Wood LLP Tax Alert

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BP 'Grossly Negligent' In Gulf Spill, Eyes $18 Billion Penalty--And Tax Deduction

Federal Judge Carl Barbier has found British Petroleum ‘grossly negligent’ in causing the Deepwater Horizon disaster. The finding paves the way for huge penalties that may reach $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 disagrees and will presumably appeal, but there is already jockeying over tax deductions if and when BP pays.

BP has already written 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.

Fire on the offshore drilling rig Deepwater Horizon as viewed from the offshore supply vessel Laney Chouest. (Photo credit: Wikipedia)

Yet many companies can and do get around this. After all, huge dollars are at stake, and 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. If BP pays $18 billion, the tax write-off could be worth $6 billion or more. The U.S. Public Interest Research Group tracks the tax implications of legal settlements. That group is not easy on BP or other companies, nor on the DOJ, saying that the DOJ should forbid deductibility.

The tax code already speaks to this subject. 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. After all, 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.

Who knows, perhaps the initials BP will start to stand for Big Penalty?

You can reach me at Wood@WoodLLP.com. This discussion is not intended as legal advice, and cannot be relied upon for any purpose without the services of a qualified professional.

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