PERSPECTIVE

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BP And Tax Deductible Damages

By Robert W. Wood

The gulf oil spill in 2010 was cataclysmic. Now, that a judge has approved BP's $20 billion settlement over the spill, it is appropriate to look at the overall societal costs, as well as the bottom line to BP. And at tax time, people understandably think about their own taxes, too.

The government struck a $20 billion settlement with BP, which is a big number. Yet BP should be able to deduct the vast majority, a whopping $15.3 billion, on its U.S. tax return. That means American taxpayers are contributing quite a lot to this settlement, whether they know it or not.

BP can write off the natural resource damages payments, restoration and reimbursement of government costs. Only $5.5 billion is labeled as a non-tax-deductible Clean Water Act penalty. One big critic of the deal is U.S. Public Interest Research Group, which often rails against tax deductions by corporate wrongdoers. U.S. PIRG has asked the Justice Department to deny tax deductions for BP and other corporate defendants.

The proposed Truth in Settlements Act (S. 1109, 114th Cong. (2015)) would require agencies to report after-tax settlement values. Another bill, S. 413, 114th Cong. (2015), would restrict tax deductibility and require agencies to spell out the tax status of settlements. 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. U.S. PIRG released a statement on April 5, in response to the finalized BP oil spill settlement that allows the $15.3 billion tax deduction:

"Though we are glad that the protracted settlement to address BP's actions in relation to the 2010 Gulf Oil Spill has finally concluded, and injured parties can begin to be made whole again, we are disappointed that BP will yet again be able to claim its settlement payments as ordinary cost of doing business tax deductions."

"$15.3 billion of the settlement qualifies as a tax deduction, earning the oil giant a tax windfall for what amounts to gross negligence. Despite thousands of comments from ordinary Americans calling on the Department of Justice to deny these tax write offs, BP will still be able to claim the settlement as business as usual. This not only shifts the burden of the deal onto ordinary taxpayers, but it also sends the wrong message."

"The Department of Justice had an opportunity to set a precedent in this case, and we are disappointed that the agency chose to instead continue subsidizing BP's wrongdoing."

Explicit provisions in settlement agreements that say "$___ cannot be deducted" can clear up the inherent ambiguity in legal settlements. That is one reason the Justice Department is often seeing taxes raised in settlement negotiations. But the practice is not uniform. Even where the DOJ makes an explicit tax demand, sometimes, the defendant is able to finesse the issue.

For example, Bank of America's legal settlement over soured mortgage securities was a historic $17 billion. Yet BofA steered around DOJ's policy regarding explicitly denying tax deductions. Some lawmakers and consumer advocates say the Justice Department and federal regulators need to take taxes into account in settlements.

Critics say it is even hard to assess the dollars being collected. Even touting settlement figures in announcements should be more clear, they say. That way people will not think that a business is paying it all, if the after-tax cost is less. 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.

These issues are more likely to be discussed today than they were in the past. And clearly, explicit provisions about taxes in settlement agreements are becoming more common. For example, the DOJ expressly prohibited Credit Suisse from deducting its $2.6 billion settlement for helping Americans evade taxes. The BNPP terror settlement also states that BNPP will not claim a tax deduction.

By contrast, BP has done very well, and not just over this $20 billion. In fact, even before this big final settlement, BP wrote off the cost of its $32 billion cleanup effort after the spill. A $32 billion tax deduction cost 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. Tax deductions can be considered — and probably should be considered — in many cases. For bad conduct that the government is seeking to punish, a non-deductible payment smarts considerably more than one that is just another business expense.

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