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Big Oil Spill Tax Write-off Shows BP Does Not Stand For 'Big Penalty'

BP’s $18.7 billion out-of-court settlement resolves charges related to the Gulf Oil spill. It is big, even historic, but is it tax deductible? Mostly yes, and that has some people angry. Some deals expressly say what portion of a settlement is tax-deductible, while this deal does not.

That is a major coup for BP, which is doing all it can to make sure BP doesn’t stand for ‘big penalty.’ A Department of Justice fact sheet contains suggestions about the after-tax value of the $18.7 billion settlement. Keep in mind that the settlement corrals BP, the federal government, five states and 400 local entities.

But on an after-tax basis, is the $18.7 billion figure correct? Consider these points noted by Phineas Baxandall, Senior Analyst for Tax and Budget Policy at the U.S. Public Interest Research Group. Only $5.5 billion is indicated explicitly as a penalty under the Clean Water Act. The federal government could have received as much as a $13.7 billion penalty under that Act based on a recent finding by a New Orleans judge that the spill was the result of “gross negligence.”

Federal Judge Carl Barbier found BP ‘grossly negligent’ in causing the Deepwater Horizon disaster. Penalties could have reached $18 billion for violations of the Clean Water Act. Although drilling rig owner and operator Transocean was also negligent in the court’s view—and so was Halliburton—it was BP that was ruled 67% responsible.

BP was clearly jockeying over tax deductions. The oil giant already wrote off the cost of its cleanup effort after the spill. Yet remediation is supposed to be tax deductible and penalties are not. Even for this penalty money, though, companies often find a way to deduct payments unless the settlement or consent documents expressly prohibit it.

Notably, when BP settled with the DOJ over its role in the deaths of 11 oil rig workers, its $4 billion settlement was expressly not tax-deductible. Of the $18. 7 billion, $13.2 billion is not categorized as a penalty. That probably means it is tax deductible. U.S. PIRG says that suggests an after-tax value of only $8.58 billion, and the whole deal would be worth only $14.08 billion to the public.

Many companies can and do take advantage of the inherent ambiguity. The tax law is famously gray about many issues. Bank of America’s historic $17 billion legal settlement over soured mortgage securities got around the Department of Justice’s recent policy of nixing tax deductions. Not everyone is pleased at such moves.

Some lawmakers and consumer advocates say the DOJ and regulators need to take taxes into account in touting the settlement figures. Otherwise, people think it’s costing a targeted business one thing, when the after tax cost—paid for by taxpayers—is something else. But isn't everything in business deductible? Not always.

In general, fines and penalties paid to the government are not deductible. Section 162(f) of the tax code prohibits deducting ''any fine or similar penalty paid to a government for the violation of any law.'' Despite punitive sounding names, though, some fines and penalties are considered remedial and deductible. That allows some flexibility. As a result, some defendants insist that their settlement agreement confirms that the payments are not penalties and are remedial.

Explicit provisions about taxes in settlement agreements are becoming more common. For example, the DOJ did expressly forbid Credit Suisse from deducting its $2.6 billion settlement for helping Americans evade taxes. Ditto for the BNPP terror settlement, which states that BNPP will not claim a tax deduction. Sometimes the government and a defendant split the baby.

Of the $13 billion JP Morgan settlement struck in late 2013, only $2 billion was said to be nondeductible. The DOJ doesn't always disclose the terms of settlements either. But that could change. The proposed Truth in Settlements Act (S. 1898 – fact sheet) would require agencies to report after-tax settlement values. Another bill, S. 1654, would restrict tax deductibility and require agencies to spell out the tax status of settlements.

A poll released by the U.S. Public Interest Research Group Education Fund says most people disapprove of deductible settlements. BP might fuel such sentiments. Federal law prohibits a deduction of government fines or penalties. But companies often deduct 'compensatory penalties,' a maneuver affirmed in a recent Circuit Court ruling. U.S. PIRG has also created a fact sheet on Wall Street settlement tax deductions.

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