



Energy Quarterly Brief

Accounting, Tax and Regulatory Developments Affecting the Energy Industry

July 9, 2004

Vol. 1, Issue 2

In this issue:

FASB Developments

- FASB Issues Final FSPs and Technical Correction
- FASB Does Not Clear AcSEC's Proposed SOP on Property, Plant, and Equipment
- FASB Issues Exposure Drafts

EITF Developments

- EITF 03-6

SEC Developments

- SEC approves PCAOB Auditing Standard No. 2
- SEC Comment Letters and Responses
- Accounting for Other Than Temporary Impairments

FERC Developments

- Notice Granting Extension of Time for Quarterly Reporting
- Recognition of a Regulatory Asset for Minimum Pension Liability

Utility Tax Developments

- Depreciation of MACRS Property after a Change In Use
- Removal of ADFIT on Excluded Property from Rate Base
- Tax Lives of Certain Above-Ground Storage Tanks
- Prepaid Income
- Business Meal and Entertainment Deductions

Upcoming Events

Appendix: Abbreviations

The purpose of this publication is to briefly describe key regulatory and professional developments that have recently occurred in the field of accounting and to provide links to locations where additional information can be found on each topic. Readers seeking additional information about a topic should review the information referred to in the hyperlinks and not rely solely on the descriptions included in this communication.

Deloitte & Touche LLP is not, by means of this publication, rendering accounting, business, financial, investment, legal, tax, or other professional advice or services. This publication is not a substitute for such professional advice or services, nor should it be used as a basis for any decision or action that may affect your business. Before making any decision or taking any action that may affect your business, you should consult a qualified professional advisor.

Deloitte and Touche LLP shall not be responsible for any loss sustained by any person who relies on this publication.

Audit. Tax. Consulting. Financial Advisory.

FASB Developments

Final FSPs Issued

FSPs FAS 141-1 and FAS 142-1, *Interaction of FASB Statements No. 141, Business Combinations, and No. 142, Goodwill and Other Intangible Assets, and EITF 04-2, Whether Mineral Rights are Tangible or Intangible Assets*

On April 30, 2004, the FASB issued final FSPs FAS 141-1 and FAS 142-1 to address inconsistencies between the consensus reached for EITF 04-2 that certain mineral rights are tangible assets and the characterization of mineral rights as intangible assets in SFAS 141 and SFAS 142. The FSPs amend SFAS 141 and 142 to conform them to the EITF consensus stating that certain mineral rights are tangible assets.

The FSPs are effective for the first reporting period beginning after April 29, 2004. If the guidance in the FSPs results in recharacterization of an asset, prior period amounts in the statements of financial position should be reclassified, and any effects on amortization or depreciation of the asset should be accounted for prospectively. Early application of this guidance is permitted in periods for which financial statements have not yet been issued.

FAS 141-1 and FAS 142-1 are available on the FASB's website at:

http://www.fasb.org/fasb_staff_positions/fsp_fas141-1&fas142-1.pdf

FSP FAS 129-1, *Disclosure Requirements Under FASB Statement No. 129, Disclosure of Information About Capital Structure, Relating to Contingently Convertible Securities*

On April 9, 2004, the FASB issued FSP FAS 129-1 to provide disclosure guidance for contingently convertible securities, including those instruments with contingent conversion requirements that have not been met and

otherwise are not required to be included in the computation of diluted earnings per share. The FSP addresses concerns that disclosures relating to contingently convertible securities are inconsistent between companies or may be inadequate. FSP FAS 129-1 notes that to comply with the requirements of SFAS 129, the significant terms of the conversion features of the contingently convertible security should be disclosed to enable users of financial statements to understand the circumstances of the contingency and the potential impact of conversion. Companies' disclosures should include:

- Events or changes in circumstances that would cause the contingency to be met and any significant features necessary to understand the conversion rights and the timing of those rights (e.g., the periods in which (1) the contingency might be met and (2) the securities may be converted if the contingency is met)
- The conversion price and the number of shares into which the security is potentially convertible
- Events or changes in circumstances, if any, that could adjust or change the contingency, conversion price, or number of shares, including significant terms of those changes
- The manner of settlement upon conversion and any alternative settlement methods (e.g., cash, shares, or a combination).

