

Limitations on Tax Deductibility of Asset Removal Expenditures and Application of ASC 740 Deferred Income Tax Accounting to Such Situations

March 15, 2013

Page 1

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Introduction

As described below, changes in tax law in the United Kingdom in 2012 have partially limited the deductibility of removal expenditures for oil and gas infrastructure assets and have raised an important deferred tax accounting issue for the oil and gas industry. Our research shows there is a lack of clarity in the authoritative tax accounting literature on how to apply the deferred tax accounting rules to a situation where asset removal expenditures have a restriction on their deductibility. That lack of clarity has led to differences of opinion among individual accounting professionals on how to interpret the U.S. GAAP income tax accounting rules in this type of situation.

Because of this lack of clarity in the authoritative accounting literature, ConocoPhillips requests this interpretive issue be considered for addition to the technical agenda of the Emerging Issues Task Force.

Background

In July, 2012, changes to tax law in the United Kingdom were enacted that restrict the tax deductibility of future spending to remove oil and gas infrastructure at the end of an asset's useful life. Instead of being able to claim a full deduction for a future removal expenditure at a 62% tax rate (30% corporate plus 32% special tax), the new restriction made 37.5% of the asset removal spending nondeductible for purposes of the 32% special tax. In 2011, the special tax rate on the oil and gas industry was increased to 32% from the previous 20% rate and government authorities at that time expressed concerns about whether asset removal expenditures should be allowed to be tax deductible at that increased tax rate. Those concerns led to the new tax legislation that was enacted in July, 2012. This restriction has the overall effect of limiting the tax deductibility for the future removal expenditure to the previous 50% overall tax rate. The enacted tax law contains a formula that forces the tax deductibility back to the 50% overall tax rate even if the special tax rate is further adjusted in the future.

ASC 410 (FAS 143) requires the recognition of an asset retirement obligation in long-term liabilities when a legal obligation is incurred to remove a long-lived asset in the future, with an offsetting asset retirement cost added to the carrying value of the related long-lived asset (which typically is PP&E in the oil and gas industry). Upon recording, temporary differences exist and deferred tax balances are recognized with respect to both the asset removal obligation as well as the asset retirement cost recorded in PP&E.

Historically, when the tax deductibility of future spending to settle the asset retirement obligation was projected to be at the same rate as the projected rate of tax for tax deductible depreciation on PP&E, the 62% tax rate was used to record the deferred tax asset for the asset retirement obligation temporary difference, as well as the deferred tax liability for the asset retirement cost temporary difference.

With the enactment in July of 2012 of the new limitation on the future tax deductibility of asset removal spending, there is general consensus ASC 740 is clear that the calculation of the deferred tax asset for

Limitations on Tax Deductibility of Asset Removal Expenditures and Application of ASC 740 Deferred Income Tax Accounting to Such Situations

March 15, 2013

Page 2

the asset retirement obligation temporary difference needs to reflect the limitation on deductibility of future asset removal spending, at the resultant effective tax rate of 50%. However, the guidance in ASC 740 and ASC 410 does not clearly address whether the calculation of the deferred tax liability for the temporary difference related to the asset retirement cost recorded in PP&E should similarly include consideration of the limited deductibility of the future spending on the asset removal.

Accounting Issues and Alternatives

Issue

- 1. Should the deferred tax liability associated with the asset retirement cost recorded in PP&E consider the reduced deductibility of the future spending on the asset removal?**

Issue #1 – Accounting alternatives considered

View A: The deferred tax liability associated with the asset retirement cost recorded in PP&E should not consider the reduced deductibility of the future spending on the asset removal.

Proponents of View A believe the deferred tax liability associated with the asset retirement cost recorded in PP&E should not reflect the limited deductibility of the future spending on the asset removal. Proponents of this view believe asset retirement costs recorded in PP&E are inseparable from the rest of the PP&E unit of account and believe separating PP&E into separate units of account for income tax accounting purposes would result in differing financial statement assertions between the financial cost accounting and the tax accounting for the same PP&E balance sheet account.

Proponents believe View A is consistent with the views expressed by the Financial Accounting Standards Board (the Board) in paragraph B42 and B43 of FAS 143:

B42. This Statement requires that upon initial recognition of a liability, an entity capitalizes an asset retirement cost by increasing the carrying amount of the related long-lived asset. The Board believes that asset retirement costs are integral to or are a prerequisite for operating the long-lived asset and noted that current accounting practice includes in the historical-cost basis of an asset all costs that are necessary to prepare the asset for its intended use. Capitalized asset retirement costs are not a separate asset because there is no specific and separate future economic benefit that results from those costs. In other words, the future economic benefit of those costs lies in the productive asset that is used in the entity's operations.

