DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, DC 20224

COMMISSIONER

October 6, 2022

The Honorable Doug LaMalfa
U.S. House of Representatives
Washington, DC 20515

Dear Representative LaMalfa:

Thank you for your letter dated June 8, 2022, supplementing your January 20, 2022 letter. Your June 8 letter asks additional questions concerning the tax treatment of settlement awards received from the Fire Victims Trust, which provides financial support for those affected by the tragic events related to multiple wildfires.

Your June 8 letter explains that victims of wildfires occurring in 2015, 2017, and 2018, began receiving settlement awards from the Fire Victims Trust in November 2020 and continue to do so.

I hope the June 16, 2022 letter we provided in response to your January 20 inquiry was helpful. I understand the importance of providing guidance and hope the following information will further assist taxpayers to determine the taxability of their settlement awards. I also encourage taxpayers with questions to talk to a professional tax advisor or financial consultant about their particular individual circumstances.

Specifically, you asked whether a settlement award for a personal physical injury is excluded from gross income. Section 104(a)(2) of the Internal Revenue Code (Code) provides that gross income does not include any damages, other than punitive damages, on account of personal physical injuries and physical sickness. We provide taxpayers more specific information about the treatment of settlements and judgements on our website.[1]

You also asked about the taxability of the settlement award if a taxpayer previously took a loss deduction under Section 165 of the Code in the year of the wildfire. Generally, taxpayers may deduct a personal casualty loss in the taxable year the loss is sustained provided insurance does not compensate for the loss or the loss is otherwise subject to a reasonable prospect of recovery. Additionally, if a taxpayer recovers amounts previously deducted, and the earlier deduction resulted in a reduction of income tax, the taxpayer must include the amount recovered in gross income in the taxable year they receive it.

1 https://www.irs.gov/government-entities/tax-implications-of-settlements-and-judgments

Additionally, you asked if Section 121 of the Code allows a taxpayer to exclude from gross income a settlement award from the Fire Victims Trust. Section 121 of the Code generally provides that gain (subject to certain limits) from the sale or exchange of property is excluded from gross income if, during the five-year period ending on the date of the sale or exchange, the taxpayer owned or used the property as their principal residence for two or more years.

Section 121(d)(5) of the Code provides that destruction, theft, seizure, requisition, or condemnation of property is treated as a sale of property. Section 121(b) generally provides the amount of gain excluded from gross income in the taxable year of the sale or exchange is limited to $250,000 for single-filers and $500,000 for joint-return filers; therefore, if the wildfires destroy or condemn a taxpayer's principal residence, and the taxpayer owned and used the property as their principal residence for two or more years within the five year period ending on the date of the destruction, the gain (up to the limits described above) from the settlement award related to the involuntary conversion of the property may be excluded from gross income.[2] Additionally, some or all of the gain in excess of the exclusion amounts in Section 121 of the Code may be deferred under section 1033 of the Code.[3]

In general, section 1033 of the Code provides that if destruction of property results in an involuntary conversion to money, the taxpayer recognizes the gain (if any).[4] However, the taxpayer may elect to defer the gain by reinvesting it in replacement property. Any excess of the settlement award over the cost of the replacement property must be recognized. Replacement property is property that is similar or related in service or use to the converted property the taxpayer purchases within the statutory replacement period.[5] Generally, a taxpayer must reinvest in replacement property within two years after the close of the taxable year the gain is realized. If the property is in a federally declared disaster area, the replacement period is extended to four years.

We realize that situations will occur where taxpayers are unable to replace the property within the statutory replacement period; therefore, we have guidance that explains existing processes taxpayers can use to request an extension of the replacement period.[6] We ask that taxpayers provide a detailed explanation of their situation and why they need the extension. The IRS may grant extensions when taxpayers show there is reasonable cause for not making the replacement within the replacement period.

I hope this information is helpful. I am sending a similar response to Representative

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[2] Section 121 of the Code
[3] Section 1033 of the Code
[4] See Section 1033(a)(2) of the Code.
[5] Section 1033(a)(2)(B) of the Code.
[6] See Rev. Proc. 2022-1 sections 6.13, 7, and 12.01.

Thompson. [redacted]

Sincerely,

Charles P. Rettig

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Charles P. Rettig