Tax Deductible Expenses: The BP Case

name redacted
Analyst in Economics

August 11, 2010

Congressional Research Service
7-....
www.crs.gov
R41365

CRS Report for Congress
Prepared for Members and Committees of Congress

Summary

Following the release of BP's second quarter earning statement, which showed a $10 billion reduction in tax liability for oil-spill-related cleanup and expenses, media headlines have generated public concern, and in some cases outrage, over these tax savings. Further, the ability of BP to realize these tax savings has generated a number of inquiries as to how and why BP is entitled to this reduction in tax liability.

BP's reduction in tax liability is the result of standard business expense deductions and the general ability of taxpayers to claim refunds for previously paid taxes when realizing a net operating loss (NOL) or carrying the loss forward to offset future tax liabilities. Business expense deductions and NOLs play a significant role in enhancing economic efficiency by reducing business-cycle-induced fluctuations and spreading risk. BP has reportedly incurred, or expects to incur, $32 billion in cleanup-related costs and settlements over a multiyear period. Under current law, these costs can be used to offset business income and reduce tax liability. To the extent that these costs generate an NOL, these costs can be used to collect a refund for taxes paid in previous years or carried forward to offset tax liability in future years.

The $10 billion "credit" that appears on BP's second quarter earnings statement is a financial account of BP's anticipated tax savings associated with legitimate cleanup-related expenses. The figure does not reflect a tax credit as typically defined in the tax code. The $10 billion reduction in tax liability relates to a multiyear period, over which the $32 billion will be spent. The $32 billion was reported in 2010 for financial reporting purposes, but reflects cleanup spending costs in the current year as well as costs the company expects to incur in future years. The financial account and financial reports do not directly correspond to current year tax liabilities. Actual oil-spill-related expenditures will be made over multiple years. Consequently, the associated tax savings will not be realized until the year expenditures are made.

Introduction

Media reports discussing BP's second quarter earning statement, which showed a $10 billion reduction in tax liability for oil-spill-related cleanup and expenses, have raised public concern, and in some cases outrage, over these tax savings.[1] Further, the ability of BP to realize these tax savings has generated a number of inquiries as to how and why BP is entitled to this reduction in tax liability.

BP's reduction in tax liability is the result of standard business expense deductions and the general ability of taxpayers to claim refunds for previously paid taxes when realizing a net operating loss (NOL) or carrying the loss forward to offset future tax liabilities. This report begins with an overview of the U.S. corporate tax system, highlighting some business expenses that are deductible and noting some that are not. NOLs, and the associated tax refunds, are subsequently addressed. Business expense deductions and NOLs play a significant role in enhancing economic efficiency by reducing business-cycle-induced fluctuations and spreading risk. Finally, the specifics of the BP case are addressed. BP has reportedly incurred, or expects to incur, $32 billion in cleanup-related costs and settlements over a multiyear period. Under current law, these costs can be used to offset business income and reduce tax liability. To the extent that these costs generate an NOL, these costs can be used to collect a refund for taxes paid in previous years or carried forward to offset tax liability in future years.

The $10 billion "credit" that appears on BP's second quarter earnings statement is a financial account of BP's anticipated tax savings associated with legitimate cleanup-related expenses. The figure does not reflect a tax credit as typically defined in the tax code. The $10 billion reduction in tax liability relates to a multiyear period, over which the $32 billion will be spent. The $32 billion was reported in 2010 for financial reporting purposes, but reflects cleanup spending costs in the current year as well as costs the company expects to incur in future years. The financial account and financial reports do not directly correspond to current year tax liabilities. Actual oil-spill-related expenditures will be made over multiple years. Consequently, the associated tax savings will not be realized until the year expenditures are made.

The U.S. Corporate Tax System

In the United States, the corporate income tax is levied on taxable corporate income earned by "C" corporations.[2] A C corporation generally operates as a taxable entity separate from its shareholders.[3] Taxable income is computed at the corporate level by aggregating all sources of business income and then subtracting qualified business expenses and other special deductions.

[1] See, for example, Neil King Jr., "BP Seeks Tax Cut on Cleanup Costs," *The Wall Street Journal*, July 28, 2010 and Patrik Jonsson, "If BP Qualifies for $10 billion Cleanup Tax Break, Should It Get One?," *Christian Science Monitor*, August 6, 2010.

