Land professionals as well as oil and gas attorneys frequently overlook the significance of a like-kind exchange under Section 1031 of the Internal Revenue Code. Section 1031 allows for the tax-free disposition of both real and personal property, including but not limited to oil and gas property and well equipment. Although the rules and reasoning behind like-kind exchanges appear to be simple and straightforward, the failure to observe formalities can be catastrophic to the exchanging party (the “taxpayer”) who could be denied exchange treatment and incur substantial tax liabilities. Furthermore, due to the nuisance and wide variations of property interests found in the oil and gas industry, there are pitfalls specific to the exchange of oil and gas properties that are not clearly addressed by the tax code.

In short, the purpose of this article is to give a brief overview of like-kind exchanges under Section 1031 and to be informative of certain pitfalls that are common in the exchange of oil and gas properties. This article is not intended to provide legal or tax advice as to any specific factual situation and should not be relied upon without consulting with a tax or legal professional as this article is not in depth and does not cover all possible structures or legal issues.

**Overview of Section 1031**

Normally the sale of property is a taxable event in which the taxpayer recognizes gain to the extent the consideration received exceeds the taxpayer’s basis in the property. Additionally, this gain can be taxed as ordinary income to the extent deductions have been taken for intangible drilling costs, depletion and equipment depreciation under the “recapture” provisions. But, taxes can be deferred if the taxpayer disposing of property receives “replacement property” in a manner that complies with Section 1031 of the Internal Revenue Code. The reasoning behind Section 1031 is that exchanging property should not be a taxable event because the taxpayer is not receiving cash and “cashing out” on the investment, but the taxpayer is merely changing the investment.

When the requirements of Section 1031 are met, it can provide a substantial tax benefit as the sale of oil and gas property can produce substantial gains, and, as noted earlier, that gain can be taxed as ordinary income due to the recapture of prior deductions.

**Requirements of Section 1031**

Section 1031(a) provides: “No gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like-kind which is to be held either for productive use in a trade or business or for investment.” Out of this language, three specific requirements are evident: (1) exchange of properties, (2) properties are like-kind and (3) properties are held for use in a trade or business or for investment.

The exchange requirement requires a reciprocal transfer of property, but the exchange does not have to be simultaneous or direct. Because the exchange of property does not have to be simultaneous or direct, you can use an intermediary party called a “qualified intermediary” to sell your property and use the proceeds to purchase a “replacement property” that you can choose at a later date and from a third party. In these types of indirect exchanges, the taxpayer will transfer property to the qualified intermediary who will sell the property to the ultimate purchaser. The qualified intermediary will then use the proceeds to buy the “replacement property” and transfer the replacement property back to the taxpayer. This type of indirect exchange is often called a deferred exchange when the taxpayer has a purchaser for his property but doesn’t locate a replacement property until after the initial sale.

In a deferred exchange, there are time requirements that must be met to defer taxable gain. First, there is a 45-day identification period, meaning that the taxpayer must identify the replacement property within 45 days after the disposition of his original property (the “relinquished property”). After the first requirement is met, the replacement property must be received by the taxpayer within the earlier of (1) 180 days...
after the date of disposition of the original property or (2) the date the taxpayer’s return (including extensions) is due for the taxpayers return reflecting the year the original property was disposed. Similarly, if a taxpayer finds a property he would like to acquire and desires to exchange property he currently owns as the consideration for the new property, a “reverse exchange” can be used, and it is subject to these same time requirements.

In a reverse like-kind exchange, the taxpayer will use an intermediary party, which is similar to a qualified intermediary to acquire and hold the replacement property until the taxpayer picks a property to sell. This is often the case when an oil company or individual finds a property to acquire but needs to dispose of other properties to free up some cash, or the company may simply view this as a good time to dispose of an existing property substantially tax free. As noted, once the intermediary party acquires the new property, the taxpayer has 45 days to identify the property the taxpayer will relinquish in the exchange, and the taxpayer will have to complete the entire transaction under the same requirements applicable to a deferred exchange.

