

Rev. Rul. 97-54

## ISSUES

(1) Is the cost of “line pack gas” or “cushion gas” a capital expenditure under § 263 of the Internal Revenue Code or an

amount that is included in inventory under § 471?

(2) If the cost of “line pack gas” or “cushion gas” is a capital expenditure under § 263, is that cost depreciable under §§ 167 and 168?

## FACTS

“Line pack gas” is the minimum volume of natural gas necessary to provide the pressure to facilitate the flow of gas through a pipeline. “Cushion gas” is the minimum volume of natural gas necessary to provide the pressure to facilitate the flow of gas from a storage reservoir to a pipeline. Recoverable line pack gas and recoverable cushion gas will be available for sale or other use upon the abandonment of the pipeline or storage reservoir, respectively. Unrecoverable line pack gas and unrecoverable cushion gas will not be available for sale or other use upon the abandonment of the pipeline or storage reservoir, but will become obsolete with that abandonment.

## LAW AND ANALYSIS

Section 263(a) provides that no deduction shall be allowed for amounts paid out for permanent improvements or betterments made to increase the value of any property or estate.

Section 1.263(a)-2 of the Income Tax Regulations provides that a “capital expenditure” includes the cost of acquisition, construction, or erection of buildings, machinery and equipment, furniture and fixtures, and similar property having a useful life substantially beyond the tax year.

Section 167(a) provides that there shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence) of property used in a trade or business or held for the production of income.

Generally, for tangible property, the depreciation deduction under § 167(a) is determined under § 168 by using the applicable depreciation method, the applicable recovery period, and the applicable convention.

Section 471 provides that whenever, in the opinion of the Secretary, the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by that taxpayer,

on the basis the Secretary may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting income.

Section 1.471-1 provides that in order to reflect income correctly, inventories at the beginning and end of each tax year are necessary in every case in which the production, purchase, or sale of merchandise is an income-producing factor. Inventories should include all finished and partly finished goods and, in the case of raw materials and supplies, only those that have been acquired for sale or that will physically become a part of merchandise intended for sale.

Rev. Rul. 68-620, 1968-2 C.B. 199, amplified by Rev. Rul. 78-352, 1978-2 C.B. 168, holds that line pack gas is merchandise in transit that is intended to be sold to customers and therefore must be included in the inventory of the taxpayer.

Rev. Rul. 75-233, 1975-1 C.B. 95, holds that the cost of unrecoverable cushion gas is a capital expenditure under § 263, which is recoverable through an annual depreciation deduction under § 167.

With respect to both line pack gas and cushion gas, several court decisions have considered the capital expenditure-versus-inventory issue, as well as the depreciation issue. In *Pacific Enterprises v. Commissioner*, 101 T.C. 1 (1993), the United States Tax Court held that the costs of line pack gas and cushion gas are capital expenditures. *Accord Transwestern Pipeline Co. v. United States*, 639 F.2d 679 (Ct.Cl. 1980), regarding line pack gas; *Arkla, Inc. v. United States*, 765 F.2d 487 (5th Cir. 1985), regarding cushion gas. The United States Court of Appeals for the Fifth Circuit in *Arkla* further held that recoverable cushion gas was not subject to depreciation because it was not subject to exhaustion, wear, tear, or obsolescence. *Accord Washington Energy Co. v. United States*, 94 F.3d 1557 (Fed. Cir. 1996). The Fifth Circuit in *Arkla* distinguished unrecoverable cushion gas as being subject to depreciation because that gas will become obsolete along with the storage facility. *Accord* Rev. Rul. 75-233. Finally, in *Arkla, Inc. v. United States*, 37 F.3d 621 (Fed. Cir. 1994), the United States Court of Appeals for the Federal Circuit held that line pack gas and cushion gas are treated the same for

purposes of depreciation. *Accord Washington Energy Co. v. United States*, 94 F.3d 1557.

Line pack gas or cushion gas is recoverable if it will be available for sale or other use upon abandonment of a pipeline or storage reservoir. *See Arkla, Inc. v. United States*, 765 F.2d at 490. The Service will treat line pack gas or cushion gas as being available for sale or other use to the extent that such gas will be recovered from an abandoned pipeline or storage reservoir pursuant to a plan, a requirement of law, or economic feasibility, whichever method projects the greatest actual recovery of such gas.

The Service will follow the court decisions cited in this revenue ruling to the extent they hold that the cost of line pack gas or cushion gas is a capital expenditure, the cost of recoverable line pack gas or recoverable cushion gas is not depreciable, and the cost of unrecoverable line pack gas or unrecoverable cushion gas is depreciable.

## HOLDINGS

(1) The cost of line pack gas or cushion gas is a capital expenditure under § 263.

(2) The cost of recoverable line pack gas or recoverable cushion gas is not depreciable, but the cost of unrecoverable line pack gas or unrecoverable cushion gas is depreciable under §§ 167 and 168. The Service will treat line pack gas or cushion gas as recoverable to the extent that such gas will be recovered from an abandoned pipeline or storage reservoir pursuant to a plan, a requirement of law, or economic feasibility, whichever method projects the greatest actual recovery of such gas.

