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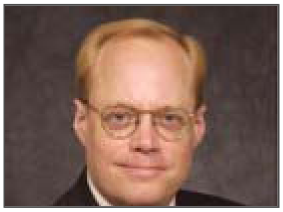

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TAXES 10/06/2015

BP's $20.8 Billion Gulf Spill Settlement Nets $15.3 Billion Tax Write-Off

The government's $20.8 billion out-of-court settlement with BP would resolve the charges related to the Gulf Oil spill. You might assume a fine of this nature is serious enough not to be tax deductible. But BP should be able to write off the vast majority, a whopping $15.3 billion. The proposed deal designates only about one quarter, $5.5 billion, as a non-tax-deductible Clean Water Act penalty. BP can write off the natural resource damages payments, restoration, and reimbursement of government costs.

One big critic of the deal is U.S. Public Interest Research Group, which often rails against tax deductions claimed by corporate wrongdoers. U.S. Public Interest Research Group has asked the Justice Department to deny tax deductions for BP and other corporate defendants in the past. The organization has a research report here (link) on settlement deductions. But a change to the tax code may be needed to have the desired effect.

The present tax code allows businesses to deduct damages, even punitive damages. Restitution and other remedial payments are also fully deductible. Only certain fines or penalties are nondeductible. Even then, the rules are murky, and companies routinely deduct payments unless it is completely clear that they cannot.

A Greenpeace activist puts up a banner as they block off a British Petroleum fuel station in protest as the BP board announced their annual results, in London on July 27, 2010. (AP Photo/Alastair Grant, FIle)

Some observers point out that at least $5.5 billion is made explicitly nondeductible by BP. Even U.S. Public Interest Research Group notes that this provision is a step in the right direction. Such explicit provisions can clear up the inherent ambiguity in legal settlements. And that is one reason the Justice Department is often seeing the tax issue raised. Sometimes, the defendant is able to finesse the issue. Bank of America's historic $17 billion legal settlement over soured mortgage securities got around the DOJ policy of trying to explicitly deny tax deductions.

Some lawmakers and consumer advocates say that the Justice Department and federal regulators need to take taxes into account in striking settlement deals, and even in touting settlement figures in announcements. Otherwise, people think it's costing a targeted business one thing, when the after tax cost —paid for by taxpayers—is something else. Given our media sensitive culture, it is a fair point.

For businesses, most legal expenses and most payments to resolve litigation are deductible. However, fines and penalties paid to the government are often 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) 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. PIRG 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.

It is worth noting that BP has paid considerable amounts, and deducted them. BP wrote off the cost of its $32 billion cleanup effort after the spill, costing American taxpayers roughly $10 billion. However, the Justice Department reached a $4 billion criminal settlement with BP over its role in the deaths of 11 workers on the oil rig when it exploded. That $4 billion was explicitly made nondeductible.

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