NOTE

SAGINAW BAY PIPELINE COMPANY v. UNITED STATES: SAGINAW WINS THE PIPELINE DEPRECIATION BATTLE, BUT IS THE WAR OVER?

I. INTRODUCTION

Saginaw Bay Pipeline Company (Saginaw Bay), an entity formed under a subsidiary of the Michigan Consolidated Gas Corporation, operated a 126-mile underground, steel pipeline network constructed to transport "raw" or "wet" natural gas. The pipeline gathered natural gas from eighteen separate production fields located in the Michigan East Central Basin and transported the gas to a gas processing plant located in Kalkaska, Michigan.[1] Because the Saginaw Bay pipeline was designed to transport raw or wet natural gas, and was used solely for that purpose, Saginaw Bay deemed its pipeline to be a natural gas "gathering" pipeline.[2] As such, the company depreciated the asset over seven years under the Modified Accelerated Cost Recovery System (MACRS). In applying this depreciation schedule, Saginaw Bay relied on a Revenue Procedure promulgated by the Internal Revenue Service (IRS), which states gathering pipelines fall within an asset class requiring a seven-year depreciation schedule.[3] The IRS challenged Saginaw Bay's use of this seven-year recovery period, maintaining a fifteen-year depreciation schedule was appropriate. In doing so, it disallowed $3,474,244 worth of depreciation deductions taken by the company. The IRS contended that the Saginaw Bay Pipeline was not a "gathering" pipeline, and, consequently, was part of an asset class requiring a fifteen-year cost recovery period.[4] In the end, however, Saginaw Bay's argument prevailed.

This case, along with its sister cases in the Eighth and Tenth circuits,[5] has given non-producer companies owning and operating gathering lines a solid foothold in the depreciation war. If the battles had ended in the trial courts, the IRS would have companies depreciating pipeline assets based on the overall activities of the company, rather than on the use of the asset. The IRS's industry-based approach fails to consider the realities associated with transporting "raw" or "wet" natural gas. Furthermore, the industry-based approach would produce inconsistent depreciation treatment for identical gathering lines whose owners engage in different business activities.

This Note introduces the dispute between Saginaw Bay and the IRS, analyzes the effect of the decision on the industry in the future, and examines the outlook for future battles in this ongoing conflict.[6]

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1. Saginaw Bay Pipeline Co. v. United States, 338 F.3d 600, 601–02 (6th Cir. 2003).

2. *Id.* at 602–03.

3. *Saginaw Bay Pipeline Co.*, 338 F.3d at 605 (relying on Rev. Proc. 87-56).

4. *Id.* at 601.

5. *See* Clajon Gas Co. v. Comm'r, 354 F.3d 789 (8th Cir. 2004); Duke Energy Natural Gas Corp. v. Comm'r, 172 F.3d 1255 (10th Cir. 1999).

6. It is important to note that the controlling case law from the Sixth, Eighth, and Tenth circuits, discussed later in this Note, is applicable to all natural gas gathering lines put to use on or before April 11, 2005. Any gathering line whose original use began after April 11, 2005 is subject to the provisions of the 2005 Energy Tax Act, which mandates that all natural gas gathering lines are assigned to the seven-year property class of MACRS property. Energy Policy Act of 2005, Pub. L. No. 109-58, § 1326(a), 119 Stat. 594.

II. BACKGROUND

A. *The Natural Gas Production Process*

Natural gas extracted from a gas well is termed "raw" or "wet" natural gas because in its native form the gas is full of impurities including water, sand, nitrogen, hydrogen sulfide, helium, carbon, dioxide, and hydrocarbons such as ethane, propane, butane, and pentane.[7] Many of these items are corrosive and before the product can be placed in a gas gathering pipeline for transportation, it must first be processed through a field separator.[8] When sufficient impurities have been removed from the natural gas, it is then placed in a lateral feeder line[9] that connects the field separator to a "main line" or "trunk line."[10]

A natural gas gathering pipeline system[11] typically consists of several lateral feeder lines, which service various wells in a natural gas basin, and a main line. The purpose of the gathering system is to collect the raw gas from the wellheads in the basin and transport that gas to a gas processing plant for further refinement. At the gas processing plant the remaining impurities are removed from the product leaving clean, dry, customer-ready natural gas now composed mostly of methane.[12] At this point the gas is ready to be placed in a transmission or distribution line[13] for transportation to the customer.