## APPLICATION

Any change in a taxpayer's treatment of the costs of line pack gas or cushion gas to conform with this revenue ruling is a change in method of accounting to which the provisions of §§ 446 and 481 and the regulations thereunder apply. A taxpayer wanting to change its method of accounting for the cost of line pack gas or cushion gas to conform with this revenue ruling must follow the automatic change in accounting method provisions of Rev. Proc. 97-37, 1997-33 I.R.B. 18.

## EFFECT ON OTHER DOCUMENTS

Rev. Rul. 68–620 and Rev. Rul. 78–352 are revoked. Rev. Rul. 75–233 is superseded. Rev. Proc. 97–37 is amplified to include this change in the Appendix.

## PROSPECTIVE APPLICATION

The Service will not require a taxpayer to change its method of accounting to comply with the holding that the cost of line pack gas or recoverable cushion gas is a capital expenditure for any taxable year beginning before December 29, 1997. In addition, the Service will not require a taxpayer to change its method of accounting to comply with the holding for determining the amount of recoverable line pack gas or recoverable cushion gas for any taxable year beginning before December 29, 1997, provided the method used by the taxpayer projects recoverable line pack gas or recoverable cushion gas in an amount equal to or greater than an amount that would be projected using an economic feasibility of recovery standard.

## DRAFTING INFORMATION

The principal author of this revenue ruling is Jennifer L. Nuding of the Office of Assistant Chief Counsel (Income Tax and Accounting). For further information concerning this revenue ruling, contact Ms. Nuding at (202) 622-4970 (not a toll-free call).

### Section 267.—Losses, Expenses, and Interest With Respect to Transactions Between Related Taxpayers

*26 CFR 1.267(a)-1: Deductions disallowed.*

When a payor provides a per diem allowance to an employee who is a related party, the rules set forth for the deemed substantiation to the payor of the amount of the employee's ordinary and necessary business expenses for lodging, meal, and/or incidental expenses incurred while traveling away from home, do not apply. See Rev. Proc. 97–59, page 31.

### Section 274.—Disallowance of Certain Entertainment, Etc., Expenses

*26 CFR 1.274(d)-1(a): Substantiation requirements.*

Simplified optional method for substantiating the amount of a deduction or expense for business use of an automobile. See Rev. Proc. 97–58, page 24.

*26 CFR 1.274-5T: Substantiation requirements (temporary).*

Simplified optional method for substantiating the amount of a deduction or expense for business use of an automobile. See Rev. Proc. 97–58, page 24.

*26 CFR 1.274(d)-1(a): Substantiation requirements.*

Rules are set forth for substantiating the amount of ordinary and necessary business expense of an employee for lodging, meals, and incidental expenses or meal and incidental expenses incurred while traveling away from home when a payor provides a per diem allowance under a reimbursement or other expense allowance arrangement to pay for such expenses. See Rev. Proc. 97–59, page 31.

*26 CFR 1.274-5T: Substantiation requirements (temporary).*

Rules are set forth for substantiating the amount of ordinary and necessary business expense of an employee for lodging, meals, and incidental expenses or meal and incidental expenses incurred while traveling away from home when a payor provides a per diem allowance under a reimbursement or other expense allowance arrangement to pay for such expenses. Rules are also set forth for an optional method for employees and self-employed individuals to use in computing the deductible costs of business meal and incidental expenses paid or incurred while traveling away from home. See Rev. Proc. 97–59, page 31.

### Section 471—General Rule for Inventories

*26 CFR 1.471-1: Need for inventories.*

The cost of recoverable and nonrecoverable line pack gas or cushion gas is a capital expenditure. Line pack gas or cushion gas in not inventory. See Rev. Rul. 97–54, page 8.

### Section 483.—Interest on Certain Deferred Payments

*26 CFR 1.483-1: Computation of interest on certain deferred payments.*

As defined by section 1274A, the definitions for both “qualified debt instruments” and “cash method debt instruments” have dollar ceilings on the stated principal amount. The limits to the stated principal amount are adjusted for inflation for sales or exchanges occurring in the 1998 calendar year. See Rev. Rul. 97–56, page 11.

### Section 512.—Unrelated Business Taxable Income

The Service provides an inflation adjustment to the maximum amount of annual dues that can be paid to certain agricultural or horticultural organizations without any portion being treated as unrelated trade or business income by reason of any benefits

or privileges available to members for taxable years beginning in 1998. See Rev. Proc. 97–57, page 20.

### Section 513.—Unrelated Trade or Business

The Service provides an inflation adjustment to the maximum amount of a “low cost article” for taxable years beginning in 1998. Funds raised through a charity's distribution of “low cost articles” will not be treated as unrelated business income to the charity. See Rev. Proc. 97–57, page 20.

### Section 877.—Expatriation to Avoid Tax

The Service provides an inflation adjustment to amounts used to determine whether an individual's loss of United States citizenship had the avoidance of United States taxes as one of its principal purposes for calendar year 1998. See Rev. Proc. 97–57, page 20.

### Section 1274.—Determination of Issue Price in the Case of Certain Debt Instruments Issued for Property

*26 CFR 1.1274A-1: Special rules for certain transactions where stated principal amount does not exceed \$2,800,000.*

As defined by section 1274A, the definitions for both “qualified debt instruments” and “cash method debt instruments” have dollar ceilings on the stated principal amount. The limits to the stated principal amount are adjusted for inflation for sales or exchanges occurring in the 1998 calendar year. See Rev. Rul. 97–56, page 10.