequent year would not allow the trust to claim a tax deduction that offsets the trust's income tax liability generated by the income.

Effectively, then, this issue likely only applies to non-grantor trusts that did happen to make distributions of distributable net income in 2020-2023 in connection with their wildfire recoveries, and to wildfire recoveries received by non-grantor trusts in 2024 or 2025 that may yet still choose to make distributions of distributable net income that effectively shift the tax on the wildfire recovery from the trust to its individual beneficiaries.

[40] *See* section 643.

[41] *See* sections 651 and 661.

[42] *See* section 662.

Even if this solution for non-grantor trusts is shown to be plausible, how would the distributed money then get back into the trust so it can be used to rebuild or replace the damaged property? Presumably the beneficiaries would need to contribute or loan the distributed proceeds back to the trust so the trust could use the funds to repair or replace the damaged property.

A distribution followed by an immediate contribution or loan by the individual owners could raise the specter of several IRS tax doctrines, such as the substance-over-form rule or the step transaction doctrine. Therefore, it would seem safer from a tax perspective for the individual beneficiaries to retain the distributed funds from the wildfire recovery and for the trust to find other, internal sources of funds to make repair and replacement efforts. Alternatively, the trust could choose not to distribute any of the wildfire recovery to its beneficiaries and instead rely on the traditional approaches, like section 1033 elections, to minimize and defer the resulting income tax.

Tax Benefit Rule

The tax benefit rule was created by the Tax Court more than 80 years ago,[43] and it has since been codified into section 111.[44] It can be a frustrating exception to an otherwise tax-efficient result. You generally cannot claim a deduction or a loss for an amount for which you have been reimbursed.[45] If someone has already reimbursed you for an expense you fronted, you have already been made whole. Economically, they, and not you, were the taxpayer that ultimately paid the expense.

If you are reimbursed before you file your tax return for the relevant year, the solution is simple. You simply do not claim a deduction or a loss for the reimbursed expense. But the situation gets more complicated if you are reimbursed for a loss or a payment after you have already filed your tax return claiming a deduction or loss. You might think you should amend the prior return to reduce the deduction or loss by the amount that has subsequently been reimbursed, but in practice that introduces a whole host of complications.

For example, what if the original return is beyond the statute of limitations? Section 6511's statute of limitations formally applies only to amending tax returns that claim a tax refund. There is not formally any federal statute of limitations for amending a tax return that reports additional tax owed.

But even the IRS may not be keen on amending very old returns even if the amended return reports additional tax owed. Anecdotally, we have had especially diligent clients insist on filing an amended return to correct a mistake they made more than six years earlier. They have submitted payment for all additional tax owed plus interest and a self-imposed accuracy-related penalty. Yet in some cases, the IRS has refused to accept the amended return and returned the client's check.

The statute of limitations also complicates the IRS's ability to review and audit an amended return filed for an old tax year. The IRS's statute of limitations for auditing a specific tax year is based on the filing of the taxpayer's original tax return for that year.[46] In most cases, filing an amended tax return does not extend or restart the statute of limitations for the IRS to audit the tax year. An exception to this is if the amended return is filed in the last 60 days of the regular three-year statute of limitations, in which case filing the amended return extends the statute of limitations for that year until 60 days from the date the amended return is filed.[47]

Addressing the previous tax deduction through amendment could also have spillover effects into other tax years, requiring the amendment of returns for multiple tax years. Although a deduction may be claimed in one year, it may not be entirely applied in the same year to offset income. If any unused portion of the deduction creates or is added to a net operating loss, that NOL could carry forward for multiple

[43] *See, e.g.*, *Dobson v. Commissioner*, 320 U.S. 489 (1943).

[44] *See also*, Rev. Rul. 2019-11, 2019-17 IRB 1041; Rev. Rul. 93-75, 1993-2 C.B. 63.

[45] *See, e.g.*, section 165(a) (only allowing deductions for losses "sustained during the taxable year and not compensated for by insurance or otherwise").

[46] *See* section 6501(a).

[47] *See* section 6501(c)(7).

tax years until all of the original deduction was actually applied to offset income.[48]

A taxpayer's amending of their previous return to remove the deduction could therefore require the amendment of returns for multiple years to fully remove the tax benefit created by the deduction. Amending the previous return could also create inequitable results for taxpayers, depending on how much later their deducted expense was reimbursed. This is because tax liabilities accrue interest that must be paid in addition to the principal tax liability.

Therefore, a taxpayer whose deducted expense was unexpectedly reimbursed 20 years later may owe significantly more interest if they amend their return to remove the deduction than a taxpayer with a deducted expense of the same amount that was reimbursed just one year later. Taxpayers are not necessarily in control of when they are reimbursed or compensated for losses or expenses they incur. The interest charge that would apply if this situation was addressed by amending the return that originally claimed the now-reimbursed deduction or loss would arguably penalize taxpayers for a third party's delay in reimbursing the taxpayer, not for any mistake made by the taxpayer.

To obviate those complications and undesirable results, the tax benefit rule provides that if you are reimbursed for an expense or loss that you already deducted or claimed as a loss in a previous year's tax return, you are not allowed to go back and amend the return where you originally claimed the deduction or loss.[49] Instead, you must treat the reimbursement as taxable income in the current year to the extent the previous deduction or loss you claimed actually reduced the tax you owed (that is, to the extent you obtained a "tax benefit" from the deduction or loss).[50] By treating the otherwise tax-free reimbursement as taxable income, you are effectively reimbursing the U.S. treasury for the tax savings produced by the previous deduction.