A crucial point to remember is that in a deferred exchange, you cannot control or receive any cash paid for the relinquished property, but a qualified intermediary can hold the cash (or replacement property in the case of a reverse exchange) until you identify a replacement property. Many businesses market themselves as qualified intermediaries, and an attorney can assist you in protecting any property or cash that will be held by a qualified intermediary. It should also be noted that several individuals are disqualified from serving as a qualified intermediary, including but not limited to an employee, accountant, attorney, banker or a party related to the taxpayer including anyone owning 10 percent or more of the taxpayer. If a “disqualified person” serves as the qualified intermediary, the taxpayer will be deemed to have constructive receipt of the proceeds, meaning the transaction will be fully taxable because the taxpayer will be deemed to have control of the proceeds.

**Like-Kind**

As stated earlier, Section 1031(a) requires that the relinquished property be “like-kind” with the replacement property received by the taxpayer. In the context of oil and gas properties, this concept is very important as personal property such as well equipment is not like-kind to real property. Operating interests in producing oil and gas leases are considered real property used in a trade or business and can be exchanged under Section 1031 for real property. Rev. Rul. 68-331, 1968-1 CB 352; Rev. Rul. 68-226, 1968-1 CB 362. Whether real
property is improved or unimproved doesn’t make a difference because unimproved real property is considered like-kind to improved property under the treasury regulations. Tres. Reg. 1.1031(a)-1(b). But, deductions for intangible drilling costs and depletion can be recaptured when the taxpayer relinquishes property that is subject to these deductions and receives property that is not. (See “Recapture and Taxable Boot.”)

As noted, personal property such as well equipment is not like-kind to real property. This means that when an operating interest is exchanged under section 1031 for another operating interest, the personal property being exchanged will have to be examined separately from the real property in determining the extent to which section 1031 applies.

**Held for Use in a Trade or Business or for Investment**

The relinquished and the replacement property in a Section 1031 exchange must meet the “held for” requirement. Generally, oil and gas properties qualify for the “held for” requirement, but property held only for sale will not qualify. This means that the taxpayer should have owned the property relinquished in the exchange for a meaningful time before the like-kind exchange and should hold the replacement property for a meaningful time after the exchange. Although the time period the property has to be held for is unclear, two years is generally considered to be an appropriate and safe time period because, in the case of like-kind exchanges between related parties, the tax code provides the exchange qualifies if each property is held for two years after the exchange.

**COMMON ISSUES IN LIKE-KIND EXCHANGES OF OIL AND GAS PROPERTY**

**Sale vs. Lease**

At the time of sale or exchange, the taxpayer may wish to retain an overriding royalty or similar interest so that the taxpayer can benefit from the continued development of the property. But, when an overriding royalty is retained in the transfer, the transaction is generally considered to be a sublease and not a sale. I.R.S. G.C.M. 22730, 1941 C.B. 214. If the transaction is treated as a lease (or sublease), the consideration received for the property will be treated as a lease bonus and will be taxed as ordinary income and not as a capital gain. Additionally, the consideration received will not be reduced or offset by the taxpayer’s basis in the property like it would be in the case of a sale. These consequences can be disastrous but with proper planning, an interest can
be held in the property and the transaction can qualify for sale or exchange treatment.

One way sale or exchange treatment is accomplished is where the retained overriding royalty interest was acquired in a separate transaction, so that the assignment of a separate interest in the property is a sale (or exchange) and not a lease. This can be accomplished at the time of the original acquisition of the property or at a later date before the property is transferred. For example, in Badger Oil Co. v. Comm., the 5th Circuit ruled that the taxpayer had made a sale (and not a sublease) of its producing oil and gas lease even though the taxpayer still owned a royalty in the same property that was purchased in a separate transaction. Badger Oil, 118 F.2d 791.

