Pacific Enterprises & Subsidiaries v. Commissioner, 101 T. C. 1 (1993)

Cushion gas and line pack gas in natural gas utility systems are capital assets, not inventory, because they are integral to the operation of the system and not held for sale in the ordinary course of business.

Summary

Pacific Enterprises, a holding company for gas utilities, sought to classify cushion gas (used to maintain pressure in underground storage reservoirs) and line pack gas (maintaining pressure in pipelines) as capital assets rather than inventory. The Tax Court held that these gases were capital assets because they were essential to the operation of the utilities and not held for sale. The court also found that a 1985 reclassification of working gas to cushion gas was a change in accounting method requiring IRS approval, which was not obtained. The decision clarified the economic recoverability standard for depreciation and influenced how gas utilities account for their gas reserves.

Facts

Pacific Enterprises operated through subsidiaries Southern California Gas Co. (SoCalGas) and Pacific Lighting Gas Supply Co. (PLGS), which merged in 1985. These companies used underground reservoirs and pipelines to store and transport natural gas. The gas in these systems was categorized as working gas, cushion gas, and line pack gas. Working gas was inventory, while cushion gas and line pack gas were treated as capital assets by the companies. In 1985 and 1986, SoCalGas reclassified some working gas to cushion gas based on engineering reports, claiming it was a change in estimate rather than accounting method.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in Pacific Enterprises' federal income taxes for several years, asserting that cushion gas and line pack gas should be treated as inventory. Pacific Enterprises challenged this in the U. S. Tax Court, which heard the case and issued its decision on July 12, 1993.

Issue(s)

1. Whether cushion gas and line pack gas should be treated as inventory or capital assets.
2. Whether the 1985 and 1986 reclassifications of working gas to cushion gas constituted a change in the method of accounting under IRC § 446(e).
3. Whether the standard for determining the nonrecoverable portions of cushion and line pack gas at the abandonment of operations is economic or physical recoverability.

Holding

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1. No, because cushion gas and line pack gas are integral parts of the reservoirs and pipelines and essential to the utilities' operations, they are capital assets.
2. Yes, because the reclassification deferred income by changing the method of identifying a material item of inventory, it was a change in the method of accounting under IRC § 446(e) that required IRS approval.
3. Economic recoverability is the standard for determining nonrecoverable cushion and line pack gas at abandonment because it reflects the realistic potential for recovery based on economic feasibility.

Court's Reasoning

The court applied the legal rule from IRC § 446 and § 471, which allow for the classification of assets based on whether the method clearly reflects income. The court found that cushion and line pack gas were not held for sale in the ordinary course of business but were essential for the operation of the reservoirs and pipelines. This made them capital assets rather than inventory. The court rejected the IRS's argument that the physical similarity between working gas and cushion gas required similar treatment, emphasizing the different purposes they served. The reclassification of working gas to cushion gas was deemed a change in accounting method because it affected the timing of income recognition, requiring IRS approval under IRC § 446(e). The court also determined that economic recoverability was the appropriate standard for depreciation because it considers the feasibility of recovery based on market prices and costs, aligning with industry practices and regulatory standards. The court relied on expert testimony and computer simulations to determine the volumes of nonrecoverable gas.

Practical Implications

This decision impacts how gas utilities and similar industries classify and account for gases essential to their operations. It establishes that gases used for maintaining system pressure are capital assets, not inventory, which can affect tax treatment and depreciation. The ruling also clarifies that changes in gas classification require IRS approval, emphasizing the importance of consistent accounting methods. For legal practice, attorneys must consider the economic recoverability standard when advising clients on depreciation and tax credits for similar assets. The decision may influence future cases involving the classification of assets in regulated industries and could affect how businesses plan their operations and tax strategies. Subsequent cases, such as Transwestern Pipeline Co. and Arkla, Inc. , have applied similar reasoning in determining the classification of line pack and cushion gas.

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