B. *Historical Account of the Seven-Year vs. Fifteen-Year Depreciation Dispute*

1. Private Letter Ruling 95-48-003

In 1995, a public utility requested a private letter ruling[14] from the IRS asking to treat its gathering pipelines as seven-year MACRS property. The utility offered a few creative arguments towards its position, but ultimately the IRS rejected all of them and stated that the utility's gathering pipelines should be

7. NaturalGas.org, Natural Gas Processing, http://www.naturalgas.org/naturalgas/processing_ng.asp (last visited Mar. 26, 2006).

8. As previously noted, when natural gas is first extracted from the ground it often contains items undesirable for transportation in a gathering line. Additionally, natural gas is sometimes dissolved in oil underground primarily due to the pressure the formation is under, and often when the natural gas and oil are extracted and the pressure is relieved the two items will separate. However, sometimes this separation does not occur and special "separation" equipment is needed. This special equipment is known as a "field separator." *NaturalGas.org*, Processing Natural Gas, http://www.naturalgas.org/naturalgas/processing_ng.asp (last visited Mar. 26, 2006).

9. A lateral feeder line is the portion of the gathering line connecting the wellhead to the main line, or in this case, connecting the field separator to the main line. *See* The American Gas Association, Natural Gas Glossary, http://www.aga.org/Content/NavigationMenu/About_Natural_Gas/Natural_Gas_Glossary/Natural_Gas_Glossary_(F).htm#F (last modified Mar. 26, 2006).

10. The terms "mainline" and "trunk line" are synonymous terms used in the natural gas industry to indicate a central line whereby lateral feeder lines coming from different wellheads interconnect. Saginaw Bay Pipeline Co. v. United States, No. 99-CV-70454, 2001 WL 1203283, at *2 (E.D. Mich. Aug. 23, 2001).

11. Gathering pipelines typically range in diameter from four to twelve inches and span anywhere from a few feet to several miles. Jennifer Pogue, *Mystifying the Meaning of "Used By" in the Depreciation of Pipelines: Clajon v. Commissioner*, 57 TAX LAW. 283 (2003).

12. NaturalGas.org, Processing Natural Gas, http://www.naturalgas.org/naturalgas/processing_ng.asp (last visited Mar. 26, 2006).

13. Distribution lines range in diameter from sixteen to forty-two inches and can span hundreds or thousands of miles in length. Pogue, *supra* note 11, at 284.

14. I.R.S. Priv. Ltr. Rul. 95-48-003 (July 31, 1995).

classified and depreciated as fifteen-year property.[15]

2. True v. United States

In *True v. United States*,[16] the U.S. District Court for Wyoming reached the opposite conclusion. It determined that a gathering pipeline system owned and operated by a non-producer should be depreciated over seven years, reasoning that the depreciable life of an asset should be determined based on the asset's use, not the activities of the owner company.[17]

3. Duke Energy Natural Gas Corp. v. Commissioner

True finds support in *Duke Energy Natural Gas Corp v. Commissioner*.[18] The court of appeals reversed the trial court's decision[19] holding Duke's pipeline system in dispute was a gathering pipeline, and, therefore, should be depreciated over seven years.[20] The court found that the pipeline was "used in the exploration for and production of petroleum and natural gas deposits."[21]

4. Saginaw Bay Pipeline Co. v. United States – Trial Court Decision

On the other side of the issue is the trial court decision preceding the appellate level dispute now being discussed.[22] The lower court disallowed Saginaw Bay's claim to recover taxes it paid under protest of a fifteen-year depreciation schedule, finding that Saginaw Bay is a pipeline transportation company, and ignoring the actual use of the pipeline.[23]

III. CASE OVERVIEW

A. *Geographic Description of the Saginaw Bay Pipeline*

The wellheads serviced by the Saginaw Bay pipeline in the Michigan East Central Basin belonged to Shell Western Exploration and Production, Inc. (SWEPI), a subsidiary of Shell Oil Company. Late in the 1980s, SWEPI entered into negotiations with Michigan Consolidated Gas Corporation (MichCon). MichCon agreed to supply a pipeline system for the purpose of transmitting raw natural gas from SWEPI's wellheads to a gas processing plant in Kalkaska, Michigan. MichCon, through a subsidiary, then formed the Saginaw Bay to construct and operate this pipeline now known as the Saginaw Bay pipeline.[24]

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15. Patrick A. Hennessee, *The Current Status of Depreciation of Pipeline Gathering Systems*, TAXES – THE TAX MAGAZINE, July 2002, at 49, 50.

