

ACTION ON DECISION

Subject: Duke Energy Natural Gas Corporation v. Commissioner
- F.3d - (10th Cir. 1999)

Issue: Whether, for depreciation purposes, a taxpayer engaged in the business of pipeline transmission of natural gas, who is not a producer of natural gas, must include gathering pipelines in asset class 46.0 Pipeline Transportation (15-year recovery period) or in class 13.2 Exploration for and Production of Petroleum and Natural Gas Deposits (7-year recovery period)?

Discussion: Under I.R.C. § 168(e), the recovery period of an asset depends upon its "class life." Rev. Proc. 87-56, 1987-2 C.B. 674, sets forth the applicable class lives in effect during the years at issue in this case for purposes of section 168(e). Generally, under Rev. Proc. 87-56 class lives are associated with particular asset classes categorized by business activity. The asset classes at issue in this case are asset class 46.0 Pipeline Transportation, which includes assets used in the private, commercial, and contract carrying of petroleum, gas and other products by means of pipes and conveyors, and asset class 13.2 Exploration for and Production of Petroleum and Natural Gas Deposits, which includes assets used by petroleum and natural gas producers for drilling of wells and production of petroleum and natural gas, including gathering pipelines and related facilities.

Although gas gathering is not traditionally considered part of gas production, Asset Class 13.2 specifically includes gathering lines when such gathering lines are "used" by producers. Placement of gathering lines owned and operated by crude oil and natural gas producers in Asset Class 13.2 reflects two fundamental principles of depreciation tax law: 1) the depreciation system is based on the taxpayer having a depreciable interest in the property, and 2) a deduction for depreciation is dependent upon "use" of the depreciable property in the taxpayer's trade or business.

The asset classes at issue describe two different trades or businesses. In this regard, section 167(m) provides that the depreciation allowance is based on "the class life prescribed by the Secretary which reasonably reflects the anticipated useful life of that class of property **to the industry or other group.**" (Emphasis supplied). Accordingly, under a class life depreciation regime the same asset might have a different class life and recovery period if used by a different industry in a different pool of assets having a different average life. See S. Rep. No. 437, 92nd Cong. 1st Sess. 45 - 50 (1972-1 C.B. 559, 584-586). Rev. Proc. 62-21, 1962-2 C.B. 418, 463, used a class life regime when it originally grouped assets into broad classes for depreciation purposes. Successor revenue procedures, including Rev. Proc. 87-56, maintained the class life regime.

The relevant pool of assets here was pipeline transportation assets because taxpayer was in the trade or business of transporting crude oil and/or natural gas rather than in the trade or business of producing these hydrocarbon commodities. Thus, the class life for the class of assets used for production, which is based on the average life of a variety of assets used for production, is not applicable, notwithstanding that there is an overlap of equipment in the two pools of assets.

The Tax Court upheld the Commissioner's determination that the gathering lines of the taxpayer must be included in the pipeline transportation asset class. On appeal, however, the Tenth Circuit reversed the Tax Court, holding that natural gas "gathering systems" are property includible in asset class 13.2 and must be depreciated over a 7-year period. The Tenth Circuit reasoned that the systems are assets "used" in production since "producers would not be able to produce natural gas" without the necessary means to transport the raw hydrocarbon product for processing prior to its eventual use as a source of energy. In this manner, the court ignored the usual meaning of "production," which, in the oil and gas context, only includes the extraction of hydrocarbons from the formation in which they are found. Furthermore, the court failed to apply the fundamental depreciation tax law principle that the "use" specified in asset class 13.2 must be by the taxpayer having a depreciable interest in the property. The court also ignored the fact that, under Rev. Proc. 87-56, asset classes generally are categorized by business activity and not by assets.

Although we believe that the reasoning and conclusion of the Tenth Circuit are incorrect as a matter of law, this is the first appellate court to consider this issue. Thus, sufficient administrative importance to warrant filing a petition for writ of certiorari to the Supreme Court could not be demonstrated. Accordingly, the decision will be precedential in cases appealable to the Tenth Circuit, and the Service will follow it with respect to cases within that circuit, if the opinion cannot be meaningfully distinguished. The Service, however, will not acquiesce in this decision of the Tenth Circuit and will continue to litigate this issue in cases appealable to courts of appeal in other circuits.

Recommendation: Non-Acquiescence.

Reviewers:

WILLIAM A. HEARD, III
Attorney, P&SI Branch

Approved: STUART L. BROWN
Chief Counsel

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

THIS DOCUMENT IS NOT TO BE RELIED UPON OR
OTHERWISE CITED AS PRECEDENT BY TAXPAYERS