# 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

# HB 3523

- 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<br>• Emotional distress or mental anguish, if attributable to personal physical injury or sickness<br>If not otherwise deducted | • Lost wages or lost profits (not personal injury/sickness)<br>• Loss in value of property (potentially)<br>• 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

| Settlement Exceeds Basis | |
|---|---|
| Adjusted basis | $100,000 |
| Value at time of disaster | $300,000 |
| Settlement | $300,000 |
| Excess amounts | $200,000 |
| Capital gain income | **$200,000** |

## 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

# Example

| Settlement Exceeds Basis | |
|---|---|
| Adjusted basis | $100,000 |
| Value at time of disaster | $300,000 |
| Settlement | $300,000 |
| Excess amounts | $200,000 |
| Capital gain income | **$200,000** |

## 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

## Exclusion of gain for primary residence

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

# 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