B43. . The Board considered whether asset retirement costs should be recognized as a separately identifiable intangible asset. The Board acknowledges that in certain situations an intangible asset, such as the right to operate a long-lived asset, may be acquired when obligations for asset retirement costs are incurred. However, the intangible asset is not separable from the long-lived asset, and similar intangible assets, such as building and zoning permits, are generally included in the historical cost of the long-lived asset that is acquired or constructed. Furthermore, the acquisition of an intangible asset in exchange for the agreement to incur asset retirement costs does not occur in all situations.

Proponents of View A additionally note the enacted tax rate--not a calculated tax rate--is applied to temporary differences. ASC 740-10-30-8 requires that currently-enacted tax rates be applied to taxable income projected to occur in the periods in which the deferred tax liability or asset is expected to be settled or realized. The United Kingdom has not changed the tax rate that is applied to taxable income--it remains at 62%. The tax law change instead relates to the deductibility of the asset retirement expenditures included in the calculation of taxable income. Therefore, the expected deductibility of the asset retirement obligation has changed, but there has been no change to the deductibility of PP&E (either the portion of PP&E related to the asset retirement cost or the initial cost basis).

Limitations on Tax Deductibility of Asset Removal Expenditures and Application of ASC 740 Deferred Income Tax Accounting to Such Situations

March 15, 2013

Page 3

View B: The deferred tax liability associated with the asset retirement cost recorded in PP&E should consider the reduced deductibility of the future spending on the asset removal.

Proponents of View B acknowledge the conceptual inseparability of the asset retirement cost from the rest of PP&E, but these proponents also believe the ASC 410 accounting model is unique in that future accounting estimate changes to the liability have an ongoing direct linkage back to the ongoing accounting for the related long-lived asset. Depreciation expense on the asset retirement cost plus accretion of discount on the asset retirement obligation must equal actual removal spending at the end of the asset's life cycle, and the asset retirement obligation and related asset retirement cost are periodically reviewed and recalibrated in a joint manner over time to achieve that outcome.

Because of this unique and on-going linkage of the liability to the asset in the ASC 410 accounting model, proponents of View B believe the related deferred tax calculations should also be linked. That is, advocates of this view believe this ongoing linkage in the accounting model indicates the measurement of the temporary differences for the asset retirement obligation and the related capitalized asset retirement cost should also be aligned, with both reflecting the limitation of deductibility of the future asset removal spending.

To support their view of the unique and ongoing linkage of the asset retirement cost to the asset retirement obligation, View B advocates primarily point to paragraph B55 of FAS 143:

B55. The Board concluded that revisions in estimates of cash flows are refinements of the amount of the asset retirement obligation, and as such are also refinements of the estimated asset retirement costs that result in adjustments to the carrying amounts of the related asset. Therefore, the Board noted that it was not necessary to distinguish revisions in cash flow estimates that arise from changes in assumptions from those revisions that arise from a new liability — both adjust the carrying amount of the related asset.

Proponents of View B also point out the following accounting outcomes which they view to be anomalies that would result under the View A approach to Issue #1:

- (1) Upon the initial incurrence and recognition of the asset retirement obligation and the offsetting asset retirement cost, recording the deferred tax asset with an adjustment for the future nondeductibility of 37.5% of the future asset removal spending, but not doing the same nondeductibility adjustment for the deferred tax liability, will cause an imbalance in the overall Day One accounting entry. Subsequent changes in estimates of the asset retirement obligation and the offsetting asset retirement cost adjustment to PP&E would similarly have an imbalanced accounting entry. Alternatives under View A to address these imbalanced accounting entries are described in Issue #2 below. View B proponents point out that the anomaly of imbalanced accounting entries would be entirely avoided under their view of Issue #1.
- (2) The recognition of an asset retirement obligation and the related asset retirement cost early in the life of a long-lived asset will be a heavily-discounted net present value amount. If the early cost estimates ultimately turn out to be fairly accurate, most of the income statement effect of the asset removal spending, over time, will be recorded as accretion expense which would have an overall effective tax rate of 50% under View A. If, instead, there are large cost estimate changes later in the life of the long-lived asset, a large portion of the income statement effect of the asset removal spending will be recorded as depreciation expense which would have an overall effective tax rate of 62% under View A. View B advocates point out that it is odd for the overall effective tax rate reported over time for an asset removal to vary widely between 50% and 62% under View A, based solely on the timing of when accounting estimate changes are recognized. The View B approach, in contrast, would report one overall effective tax rate for an asset removal, and would be relatively unaffected by the timing of accounting estimate changes.