16. *True v. United States*, No. 96-CV-1050-J, 1997 WL 836474 (D. Wyo. Nov. 3, 1997).

17. Hennessee, *supra* note 15, at 49–50.

18. Duke Energy Natural Gas Corp. v. Comm'r, 172 F.3d 1255 (10th Cir. 1999), *rev'g*, Duke Energy Natural Gas Corp. v. Comm'r, 109 T.C. 416 (1997); *see also* Clajon Gas Co. v. Comm'r, 354 F.3d 789, 791 (8th Cir. 2004) (holding the taxpayer's natural gas gathering pipeline systems were production assets subject to a seven-year depreciation system even though the taxpayer was not itself a producer).

19. Duke Energy Natural Gas Corp. v. Comm'r, 109 T.C. 416 (1997).

20. *See Duke Energy Natural Gas Corp.*, 172 F.3d at 1262.

21. Hennessee, *supra* note 15, at 51.

22. Saginaw Bay Pipeline Co. v. United States, No. 99-CV-70454, 2001 WL 1203283 (E.D. Mich. Aug. 23, 2001).

23. *Id.* at *3.

24. Saginaw Bay Pipeline Co. v. United States, 338 F.3d 600, 601–02 (6th Cir. 2003).

The Saginaw Bay pipeline is an extensive underground steel pipeline system spanning 126 miles and six counties in Michigan. The system is made up of a trunk line and several branching lateral feeder lines. The lateral feeder lines connect each of SWEPI's eighteen wellheads to Saginaw Bay's trunk line that feeds into the Kalkaska gas processing facility.[25] At the Kalkaska plant, the raw natural gas is processed to pipeline quality and placed into transmission or distribution lines for transportation to the customer.[26]

Due to the corrosive nature of raw natural gas and the potential for obstruction, Saginaw Bay's standard service contracts required producers to feed the raw product through a field separator prior to the introduction of the product into the company's lateral feeder lines. As a result of this contractual obligation on the part of the producer, Saginaw Bay's lateral feeder lines did not *directly* connect to SWEPI's wellheads. Instead, the feeder line branched from the trunk line to the field separator, and the field separator handled the natural gas coming directly from the wellhead.[27]

B. The Issue on Appeal

The overt issue for the Sixth Circuit Court of Appeals was whether Saginaw Bay's subterranean natural gas pipeline system should be depreciated over a seven-year period as opposed to a fifteen-year period. The deeper issue was whether Saginaw Bay's pipeline system should be categorized as a "gathering" pipeline, even though the company was actually in the business of transporting natural gas rather than producing it. If so, the seven-year depreciation method is applicable.[28]

C. Rationale and Holding

The IRS has established guidelines[29] whereby a company can determine an appropriate depreciation schedule for its pipelines. However, these guidelines are only useful if an asset can be categorized within one of the "asset classes" provided in the guidelines. Here, the Sixth Circuit faced categorizing the Saginaw Bay pipeline as either a "gathering line," placing it within an asset class requiring a seven-year depreciation period, or as a "transmission" or "distribution" pipeline, which mandates a fifteen-year depreciation period. Its decision considered several items.

First, normal transmission lines are not designed to handle any significant amount of solid or liquid contaminates, while a gathering line possesses this capability. Saginaw Bay's pipeline was designed to accommodate such contaminates.[30] Second, transmission line service contracts typically provide for the movement of product having a comparatively low heating value, normally less than 950 British Thermal Units (BTUs). However, Saginaw Bay's contracts stated that "the Gas shall have a total heating value . . . of *not less* than 950

25. *Id.* at 602.
26. *Saginaw Bay Pipeline Co.*, 338 F.3d at 602.
27. *Id.* at 602 n.2.
28. *Saginaw Bay Pipeline Co.*, 338 F.3d at 601.
29. Rev. Proc. 87-56, 1987-2 C.B. 674.
30. Saginaw Bay Pipeline Co. v. United States, 338 F.3d 600, 603 (6th Cir. 2003).

