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Many 2020-2025 Wildfire Settlements To Be Retroactively Tax-Free

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Tax relief for wildfire victims has been a hot topic. When a larger tax bill with wildfire tax relief seemed poised to fail in the Senate (as it eventually did), the House passed in May of this year an older stand-alone bill, H.R. 5863, the "Federal Disaster Relief Act of 2023" that contained only the disaster relief provisions. H.R. 5863 passed the House by a large margin, 382 in favor and only 7 against. The Senate has finally passed it as well, by unanimous voice vote. President Biden is expected to sign 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, and the 2021 Dixie Fire. There have also been large wildfires in recent years 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. In response, California added *four* temporary provisions to the California Revenue & Taxation Code (with corresponding provisions for corporate taxpayers) that exclude from California income tax amounts received in connection with *six* of the California wildfires (the Butte Fire (if the recovery is received from the Fire Victim Trust), the North Bay Fires (if the recovery is received from the Fire Victim Trust), the Thomas Fire, the Woolsey Fire, the Kincade Fire, and the Zogg Fire). This state-level relief is limited to the specific fires covered by the legislation, and it 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. Damages can include, but are not limited to, additional living expenses, lost wages (except when paid by the employer), personal injury, death, or emotional distress.

A Qualified Wildfire Disaster is any *federally declared disaster* declared after December 31, 2014, as a result of "any forest or range fire." The only major carve-out of the exclusion is that an amount cannot be excluded if it compensates the taxpayer for a loss or expense that *has already been reimbursed by another source*, say through insurance. There are also a few technical provisions to prevent taxpayers from getting a double tax benefit from the exclusion.

One provision is analogous to the rules that apply to a Section 1033 election, 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. 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.

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. Whether or not a wildfire is a federally declared disaster is a decision usually made by FEMA, and generally it is rather cut-and-dry whether a wildfire has been formally declared a federal disaster. Plainly, any wildfire is devastating to the victim whose home is destroyed by it.

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, local, and disaster relief organizations to respond to the disaster without federal assistance. As a result, 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 burned for nearly a month, burning nearly 21,000 acres of California, destroying 80 buildings (damaging many more) and killing at least one person.

As devastating as the Mountain View Fire surely was to the people who lived on those 21,000 acres, 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. Therefore, the Mountain View Fire was designated by California as a *state* disaster, but was never designated as a *federal* disaster.

Although there are usually some provisions of any law that may be open to interpretation or ambiguity, the requirement that the wildfire be a federally declared disaster designated on or after December 31, 2014, seems difficult to avoid if your wildfire was not declared a federal disaster. For wildfire victims who do not satisfy this requirement for the exclusion, they 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. The exclusion applies only to payments received in tax years beginning after December 31, 2019, and before January 1, 2026. Because most individuals report their tax using the calendar year, this effectively means any qualifying payments received in 2020–2025.

Therefore, taxpayers who are currently still in litigation over their wildfire damages, or are mired in settlement negotiations may lose out on the exclusion if these disputes are not resolved, and the recovery paid, by the end of next year. Wildfire victims who are being paid in installments,

such as claimants of the Fire Victim Trust in California who have to date only been paid 70% 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 legislation 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 tax refund on federal tax they paid on recoveries that are now retroactively excludible. Under the standard rule for claiming a tax refund, taxpayers only have three years from the date their original tax return was filed to claim a refund by filing an amended return.

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. 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 the date they were actually filed. Applying these rules, it may 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 earlier this year.

Applying the standard three-year rule, it would also appear that taxpayers will need to rush to amend their 2021 tax returns in the upcoming months. Under the regular three-year rule, the statute of limitations for claiming a tax refund for 2021 would ordinarily 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 this timing issue, H.R. 5863 contains a provision that provides 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 signed into law. Assuming President Biden signs the bill into law before January 1, 2025, taxpayers should have until a date in December of 2025 to claim refunds in connection with the new exclusion related to their 2020 and 2021 reporting, notwithstanding that 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 December 2025 end of the one-year grace period. It therefore seems likely that the deadline for filing amended returns for these later years will be governed by the regular three-year rule. Taxpayers and their tax advisors should be very 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 on 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 choose to simply conform to the new federal exclusion, which is not limited to any particular wildfire. This 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.

