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Tax triage for LA fire victims

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If you have recently experienced the loss of your home, you have many issues to consider, and taxes are probably far down on the list. However, some fire victims may be receiving money soon from insurance companies, even if any eventual lawsuit recoveries from Edison or other defendants may be years away. 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, 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.

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 receive $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 (i.e., 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

To the extent the insurance proceeds for your home exceed your tax basis in the property, you may qualify to claim the principal residence gain exclusion (which is $250k or $500k, depending on your filing status--e.g., single, married filing separately, 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 involuntary conversion election

However, 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 Dec 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.

Casualty loss deductions

Another form of relief under the tax code if your principal residence is destroyed in a federally declared disaster is the ability to claim casualty loss deductions. A casualty loss deduction is generally measured principally by your tax basis in the home, not by its fair market value, which is consistent with the tax law's view that what you lose in disaster is what you invested in the home, not what it was worth. Nevertheless, the tax law also does not allow you to claim a casualty loss deduction for more than the decrease in value of your home as a result of the fire, so the change in fair market value can limit the size of your casualty loss deduction, but not increase it.

Claiming a casualty loss deduction might appear to be attractive, particularly in the short term. It allows you to essentially get more money in your hands in the form of a

reduction in income tax owed. However, the amount to claim as a casualty loss deduction, and whether it is advisable to claim a casualty loss deduction at all, is tricky when you expect to receive additional insurance proceeds or possible litigation proceeds in the future. Some fire victims who claim a casualty loss end up regretting it later.

You are only allowed to claim a casualty loss deduction to the extent you do not have, and do not expect to have, your tax basis in your property reimbursed to you through insurance or other means (including litigation recoveries). Therefore, if your tax basis in your home is $1 million, and you expect to receive $800k in insurance for the home and a litigation recovery from a defendant (e.g., a utility company) for an additional $1.2 million, then you are expecting to fully recover your $1 million in tax basis in the home (and then some). Therefore, you should not claim a casualty loss deduction for your home.

A casualty loss deduction should be calculated to be only the amount of tax basis you expect to have left after receiving all your future insurance proceeds and any litigation recovery. If you are too aggressive with the size of your casualty loss deduction, and end up receiving more in insurance and litigation recovery than you accounted for, it can adversely impact the tax treatment of your future recoveries. To reimburse the IRS for the tax savings you received from the excess casualty loss deduction, you are generally required to treat a portion of your future recovery as ordinary income under the tax benefit rule.

This usually means higher income tax rates on the portion of the future recovery that has to be recharacterized as ordinary income. It also means that the portion that has to be recharacterized as ordinary income cannot be deferred under Section 1033. We also anticipate that an excessive casualty loss deduction could require taxpayers to include in income part of their subsequent recoveries that may otherwise qualify for exclusion under the new tax exclusion, discussed below. Therefore, we generally suggest that taxpayers exercise caution in calculating their casualty loss deductions, especially if it is reasonably likely that they will receive insurance or litigation recoveries for property damages related to the fire in future years.

In many cases, the question of whether to claim a casualty loss deduction will be mooted by the insurance proceeds. Because insurance proceeds are often based on reconstruction costs (which are currently often higher than many homeowners' tax basis in their homes), the amount you receive from insurance for property damages may exceed your tax basis in your home. If your insurance proceeds fully reimburse you for your tax basis in your home, reducing your basis to $0, then you generally cannot claim a casualty loss deduction, since it is limited to the unrecovered portion of your tax basis, which would be $0.

New federal tax exclusion

The discussion above concerns the standard tax rules as they were before December 2024. In December, the tax law regarding federally declared disasters changed, and we are still waiting to see 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 for victims of the recent LA wildfires, at least if your home was damaged or destroyed in a fire that is included in a federal disaster declaration.

A new federal tax law, P.L. 118-148 creates a tax exclusion for certain payments related to federally declared disasters. However, due to some language in the new law, it is not clear if it will be of much direct benefit to the victims of the recent fires with regard to their insurance proceeds. First, 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 for the exclusion.

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 is not intended to apply to insurance proceeds at all. The reason for this language is not addressed in the legislative history of the new exclusion. It appears that the language was essentially copied from another section of the tax code that also addresses payments made in connection with certain large disasters, Section 139. Section 139 was enacted to clarify the tax treatment of "disaster relief" payments in the wake of the Sept. 11, 2001, attacks.

In the context of Section 139, the reason for the insurance carve-out was fairly clear. There was already a relatively clear set of rules, discussed above, about how insurance proceeds were to be treated for tax purposes. There was also a clear statutory rule that damages paid on account of a physical injury or physical sickness were tax-free. However, it was less clear before Section 139 was enacted how other forms of more voluntary or altruistic relief paid to victims of the attacks and their families, such as relief paid by employers, governmental relief payments, and relief paid by the airline industry to families of the passengers killed in the attacks, should be treated for tax purposes.

Therefore, Section 139 was drafted not to interfere with or override the application of the long-established rules regarding the treatment of insurance proceeds or litigation proceeds. Instead, Section 139 only describes the tax treatment for "disaster relief" payments that did not already have clear statutory rules when the provision was enacted. In this context, it makes sense that the language of Section 139 would treat insurance payments as a separate concept from the more altruistic "disaster relief" payments it was intended to address. It also makes sense that the exclusion created under Section 139 would not apply to any relief payments to the extent they are paying you for something you have already been paid for through insurance.

In essence, if insurance has already reimbursed you fully for a loss, then receiving a relief payment that compensates you again for the same loss can be seen as a windfall. As a result, there would be no tax exclusion for that second payment.