Limitations on Tax Deductibility of Asset Removal Expenditures and Application of ASC 740 Deferred Income Tax Accounting to Such Situations

March 15, 2013

Page 4

2. If View A is applied on Issue #1, what is the appropriate methodology to balance the overall accounting entry recorded upon the incurrence of an asset retirement obligation and upon any subsequent changes in cost estimate of that obligation?

Under the View A position on Issue #1, upon both the initial recognition and subsequent revision of the asset retirement obligation, the associated deferred tax asset will reflect an adjustment for the future nondeductibility of 37.5% of the future asset removal spending. However, under View A the deferred tax liability associated with the offsetting asset retirement cost adjustment to PP&E will be recorded at the full enacted tax rate, causing an imbalance in the accounting entry.

Issue #2 – Accounting alternatives considered

View C: The accounting entry imbalance should be addressed by analogizing to the asset purchase guidance in ASC 740-10-25-51 (EITF 98-11) for both initial incurrences of asset retirement obligations as well as later changes in accounting estimates.

View C proponents believe the accounting entry imbalances, upon both initial incurrences of asset retirement obligations as well as later changes in accounting estimates, could be addressed by analogizing to the asset purchase guidance in ASC 740-10-25-51 (EITF 98-11). Under an analogy to that guidance, the imbalances would be addressed by recording an iterative gross-up effect to PP&E, using the initial amount of the asset retirement obligation (or the later change in its cost estimate) minus the related deferred tax asset accounting entry, as the Cash Purchase Price in the iterative gross-up formula of ASC 740-10-25-51. View B advocates point out that such a linkage to the asset retirement obligation in the iterative gross-up calculation conflicts with View A's own basic assertion on Issue #1 of complete separation of the PP&E unit of account from the asset retirement obligation unit of account and thus is another rebuttal to View A's position on Issue #1.

View D: The accounting entry imbalance should be addressed by analogizing to the asset purchase guidance in ASC 740-10-25-51 (EITF 98-11) for initial incurrences of asset retirement obligations, but by immediate recognition of net deferred tax expense on any later changes in accounting estimates.

View D proponents agree with View C with regard to initial incurrences of asset retirement obligations, but note that later changes in accounting estimates are not asset acquisition events and thus analogizing to asset purchase accounting guidance for such events is a questionable extension of the scope of EITF 98-11. As such, View D proponents believe any accounting entry imbalances on later changes in accounting estimates would, by default, result in immediate recognition of net deferred tax expense. View C advocates note the accounting anomaly of an immediate impact on tax expense when it is related to revisions of estimates of liabilities that will be settled years, if not decades, in the future, under an accounting model (ASC 410) that has no immediate impact on pretax income. View B advocates also note this accounting anomaly and point to it as another rebuttal to View A's position on Issue #1.

Case Study Example

The Appendix to this memo presents a case study example that contrasts the accounting entries between View A and View B, over the entire life-cycle of an asset removal obligation. The View A accounting entries in this case study assume that the positions of View A on Issue #1 and View C on Issue #2.

Conclusion

The limitation of the deductibility of asset removal expenditures in the United Kingdom is, we believe, the first example of such a limitation and thus explains why this interpretive issue of ASC 740 and its interplay with ASC 410 has not been raised in the past. As such, careful consideration needs to be applied on how

**Limitations on Tax Deductibility of Asset Removal Expenditures and Application of ASC 740 Deferred
Income Tax Accounting to Such Situations**

March 15, 2013

Page 5

to interpret and apply the deferred tax accounting rules to such a new situation. Asset removal obligations are material to our company, as well as most other oil and gas companies, and the action taken by the United Kingdom government to limit the tax deductibility of asset removal expenditures may become a tax policy approach adopted by other countries in the future. Thus, this is an important and evolving accounting issue that needs clarity. If the FASB staff believes there are legitimate arguments on both sides of this issue, we would appreciate you advancing the issue to the Agenda Committee of the EITF as an addition to its technical agenda.