[BTUs]."[31] Third, transmission lines are constructed to accommodate high pressure within the pipeline over a long distance, whereas gathering pipelines are designed to operate under relatively lower pressure over shorter distances (Saginaw Bay's pipeline, covering only 126 miles, and was capable of handling a maximum of no more than 1440 pounds per square inch of pressure).[32] Finally, transmission lines, because they transport clean, dry gas, require less internal maintenance, while a gathering line, which handles raw or wet natural gas, requires "pigging"[33] two or three times per day.[34]

Considering these items, the court concluded that Saginaw Bay's pipeline was a gathering system, and, under the IRS guidelines it should be depreciated over seven years. The court supported the shorter depreciation schedule reasoning that the aforementioned items would create a shorter operational life span for the Saginaw Bay Pipeline than that of a transmission line transporting clean, dry product.[35] What is more, the court acknowledged that a gathering line might even become obsolete prior to its expected expiration if, for some reason, the natural gas wells the line services stop producing.[36] Taken as a whole, the court felt it was just to allow a more accelerated cost recovery system.

IV. ANALYSIS

A. *Applicable Law*

The Sixth Circuit relied primarily on the pertinent depreciation sections of the Internal Revenue Code (IRC), Treasury Regulations, a specific IRS Revenue Procedure, and persuasive Tenth Circuit case law.

1. Relevant Code Sections of the Internal Revenue Code

IRC section 167(a) is the starting point for depreciation analysis.[37] So long as Saginaw Bay's pipeline constitutes property used in conducting its trade or business, the company will be allowed a reasonable deduction against ordinary income. The amount of this deduction is determined by looking at the depreciation method,[38] recovery period, and convention[39] for the asset in

31. *Id.*

32. *Saginaw Bay Pipeline Co.*, 338 F.3d at 603.

33. A pipeline pig is a device used to clean the inside of a pipeline. Pigs are either round or barrel-shaped, made of metal or urethane, and covered with metal brushes. They are inserted into the pipeline by using a device called a pig-trap and pushed through the pipeline by pressure in the line. The forward movement of the pig and its rotation cleans the corrosive and contaminating substances from the pipeline. American Gas Association, Natural Gas Glossary, http://www.aga.org/Content/NavigationMenu/About_Natural_Gas/Natural_Gas_Glossary/Natural_Gas_Glossary_(P).htm#P (last visited Mar. 26, 2006).

34. *Saginaw Bay Pipeline Co.*, 338 F.3d at 603.

35. *Id.* at 604.

36. Saginaw Bay Pipeline Co. v. United States, 338 F.3d 600, 604 (6th Cir. 2003).

37. 26 U.S.C. § 167(a)(1)–(2) (2000) (stating in pertinent part that "[t]here shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—(1) of property used in the trade or business, or (2) of property held for the production of income").

38. According to the IRC there are three available depreciation methods: (1) the 200% declining balance method (also known as the double declining balance method) that switches to the straight line method as soon as use of the straight line method would allow a larger deduction, (2) the 150% declining balance method, and (3) the straight line method. 26 U.S.C. § 168(b)(1)–(3) (2000).

question. The only item applicable to this controversy is the recovery period, which is determined by the "asset class" in which the asset falls.[40] These asset classes, which were key to the court's holding, are defined in Revenue Procedure 87-56.

2. Pertinent Treasury Regulations and Revenue Procedure 87-56

The Treasury Regulations used for assigning an asset a classification "posit a 'use-driven' functional standard."[41] An asset is included in an asset class based on the asset's primary use "even though the activity in which such [asset] is primarily used is insubstantial in relation to all the taxpayer's activities."[42] Asset classes, as well as the assets falling within those classes, are described in Revenue Procedure 87-56.

Two specific asset classes described in Revenue Procedure 87-56[43] form the basis of the controversy before the court: Asset Class 13.2 and Asset Class 46.0. Asset Class 13.2, dealing with exploration for and production of petroleum and natural gas deposits, specifies a seven-year depreciation period; gathering pipelines are included in this asset class.[44] Asset Class 46.0 includes "assets used in the private, commercial, and contract carrying of petroleum, gas and other products by means of pipes and conveyors,"[45] and assigns these assets a fifteen-year depreciation period.

