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Tax Alert

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PG&E $1.6 Billion Explosion Tax Break Under Fire

On September 9, 2010, a horrific pipeline explosion and fire destroyed a neighborhood in San Bruno, California. The catastrophe killed eight, injured 66, and destroyed 38 homes. Few have forgotten. A record $1.6 billion package of fines and penalties was imposed by the California Public Utilities Commission. In the context of this kind of event, talk of taxes may seem out of place, but they too are touchy.

Some reports have said that PG&E may be able to deduct 100% of these penalties on its taxes. That rubs some people the wrong way. But as San Jose's Mercury News has noted, the PUC wrote to the IRS and California tax authorities saying that the penalty was punitive so should not be deducted. At stake are federal deductions and state ones too. In case PG&E tries to claim deductions, two California lawmakers introduced legislation to bar PG&E state tax deductions.

SB 681 was proposed by state Sen. Jerry Hill, D-San Mateo/Santa Clara counties, and Assemblymember Kevin Mullin, D-San Mateo, in the wake of a letter sent by the PUC to federal and state tax agencies. “It is unclear whether the tax agencies will prohibit PG&E from taking deductions for these penalties,” Hill said in a news release about his bill. “SB 681 will remove this ambiguity” in regard to state deductions, Hill said.

From the beginning, San Bruno has said the money ought really to come out of after-tax dollars. San Bruno also wants a series of remedial measures. For many tax deductions are surprising, though they probably should not be. After all, most payments in business are deductible, even punitive damages. The tax code prohibits deducting “any fine or similar penalty paid to a government for the violation of any law.” That includes criminal and civil penalties, yet many companies are able to deduct fine-like settlements.

The line-drawing can be extreme. If a fine or penalty is intended to be punitive, it is probably nondeductible. But if the fine is remedial in nature, it may be deductible despite its “fine or penalty” name. Environmental payments and other payments to governmental entities may qualify.

***Example*:** Suppose you pay a $100 million fine. If it's nondeductible, it costs $100 million. But if you are in a 40% tax bracket and can deduct it, the fine actually costs you $60 million after taxes.

Some find this troubling from a policy standpoint. Remember Exxon's $1.1 billion Alaska oil spill settlement? It actually cost Exxon $524 million after taxes. More than half of the $900 million in civil damages Exxon paid were also deductible.

It is sometimes possible to settle with a government agency and to address this issue. The settlement agreement may specify that a fine is remedial rather than punitive in character. If the settlement agreement isn't specific—and sometimes even if it is—tax deductions may land companies in court a second time. There is often considerable ambiguity, which can encourage taxpayers to claim deductions.

Compensatory damages are clearly deductible. So are punitive damages paid in the course of a trade or business. Thus, deductions are likely despite the fact that tax deductions for wrongdoers rub many the wrong way. A good example was BP's large payments relating to the Gulf oil spill. Sen. Bill Nelson, D-Fla., called for a congressional inquiry into BP's tax treatment. Senator Nelson didn't focus solely on the extent to which BP would deduct fines, penalties or related counsel fees.

He also asked whether BP should be allowed to deduct the $20 billion placed in escrow for injured parties. He even questioned the tax treatment of the compensatory damages paid to federal and state governments. Whether the wrongdoer is BP or PG&E, the public is becoming increasingly watchful for tax breaks that it perceives help to ameliorate—or might even be seen to encourage—bad behavior.

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