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Wildfire Settlements Are Now Tax Free In California & Taxed By IRS

California has passed two laws to shield certain wildfire victims from state tax on their legal settlements in wildfire cases. One law applies to PG&E recoveries, the other to Edison suits. Both bills provide needed tax relief, but the IRS still treats lawsuit settlements as taxable. Most legal settlements are taxable, even for a devastating fire loss. That grim fact can be an unpleasant surprise to fire victims. California legislation has recently been signed into law, but it is not clear how the federal bill will fare. Large numbers of tax bills are introduced that never pass.

The proposed federal bill was introduced by Congressmen Doug LaMalfa (R – Calif.) and Mike Thompson (D – Calif.) and would exempt thousands of fire victims who are receiving compensation from the PG&E Fire Victim Trust from having to pay federal income tax on their settlements. California recently enacted a state-level version of this legislation, AB-1249, authored by Assemblyman James Gallagher, which created a similar exemption from California state taxes. Although AB-1249 now provides relief to some fire victims for California income tax, federal tax remains a serious concern for fire victims unless and until the federal bill passes into law.

In addition to AB-1249, California *also* recently enacted the confusingly similarly numbered bill, SB-1246. This new law in California excludes from income any settlement payments received from Southern California Edison in connection with the Thomas or Woolsey fires. Similarly to AB-1249, SB-1246 only affects California income tax. Therefore, fire victims in the Thomas and Woolsey fires must also continue to consider their fire recoveries when they do their *federal* taxes with the IRS.

That does not mean paying tax on every dollar. In some cases, none of the recovery will be subject to current tax. But it can take ingenuity to turn the gross settlement figure into a viable tax reporting strategy that is defensible to the IRS and (for Californians, to the Franchise Tax Board). Fire victims should account for it all, including the attorney fees. Most fire victim plaintiffs use contingent fee lawyers. Contingent legal fees may be separately paid to the plaintiff lawyers, but it is still attributed to the plaintiff for tax purposes. It is how legal fees are treated under tax law.

Up until 2018, legal fees were usually tax deductible. But under the Tax Cuts and Jobs Act passed in late 2017, many legal fees are no longer deductible. Miscellaneous itemized deductions, which accounted for most legal fees, were repealed for 2018 through 2025 tax years. Accordingly, in some cases, plaintiffs may not be able to deduct the fees, even though 40 percent or more of their recoveries are paid to their lawyers. The lawyers must *also* pay tax on the fees, so some argue that it is a form of double taxation. In any event, the tax treatment of the legal fees has become a major tax problem associated with many types of litigation, but there are 12 ways to deduct legal fees under new tax laws.

Fortunately, for fire victims, for both federal and California income tax purposes, there is usually a good path to deduct or offset the legal fees. If the fire recovery can be treated as capital gain the legal fees can be treated as additional basis in the home, or as a selling expense. Of course, that still leaves plenty of tax issues to address. How fire victims are taxed depends on their circumstances, what they ultimately collect, and what they claim on their taxes.

Suppose that you lose a $1 million home, but collect $1 million from your insurance carrier or from PG&E. It might *sound* like there is nothing to tax, since you lost a $1 million home, and simply got $1 million back. However, you need to know about your tax *basis* in the property. That generally means the purchase price, plus the cost of subsequent improvements. If it was commercial property, you would need to factor in depreciation (and depreciation recapture).

But even with personal use property like a home, your basis matters. The property might be worth $1 million when it was destroyed, but if the original purchase price plus improvements was only $100,000, there is a $900,000 gain. Does that mean our fire victim has to pay tax on the $900,000 gain? Not necessarily. Fortunately, subject to requirements and limits, the tax law may treat this as an involuntary conversion despite the $900,000 gain. If you qualify, you can apply your old $100,000 tax basis to a replacement home.

That means you should not need to pay tax on that $900,000 gain until you eventually sell the *replacement* home. In order to defer a casualty gain by reinvesting insurance or litigation proceeds, the replacement property must generally be purchased within two years after the close of the *first* year in which *any* part of the casualty gain is realized. For a Federal Declared Disaster, the period is extended to four years.

However, if your insurance company has paid you enough money to create even $1 of taxable gain on your destroyed property, the clock for acquiring replacement property may already have started. Another big issue is claiming a casualty loss. Up until 2018, many taxpayers could claim casualty losses on their tax returns. But starting in 2018 and continuing through 2025, casualty losses are allowed only if your loss was the result of a Federal Declared Disaster. Many fire victims in California qualify, since most major California wildfires are a Federal Declared Disaster. Even so, there can still be some careful planning and projections in determining whether claiming a loss is a good move.

Another tricky issue is how to handle expenses for temporary housing and similar expenses. If your primary residence is damaged or destroyed, your insurance proceeds intended to compensate you for your living expenses may be partially tax-free. Examples are replacement housing and food. But, if the insurance proceeds pay you for living expenses you would have *normally* incurred if your home had not been damaged, say your mortgage payment or your typical food expenses, that portion may be taxable *income* to you. If the insurance proceeds exceed the actual amount you spend on temporary housing, food, and other living expenses, that surplus can also be taxable.

In short, even insurance proceeds raise nuanced tax issues, and the tax stakes grow larger with a lawsuit recovery. For victims who eventually collect a legal settlement or judgment, how it will be taxed? Fire recoveries are intensely factual, so the issues are complex in assessing how a fire recovery is going to be taxed. Some fire cases involve wrongful death, and compensatory wrongful death damages are tax free. Punitive damages are always taxable. Some victims experience physical injuries or physical sickness, either caused by the fire or exacerbated by it. Fortunately, Section 104 of the tax code excludes from income damages for personal physical injuries or physical sickness. The damages must be physical, not merely emotional, for money to be tax free.

Health problems from smoke inhalation or from the exacerbation of pre-existing medical problems can be enough for tax-free damages. Some of the line drawing that the tax law seems to require can seem artificial. Most emotional distress damages are fully taxable, but emotional distress triggered by physical injuries or physical sickness is tax free. It can make taxing emotional distress and physical sickness damages can seem like chicken or egg issues.

The big item in most fire cases is property damage or destruction. This may be a multi-faceted item, with a house, outbuildings, trees and shrubs, crops and more. The taxpayer's actions are also important to consider. Are you rebuilding or moving away? It will all play into how the IRS will tax the fire victim. If you do not reinvest, you may have a big capital gain, subject to claiming the up to $500,000 primary residence tax benefit if you qualify.

If you are selling a primary residence and qualify, the first $500,000 in gain for a married couple filing jointly should be free of tax. The balance should be taxed as capital gain. But bear in mind that this is only a federal tax benefit. When it comes to California taxes, remember that all income is taxed at up to 13.3 percent, so even capital gain is no bargain.

Understandably, many fire victims hope to face no taxes at all when they collect money from their insurance company or PG&E or Edison. If they are rolling over their proceeds into purchasing a new home or rebuilding, they may end up with a low basis in the new home, but that would mean paying tax much later when they eventually sell their home. But there can be some surprising gotchas in fire cases that are important to avoid.

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