The FSP further states that the disclosures should indicate whether the shares that would be issued, if the contingently convertible securities were converted, are included in the calculation of diluted earnings per share, and the reasons why or why not.

Disclosure impact of the derivative transactions entered into in connection with the issuance of contingently convertible securities should be provided, if they are necessary to help fully explain the potential impact of the contingently convertible securities.

The FSP is effective immediately and applies to all existing and newly created securities.

FSP 129-1 is available on the FASB's website at:

http://www.fasb.org/fasb_staff_positions/fsp_fas129-1.pdf

FSP FAS 106-2, Accounting and Disclosure Requirements Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003

On May 19, 2004, the FASB issued FSP FAS 106-2 to provide guidance on accounting for the effect of the *Medicare Prescription Drug, Improvement and Modernization Act of 2003* (the Act), to employers that sponsor postretirement health care plans which provide prescription drug benefits. In addition, the FSP requires those employers to provide certain disclosures in their financial statements regarding the effect of the Act and the related subsidy on postretirement health obligations and net periodic postretirement benefit cost. This FSP supersedes FSP FAS 106-1, *Accounting and Disclosure Requirements Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003*.

FSP FAS 106-2 applies only to sponsors of single-employer defined benefit postretirement health care plans for which (1) the employer has concluded that prescription drug benefits available under the plan to some or all participants, for some or all future years, are "actuarially equivalent" to Medicare Part D and thus qualify for the subsidy under the Act, and (2) the expected subsidy will offset or reduce the employer's share of the cost of the underlying postretirement prescription drug coverage on which the subsidy is based. Conclusions reached in the FSP include:

- Measurements of the accumulated postretirement benefit obligation (APBO) and net periodic postretirement benefit cost, on or after the date the Act was signed into law (December 8, 2003), should reflect the effects of the Act.

- The effects on the APBO of the initial recognition of the subsidy should be accounted for as an actuarial experience gain.
- For current measures of net periodic postretirement benefit cost, the subsidy is included in the measurement of the costs of benefits attributable to current service, which will reduce the service cost component of net periodic postretirement benefit cost.
- If the estimated amount of the expected subsidy changes for reasons other than a plan amendment, the effect of the change is treated as an actuarial experience gain or loss.
- If a plan is amended to provide actuarially equivalent prescription drug benefits, the direct effect of the plan amendment on APBO, and the effect on the APBO of any resulting subsidy to which the employer is expected to be entitled as a result of the amendment, should be combined. If the combined effect reduces the APBO, it is deemed to be an actuarial experience gain; if the combined effect increases APBO, it is deemed to be a prior service cost.
- If a plan is amended and, as a result, is no longer deemed actuarially equivalent, the combined net effect on the APBO of the reduction in benefits being provided under the plan, and the elimination of the subsidy, should be accounted for a prior service cost (credit).
- Subsidies under the Act are exempt from federal taxation and will not affect plan-related temporary tax differences.
- The FSP requires employers to provide a number of disclosures about the Act and its effects in their financial statements.

The FSP is effective for the first interim or annual period beginning after June 15, 2004; however, certain nonpublic entities meeting specified criteria may defer adoption of the FSP until fiscal years beginning after

December 15, 2004. Earlier application of the FSP is encouraged in financial statements for any period including or following enactment of the Act (December 8, 2003), that has not been issued as of the issuance date of the FSP (May 19, 2004). Detailed transition guidance, and examples of the application of that guidance are provided in the FSP.

FSP FAS 106-2 is available on the FASB's website at:

http://www.fasb.org/fasb_staff_positions/fsp_fas106-2.pdf

Technical Correction

FSP FIN 46 (R)-4, Technical Correction of FASB Interpretation No. 46 (Revised December 2003), Consolidation of Variable Interest Entities, Relating to Its Effects on Question No. 12 of EITF 96-21, Implementation Issues in Accounting for Leasing Transactions Involving Special-Purpose Entities

On April 30, 2004, the FASB issued FSP FIN 46(R)-4 to correct Appendix F of FIN 46(R), which incorrectly states that FIN 46(R) fully nullifies Question 12 of EITF 96-21. The nullification noted in FIN 46(R) should apply only to a guarantor-lessee that is the primary beneficiary of a lessor that is a variable interest entity. A guarantor-lessee that is not the primary beneficiary of the lessor under FIN 46(R) should continue to apply the Question 12 guidance for the timing of the accrual for a contingent loss under the guarantee.

