APPEALS

INDUSTRY SPECIALIZATION PROGRAM

COORDINATED ISSUE PAPER

INDUSTRY: PETROLEUM

ISSUE: PETROLEUM ISP - ESTIMATED DISMANTLEMENT AND REMOVAL COSTS

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APPROVED:

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SETTLEMENT POSITION
(SETTLEMENT GUIDELINES)

STATEMENT OF ISSUE

Issue

Whether an accrual basis taxpayer may deduct estimated cost of dismantling and removing:

1. Offshore platforms
2. Well fixtures
3. Oil and gas pipelines

EXAMINATION DIVISION'S POSITION

Accrual basis taxpayers acquire long term mineral leases for the production of oil and gas. Offshore oil and gas leases typically have durations of 20 years or more. Easements are generally negotiated for oil and gas pipeline right-of-ways.

The terms of the leases or land easements contain a contractual obligation to remove the platforms and well fixtures upon abandonment of the wells or termination of the leases. The pipeline must be removed when it is no longer used (i.e., after the last barrel of oil has moved through the pipeline) or upon termination of the easement.

Taxpayers contend that the obligation to remove is fixed and that reasonable estimates of the expense can be made. The future cost estimates may be based on a study conducted on the costs and engineering problems associated with the actual removal.

The Examination Division has taken the position that although the taxpayers are contractually obligated to incur a deductible expense at some time in the future, they have not incurred any liability to pay the costs thereof in the event the future services called for are performed. The liability under the contracts is contingent upon performance. All events are not fixed with the meaning of Treasury Regulations 1.461-1(a)(2) until the required performance is rendered. The fact that the corporations are contractually liable for the cost of the entire dismantlement services does not entitle them to deduct the cost of such services before they are performed.

Since the taxpayer has failed to meet the first requirement of an accrual deduction provided in section 1.451-(a)(2) of the Regulations, it is unnecessary to consider whether the amount of the liability can be determined with reasonable accuracy.

DISCUSSION

Section 162 of the Code allows as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.

Section 461(a) provides that the amount of any deduction shall be taken for the taxable year which is the proper taxable year under the method of accounting used in computing taxable income.

Treasury Regulation 1.461-1(a)(2) provides, in part, that under the accrual method of accounting, an expense is deductible in the taxable year that all of the events have occurred that determine liability and the amount thereof can be determined with reasonable accuracy. An expense is not incurred and, therefore, cannot be deducted by an accrual method taxpayer until such taxpayer is legally obligated to pay such expense. See Lucase vs. Ox Fiber Brush Co., 281 U.S. 115 (1930); Commissioner vs. H.E. Ives Co., 297 F. 2d 229 (2d Cir. 1961). Thus, a contingent liability is not deductible by an accrual method taxpayer even if it is virtually certain that the expense will be incurred, because liability is not incurred until occurrence of the conditional future events or facts.

Revenue Ruling 80-182, 1980-2 C.B. 167, sets forthe the Service's position with respect to the deductibility of future offshore platforms and well fixture dismantlement costs. The taxpayer involved in the ruling was obligated to remove offshore platforms and fixtures used in its drilling operation when the wells were abandoned or alternatively when certain long-term oil and gas leases were terminated. Although the taxpayer was contractually obligated to remove the platforms and fixtures, Rev. Rul. 80-182, holds that the liability did not become fixed until removal obligations were performed; hence, deductibility of the cost could not precede performance. See National Bread Wrapping Machine Co. vs. Commissioner, 30 T.C. 550 (1958); Spencer, White and Prentis, Inc. vs. Commissioner, 144 F. 2d 45 ;(2nd Cir. 1944), cert. denied, 323 U.S. 780 (1944).

However, the Service was unsuccessful in litigating premature deductions claimed by taxpayers in the somewhat analogous setting of estimated reclamation costs for strip mined land. See Denise Coal Co. v. Commissioner, 271 F. 2d 930 (3d Cir. 1959); Harrold v. Commissioner, 192 F. 2d 1002 (4th Cir. 1951); Ohio River Collieries Co. v. Commissioner, 77 T.C. 1369 (1981).

In United States v. Hughes Properties, Inc., 476 U.S. 593 (1986), aff'g 760 F. 2d

1292 (Fed. Cir. 1985), the Supreme Court considered whether a gambling casino could deduct a progressive jackpot amount as an accrued liability. The Service took the position that such amount was not fixed and certain and was not unconditional or absolute. There was no dispute that the amount could be determined with reasonable accuracy. Accordingly, the only issue was whether the liability was fixed.

The Federal Circuit had held that Nevada state law fixed the liability and ruled further that liability exists "if there is an obligation to perform an act, and the cost of performance can be measured in money." The Supreme Court decision agreed with the Federal Circuit Court's decision that state law fixed the liability. Such liability was not contingent and the remote possibility that the jackpot might never be won did not change the fact that the liability was fixed.

Finally, the decision in the case which first enunciated the all events test, United States v. Anderson, 269 U.S. 422 (1926), was cited as instructive in deciding the Hughes Properties case. In Anderson, one of the expenses that necessarily attended the production of munitions income was the commitment of a particular portion of the revenue generated to a reserve for munition taxes. Similarly, one of the expenses that necessarily attends the production of income from a progressive slot machine is the commitment of a particular portion of the revenue generated to an irrevocable jackpot.

In 1984, Congress enacted section 461(h) which adds the economic performance test to the all events test of section 461. The Service requested this legislation because courts were tending to interpret the all events test to allow what the Service considered premature accruals. This change effectively eliminated this issue in regards to liabilities arising after July 18, 1984.