This 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 for state income tax purposes to state-designated disasters, 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. In particular, it would be helpful if the IRS could clarify who is considered an "individual" for the purpose of the exclusion.

Typically, for tax purposes, an "individual" is considered a natural person rather than an entity. 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 entities' owners directly. One example is a single member LLC (unless you elect otherwise). Another is a living trust.

Amounts paid to these 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 may own their homes and properties through family partnerships, especially when the properties are used for farming and other family-run agriculture businesses whose profits are split among multiple family members.

Are these family-member partners allowed to claim the exclusion on their individual returns for what they receive through the Schedules K-1 they receive from the partnership?

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 (e.g., every time a family member dies or is added as a beneficiary of the trust). It can also help delay the triggering of property tax reassessments for the underlying property relative to if the individual family members own their shares of the property directly.

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" (essentially, the new income received by the trust during the year, net of offsetting expenses and exemptions that can be claimed by the trust to offset that income) to their beneficiaries in the same year the income is

received by the trust. This usually allows the trust to claim a tax deduction for the income distribution, which is intended to offset the trust's income. As a result of this mechanism, a non-grantor trust usually does not owe income tax on any "distributable net income" it receives that it distributes to its beneficiaries in the same year.

When distributable net income is distributed by a non-grantor trust to its beneficiaries, Section 662 of the tax code generally requires the beneficiaries to treat the distribution as their income on their tax returns. Moreover, Section 662(b) provides 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.

To be clear, H.R. 5863's tax exclusion does *not* reference, or even allude to the existence of non-grantor trusts or the possible application of the new exclusion to property owned through non-grantor trusts. Still, the beneficiaries of a non-grantor trust are often individuals, and so they 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, this 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. Effectively, then, this issue likely only applies to non-grantor trusts who 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.

Even if this 'solution' for non-grantor trusts is ultimately 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 substance-over-form 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 rely on the traditional approaches, like Section 1033 elections, to minimize and defer the resulting income tax.

Tax Benefit Rule

The tax benefit rule, codified into Section 111, 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. If someone has already reimbursed you for an expense you fronted, then you have already been made whole.

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 what if the original return is beyond the statute of limitations? What if the original loss or deduction affects *multiple* years, as a result of its creating a net operating loss or other tax attribute that carries back or carries forward until used?

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 reporting, you are not allowed to go back and amend. 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 (i.e., to the extent you obtained a "tax benefit" from the deduction or loss). 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.

After a wildfire, many taxpayers claim casualty loss deductions. 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.

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. 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 later receive potentially years later, and assigning a value to future anticipated reimbursements necessarily contains a fair degree of estimation, if not speculation.

As a result, many wildfire victims eventually receive insurance or litigation recoveries *exceeding* the amount they estimated they would receive when they claimed casualty loss deductions. Consequently, their later recoveries may compensate the wildfire victims, at least in part, for a loss that the taxpayer previously deducted as part of their casualty loss deduction, which they should not have originally deducted if they somehow could have known the actual amount of their future recoveries. When a wildfire victim receives a recovery that compensates them for amounts for which they already claimed a casualty loss deduction, there is a rather obvious conflict between H.R. 5863's tax exclusion and the tax benefit rule.

The new exclusion says that a qualifying fire recovery should be excludible from gross income, so long as it has not already been reimbursed. However, Section 111 and the tax benefit rule say 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.

So which one wins out in the conflict? H.R. 5863 is silent on this issue too, 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. 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. 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 excludible recovery payment.

This seems an unfair result for taxpayers whose casualty loss deductions were calculated more accurately. This suggests that the tax benefit rule is likely to be an exception to the new exclusion, as it already serves as an exception to most other exclusions from gross income. Perhaps the IRS will provide its view on this point if or when it issues guidance.

As these 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 the fire victims who qualify.

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