The guidance should be applied in accordance with the effective dates and transition provisions of FIN 46(R). Appendix F of FIN 46(R) is revised to reflect the guidance in this FSP.

FSP FIN 46(R)-4 is available on the FASB's website at:

http://www.fasb.org/fasb_staff_positions/fsp_fin46r-4.pdf

FASB Does Not Clear AcSEC's Proposed SOP on Property, Plant, and Equipment

On April 14, 2003, the FASB voted unanimously not to clear AcSEC's draft SOP on property, plant and equipment. The Board anticipates considering the work performed by AcSEC during the project when it deliberates the short term convergence project with IAS on property, plant, and equipment, including depreciation.

FASB Issues Exposure Drafts

Share-Based Payment, an Amendment of FASB Statement No. 123, Accounting for Stock-Based Compensation, and APB Opinion No. 95, Accounting for Stock Issued to Employees

On March 31, 2004, the FASB issued an exposure draft on share-based payments to improve existing accounting rules and provide more complete, higher quality information for investors. The exposure draft addresses the accounting for share-based payment transactions in which an enterprise receives employees services in exchange for (1) equity instruments of the enterprise or (2) liabilities that are based on the fair value of the enterprise's equity instruments or that may be settled by the issuance of such equity instruments. The proposal would eliminate the ability to account for share-based compensation transactions using APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and generally would require that such transactions be accounted for using a fair-value based method. The proposal would also achieve substantial convergence in this area between U.S. and international accounting standards. The comment period ended on June 30, 2004.

The exposure draft is available on the FASB's website at:

http://www.fasb.org/draft/ed_intropg_share-based_payment.shtml

Accounting for Conditional Asset Retirement Obligations, an Interpretation of FASB Statement No. 143

On June 17, 2004, the FASB proposed an Interpretation to clarify the scope and timing of liability recognition for conditional asset retirement obligations under SFAS 143. The exposure draft clarifies that a legal obligation to perform an asset retirement activity that is conditional on a future event is within the scope of SFAS 143. Under the FASB's proposal, an entity would be required to recognize a liability when it is incurred for the fair value of an asset retirement obligation that is conditional on a future event if the liability's fair value can be reasonably estimated. The ability of an entity to indefinitely defer settlement of the obligation or the ability of the entity to sell the asset prior to its retirement does not relieve an entity of the obligation. Uncertainty surrounding the timing and method of settlement that may be conditional on events occurring in the future would be factored into the measurement of the liability rather than the recognition of the liability. The proposal would be effective no later than the end of the fiscal years ending after December 15, 2005 (December 31, 2005 for calendar-year companies).

The comment period for the exposure draft ends August 1, 2004. Refer to the July 6, 2004 issue of the Deloitte publication *Heads Up* for further discussion and an example application of the proposed interpretation.

The exposure draft is available on the FASB's website at:

http://www.fasb.org/draft/ed_prop_interp_aro.pdf

Heads Up is available on Deloitte's website at the following address:

<http://www.deloitte.com/dtt/newsletter/0,2307,sid%253D2002%2526cid%253D53590,00.html>

Fair Value Measurements

On June 23, 2004, the FASB issued this exposure draft to provide guidance on how to measure the fair value of financial and non-financial assets and liabilities when required by other authoritative accounting pronouncements. The proposed Standard attempts to address constituents' concerns about the ability to develop reliable estimates of fair value and inconsistencies in fair value guidance provided by current GAAP, by creating a framework that clarifies the fair value objective and its application in GAAP. Also, it creates a fair value hierarchy that groups into three broad categories the inputs that should be used to estimate fair value.