[2] For an overview of the U.S. corporate tax system see CRS Report RL33171, *Federal Business Taxation: The Current System, Its Effects, and Options for Reform*, by (name redacted).

[3] Alternative, closely held corporations may be structured as "S" corporations. S corporations are treated as pass-through entities for tax purposes. As a pass-through entity, income and losses at the corporate level are passed through to shareholders and reported on those shareholder's individual tax returns. For more information on business organizational choice, see CRS Report R40748, *Business Organizational Choices: Taxation and Responses to Legislative Changes*, by (name redacted).

Tax liability is determined according to the corporate income tax schedule, and reduced in accordance with claims for tax credits. As such, a corporation's tax liability can be calculated as:

$$\text{Taxes} = [(\text{Business Income} - \text{Expenses})(1 - p) \times t] - \text{Tax Credits},$$

where t is the statutory tax rate and p is the production activities deduction.[4]

The primary components of business income are revenues generated from the sale of goods and services. Other income sources include investment income, royalties, rents, and capital gains. Once business income has been determined, expenses allowed by the Internal Revenue Code (IRC) are deducted. Theoretically, taxes are levied on profits, rather than gross income.

Deductible expenses include salaries and wages, purchased materials and inputs, advertising costs, charitable contributions, insurance premiums, legal fees, and various other items. Interest payments are also deductible. When the production activities deduction applies, the tax rate is the statutory tax rate (generally, 35%) multiplied by (1-p). For example, when p = 0.06, the tax rate at which deductions are valued is 32.9% (= 35% × 0.06).[5] Finally, a deduction can be taken for depreciation allowances.[6] Deductions reduce tax liability according to the corporation's marginal tax rate. For example, if a corporation in the 35% tax bracket has a qualifying deduction of $100,000, the corporation's tax liability is reduced by $35,000 (= $100,000 × 35%).

Once taxable income has been determined by subtracting deductible expenses from business income, a preliminary tax liability is determined using the corporate income tax schedule (denoted as t in the equation above). Like the individual income tax, the corporate tax is designed to be generally progressive. Very small firms, with taxable income of less than $50,000, pay a 15% tax rate.[7] Large firms, those with taxable income in excess of $75,000, face a marginal tax rate of at least 34%, while corporations with taxable income of $10 million face a marginal tax rate of at least 35%.[8]

Finally, tax credits reduce a corporation's tax liability dollar-for-dollar. Corporations can offset U.S. tax liability using foreign tax credits,[9] or by claiming tax credits for research and

4 The production activity deduction (Internal Revenue Code (IRC) §199) was introduced as part of the American Jobs Creation Act of 2004 (P.L. 108-357). Qualified production activities are allowed a 9% deduction from taxable income. For oil extraction, the deduction is limited to 6%.

5 For oil extraction, p = 0.06. For other manufacturing sectors, generally p=0.09, and deductions are valued at 31.85% (= 35% × 0.09).

6 Depreciation allowances account for the decline in value of tangible capital. When corporations purchase capital assets, such as buildings and equipment, it is expected that these capital assets will be used in the production process for many years. The tax code requires that businesses capitalize such investments, and take depreciation deductions over time. Oftentimes, depreciation deductions are allowed at a rate that approximates the rate at which the capital investment loses value. Other times, depreciation allowances are accelerated, providing additional deductions early-on, increasing the value of the stream of deductions to the taxpayer.

7 The corporate tax brackets and rates cited here are current for 2010 and have remained the same in all years since 2005.

8 In practice, the corporate tax schedule contains two brackets where the marginal tax rate exceeds 35%. Corporations with taxable income between $100,000 and $335,000 face a marginal tax rate of 39% while firms with taxable income between $15 million and $18.33 million face a marginal tax rate of 38%. The higher marginal tax rates for these tax brackets capture revenue forgone in the lower tax brackets from large corporations, such that average tax rate for large firms equals the marginal tax rate faced by most firms of 35%.

9 See CRS Report RL32749, *U.S. Taxation of Overseas Investment and Income: Background and Issues*, by (name reda cted) and CRS Report RL34115, *Reform of U.S. International Taxation: Alternatives*, by (name redacted).

development (R&D),[10] an employment tax credit,[11] various energy-related tax credits,[12] and other various tax credits.