Yet, the reasoning that explains the exception for insurance for Section 139 does not necessarily apply to the new tax exclusion. It is clear that the new exclusion is not intended to be limited to altruistic "disaster relief" payments like those covered by Section 139. Because Section 139 already provides a tax exclusion for disaster relief payments that cover personal, living, or funeral expenses and payments to repair or rehabilitate a recipient's primary residence, it would be pointless to create a new tax exclusion under P.L. 118-148 that simply excludes the same types of payments that are already granted exclusion under Section 139.

It is therefore clear that the new exclusion is intended to have a broader scope than Section 139, but there remain questions about how broad that scope is, or will be interpreted to be, intended. There are strong indications, for example, that the new exclusion is intended to cover payments received from defendants, such as utility companies, that are not altruistic in nature, but which are intended to satisfy claims made against the defendants for damages. Nevertheless,

because the new exclusion carries over the same language adopted from Section 139 suggesting that insurance payments may not be excludable, it remains unclear whether insurance payments will be included in that broader scope.

Double recoveries?

However, it is not entirely clear that the insurance carve-out copied from Section 139 was intended to mean that insurance payments are categorically denied exclusion under the new provision. The insurance carve-out language and its interpretation in the context of Section 139 strongly imply that its principal purpose is to prevent someone from receiving a double recovery for the same loss and claiming tax-free treatment for both. That is, under Section 139, if you already received insurance proceeds for a loss, you cannot treat any subsequent disaster relief payment as tax-free to the extent it compensates you for the portion of your loss that you have already been compensated for through insurance.

Therefore, the language of the insurance carve-out seems to be intended to apply principally when the taxpayer is receiving two different recovery payments for the same underlying loss. It may not be intended to apply when the taxpayer only receives one reimbursement payment for their loss, even if that reimbursement payment is in the form of insurance proceeds. A homeowner who is only being reimbursed for their loss through insurance proceeds is not obtaining the double recovery that motivated the addition of the language to Section 139.

However, that is speculation. The federal tax exclusion is brand new, so we are unfortunately still at the point of having to reason only from the text of the new law and from the inferred purposes of its provisions, without any rulings or guidance from the IRS or a court to resolve any of these ambiguities. We are hopeful that IRS guidance will be issued. In the meantime, the language in the new law specifically appears to carve out insurance payments from the exclusion from tax.

As a result, it seems safer for homeowners to not assume that their 2025 insurance proceeds qualify for the new exclusion. Unless the IRS clarifies that insurance proceeds also qualify for the new exclusion if received before the end of 2025, it would be safer for taxpayers to rely on the more traditional methods for reducing and deferring tax from their insurance proceeds, such as the Section 1033 election. If the IRS later announces that some insurance proceeds may qualify for the exclusion, notwithstanding the carve-out language, the taxpayer can then consider amending their returns or otherwise addressing the change in their position as part of their tax reporting.

Uninsured homeowners?

Conversely, some people are reading the new federal tax law to suggest that lawsuit damages can be excluded from tax only if there were no insurance proceeds. It seems that the same Section 139 insurance carve-out language carried over into the new exclusion is the culprit for this concern too. The good news is that, for the reasons discussed above, this language has not been interpreted in the context of Section 139, where it was copied, to mean that only uninsured taxpayers qualify for the exclusion under Section 139 for disaster relief payments.

The key language in this exception is "to the extent." As discussed earlier in this article, this has been applied in the context of Section 139 to mean that you cannot claim an exclusion on the portion of a disaster relief payment you receive that has already been separately compensated for through an insurance payment you previously received. The point is not 100% clear, but it seems a safe bet that the language would be applied similarly under the new exclusion.

Of course, most lawsuits for fires are subject to an "insurance offset" that subtracts from the claimed damages the portion of the loss that has already been compensated for through insurance payments. Consequently, the taxpayer is not receiving a double recovery from the later litigation recovery. The later recovery only compensates the plaintiff for the portion of their loss for which insurance has not already provided reimbursement. Therefore, we would not expect the interest carve-out language to prevent the taxpayer from qualifying for the new exclusion.

It may be best to describe the likely application of this language using an example. Suppose that someone loses a home that will take $5M to rebuild, and receives $3 million from insurance due to reaching their policy maximum. They can likely receive compensation for the other $2 million of their loss from a defendant utility company tax-free under the new exclusion. In this situation, the $2 million they receive from the second source does not compensate them for the $3 million of their loss that they already received from their insurance carrier. In short, there is no double recovery.

If, however, they obtain all $5 million from the defendant without reducing the claim for the $3 million that they already received from insurance, then the insurance carve-out likely does apply to limit their exclusion to $2 million. In this case, the $3 million reimbursed through insurance is effectively being reimbursed twice, resulting in the taxpayer receiving $8 million total ($3 million from insurance and $5 million from a defendant) for their $5 million loss. We would not expect the IRS to say that the taxpayer is not allowed to claim any exclusion from the $5 million recovery simply because the plaintiff received any amount of insurance recovery.

The above interpretations are how the identical language in Section 139 has been generally understood and applied. They are also consistent with the plain meaning of the "to the extent" language in the text of the new law. This offset treatment should also apply for other claims that insurance may partially reimburse a plaintiff for, such as personal property, additional living expenses, etc.

Conclusion

Any loss of a home involves enormous challenges, and taxes for most people are hardly near the top of the list of concerns. Nevertheless, it is never too early to begin thinking about taxes when insurance proceeds start to be made available.

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