



# HB 3523

## Taxation of Settlements and Judgments

Joint Committee on Tax Expenditures – Informational Meeting

4/21/2023 | 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
<ul style="list-style-type: none"><li>• Personal physical injury or sickness</li><li>• Emotional distress or mental anguish, if attributable to personal physical injury or sickness</li></ul> <p data-bbox="445 1049 955 1092">If not otherwise deducted</p>	<ul style="list-style-type: none"><li>• Lost wages or lost profits (not personal injury/sickness)</li><li>• Loss in value of property (potentially)</li><li>• Punitive damages (ex. wrongful death)</li></ul>





# 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	<b>\$200,000</b>





# Example

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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





# 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
  - Phase 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>

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