HB 3523 Taxation of Settlements and Judgments

Joint Committee on Tax Expenditures – Informational Meeting 4/28/2023 | LRO



Overview of Presentation

- HB 3523
- Taxation of judgment or settlement proceeds
- What is taxable, what is not under current law
- Basis, loss in value of property
- Example
- Legal fees

Topic is dense and case specific, presentation is conceptual overview



- Creates Oregon personal income tax subtraction from taxable income any amount received in settlement of a civil action arising from wildfire and awarded to plaintiff, if
 - Wildfire
 - Is subject of a state of emergency declared by the Governor, or
 - Occurs in area subject to Governor's invocation of the Emergency Conflagration Act
- No subtraction if amount deducted on taxpayer's federal income tax return for tax year
- Applies to amounts received in tax years 2020 through 2025



Taxation of Judgment or Settlement Proceeds

- Definition of income begins in federal tax law
- Gross income is defined in Internal Revenue Code (IRC) Section 61

 Except as otherwise provided...gross income means all income from whatever source derived...
- Income is taxable, unless otherwise exempted
- Facts & circumstances of each settlement payment determine potential tax implications
 - Portions of payment may be treated differently for tax purposes
 - What was the settlement payment(s) intended to replace



Settlement: Non-Taxable and Taxable

Non-Taxable	Taxable
 Personal physical injury or sickness Emotional distress or mental 	 Lost wages or lost profits (not personal injury/sickness)
anguish, if attributable to personal physical injury or sickness If not otherwise deducted	 Loss in value of property (potentially) Punitive damages (ex. wrongful death)





Loss in value of property

Key Term: Adjusted basis in property

 Adjusted basis= Purchase price + cost of subsequent improvements – depreciation (business/rental property)

- If settlement amount less than adjusted basis
 - Amount is not taxable, basis in property reduced by amount of settlement
- If settlement amount greater than adjusted basis
 - Amount in excess of adjusted basis is income



Examples

Settlement Exceeds Basis		
Adjusted basis	\$100,000	
Value at time of disaster	\$300,000	
Settlement	\$300,000	
Excess amount	\$200,000	
Capital gain income	\$200,000	



Example

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Settlement	\$300,000	
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Replace the Property

- Treated as an involuntary conversion
- Tax is deferred on gain of property until replacement property is sold, basis unchanged
- Replacement period, typically 2 to 4 years
- Gain deferred cannot exceed the Fair Market Value of the replacement property



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Exclusion of gain for primary residence

 May qualify to exclude \$250K (S) \$500K (J) of capital gain of primary home

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Legal Fees

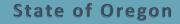
- Generally, legal fees are not deductible and are taxable income (aligned with settlement source)
- If the settlement award is non-taxable, legal fees are not taxable (personal physical injury & illness)
- Adjustment to income (above the line deduction)
 - Employment recovery
 - Certain whistleblower cases
- Business expense deduction
- Potential to capitalize if recovery is for capital asset



Legal Fees Continued

- Certain Miscellaneous Deductions
 - Itemized deduction
 - Allowed deduction of legal fees
 - Only deduct amount exceeding 2% of AGI
 - Pease limit on itemized deduction, AMT (federal)
- Federal Tax Cuts and Jobs Act of 2017 (TCJA)
 - Eliminated certain misc. deduction for tax years 2018 through 2025

Legislative Revenue Office https://www.oregonlegislature.gov/lro 503-986-1266



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