Foreign corporations operating in the United States are generally subject to U.S.-business taxes on their U.S.-source income.[13] Generally, foreign firms operate in the U.S. either through a U.S.-chartered subsidiary corporation or as a branch of the foreign-chartered parent corporation. If the foreign firm is operating as a U.S.-chartered subsidiary, the firm is treated like other U.S.-chartered corporations and subject to tax on its worldwide income (although income tax on foreign-source income can be deferred and is eligible for foreign tax credits). If the foreign firm is operating in the United States as a branch of the foreign-chartered parent corporation, the foreign firm is subject to U.S. tax only on its income derived from U.S. sources.

Like individuals, corporations may be subject to the alternative minimum tax (AMT). The purpose of the AMT is to guarantee that corporations are subject to a minimum level of taxation by limiting the ability to claim deductions and credits. The AMT requires that taxpayers pay the higher of their regular corporate tax liability or their tax liability as calculated under the AMT. The AMT imposes a lower statutory rate than the standard corporate tax schedule, but limits deductions and credits, effectively broadening the tax base.

What Expenses are Deductible?

Generally, a deduction is allowed for all "ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business."[14] Examples of deductions allowed under this provision were noted above. Capital expenditures cannot be immediately deducted, but are instead depreciated over a number of years. Additional tax-deductible expenses an oil company might face in cleaning up an oil spill include expenses for repair to damaged equipment, expenses for settling claims of various parties affected by the spill, legal and accounting expenses, and various fines and penalties (see below for instances where fines and penalties cannot be deducted). If the oil spill occurred during operations that were directly connected with the business of operating an oil company, and if the damage caused resulted directly from the oil company's business operations, the expense involved in the cleanup, the repair of equipment, and the settlement of claims resulting from the oil spill would be treated as ordinary and necessary business expenses. A company cannot deduct expenses or claims that were paid by insurance, but can deduct insurance premiums.

The tax code explicitly denies deductions for certain types of expenditures.[15] Specifically, taxpayers cannot claim a deduction "for any fine or similar penalty paid to a government for the

---

[10] See CRS Report RL31181, *Research and Experimentation Tax Credit: Current Status and Selected Issues for Congress*, by (name redacted).

[11] See CRS Report R41034, *Business Investment and Employment Tax Incentives to Stimulate the Economy*, by (name r edacted) and (name redacted).

[12] See CRS Report R40999, *Energy Tax Policy: Issues in the 111th Congress*, by (name redacted) and (name reda cted).

[13] See CRS Report RL33171, *Federal Business Taxation: The Current System, Its Effects, and Options for Reform*, by (name redacted).

[14] IRC § 162(a).

[15] For information on the tax treatment of litigation expenses, see CRS Report RL32253, *Tax Issues in Litigation: Treatment of Judgment and Settlement Payments and Deductibility of Legal Expenses*, by (name redacted).

violation of any law."[16] Fines and penalties do not include compensatory damages or legal fees. Deductions are also limited for damage payments awarded as part of a civil antitrust suit.[17] In civil antitrust suits, damages awarded are typically three times the actual damages incurred. The party responsible for paying the damages is only allowed to deduct one-third of the damage award, or the compensatory part of the award. Taxpayers are also not allowed to claim deductions for bribes paid to public officials,[18] or for other unlawful bribes or kickbacks.[19] There are also limits on deductions that can be taken for "excessive" employee compensation.[20] Under current law, compensatory damages are deductible, as are most punitive damages, paid in the course of conducting business.[21]

Net Operating Losses

Corporations with negative taxable income are said to have a net operating loss (NOL). [22] Generally, an NOL can be used to obtain a refund for taxes paid in previous years (carried back) or used to offset future tax liability (carried forward).[23] For most taxpayers, NOLs can be carried back for two years or carried forward for up to 20 years. For a corporation with an NOL, the loss is first used to claim a refund for taxes paid in the previous two years (the most recent year first, then additional losses can result in a refund for taxes paid two years prior).[24] If the carryback does not fully exhaust the NOL, the remaining portion can be carried forward for up to 20 years.

The intent of the NOL carryback/carryforward provision is to give taxpayers the ability to smooth changes in business income, and thus tax liability, over the business cycle. Further, the NOL carryback/carryforward provision addresses the arbitrary nature of a one-year accounting period generally imposed on businesses. Take, for example, a corporation with an NOL in 2010. Suppose that the corporation had a positive taxable income in the previous year, 2009, that exceeded the current NOL.[25] If the corporation had been subject to a two-year accounting period, rather than a one-year accounting period, the corporation would never have realized the loss. Thus, from this perspective, the NOL provision helps overcome restrictions on offsets imposed by the one-year accounting period.