Notable differences between the proposed guidance and current practice include:

- The fair value of financial instruments for which bid and asked prices are more readily available than closing prices should be estimated at:
 - Bid prices for long positions (assets)
 - Asked prices for short position (liabilities)
- The fair value of restricted securities should be estimated using the quoted price of an otherwise identical unrestricted security, adjusted for the effect of the restriction.
- The fair value of instruments with no quoted price for identical or similar assets or liabilities should be estimated using multiple valuation techniques consistent with the market approach, income approach, and cost approach that emphasize relevant market inputs.
- Present value techniques discussed in FASB Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*, will be incorporated into the statement, thus elevating that guidance to Level A GAAP.
- Expanded disclosure about the use of fair value to remeasure assets and liabilities

recognized in the statement of financial position will be required.

The proposed Standard would be effective for financial statements issued for fiscal years beginning after June 15, 2005, with earlier application encouraged. The provisions of this Standard would be applied prospectively, except for the change in accounting principle relating to bid-asked spread measurements, which will require a retroactive transition approach. The comment period ends September 7, 2004.

The exposure draft is available on the FASB's website at:

http://www.fasb.org/draft/ed_fair_value_measurements.pdf

EITF Developments

EITF 03-6, Participating Securities and the Two-Class Method Under FASB Statement No. 128, Earnings Per Share

SFAS 128 states that entities with participating securities that are not convertible into a class of common stock should use the two-class method of computing earnings per share (EPS). However, questions concerning the definition of a participating security and when that participating security requires the application of the two-class method for calculating EPS have been raised. This Issue discusses how to define a participating security when applying the provisions of SFAS 128, and whether the two-class method is required for all nonconvertible participating securities, regardless of the characteristics of that participating security. Refer to the May 5, 2004 issue of the Deloitte publication, *Heads Up*, for further discussion and illustrative examples of the application of the consensus reached in EITF 03-6.

The consensus reached in EITF 03-6 are effective for fiscal periods beginning after March 31, 2004 (effectively the second fiscal quarter for calendar year-end companies). Prior period EPS should be restated to comply

with the consensus decisions reached in EITF 03-6.

Heads Up is available on Deloitte's website at the following address:

<http://www.deloitte.com/dtt/newsletter/0,2307,sid%253D2002%2526cid%253D47541,00.html>

SEC Developments

SEC approves PCAOB Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements*

On June 17, 2004, the SEC approved PCAOB's Auditing Standard No. 2, which addresses both the work required to audit internal controls over financial reporting, and the relationship between that audit and the audit of financial statements. The rule requires a registrant company to include in its annual report a report by management on the company's internal control over financial reporting and an accompanying auditor's report. The management's report is required to include management's assessment of the effectiveness of the registrant company's internal control over financial reporting. The independent auditor is required to attest to and report on management's assessment, and on whether the registrant company has maintained effective internal control over financial reporting. The rule was issued in accordance with Sections 404 and 103 of the Sarbanes-Oxley Act of 2002. Auditing Standard No. 2 is effective for audits of companies with fiscal years ending on or after November 15, 2004, for accelerated filers, or July 15, 2005, for other companies. The rule is available on the SEC's website at:

<http://www.sec.gov/rules/pcaob/34-49884.htm>

SEC Staff Announces Intent to Publicly Release Comment Letters and Responses

On June 24, 2004, the SEC staff announced that it will begin providing public access to

comment letters and filer responses. Comment letters and filer responses currently are released only in response to a Freedom of Information Act request (FOIA process) after the staff's review is complete. The staff decided to expand the transparency of the comment process so that this information is available to a broader audience, free of charge. The letters set forth the staff's positions on a particular filing only and do not constitute an official expression of the SEC's views.

The SEC staff will begin releasing its comment letters and response letters relating to filings made after August 1, 2004 that are selected for review. The staff will announce shortly a specific date after which these documents will become publicly available. Filers may still request confidential treatment for some portions of a written response to a staff comment letter under SEC rule 83 (17 CFR 200.83).

Since the staff will be making all comment letters and responses publicly available, it may ask companies to represent in writing that they will not use the SEC's comment process as a defense in any securities-related litigation against them. (This request is known as a "Tandy" letter). This request and representation should not be construed as confirming that there is or is not, in fact, an inquiry or investigation or other matter involving the filer.