If you have any questions or want to schedule a phone call to discuss, you can reach me by phone at (281)293-5628 or by email at Ken.W.Seaman@conocophillips.com.

Sincerely,



Ken Seaman
Assistant Controller
ConocoPhillips

Limitations on Tax Deductibility of Asset Removal Expenditures and Application of ASC 740 Deferred Income Tax Accounting to Such Situations

March 15, 2013

Page 6

APPENDIX**Case Study Example Contrasting View A and View B**

1. Assume an oil and gas company self-constructs and installs an offshore oil and gas production platform in the United Kingdom, for which it is required by contract to remove from the field at the end of the platform's useful life. The initial estimate of inflated future spending for the removal, 30 years out, is \$973 million and the NPV of that removal obligation, discounted at 4% per annum, is \$300 million. Prior to recording the asset removal obligation, assume the book and tax basis of the PP&E were equal and thus can be ignored when illustrating the impacts of deferred tax accounting entries over time.

The Day One accounting entries would be:

	<u>DR</u>	<u>CR</u>
<i>View A (assumes application of ASC 740-10-25-51):</i>		
PP&E (Asset Retirement Cost)	300	
Asset Removal Obligation		300
Deferred Tax Asset ((300 x 30%) + (300 x (1-.375) x 32%))	150	
Deferred Tax Liability (300 x 62%)		186
PP&E (Gross-up) (a)	95	
Deferred Tax Liability (95 x 62%)		59

(a) ASC 740-10-25-51 formula:

$$\text{FBB} - [\text{TR} \times (\text{FBB} - \text{TB})] = \text{CPP}$$

$$\text{FBB} - [.62 \times (\text{FBB} - 0)] = 150 \text{ (have to set CPP at the amount of the ARO minus the DTA above)}$$

$$\text{FBB} = 395$$

$$\text{Gross-up} = \text{FBB} - \text{PP\&E before Gross-up}$$

$$\text{Gross-up} = 395 - 300 = 95$$

View B:

PP&E (Asset Retirement Cost)	300	
Asset Removal Obligation		300
Deferred Tax Asset ((300 x 30%) + (300 x (1-.375) x 32%))	150	
Deferred Tax Liability (same calculation as DTA)		150

2. Over the next ten years, there are no changes in the cost estimate. The asset retirement obligation increases to \$444 for the accretion of discount and the PP&E is depreciated by 57% under the unit-of-production method.

	<u>DR</u>	<u>CR</u>
<i>View A:</i>		
Accretion Expense (444 – 300)	144	
Asset Retirement Obligation		144
Deferred Tax Asset ((144 x 30%) + (144 x (1-.375) x 32%))	72	
Deferred Tax Benefit		72
Depreciation Expense (395 x 57%)	225	
Accumulated Depreciation		225
Deferred Tax Liability (225 x 62%)	140	
Deferred Tax Benefit		140

Limitations on Tax Deductibility of Asset Removal Expenditures and Application of ASC 740 Deferred Income Tax Accounting to Such Situations

March 15, 2013

Page 7

View B:

Accretion Expense (444 – 300)	144	
Asset Retirement Obligation		144
Deferred Tax Asset ((144 x 30%) + (144 x (1-.375) x 32%))	72	
Deferred Tax Benefit		72
Depreciation Expense (300 x 57%)	171	
Accumulated Depreciation		171
Deferred Tax Liability ((171 x 30%) + (171 x (1-.375) x 32%))	86	
Deferred Tax Benefit		86

3. At the beginning of Year 11, there is a cost estimate change of the future inflated spending amount to \$1,315 million, and the timing is still expected to be in Year 30 (now only 20 years out). The updated NPV of the asset retirement obligation (assumed to still be discounted at a 4% discount rate to simplify the example) is now \$600 million, an increase of \$156 million over the previously-accreted balance.

	<u>DR</u>	<u>CR</u>
<i>View A:</i>		
PP&E (Asset Retirement Cost)	156	
Asset Removal Obligation		156
Deferred Tax Asset ((156 x 30%) + (156 x (1-.375) x 32%))	78	
Deferred Tax Liability (156 x 62%)		97
PP&E (Gross-up) (a)	49	
Deferred Tax Liability (49 x 62%)		31

(a) ASC 740-10-25-51 formula:

$$FBB - [TRx(FBB-TB)]=CPP$$

$$FBB - [.62x(FBB-0)]=78(\text{have to set CPP at the amount of the ARO minus the DTA above})$$

$$FBB=205$$

$$\text{Gross-up}=FBB - \text{PP\&E before Gross-up}$$

$$\text{Gross-up}=205-156=49$$

View B:

PP&E (Asset Retirement Cost)	156	
Asset Removal Obligation		156
Deferred Tax Asset ((156 x 30%) + (156 x (1-.375) x 32%))	78	
Deferred Tax Liability (same calculation as DTA)		78

4. No cost estimate changes are made over the next 20 years. The asset retirement obligation continues to be accreted and the remaining PP&E is depreciated over that time frame.