[48] *See*, *e.g.*, section 172(b).

[49] *Lexmont Corp. v. Commissioner*, 20 T.C. 185 (1953); *Harbor Building Trust v. Commissioner*, 16 T.C. 1321 (1951); *Faidley v. Commissioner*, 8 T.C. 1170 (1947).

[50] *See* section 111.

After a wildfire, many affected taxpayers claim casualty loss deductions.[51] Indeed, a major component of many disaster relief tax provisions is to extend and create incentives for disaster victims to claim casualty loss deductions that can, in the short term at least, reduce their tax liabilities to keep more money in their pockets for living expenses, medical care, and repair efforts.[52]

A taxpayer is not supposed to claim a casualty loss deduction to the extent they expect to later receive reimbursement for the loss through anticipated insurance or litigation proceeds.[53] However, a casualty loss is usually claimed in the tax return for the year of the wildfire or other casualty. Many wildfire victims and their tax preparers are understandably not very optimistic about the insurance or litigation recoveries they may potentially receive years later, and assigning a value to future anticipated reimbursements necessarily involves a fair degree of estimation, if not speculation.

Many wildfire victims eventually receive insurance or litigation recoveries exceeding the amount they estimated they would receive when they claimed casualty loss deductions. Thus, their later recoveries may compensate them, at least in part, for a loss that the taxpayer previously deducted as part of their casualty loss deduction. When a wildfire victim receives a recovery that compensates them for amounts for which they already claimed a casualty loss deduction, there is a conflict between H.R. 5863's tax exclusion and the tax benefit rule.[54]

The new exclusion states that a qualifying fire recovery should be excludable from gross income, as long as it has not already been reimbursed. However, section 111 and the tax benefit rule

[51] *See* section 165(h).

[52] *See* section 165(h)(5).

[53] *See* section 165(i)(3) (limiting disaster loss deduction to "uncompensated" loss); Form 4684, "Casualties and Thefts," section A, line 3 (requiring taxpayers to subtract insurance or other reimbursements from the calculation of their casualty loss deduction); reg. section 1.165-1(c)(4) (requiring that taxpayers make "proper adjustment" to their claimed losses for "salvage value and for any insurance or other compensation received"). *See also Dunne v. Commissioner*, 29 B.T.A. 1109 (1934), *aff'd*, 75 F.2d 255 (2d Cir. 1935).

[54] *See*, *e.g.*, Rev. Rul. 74-206, 1974-1 C.B. 198 (ruling that tax benefit rule takes precedence over section 1033 deferral provisions when taxpayer later receives recovery related to involuntary conversion that compensates taxpayer for loss taxpayer previously deducted as a casualty loss).

provide that even if a payment is otherwise tax free, you must treat it as taxable income to the extent it compensates or reimburses you for a loss that you have already deducted to the extent you obtained a tax benefit from the deduction.

Which one wins out in the conflict? H.R. 5863 is silent on the issue, and it is difficult to infer Congress's intent based on the language of the statute. The exclusion language is broad. However, H.R. 5863 contains multiple provisions that are clearly intended to prevent taxpayers from obtaining any unfair or "double" benefit from the exclusion.

For example, the exclusion does not apply to any losses for which the taxpayer has already received reimbursement through insurance or otherwise.[55] H.R. 5863 also does not allow taxpayers to deduct, claim a credit for, capitalize or otherwise obtain a "double benefit" from the reinvestment of funds that are subject to the exclusion.[56] These provisions clearly suggest that Congress did not want taxpayers to obtain double benefits from the new exclusion.

Being able to claim a casualty loss (and reduce your tax liability) for an amount that is later reimbursed tax free is arguably a double benefit. In effect, it would penalize taxpayers whose original calculations of their casualty loss deductions were more accurate. It would effectively reward taxpayers who were less accurate in their estimations of future reimbursements by allowing them a larger than appropriate casualty loss deduction and a fully excludable recovery payment.

That seems an unfair result for taxpayers whose casualty loss deductions were calculated more accurately. That suggests the tax benefit rule is likely to be an exception to the new exclusion because it already serves as an exception to most other exclusions from gross income and income deferral provisions, even those intended specifically to help victims of thefts, disasters, and other involuntary conversions.[57] Perhaps the IRS will provide its view on this point when it issues guidance.

As the examples illustrate, there are still several topics on which IRS guidance could provide taxpayers additional peace of mind. But H.R. 5863 is still a victory for wildfire victims, and we should not let the unresolved issues obscure the clear benefits this new law should provide to many fire victims. Even with these important issues to iron out, after so many years of loss, stress, and bureaucracy for wildfire victims, this tax bill is wonderful news for those who qualify. ■

[55] Section 3(b), H.R. 5863.

[56] Section 3(c), H.R. 5863.

[57] *See, e.g.*, Rev. Rul. 74-206 (ruling that tax benefit rule takes precedence over section 1033 deferral provisions); Rev. Rul. 80-65, 1980-1 C.B. 183 (ruling that tax benefit rule takes precedence over section 1031 deferral provisions).