The related press release is available on the SEC's website at:

<http://www.sec.gov/news/press/2004-89.htm>

SEC expresses its views on using undiscounted cash flows to determine other than temporary impairments of equity method investments

At the 2002 AICPA's National Conference on Current SEC Developments, the SEC staff specifically stated that it would object to registrants using a SFAS 144 undiscounted cash flow analysis to determine whether an equity method investment is impaired.

Further, at the March 17-18, 2003, EITF meeting, during deliberations of EITF 03-1, *The Meaning of Other Than Temporary Impairments and Its Application to Certain Investments*, the SEC Observer stated the following:

Registrants should continue to rigorously assess equity method investments for impairment and indicated that the SEC staff will continue to object to inappropriate impairment analyses for such investments, for example a SFAS 144 undiscounted cash flow approach.

Although EITF 03-1 excludes equity method investments from its scope, its guidance may be useful by analogy.

FERC Developments

Notice Granting Extension of Time for Quarterly Reporting-Docket No. RM03-8-001, Quarterly Financial Reporting and Revisions to the Annual Report

The FERC published in the *Federal Register* of February 26, 2004 Order No. 646, a Final Rule amending its financial reporting regulations and establishing new quarterly financial reporting for respondents that currently file Annual Reports with the FERC. These new quarterly financial reports include the FERC Form No. 3-Q, Quarterly Financial Report of Electric Companies, Licensees, and Natural Gas Companies.

Various interested parties requested an extension of the filing deadline for the first quarterly report from July 9, 2004 to August 23, 2004, and an extension of the filing deadline for the second quarterly report from September 8, 2004 to September 23, 2004.

These new dates would space the first FERC reports two weeks away from the SEC's second quarter, August 9, 2004 deadline, and space the initial two FERC reports a month apart. It was noted that the software needed to file the new quarterly financial reports was

not expected to be released for general use until June 30, 2004, which would have left filers only nine days from the scheduled July 9, 2004 filing date. Additionally, more time would be needed for filers to familiarize themselves with the software, prepare electronic copies of the quarterly reports, have the reports internally reviewed, approved and filed.

Based on the above, on June 22, 2004, filing dates for the first two initial quarterly financial reports for major respondents were extended by the FERC as requested and for two additional weeks (to September 3 and October 7, 2004) beyond such dates for non-major respondents.

The full text of this notice is available on the FERC's website at:

www.ferc.gov/whats-new/comm-meet/052604/m-1.pdf

Recognition of a Regulatory Asset for Minimum Pension Liability

On March 29, 2004, the FERC's Deputy Executive Director and Chief Accountant issued accounting guidance regarding recognition of a regulatory asset for a corresponding minimum pension liability recorded under SFAS 87, *Employers' Accounting for Pension*.

The guidance's introduction recognizes that the generally lower interest rate environment of recent years and decline in value of assets set aside to meet pension obligations have resulted in many FERC jurisdictional entities recognizing a minimum liability for employee pension obligations. As a result, the FERC has received a number of requests for guidance on whether a regulatory asset should be recognized for some or all of the charge to other comprehensive income (OCI) that is otherwise made at the time the minimum pension obligation is recognized.

The guidance concludes that, consistent with the FERC's Uniform System of Accounts, if it is probable that the pension allowance to be included in rates in future periods has been

and will continue to be calculated on the basis of SFAS 87, jurisdictional entities should recognize a regulatory asset for the minimum pension liability otherwise chargeable to accumulated OCI related to its cost based rate regulated business segments. This guidance is for accounting purposes only and does not limit the FERC from reviewing the reasonableness of the elements of pension expense included in future jurisdictional rate proceedings.

Deloitte has previously issued guidance which indicates that to record such a regulatory asset under GAAP, specific regulatory approval of future recovery of such OCI amount would be required. Such approval should include recovery through both continuing SFAS 87 normal net periodic pension costs and SFAS 88, *Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits*. Because the FERC guidance does not address rate treatment for SFAS 88 events, we do not believe this guidance alone is sufficient to justify recording a regulatory asset under GAAP. In addition, evidence that state jurisdictional rate recovery would be probable, including the SFAS 88 type events would be generally necessary to provide sufficient evidence to record a regulatory asset for the charge that would otherwise be recorded in OCI.