Similarly, in a Technical Advice Memorandum, the IRS concluded that the transfer by an S corporation of all of its mineral interest in a property to an unrelated party constituted a sale of the interest even though shareholders of the corporation also owned royalty interests in the property transferred. The IRS held that the shareholders held two separate interests in the property, one being the royalty interest and the second being their S corporation stock (representing the lease made by the shareholders to the S corporation five years earlier). T.A.M. 8537007. It should be noted that there are state property laws to be considered to ensure that the two property interests do not “merge” into one interest, and there can be “substance over form” issues under the federal tax laws if the transaction appears to only be structured to avoid taxes. Because an overriding royalty interest is noncost bearing and carries a different level of risk than a working interest, there is room to plan around any substance over form issues with the help of counsel.

**Tax Partnerships**

Under the “like-kind” requirement, interests in an entity, including a partnership, generally do not qualify as property of like-kind, although there are exceptions for disregarded entities. When working interests are subject to a joint operating agreement, each interest may be considered a partnership interest if the parties elected to be treated as a partnership for federal income tax purposes. If a tax partnership election has been made under the joint operating agreement, the holders of the working interests can elect out of partnership status before proceeding with a like-kind exchange. It is crucial that a valid election out of subchapter K be made before proceeding with a like-kind exchange.

**Provisions to be Included in Purchase and Sale Agreements**

When entering into a purchase and sale agreement, it is important that the agreement stipulate that each party will consent to the other party carrying out a like-kind exchange. In order to facilitate a like-kind exchange, even if you are not sure that you will proceed with one at the time, it is important that you include a paragraph stating that each party to the purchase and sale agreement consents to the other party’s assignment of its rights and obligations under the agreement to a qualified intermediary or exchange accommodation titleholder. If not, it can be burdensome to pursue the other party’s consent to allow you to transfer your rights and obligations to an intermediary party that will be necessary to carry out a like-kind exchange. These provisions are simple, common and shouldn’t pose much of an issue when negotiating a purchase agreement, but they can save you time in the event you have an opportunity to pursue a like-kind exchange.

**Recapture and Taxable Boot**

When cash or any nonqualifying property is received, taxable gain will be triggered to the extent boot is received. When relinquished property is burdened with debt that will be assumed by the purchaser or when cash or nonqualifying property is received, it is important to consult with your accountant to determine the extent taxable gain will be recognized. Once tax is triggered, deductions for intangible drilling costs, depletion deductions and depreciation on equipment can be “recaptured” — meaning that some or all of the tax owed could be treated as ordinary income. Also, these deductions can be recaptured when the taxpayer relinquishes property subject to recapture but receives replacement property that is not.

**Exchanges Between Related Parties**

As stated earlier, when related parties exchange property under Section 1031, each related party must hold the property received for at least two years. An example of a related party exchange would be an individual exchanging property held in his (or her) name with an entity owned by that individual. For two years following this exchange, neither the individual nor the entity should sell the property received; if either property is sold within two years of the like-kind exchange, both parties will realize taxable gain to the extent applicable. (And losses will not be allowed between related parties under Section 267.)

**CONCLUSION**

When disposing of oil and gas properties, or other mineral properties, taxes can be deferred under a properly structured Section 1031 like-kind exchange. While the structures and definition of property can be flexible, the formalities of a like-kind exchange must be complied with. Due to the special circumstances of the mineral property and due to the wide range of property interests encountered in the oil and gas industry, there are pitfalls and traps specific to these properties that must be carefully navigated. The structure of the like-kind exchange and the documentation required varies from being fairly routine to very complex depending upon the circumstances. Planning should begin early and possibly even as interests in oil and gas properties are
acquired to better facilitate for the disposition of property through a like-kind exchange. Owners of oil and gas properties can greatly benefit by deferring taxes as tax savings can be reinvested, and, in theory, Section 1031 could defer taxes for as long Section 1031 is utilized.

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