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THE TAX LAWYER

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Will BP Oil Spill Victims Pay Tax On \$7.8B Settlement?

The [news release](#) that BP reached a \$7.8 billion settlement over its Deepwater Horizon oil spill could mean cash for many victims soon. It's good news for BP too, although BP must still deal with probable government fines. See [BP Spill Saga Far From Over](#). BP can deduct compensation paid to victims but may have a hard time deducting government fines.



BP set aside a whopping \$20 billion to cover costs after its rig exploded and spread crude across a large portion of the Gulf of Mexico back in April of 2010. Although repeatedly trumpeting the \$20 billion figure, BP has paid out only \$8.1 billion from the trust administered by Kenneth Feinberg. Individuals and businesses can file claims directly against the fund without paying lawyers.

The proposed settlement includes a matrix of scheduled payments for a variety of illnesses said to have been caused by leaking oil. A 21-year window allows more health claims to materialize. The settlement is designed to resolve most private claims for economic loss, property damage and medical injuries.

That mix of claims means some monies won't be taxed but others will. Understandably, most victims were focused on recovering, but now that payment is on the way, what's taxed and what's not?

Physical Injury Awards are Tax-Free. Damages for personal physical injuries or physical sickness are tax-free. Up until 1996, just about anything qualified including emotional distress, defamation or invasion of privacy. See [Don't Fail To Consider Taxes When Settling Litigation](#). But in 1996, [Section 104](#) of the tax code was amended so only recoveries for personal ***physical*** injuries or ***physical*** sickness count.

Since then, there's been no end of litigation about how "physical" injuries must be. Headaches, insomnia and stomachaches are not enough. See [IRS To Collect on Italian Cruise Ship Settlements](#). But many injuries are internal and much physical sickness can't be observed with the naked eye. See [Are PTSD Recoveries Tax Free?](#)

Property Damages Can Be Tax-Free. If a settlement pays for damaged or destroyed property it may be a "recovery of basis." That means tax-free as long as you don't get back more than you paid and haven't claimed a casualty loss deduction. A recovery in excess of your basis may be taxed at the 15% capital gains rate.

Punitive Damages and Interest. These items are always taxable.

Attorney Fees Can Be a Tax Trap. Contingent legal fees can produce tax traps. If a 40% of a settlement goes to the lawyer, the tax law still treats the plaintiff as receiving 100%. If the damages aren't taxable, arise out of employment or your business, that's no problem. See [Six Tax-Wise Ways To Reduce Your Legal Bills](#).

But elsewhere attorney fees are usually a miscellaneous itemized deduction, meaning the [alternative minimum tax](#) and other gotcha tax provisions may mean you pay tax on moneys your attorney received. It's another reason to talk to a tax expert before you sign any settlement.

For more, see:

[BP Case Shifts to Fight Over U.S. Pollution Fines That May Top \\$17B](#)

[Tax-Free Physical Sickness Recoveries In 2010 And Beyond](#)

[BP, Plaintiffs Reach Gulf Oil Spill Settlement](#)

[BP Announces Settlement With PSC](#)

[Your Pain, The IRS' Gain](#)

[IRS Issues New Rules For Tax-Free Legal Settlements](#)

[IRS To Collect on Italian Cruise Ship Settlements](#)

[Bar Is Burned Down, Condemned, Then Taxed!](#)

[Duke Lacrosse Tax Lien Highlights How Lawsuits Are Taxed](#)

[Tax Issues in Employment Mediations](#)

[Six Tax-Wise Ways To Reduce Your Legal Bills](#)

[Is Physical Sickness the New Emotional Distress?](#)

[Watch Your Mail For 1099s](#)

[Address Taxes When You Mediate Civil Disputes](#)

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