Utility Tax Developments

Depreciation of MACRS Property after a Change In Use

On June 16, 2004, the IRS released final regulations (§1.168(i)-4) that provide guidance regarding how to compute depreciation for modified accelerated cost recovery system (MACRS) property for which the use changes in the hands of the same taxpayer. These changes include:

- Conversion of personal use property to a business or income-producing use.
- Conversion of MACRS property to personal use.

- Change in the use of MACRS property that results in a different recovery period, depreciation method, or both.
 - Begins or ceases to be used predominantly outside the United States.
 - Results in a reclassification due to a change in use of the property (e.g., conversion of a combustion turbine production plant to a steam production or combined cycle plant).
 - Begins or ceases to be tax-exempt use property.

A change in computing the depreciation allowance in the year of change for property subject to this regulation generally is not a change in method of accounting under §446(e). As such, changes do not involve cumulative catch-up (§481(a)) adjustments and do not require advance consent of the IRS.

MACRS Property – Use Changes After Placed in Service

As in the proposed regulations, a change in the use of MACRS property generally occurs when the primary use of the MACRS property in the taxable year is different from its primary use in the immediately preceding taxable year. The primary use may be determined in any reasonable manner that is consistently applied. MACRS property changes to tax-exempt bond financed property when a tax-exempt bond is first issued after the MACRS property is placed in service. That property continues to be tax-exempt bond financed property in the hands of the taxpayer even if the tax-exempt bond is no longer outstanding or is redeemed.

If a change in use of MACRS property results in a shorter recovery period and/or a more accelerated depreciation method, the adjusted depreciable basis of the property as of the beginning of the year of change is depreciated with the new period/method beginning with the year of change as though the MACRS property is placed in service by the taxpayer in the year of change. To accommodate situations in which restarting the tax recovery

period (albeit with a shorter recovery period and/or a more accelerated method) results in less/slower tax depreciation than if the change in use had not occurred, a taxpayer may elect to disregard the change in use for depreciation purposes. If a change in use results in a longer recovery period and/or a slower depreciation method, the adjusted depreciable basis of the MACRS property as of the beginning of the year of change is depreciated with the new period/method beginning with the year of change as though the taxpayer originally placed the MACRS property in service with the longer recovery period and/or slower depreciation method.

MACRS Property – Use Changes During Placed-in-service Year

If the use of MACRS property changes during its placed-in-service year, the depreciation allowance is generally determined by the “primary use” of the property during that taxable year.

Removal of ADFIT on Excluded Property from Rate Base

On January 13, 2004, the IRS issued Letter Ruling 200418001 to a taxpayer addressing the application of the normalization requirements to the accumulated deferred federal income tax (ADFIT) reserve associated with property removed from the taxpayer’s regulated books of account.

In the taxpayer’s rate case filing, the taxpayer excluded property from rate base that was removed from its regulated book of accounts as a result of an earlier physical inventory and audit ordered by the state commission. Additionally, the taxpayer removed the ADFIT reserve associated with the excluded plant assets from its computation of regulated rate base. After initially disagreeing with the taxpayer, the state commission adopted the taxpayer’s position of removing the ADFIT reserve. However, the commission ordered the taxpayer to request an IRS letter ruling to determine if retaining the ADFIT reserve on the taxpayer’s regulated book of account would violate the normalization requirements.

A normalization method of accounting must be used if public utility property is to be eligible for MACRS (accelerated) depreciation. Accordingly, ratemaking tax expense must be computed using regulatory depreciation expense. Additionally, a reserve account must be used to reflect the deferral of federal income tax resulting from the difference between tax depreciation and the amount used to compute depreciation for ratemaking purposes. This reserve account may reduce rate base.

The IRS concluded that maintenance of the ADFIT reserve associated with the excluded property on the taxpayer’s regulated books of account and its reflection in the computation of regulated rate base would constitute a violation of the consistency requirements of the normalization rules. The consistency requirements provide that a procedure or adjustment violates the normalization requirements unless it results in consistency among all four of the following components of the regulatory books of account and the revenue requirement:

- Regulatory depreciation expense
- Regulatory tax expense
- ADFIT reserve
- Rate base

Tax Lives of Certain Above-ground Storage Tanks

A favorable tax court decision on May 12, 2004, held that above-ground storage tanks are depreciable using the shorter tax lives for §1245 property used in marketing petroleum and petroleum products rather than the longer tax lives required to be used for §1250 property used in marketing petroleum and petroleum products. In *PDV America, Inc.*, T.C. Memo 2004-118, the Tax Court concluded that certain above-ground storage tanks should be depreciated over a five-year recovery period (asset class 57.0) instead of a 15-year recovery period (asset class 57.1). The dispute centered on whether the storage tanks in question are inherently permanent structures.