	<u>DR</u>	<u>CR</u>
<i>View A:</i>		
Accretion Expense (1315 - 600)	715	
Asset Retirement Obligation		715
Deferred Tax Asset ((715 x 30%) + (715 x (1-.375) x 32%))	358	
Deferred Tax Benefit		358
Depreciation Expense	375	
Accumulated Depreciation		375
Deferred Tax Liability (375 x 62%)	232	
Deferred Tax Benefit		232

Limitations on Tax Deductibility of Asset Removal Expenditures and Application of ASC 740 Deferred Income Tax Accounting to Such Situations

March 15, 2013

Page 8

View B:

Accretion Expense (1315 - 600)	715	
Asset Retirement Obligation		715
Deferred Tax Asset ((715 x 30%) + (715 x (1-.375) x 32%))	358	
Deferred Tax Benefit		358
Depreciation Expense	285	
Accumulated Depreciation		285
Deferred Tax Liability ((285 x 30%) + (285 x (1-.375) x 32%))	142	
Deferred Tax Benefit		142

5. At the end of Year 30, the asset removal expenditure occurs at the amount of \$1,315 million that was projected at the beginning of Year 11.

	<u>DR</u>	<u>CR</u>
<i>View A:</i>		
Asset Removal Obligation	1,315	
Cash		1,315
Deferred Tax Asset		658
Deferred Tax Expense	658	
Cash Tax Benefit		658
Income Tax Receivable	658	

View B:

Asset Removal Obligation	1,315	
Cash		1,315
Deferred Tax Asset		658
Deferred Tax Expense	658	
Cash Tax Benefit		658
Income Tax Receivable	658	

The complete life-cycle effective tax rate impacts on the income statement were:

View A:

Accretion Expense	(859)
Depreciation Expense	<u>(600)</u>
	(1,459)
Tax Benefit	<u>802</u>
Net Income Effect	657

Effective tax rate: $802 / 1,459 = 55\%$

View B:

Accretion Expense	(859)
Depreciation Expense	<u>(456)</u>
	(1,315)
Tax Benefit	<u>658</u>
Net Income Effect	657

Effective tax rate: $658 / 1,315 = 50\%$

**Limitations on Tax Deductibility of Asset Removal Expenditures and Application of ASC 740 Deferred
Income Tax Accounting to Such Situations**

March 15, 2013

Page 9

Following is a schedule that summarizes all the above case study accounting entries, along with the financial statement positions at the five events described above.

DR (CR)								
	Cash	PP&E-Asset Retirement Cost	Accumulated DD&A	Asset Removal Obligation	Deferred Tax Asset	Deferred Tax Liability	Pretax Income	Tax Expense
<i>View A</i>								
<i>Summary:</i>								
		300		(300)	150	(186)		
		95				(59)		
1.	0	395	0	(300)	150	(245)	0	0
			(225)	(144)	72	140	369	(212)
2.	0	395	(225)	(444)	222	(105)	369	(212)
		156		(156)	78	(97)		
		49				(30)		
3.	0	600	(225)	(600)	300	(232)	369	(212)
			(375)	(715)	358	232	1090	(590)
4.	0	600	(600)	(1315)	658	0	1459	(802)
	(1315)			1315	(658)			658
	658							(658)
5.	(657)	600	(600)	0	0	0	1459	(802)
<i>View B</i>								
<i>Summary:</i>								
		300		(300)	150	(150)		
1.	0	300	0	(300)	150	(150)	0	0
			(171)	(144)	72	86	315	(158)
2.	0	300	(171)	(444)	222	(64)	315	(158)
		156		(156)	78	(78)		
3.	0	456	(171)	(600)	300	(142)	315	(158)
			(285)	(715)	358	142	1000	(500)
4.	0	456	(456)	(1315)	658	0	1315	(658)
	(1315)			1315	(658)			658
	658							(658)
5.	(657)	456	(456)	0	0	0	1315	(658)