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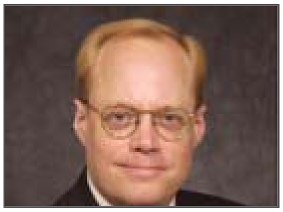

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The BNP Paribas $9 Billion Terror Settlement & Tax Deductions

French banking giant BNP Paribas settled with state and federal authorities by paying nearly $9 billion in penalties. It even pleaded guilty to illicitly transferring funds on behalf Sudan, Iran, and Cuba despite economic sanctions. The conduct is reprehensible, but is it tax deductible? Often, reprehensible conduct still leads to tax deductions that are perfectly legit.

In fact, this extreme case might even be no exception. However, it turns out that here the answer is no, at least not in the U.S. The settlement states that BNPP agrees not to claim any tax deduction for U.S. federal, state, or local tax. Yet the deal does *not* prohibit the bank from taking tax deductions overseas. That's a twist that means in some ways here the answer is yes. And with global companies, a tax deduction one place can have effects elsewhere.

Tax deductions are big business. Yet deductions for big legal settlements—especially fines and penalties—have come under fire in recent years. How many tax dollars are at stake in this $9 billion deal? Based on the 35% federal tax rate on corporate profits, if this deal were deductible it would mean that U.S. taxpayers would have to pick up over a third of the total, more than $3 billion.

The [U.S. Public Interest Research Group] tracks the tax implications of legal settlements. And they are not easy on the DOJ, saying that DOJ should forbid deductibility. In this case, DOJ required the foregone tax deductions. Mr. Phineas Baxandall, Senior Analyst at the U.S. Public Interest Research Group, noted, "If BNP truly did aid terrorists as the Justice Department alleges, they certainly shouldn't get a tax break for it."

Whether a settlement is tax-deductible does not depend on whether there is a guilty plea. In fact, most criminals who are ordered to pay restitution can deduct it, though the mechanics are notoriously nuanced. 1980s junk bond king Michael Milken paid $600 million in fines and restitution after he pled guilty to securities violations. Much of that was restitution paid back to injured parties.

And that generally means business expense deductions, since restitution is different from fines under the tax law. As recent controversies confirm, some fines—like much of JP Morgan Chase's $13 billion settlement—are tax deductible. Punitive damages are too. Section 162(f) of the tax code prohibits deducting ''any fine or similar penalty paid to a government for the violation of any law,'' including criminal and civil penalties plus sums paid to settle potential liability for fines. But the tax law allows businesses and business people to deduct compensatory and remediation payments.

Despite punitive sounding names, some fines and penalties are viewed as remedial rather than penal so are deductible. That is precisely why some defendants insist that their settlement agreement confirms that the payments are *not* penalties and *are* remedial. Behind the headlines, it's often not clear what's being paid even when something is called a penalty.

Consider convicted hedge fund titan Raj Rajaratnam, ordered to pay a $92.8 million penalty. Mr. Rajaratnam was sentenced to 11 years in prison plus $156 million. Unless a settlement says otherwise, companies that acknowledge fault can still claim deductions for restitution or compensation. Tax language in settlement agreements doesn't bind the IRS, but it goes a long way toward avoiding tax disputes. But public outrage to some large settlements that end up being deducted is creating more tax focus at settlement time.

Thus, explicit provisions about taxes are becoming more common. Explicit provisions impact cost and avoid confusion. DOJ did expressly forbid Credit Suisse from deducting its $2.6 billion settlement for helping Americans evade taxes. Sometimes the government and a defendant split the baby. For example, of the $13 billion JP Morgan settlement struck in late 2013, only $2 billion was said to be nondeductible.

The Justice Department hasn't explained why it allows some companies to treat settlement payments as business expenses. DOJ doesn't always disclose the terms of settlements either. But that could change. Proposed legislation, The Truth in Settlements Act (S. 1898 – fact sheet) would require agencies to report expected after-tax settlement values. It is cosponsored by Senators Warren (MA-D) and Coburn (OK-R).

Another bill, S. 1654, cosponsored by Senators Reed (RI-D) and Grassley (IA-R) would restrict tax deductibility and require agencies to spell out the tax status of settlements. A similar bill in the House was sponsored by Representative Peter Welch (VT-D). A poll released this spring by the U.S. Public Interest Research Group Education Fund and conducted by Lake Research Partners found that substantial majorities across party lines disapprove of deductible settlements and want federal agencies to be more transparent.

But for now, except where there's an express denial of tax deductions, we can expect businesses to deduct all that they can.

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.