3. Tenth Circuit Case Law

As of the date of this case, only the Tenth Circuit in *Duke Energy Natural Gas Corp. v. Commissioner*[46] had encountered this issue. In *Duke*, the Tax Court, agreeing with the contention of the IRS, found that Duke's gathering systems should be categorized as "pipelines that are used by a nonproducer privately, commercially, and/or contractually to carry gas; they are not used by a producer to drill wells or produce gas."[47] As a result of this assessment, the Tax Court concluded Duke's gathering pipeline should fall within Asset Class 46.0 and be depreciated over fifteen years.[48]

The Tenth Circuit reversed after considering the relatively low operational pipeline pressure, the limited geographic span, and the comparatively short operational life span of Duke's gathering system.[49] The court viewed the controversy from a functional perspective, stating "[t]he net effect is that the economic character of Duke's gathering activities is more akin to *production*

39. Depending on the situation and the type of asset, the IRC allows for the following three conventions: (1) the half-year convention, (2) the mid-month convention, and (3) the mid-quarter convention. 26 U.S.C. § 168(d)(1)–(4) (2000).

40. *Saginaw Bay Pipeline Co.*, 338 F.3d at 604.

41. Saginaw Bay Pipeline Co. v. United States, 338 F.3d 600, 604 (6th Cir. 2003).

42. Treas. Reg. § 1.167(a)-11(b)(4)(iii)(b) (1971).

43. Rev. Proc. 87-56, 1987-2 C.B. 674.

44. *Id.*

45. Rev. Proc. 87-56, 1987-2 C.B. 674.

46. Duke Energy Natural Gas Corp. v. Comm'r, 172 F.3d 1255 (10th Cir. 1999).

47. Duke Energy Natural Gas Corp. v. Comm'r, 109 T.C. 416, 420 (1997).

48. *Id.* at 422.

49. *Duke Energy Natural Gas Corp.*, 172 F.3d at 1256.

than to pipeline operation."[50] Consequently, the court determined Duke's gathering system should be classified as a gathering system within Asset Class 13.2 and depreciated over seven years.[51]

B. Impact on the Industry: Use-Based Classification vs. Industry-Based Classification

At odds in this dispute is the classification of Saginaw Bay's pipeline through either a use-based approach or an industry-based approach. Classification of an asset based upon its function or use—the approach endorsed by Saginaw Bay and the Sixth Circuit—considers the primary use of the pipeline, the type of product it transports and that product's effects on the pipeline, the size of the pipeline, and the expected operational life of the line.[52] In contrast, an industry-based approach, the approach—as advanced by the IRS—considers only the business identity of the owner.

In adopting a use-based approach, the Sixth circuit addressed two flaws associated with the IRS industry-based approach. First, the industry-based approach fails to consider the realities inherent within the natural gas industry, and, second, application of the approach could result in disparate depreciation treatment for identical gathering pipelines.

1. The Industry-Based Approach and the Realities of the Natural Gas Industry

A common misconception regarding depreciation or cost recovery is that depreciation deductions represent an estimated amount tied to the deterioration or degradation of an asset over its useful life. Were this the case, Saginaw Bay's argument for the shorter depreciation schedule might have been easier for the IRS to accept because a gathering line will not have the same lifespan as a transmission line. But this is not the purpose behind the accounting convention of depreciation. The purpose of a depreciation allowance, as stated by Bittker, McMahon, and Zelanak,[53] is as follows:

> [Depreciation does not reflect] the asset's actual decline in value during any particular year; they are methods of cost allocation, not of valuation. In theory, total depreciation is equal to the anticipated decline in an asset's value over the period of expected use, since the amount to be depreciated over the asset's useful life is the difference between its adjusted basis and its anticipated salvage value. But this amount, once determined, is allocated to the years of service by methods that do not purport to measure the actual decline in the asset's value from year to

50. Saginaw Bay Pipeline Co. v. United States, 338 F.3d 600, 606–07 (6th Cir. 2003) (quoting Duke Energy Natural Gas Corp. v. Comm'r, 172 F.3d 1255, 1258–59 (10th Cir. 1999)).

51. *See Duke Energy Natural Gas Corp.*, 172 F.3d at 1262.

52. Apparently Congress placed a great deal of credence in the use-based approach when it mandated that all natural gas gathering lines placed in service after April 11, 2005 are subject to MACRS seven-year depreciation. Evidence of this is found in the legislative history behind the 2005 Energy Tax Act where Congress acknowledged that the unprocessed gas which flows through gathering lines is potentially more corrosive than interstate pipeline quality gas. H.R. REP. NO. 109-45 (2005). The relevant provisions of the 2005 Energy Tax Act pertaining to the depreciation of gathering lines ends the controversy at issue in this Note for assets placed in use after April 11, 2005. However, for those assets in use before the passage of this Act, and there are obviously many, the dispute will be controlled by the court decisions illustrated in this Note.

