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Robert W. Wood
THE TAX LAWYER

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Tax Law Passes To Make Wildfire Settlements Tax Free—Retroactively

For some time, Congress has tried to pass tax relief for wildfire victims. When a larger tax bill failed, the House passed a stand-alone bill, H.R. 5863. Now, the Senate has finally also passed—by unanimous voice vote—the "Federal Disaster Relief Act *of 2023*." The bill goes straight to President Biden who is expected to sign the bill into law.

The last decade has contained some of the largest and most destructive wildfires in California history, including 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. California has not been the exception, with states including Washington, Kansas, Oklahoma, Tennessee, Montana, Arizona, Wyoming, Oregon, New Mexico, Hawaii, and Virginia all experiencing notable wildfires during this time.

In many cases, the federal tax law's existing provisions intended to help victims of disasters rebuild without facing taxes have been unhelpful or incomplete. In the resulting chaos, states have scrambled to fill the gap with regard to state income tax. California, for example, has 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).

Federal Tax Law Finally Passes

But, at last, a new federal tax bill provides its own temporary exclusion for 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 by a payment excludible under the new wildfire exclusion.

Limited Number of Tax Years

The exclusion applies to tax years beginning after December 31, 2019, and before January 1, 2026. Taxpayers may amend their previously filed tax returns for these years to claim a tax refund in connection with their reporting as income any amounts that are retroactively excludible under the new legislation. Under the standard rule for claiming a tax refund, taxpayers only have three years to file an amended return and claim a tax refund. Any tax return filed before the original filing due date (usually April 15, unless it fall on a weekend) is considered filed on the filing due date.

Applying these rules, it may appear that 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 has already passed. However, H.R.

5863 also contains time-limited relief for claiming a resulting refund. H.R. 5863 contains a provision that *extends* the statute of limitations for claiming a tax refund for any tax year affected by the new law until at least one year from the date the new law is enacted (i.e., the date President Biden signs the law).

Deadlines to File Amended Tax Returns

Assuming that the bill is signed into law sometime this month, taxpayers who reported amounts as income in their 2020 reporting that are now retroactively tax-free would have until around this time next year to amend their 2020 returns to claim a refund. If, however, the taxpayer delays filing their 2020 refund request beyond this one-year grace period, their refund may be lost to the statute of limitation. The one-year-from-enactment special grace period for refunds should also provide a few extra months for filing a refund for 2021 tax reporting.

Under the regular three-year rule, the statute of limitations for claiming a tax refund for 2021 would ordinarily expire as early as April 15, 2025, so extending the statute for refunds until at least one year from enactment may give taxpayers about 8 extra months to prepare and submit their 2021 amended reporting. Still, delaying preparing and submitting amended reporting, especially for 2020 and 2021, can put a taxpayer beyond the statute of limitations for claiming a refund, which can lose them the benefits of this tax new tax relief.

The new provision could streamline states' efforts to provide relief to wildfire victims. Rather than add exclusions on a fire-by-fire basis, as California has done, a state could conform its rules 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. There are multiple wildfires for which California has declared a disaster, but the federal government has not. California would still need to find a mechanism to address this potential mismatch, but that seems relatively easily done, for example, by providing that for California income tax purposes, California also includes California-designated disasters within the ambit of the exclusion.

Tax Questions Remain

Although the new exclusion is likely to be profoundly helpful to wildfire victims, there are a few provisions that it would be helpful to see if the IRS can address or refine. Principally, it would be helpful if the IRS could clarify who is considered an "individual" for the purpose of the exclusion. Typically, in tax law, an individual is considered a natural person, a human being, rather than an entity of some kind. Nevertheless, some entity types are treated as *entirely* transparent and disregarded from their owners, so it should be uncontroversial that amounts paid to these types of entirely transparent entities should qualify for exclusion because they are treated as received by the individuals who own them.

These entirely transparent entities include grantor trusts (typically including the usual estate planning "living" trust), and "disregarded" business entities (often, single-member LLCs). However, many types of properties are owned through entities that are not quite so transparent for tax purposes. Families may own their homes and properties through family partnerships, especially when the homes 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 the income that they recognize on behalf of the family partnership, even though the partnership itself presumably cannot claim it on its tax return?

Some families put their properties in non-grantor trusts for estate planning (and probate avoidance) purposes, for the benefit of their children or other relatives to avoid having to divide a single property among several children for legal ownership or to avoid having to re-record ownership of the property 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). Does this mean non-grantor trusts must distribute their recoveries in the year received to the individual beneficiaries so that the individual beneficiaries can claim the exclusion the trust itself cannot claim? If so, how does that money then get back into the trust so it can be used to rebuild or replace the damaged property?

Clearly, a distribution followed by an immediate contribution by the individual owners would raise the specter of substance-over-form or step-transaction doctrine recharacterization. Still, it seems unfair to categorically deny wildfire relief for family-held properties that happen to be owned through a partnership or non-grantor trust for non-tax purposes. Therefore, it would be good to see whether the IRS issues guidance on how H.R. 5863 will be applied to indirect ownership of property.

Even with these issues to iron out, after so many years of loss, stress, and bureaucracy for wildfire victims, this relief is wonderful news!

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