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Los Angeles Area Fire Victims May Also Have Tax Issues To Address

The victims of the wildfires in the Los Angeles have many issues to address, and taxes may be far down the list. Fortunately, both the IRS and the California FTB granted extensions of time to fire victims, and other relief. But could fire victims still have to pay any taxes on money they collect, even

possibly on payments from their insurance companies? Yes, it is possible. Amounts received following a wildfire are not *automatically* tax-free, although there are mechanisms that can make them effectively tax-free in many cases.

Insurance Proceeds

Some types of insurance payments are treated as tax-free by the IRS. For example, the tax code allows taxpayers to exclude from their income amounts received from insurance for the temporary additional living expenses created by the wildfire resulting from the loss of the taxpayer's principal residence. However, this exclusion applies only if those expenses are reasonable and necessary, such as rental payments for temporary replacement housing or replacement transportation.

If the wildfire that destroyed your home was a federally declared disaster, the tax code also generally allows you to treat insurance proceeds that compensate you for your personal property, such as clothing, furniture, and household goods, as tax-free, if the home was your primary residence. So, between your home's contents, and your temporary housing and replacement transportation coverages, you should not have to pay tax on those amounts.

But most insurance proceeds have tax implications. Under the normal tax rules, amounts received for damage to property, including property-insurance payments, are treated for tax purposes as sales proceeds. In a sale, whether or not you have taxable profit or gain is based on your tax basis in the property sold, not its fair market value. This may seem unfair, because you are only being reimbursed for what you lost.

However, for tax purposes, if you invested $1 million into the purchase and renovation of a home, and then received $3 million in insurance proceeds for the home when it is damaged or destroyed in a fire, you have *not* merely broken even. You have received $2 million in cash "profit" from your investment. Therefore, it is possible you may have "casualty gain" from insurance proceeds if you receive insurance proceeds for your property that exceed your tax basis in the property.

As with any "sale," insurance proceeds for property damage are tax-free to the extent of your tax basis in their damaged property (the amount you paid to purchase the property plus any expenses that can be capitalized into their tax basis of the property, such as the cost of major renovations and repairs to the property prior to the fire and post-fire repairs made prior to receiving the insurance proceeds).

Principal Residence Exclusion

If the insurance proceeds for your home exceed your tax basis in the property, you may qualify to claim the principal residence gain exclusion ($250,000 or $500,000, depending on your filing status — single, married filing separately or married filing jointly), which can shield additional amounts from being taxable casualty gain. For any remaining surplus, that amount is ostensibly capital gain that would ordinarily be subject to income tax.

Section 1033 Election

Fortunately, property owners can usually claim an election under Section 1033 of the tax code to *defer* paying tax on their casualty gain. Making such an election allows you to reinvest the insurance proceeds into the repair, reconstruction, or replacement of your damaged property within a prescribed

statutory timeframe. The time to reinvest under Section 1033 is simple in concept, but it depends heavily on your facts.

Generally, if you have casualty gain from a federally declared wildfire that damaged your principal residence for the *first* time in a given tax year, then you have until four years from December 31 of that year to reinvest the proceeds under Section 1033. Any casualty gain you have in any subsequent tax year must be reinvested by the same deadline, which was based on the first year you had casualty gain.

Therefore, it is possible that some casualty gain in a given year may have *less than* four years to be reinvested under Section 1033, if casualty gain was *first* triggered in a previous tax year. This can create complications for taxpayers who receive insurance proceeds over several years. It can also create timing problems where a taxpayer receives insurance proceeds in one year, and a litigation recovery for the same fire several years later.

Indeed, it is possible that the Section 1033 replacement period may have already *ended* as a result of casualty gain created several years earlier. That is, the Section 1033 replacement period may have already ended when the taxpayer receives a litigation recovery for their fire. It can essentially make the Section 1033 election unavailable.

In short, the timing rules under Section 1033 are tricky, and not exactly intuitive. But if you can meet its timing rules, the property owner does not have to pay immediate tax on the casualty gain, and the gain can be deferred indefinitely until the property is later sold. The net effect of these rules is that a fire victim often will not owe any income tax on their insurance proceeds until the property is later sold. However, this is not because of a blanket

exclusion, but because of a more complex set of tax rules and elections that should be addressed on your tax returns.

New Federal Tax Exclusion?

In December of 2024, the tax law regarding federally declared disasters changed to make many wildfire settlements tax free. However, it is not exactly clear if or how how the new law will be applied to insurance proceeds. If it is determined that the new law applies to insurance proceeds, it could make life much easier if your home was damaged or destroyed in a fire that is included in a federal disaster declaration.

The new federal tax law, P.L. 118-148, creates a tax *exclusion* for certain payments related to federally declared disasters. The exclusion only applies to compensation received *before the end of 2025*, and that sunset could make many insurance payments and lawsuit payments too late to qualify. Moreover, the exclusion only applies to a payment to the extent the loss being reimbursed is not "compensated for by insurance or otherwise."

This language suggests that the exclusion may not apply to insurance proceeds. However, it is also possible that the new law will be interpreted to *apply* to insurance payments, just not to duplicate or double payments. That is, the new tax exclusion might be interpreted to cover an insurance payment, as long as the taxpayer only receives *one* reimbursement for their loss. A homeowner who is only being reimbursed for their loss through insurance proceeds is not obtaining a double recovery.

The federal tax exclusion is brand new, so it is too soon to say how these and other points will be resolved. The language in the new law appears to carve out any insurance payments from the exclusion from tax. Therefore, unless the

IRS clarifies that insurance proceeds *also* qualify for the new exclusion if received before the end of 2025, it would be safer to rely on the more traditional methods for reducing and deferring tax, such as the Section 1033 election.

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