53. Boris I. Bittker is the Sterling Professor of Law Emeritus at Yale University. Martin J. McMahon, Jr. is the Clarence J. TeSelle Professor of Law at the University of Florida. Lawrence A. Zelenak is a law professor at Duke University. These authors are considered among the top tax scholars in the country.

year.[54]

Therefore, if an argument is to be made that gathering lines should not be classified in Asset Class 46.0 with transmission lines, a different distinction must be made. This distinction exists, as noted by the Sixth Circuit, with regard to the size (diameter and length) of Saginaw Bay's gathering line, the pressure of the line, the energy value of the product moving through the line, and the type of product carried in a gathering line as well as its effect on the line as compared to the type and effect of the product transported in a transmission line.[55] Based on these attributes of the Saginaw Bay pipeline, it seems contrary to the realities of the natural gas industry to place gathering lines like that of Saginaw Bay in the same category as Asset Class 46.0 transmission lines.

2. The Industry-Based Approach and its Disparate Depreciation Treatment of Identical Gathering Pipelines

The IRS's industry-based approach also creates inconsistent treatment of gathering pipelines on two fronts. First, if the Sixth Circuit had determined that the depreciable period for a pipeline was keyed to the activities of its owners, the court would have "created a framework of inconsistent treatment of taxpayers in different states."[56] The reason for this is due to the Tenth Circuit's decision in *Duke* where the court adopted a used-based approach. Thus, a non-producer operating a pipeline in Oklahoma, in the Tenth Circuit, would be allowed classify its natural gas gathering pipeline within Asset Class 13.2 and depreciate it over seven years. To the contrary, a non-producer operating an identical pipeline in Michigan would be required to categorize its pipeline as an Asset Class 46.0 asset and utilize a fifteen-year depreciation schedule.

Second, the position advocated by the IRS would "lead to the absurd result"[57] whereby pipelines utilized for natural gas gathering would be subject to a seven-year cost recovery period if owned by a natural gas producer, but would be subject to a fifteen-year cost recovery period if owned by a non-producer. Not only does this result seem inconsistent and illogical, it creates unneeded complexities within the tax landscape as shown by the following:

> Suppose the pipelines of Company A and Company B fall within the jurisdiction of the Sixth Circuit, and the Sixth Circuit has adopted the IRS's industry-based approach. Company A, a producer, enters into an agreement to sell its natural gas gathering line to Company B, a non-producer. Because Company B is a non-producer, the IRS-endorsed industry-based approach would require Company B to reclassify the pipeline under Asset Class 46.0 and deprecate it over fifteen years. The effect of this transaction is a switch in the pipeline's cost recovery period for an asset that has not changed in nature.[58] The result achieved is illogical: Regardless of who owns the pipeline, it still transports the same raw natural gas, it is still subject to the same corrosive elements and deteriorative maintenance, and its

54. BORIS I. BITTKER, MARTIN J. MCMAHON & LAWRENCE A. ZELENAK, FEDERAL INCOME TAXATION OF INDIVIDUALS ¶ 14.01 (2002).

55. Saginaw Bay Pipeline Co. v. United States, 338 F.3d 600, 603–04 (6th Cir. 2003).

56. Pogue, *supra* note 11, at 292.

57. *Saginaw Bay Pipeline Co.*, 338 F.3d at 607.

58. Note that this same net result would be achieved had the hypothetical considered a transaction between a company with assets falling within the jurisdiction of the Sixth Circuit and one with assets within the jurisdiction of the Tenth Circuit, assuming, of course, the Sixth Circuit adopted the industry-based approach rather than the use-based approach.

operational life has not changed. Why, then, should it be reclassified and depreciated over a longer period of time?