In determining the proper asset classification for depreciation purposes, the court

considered the analysis in case law involving the investment tax credit. The following six factors were considered in determining whether an asset was an inherently permanent structure:

- Is the property capable of being moved, and has it in fact been moved?
- Is the property designed or constructed to remain permanently in place?
- Are there circumstances which tend to show the expected or intended length of affixation (i.e., are there circumstances which show that the property may or will have to be moved)?
- How substantial a job is removal of the property and how time-consuming is it? Is it "readily removable?"
- How much damage will the property sustain upon its removal?
- What is the manner of affixation of the property to the land?

The court considered no single factor to be decisive. Based on these factors, the court held that the tanks were not inherently permanent structures and, as such, were to be treated as five-year property.

Prepaid Income

Amounts received by accrual basis taxpayers for goods or services to be provided in years after the receipt are generally fully taxable in the year of receipt. Various exceptions have existed to provide deferral until the goods or services are rendered or for a limited time period. On May 6, 2004, the IRS released Revenue Procedure 2004-34 that provides revised guidance for the deferral of certain advance payments. Generally, a payment received by a taxpayer is an "advance payment" if:

- Including the payment in gross income for the taxable year of receipt is a permissible method of accounting for federal income

tax purposes (without regard to this revenue procedure);

- The payment is recognized in income by the taxpayer in its financial statements in a subsequent taxable year; and
- The payment is for:
 - Services;
 - The sale of goods (other than for the sale of goods for which the taxpayer uses a method of deferral provided in §1.451-5(b)(1)(ii));
 - The use of intellectual property;
 - The occupancy or use of property if the occupancy or use is ancillary to the provision of services;
 - The sale, lease, or license of computer software;
 - A guaranty or warranty ancillary to items described above;
 - Subscriptions other than those with an election under §455 in effect;
 - Memberships in an organization other than those with an election under §456 in effect; or
 - Any combination of items described above.

The revised guidance broadens the scope of the types of prepaid revenue eligible for disclosure. However, the deferral method under Revenue Procedure 2004-34 does not apply to:

- Rent;
- Insurance premiums;
- Payments with respect to financial instruments, including prepayments of interest; or
- Property transferred in connection with the performance of service to which §83 applies.

Permissible Methods of Accounting for Advance Payments

The "full inclusion" method permits the inclusion of the full amount of advance payments in federal taxable income in the year of receipt, regardless of whether the taxpayer recognizes the full amount in revenues for financial statement purposes and

regardless of whether the taxpayer earns the full amount of advance payments in that taxable year.

A taxpayer using the deferral method must include the advance payment in gross income for the taxable year of receipt to the extent recognized in revenues in its financial statements for that taxable year and include the remaining amount of the advance payment in gross income for the next taxable year.

Change in Method of Accounting

A change in a taxpayer's treatment of advance payments to either method described above is a change in method of accounting for federal income tax purposes. Generally, the automatic change provisions in Revenue Procedure 2002-9 would apply.

Business Meal and Entertainment Deductions

Since 1987, a portion of a taxpayer's expenditures for certain business-related meals and entertainment (M&E) has not been allowable as a tax deduction. The current disallowance rate is 50 percent. This disallowance results in a permanent book-tax difference. Various exceptions to the disallowance exist that require analysis of the facts and circumstances surrounding each M&E expenditure. On May 3, 2004, the IRS released Revenue Procedure 2004-29 providing the statistical sampling methodology a taxpayer may use to establish the amount of substantiated M&E expenses excepted from the 50 percent deduction disallowance of §274(n).

This methodology may relieve taxpayers, especially those with large M&E accounts, of the burden of scrutinizing every item relating to M&E. The revenue procedure is effective for tax years ending on or after May 3, 2004. The IRS will permit, but not require, application of this revenue procedure to open years ending before this effective date.

