

CC:TL-R-870-76  
DOM:FS:IT&A:ML Osborne

CC-1997-014  
Dec. 29, 1997

### REVISED ACTION ON DECISION

Subject:      Transwestern Pipeline Co. v. United States  
                        639 F.2d 679 (Ct. Cl. 1980)

Issue:

Whether the cost of recoverable line pack gas, the gas used to charge and operate an interstate natural gas pipeline system, is properly treated as (i) merchandise and thus included in inventory; (ii) a depreciable capital asset; or (iii) a nondepreciable capital asset.

Discussion:

The taxpayer was engaged in the interstate transportation of natural gas. For the taxpayer's pipeline to operate, a relatively constant pressure had to be maintained in the pipeline at all times. Such pressure is created through the injection and maintenance of a relatively constant volume of natural gas, known as line pack gas, in the pipeline. When the taxpayer abandons the pipeline, a certain amount of the line pack gas is unrecoverable. A certain amount, known as recoverable line pack gas, is available for sale upon the abandonment of the pipeline.

The Court of Claims held that the line pack gas was properly capitalized and depreciable. In reaching its decision, the court was strongly influenced by the fact that line pack gas was required for the system to operate and the "vast majority" of the line pack gas would be unrecoverable at the end of the pipeline's useful life. Further, the court was convinced that line pack gas was the functional equivalent of unrecoverable cushion gas, which the Service had ruled was a permanent improvement subject to depreciation over the life of the reservoir. Rev. Rul. 75-233, 1975-2 C.B. 95. Finally, the court was persuaded by the taxpayer's uncontradicted accounting evidence.

The Service disagreed with the Court of Claims' holding, especially that the "vast majority" of the line pack was not recoverable. The Service relied on its published position in Rev. Rul. 68-620, 1968-2 C.B. 199, that line pack gas is merchandise and thus includable in inventory. The Service did not seek a writ of certiorari since this was a new issue for which no conflict existed and the case lacked administrative importance as it rested largely on the facts of the case.

The Federal Circuit has overturned the holding of the Court of Claims regarding the depreciable aspect of the line pack gas. Arkla, Inc. v. United States, 37 F.3d 621 (Fed. Cir. 1994), cert. denied, 115 S. Ct. 1339 (1995) [involving both recoverable line pack gas and recoverable cushion gas]. See also Washington Energy Co. v. United States, 94 F.3d 1557 (Fed. Cir. 1996) [involving only recoverable cushion gas]. The Federal Circuit agreed with the Fifth Circuit's rationale that the recoverable portion of line pack gas is a nondepreciable capital asset because it is not subject to exhaustion, wear and tear or obsolescence. Arkla, Inc. v. United States, 765 F.2d 487 (5th Cir. 1985), rev'd 592 F. Supp. 502 (W.D. La. 1984) [involving only recoverable cushion gas]. The Tax Court has reached the identical conclusions regarding recoverable gas. Pacific Enterprises and Subsidiaries v. Commissioner, 101 T.C. 1 (1993) [involving recoverable line pack gas and recoverable cushion gas]. Accordingly, the Service now agrees that the recoverable portion of line pack gas is not merchandise held for sale as inventory. However, we disagree with the Court of Claims that the line pack gas was properly depreciable. Instead, recoverable line pack gas is appropriately treated as a nondepreciable capital asset.

Recommendation:

Nonacquiescence. Revocation of Rev. Rul. 68-620. That the Action on Decision approved September 7, 1990, be withdrawn and that this Action on Decision be substituted therefore.

Reviewers:

Approved: STUART L. BROWN  
Chief Counsel

/s/

By: \_\_\_\_\_  
MARTIN L. OSBORNE  
Attorney

/s/

By: \_\_\_\_\_  
JUDITH C. DUNN  
Associate Chief Counsel (Domestic)