C. *Gathering Lines vs. Transmission Lines: The FERC's Approach Compared to the IRS's Approach*

The test employed by the Federal Energy Regulatory Commission (FERC) used to distinguish between gathering lines and transmission lines for jurisdictional purposes appears to parallel the rationale behind the Sixth Circuit's decision in *Saginaw Bay*. Prior to 1982, the FERC employed two principal tests to determine whether a pipeline was considered a gathering line or a transmission line: (1) the "behind-the-plant"[59] test; and (2) the "central-point-in-the-field"[60] test. After 1982, the FERC adopted the "primary function" test. This test considers the following criteria: *(1) the length and diameter of the lines*; (2) the extension of the facility beyond the central point in the field; (3) the geographic configuration of the facility; (4) the location of compressors and processing plants; (5) the location of wells along all or part of the line facility; and *(6) the operating pressure of the lines.*[61]

The italicized items in the quotation above closely resemble some of the factors considered in the use-based or functional approach adopted by the Sixth, Eighth, and Tenth circuits. Notice that nothing in this test considers the business activity of the owner of the pipeline, a consideration the IRS deems of utmost importance in its industry-based approach. Thus, the FERC, which is the principal regulator of pipelines, has adopted an approach to distinguish between gathering and transmission lines that is contrary to the position taken by the IRS.

D. *Decisions in Other Circuits*

To date, the Eighth,[62] Tenth,[63] and now the Sixth,[64] Circuits have rejected the IRS industry-based approach. Although in theory the IRS has nine more forums in which it could establish its argument, this seems unrealistic. States with major natural gas reserves falling outside the jurisdiction of these court are dwindling. Texas, Louisiana, Alaska, New Mexico, and Oklahoma hold more than one half of the United States' domestic reserves;[65] of this group Oklahoma and New Mexico have been spoken for by the Tenth Circuit. Thus, if the IRS is

59. The "behind-the-plant" test treated facilities upstream of compressors and processing plants as gathering facilities. Facilities located more toward the consumer were treated as transmission facilities. ENERGY INFO. ADMIN., DEP'T OF ENERGY, FERC POLICY ON NATURAL GAS GATHERING SYSTEM OWNERSHIP SINCE 1992, http://www.eia.doe.gov/oil_gas/natural_gas/analysis_publications/ngmajorleg/fercpolicy.html (last visited Mar. 26, 2006).

60. The "central-point-in-the-field" test was used for gas that did not require processing. This test treated lateral lines that gathered gas and transported it to a central location as gathering lines. The single line where the lateral lines converged was treated as a transmission line. ENERGY INFO. ADMIN., DEP'T OF ENERGY, FERC POLICY ON NATURAL GAS GATHERING SYSTEM OWNERSHIP SINCE 1992, http://www.eia.doe.gov/oil_gas/natural_gas/analysis_publications/ngmajorleg/fercpolicy.html (last visited Mar. 26, 2006).

61. Lomak Petroleum, Inc. v. FERC, 206 F.3d 1193, 1196 (D.C. Cir. 2000) (emphasis added).

62. Clajon Gas Co. v. Comm'r, 354 F.3d 786 (8th Cir. 2004).

63. Duke Energy Natural Gas Corp. v. Comm'r, 172 F.3d 1255 (10th Cir. 1999).

64. Saginaw Bay Pipeline Co. v. United States, 338 F.3d 600 (6th Cir. 2003).

65. United Nations Conference on Trade and Development, Market Information in the Commodities Area: Natural Gas, http://r0.unctad.org/infocomm/anglais/gas/market.htm (last visited Mar. 26, 2006).

going to prevail, it seems it will have to do so in the Fifth or Ninth Circuits.

IV. CONCLUDING SAGINAW BAY PIPELINE CO. V. UNITED STATES

As a result of Congress's efforts to enact legislation to plug the holes exploited by zealous practitioners seeking to develop creative tax solutions for their clients, the tax landscape has become increasingly complex. Decisions that contribute logic and consistency to this arena are welcome.

The Sixth Circuit's decision does just that. The court considered and compared all the relevant physical traits of pipelines falling within Asset Class 13.2 and Asset Class 46.0. Furthermore, the court examined the impractical aspects of adopting the industry-based approach advanced by the IRS in its dispute with Saginaw Bay at the trial court level. Application of such an approach would result in inconsistent treatment of identical assets.[66]

In conclusion, by striking down the IRS's argument, the Sixth Circuit further strengthened the foothold of the taxpayers in the continuing war over the appropriate depreciation period for gathering pipelines. A domino effect has begun and as each circuit is faced with this decision the waves of persuasive authority continue to swell and gain momentum. The IRS's opportunities are waning and its chances to swing the pendulum in its favor are becoming more and more limited with each knock of the circuit courts' gavel.

Sean Hennessee

66. Saginaw Bay Pipeline Co., 338 F.3d at 607 (illustrating the idea that pipelines owned by producers would be depreciated over seven years while pipelines owned by non-producers would be depreciated over fifteen years).