The NOL carryback/carryforward provision not only helps taxpayers smooth income as income changes over the business cycle, but also helps businesses reduce risk of financial loss. The government, by allowing firms to claim loss offsets, effectively enters into a partnership with taxpayers. Under this partnership, the government shares in both the return to investment (tax

---

[16] IRC § 162(f).

[17] IRC § 162(g).

[18] IRC § 162(c)(1).

[19] IRC § 162(c)(2).

[20] IRC § 162(m).

[21] For background and legal analysis of this issue, see Robert W. Wood, "BP, Oil, and Deducting Punitive Damages," *Tax Notes*, August 9, 2010, pp. 663-669.

[22] For additional background information on NOLs, see CRS Report RL34535, *Net Operating Losses: Proposed Extension of Carryback Period*, by (name redacted).

[23] IRC § 172(b).

[24] Taxpayers seeking a refund for taxes paid must either file an amended tax return (IRS Form 1120X) or an application for a tentative refund (IRS Form 1139).

[25] Assume also that the corporation did not claim any tax credits in the previous year.

revenues) and the risk of investment (revenue loss). The allowance of NOL carryback/carryforward reduces risk to the investor (the firm) by sharing that risk with the government. The longer the carryback period, the less risk for investors. Reducing the private risk associated with investing increases investment, minimizing the distorting effects of taxation on investment decisions, enhancing economic efficiency. If the government can spread risk better than private markets, additional gains in economic efficiency may result from an extended NOL carryback period.

The BP Case

In late July 2010, a number of media outlets reported that costs incurred by BP in conjunction with cleaning up the Gulf of Mexico oil spill reduced BP's tax liability by nearly $10 billion.[26] This figure was initially reported in BP's second quarter earnings statement, and reflects a reduction in tax liability over a multiyear period.[27] As discussed below, BP's reduced tax liability has been calculated based on deductions associated with costs of doing business. Further, to the extent that cleanup costs and other deductible expenses generate negative taxable income, BP may claim a rebate for previous taxes paid using an NOL carryback. The $10 billion "credit" in BP's second quarter financial statement is a credit in terms of their financial account, and not explicitly a tax credit. BP is not currently eligible for any tax credits, as defined in the tax code, as a result of expenditures associated with oil spill cleanup or settlements.[28]

BP's second quarter earnings statement shows a loss of $17 billion for the period.[29] This loss includes more than $32 billion in costs associated with cleanup in the Gulf of Mexico that will be spent over a multiyear period.[30] The $32 billion in cleanup costs includes the present value of the $20 billion escrow account BP has set up to help compensate oil spill victims,[31] BP's estimate of penalties it may face under the Federal Water Pollution Prevention and Control Act (Clean Water Act); general costs related to spill cleanup and relief well drilling; grants to states whose shorelines were affected; federal costs (including the involvement of the U.S. Coast Guard); legal costs anticipated in relation to litigation, and the funding of the Louisiana barrier islands project.[32] According to Lee Sheppard at *Tax Notes*, "the $10 billion tax reduction relates to the multiyear period over which the $32 billion will be spent."[33] Reportedly, BP has stated that some of these deductions will create NOLs and be carried back to generate refunds based on taxes previously

[26] See, for example, King Jr., "BP Seeks Tax Cut on Cleanup Costs" and Jonsson, "If BP Qualifies for $10 billion Cleanup Tax Break, Should It Get One?."

[27] Credits reported in financial statements are not necessarily the same as tax credits. Financial reporting generally uses accrual accounting, where spending and tax savings may be reported when an economic event occurs rather than when cash transactions take place.

[28] Tax credits in this context include those noted above that offset tax liability dollar-for-dollar in the current year. Oftentimes, tax credits may be carried forward to offset future tax liability.

[29] BP, "Second Quarter and Half Year 2010," press release, July 27, 2010, available at http://www.bp.com/liveassets/bp_internet/globalbp/STAGING/global_assets/downloads/B/bp_second_quarter_2010_results.pdf.

[30] Lee Sheppard, "Cash on the Barrelheads: BP and Taxes," *Tax Notes*, August 9, 2010, pp. 571-576.

[31] BP will contribute $3 billion in cash to the escrow account in the 3rd quarter of 2010, $2 billion in the 4th quarter of 2010, and $5 billion per year over the next three years. The deduction currently taken is the present value of these cash flows.