Other Considerations

- Statistical sampling may not be used as a replacement for substantiation

requirements (i.e., unsubstantiated M&E remains nondeductible).

- Statistical sampling may not be used to determine a taxpayer's liability for employment taxes or whether an amount is excludable from an employee's income.
- Statistical sampling may not include the use of judgment sampling.
- Taxpayers may apply the results of a statistical sample only to the taxable years included in the sample.
- A statistical sample may include data from no more than three consecutive taxable years.
- Data from a taxable year may only be included in one statistical sample.

Upcoming Events

Save these Dates

- November 17, 2004: Deloitte 2004 Oil & Gas Conference – Houston
- November 30, 2004: Deloitte Annual Accounting, Financial Reporting & Tax Update – Chicago
- May 19-20, 2005: Deloitte Energy Conference – Washington, DC

For more information, please contact ndickter@deloitte.com.

Appendix:

Abbreviations

AcSEC	Accounting Standards Executive Committee of the AICPA	GAAP	Generally Accepted Accounting Principles in the United States of America
AICPA	American Institute of Certified Public Accountants	IAS	International Accounting Standards
APB	Accounting Principles Board	IRS	Internal Revenue Service
ARB	Accounting Research Bulletin	PCAOB	Public Company Accounting Oversight Board
EITF	Emerging Issues Task Force	SAB	SEC Staff Accounting Bulletin
FASB or Board	Financial Accounting Standards Board	SEC	Securities and Exchange Commission
FAS	Financial Accounting Standards	SFAS	Statement of Financial Accounting Standards
FERC	Federal Energy Regulatory Commission	SOP	Statement of Position
FIN	FASB Interpretation	Statement	Statement of Financial Accounting Concepts
FSP	FASB Staff Position	TPA	Technical Practice Aid

Deloitte Accounting Research Tool Available

Deloitte is making available, on a subscription basis, access to its online library of accounting and financial disclosure literature. Called the Deloitte Accounting Research Tool (DART), the library includes material from the FASB, the EITF, the AICPA, the PCAOB, the IASB, and the SEC, in addition to Deloitte's own accounting manual and other interpretative accounting guidance.

Updated every business day, DART has an intuitive design and navigation system which, together with its powerful search features, enable users to quickly locate information anytime, from any computer. Additionally, DART subscribers receive periodic e-mails highlighting recent additions to the DART library.

For more information, including subscription details and an online DART demonstration, visit www.deloitte.com/us/dart

Prepared by Deloitte's Energy & Resources Group. For further information please contact your local office.

About Deloitte

Deloitte & Touche, one of the nation's leading professional services firms, provides audit, tax, consulting, and financial advisory services through nearly 30,000 people in more than 80 U.S. cities. Known as an employer of choice for innovative human resources programs, the firm is dedicated to helping its clients and its people excel. "Deloitte" refers to the associated partnerships of Deloitte & Touche USA LLP (Deloitte & Touche LLP and Deloitte Consulting LLP) and subsidiaries. Deloitte is the U.S. member firm of Deloitte Touche Tohmatsu. For more information, please visit Deloitte's Web site at www.deloitte.com/us.

Deloitte Touche Tohmatsu is an organization of member firms devoted to excellence in providing professional services and advice. We are focused on client service through a global strategy executed locally in nearly 150 countries. With access to the deep intellectual capital of 120,000 people worldwide, our member firms, including their affiliates, deliver services in four professional areas: audit, tax, consulting, and financial advisory services. Our member firms serve more than one-half of the world's largest companies, as well as large national enterprises, public institutions, locally important clients, and successful, fast-growing global growth companies.

Deloitte Touche Tohmatsu is a Swiss Verein (association), and, as such, neither Deloitte Touche Tohmatsu nor any of its member firms has any liability for each other's acts or omissions. Each of the member firms is a separate and independent legal entity operating under the names "Deloitte," "Deloitte & Touche," "Deloitte Touche Tohmatsu," or other, related names. The services described herein are provided by the member firms and not by the Deloitte Touche Tohmatsu Verein. For regulatory and other reasons, certain member firms do not provide services in all four professional areas listed above.