[32] BP, "Second Quarter and Half Year 2010," p. 25.

[33] Sheppard, "Cash on the Barrelheads: BP and Taxes," p. 571.

paid.[34] The information presented in BP's second quarter financial statements is not, however, sufficient to determine whether qualified deductions claimed for tax purposes in 2010 will exceed 2010 income, generating NOLs.

Although BP is expected to take a deduction for funds in the escrow account, it is not clear that federal revenues will ultimately be reduced by the full amount of the deduction. Funds in the $20 billion escrow account are currently being paid as claims to businesses and individuals. To the extent that these funds are being used to replace lost income, the federal government will collect a portion of tax revenues through income taxes.[35] Claims payments received by businesses and individuals as compensation for lost income are currently taxable.

It has been suggested that BP should not claim a tax deduction for oil spill cleanup and related expenses, and realize the associated reduction in tax liability.[36] Although companies in the past have forgone legitimate deductions, the practice is highly uncommon. Further, it might be argued that a corporation's forgoing of legitimate tax deductions violates obligations to shareholders. Nonetheless, in recent years, there have been a few cases where high-profile companies have chosen to forgo deductions associated with settlements or fees. For example, in 2006, Boeing did not claim a deduction for a $615 million settlement over contract improprieties.[37] In 2010, Goldman Sachs Group agreed to not deduct $550 million in penalties. This agreement, however, was negotiated as part of a settlement with the Securities and Exchange Commission (SEC).[38] In both the Boeing and Goldman Sachs cases, the forgone deductions were for settlement fees, not costs associated with business operations.

There is precedent for corporations claiming a tax deduction for costs associated with oil spill cleanup and settlements. In an analysis of the value of the *Exxon Valdez* settlement, the Congressional Research Service noted that the actual cost to Exxon of the settlement would be reduced as civil payments were tax deductible.[39]

From a policy perspective, some commentators note that it is important to balance efforts to hold BP accountable for oil-spill-related costs against the possibility of driving the company into bankruptcy. They assert that should BP be forced into bankruptcy, the ability to hold BP liable for oil-spill-related costs in the future would diminish considerably.

---

[34] Ibid, p. 571.

[35] For an overview of the tax treatment of claims payments, see CRS Report R41323, *Tax Issues and the Gulf of Mexico Oil Spill: Legal Analysis of Payments and Tax Relief Policy Options*, by (name redacted), (name redacted), and (name redacted).

[36] Jia Lynn Yang, "BP to cut U.S. tax bill by $10 billion because of losses in gulf spill," *The Washington Post*, July 27, 2010.

[37] Wood, "BP, Oil, and Deducting Punitive Damages," p. 663.

[38] Ryan J. Donmoyer, "Goldman Waives Tax Deduction on SEC Settlement," *Bloomberg*, July 16, 2010, available at http://www.bloomberg.com/news/2010-07-16/goldman-waives-tax-deduction-on-sec-settlement.html.

[39] U.S. Congress, House Committee on Merchant Marine and Fisheries, Subcommittee on Fisheries and Wildlife Conservation and the Environment, *Negotiated Settlement from the Exxon Valdez Oil Spill*, 102nd Cong., March 20, 1991, Serial No. 102-8.

Legislative Responses

Lawmakers have responded to BP's quarterly earnings statement by introducing legislation that would limit BP's ability to claim a deduction for certain oil spill cleanup and other related costs. The Closing Oil Spill Tax Loopholes Act of 2010 (H.R. 5995) seeks to prevent a deduction for any payments made under the Oil Pollution Act of 1990 (OPA).[40] The Denial of Certain Tax Benefits to Offending Oil Polluters Act of 2010 (H.R. 6031) would deny all income tax credits and deductions to parties determined to be "offending oil polluters." In addition, Senator Bill Nelson, in a letter to the Senate Finance Committee dated July 28, 2010, requested an investigation of BP's tax deductions.[41]

Author Contact Information

(name redacted)
Analyst in Economics
[redacted]@crs.loc.gov, 7-....

[40] For background information on the OPA, see CRS Report R41266, *Oil Pollution Act of 1990 (OPA): Liability of Responsible Parties*, by (name redacted).

[41] Letter from Bill Nelson, Senator, to Chairman Max Baucus and Senator Chuck Grassley, July 28, 2010.