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1031 exchanges of oil, gas and mineral interests: Do they qualify?

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As an alternative to purchasing replacement real estate, some taxpayers opt to purchase oil, gas and mineral interests. There are several types of oil, gas and mineral interests. They are often divided up into leases, royalties and production payments. Mineral property includes oil and gas wells. The biggest question, for 1031 purposes, is whether these various types of interests qualify for 1031 purposes, specifically when they are purchased as replacement property for real estate that was sold.

Whether one looks to federal or state law in order to determine whether a particular interest in oil and gas is "real property" under section 1031 is not entirely clear. One federal court has held that state law determines whether an oil and gas interest qualifies as "real property" for purposes of section 1031. The IRS has stated that "in determining the proper classification of property as real or personal for purposes of section 1031 and the like-kind exchange rules, it is well settled that state law must be considered." Several prior revenue rulings, however, held that state law is not considered in determining whether an oil and gas interest qualifies as "real property" for purposes of section 1031. These rulings generally hold that federal law, not state law, determines the nature of an oil and gas interest. All of them hold that leasehold interests and royalty interests are considered "real property" for purposes of section 1031, regardless of how state law may classify such interests.

1. Oil, gas and mineral leases (a "working" or "operating" interest.) A mineral lease typically gives the lessee the right to conduct exploration activities, control drilling operations and share in production. The lessee is charged with the costs and responsibilities of developing and operating the property. Costs of extraction can be recovered through depletion, and the lessee may deduct intangible drilling costs. Such a lease (or working interest or operating interest) is a real estate interest for federal tax purposes. These leases can be subleased to other operators. Operating interests may also contain equipment and other tangible personal property. An exchange of an operating interest with personal property would be a multi-asset exchange.

2. Oil, gas and mineral royalties (a "non-operating" interest.) A non-operating interest bears none of the costs and responsibilities of operating the property, but simply receives a specified part of the gross production or income. The holder has the right to receive a designated percentage of all minerals produced for the life of the property interest (a royalty interest).

Prior revenue rulings and case law have held that a non-operating (i.e., royalty) interest is considered ownership of real property for purposes of section 1031, and thus is eligible for like-kind exchange treatment. These authorities, however, were all decided prior to the 1984 Tax Reform Act, and so did not specifically consider whether such an interest is properly treated as an interest in a partnership for purposes of Section 1031(a)(2). Although ownership of a non-operating interest in an

oil and gas venture most closely resembles ownership of a fractional interest in property (i.e. a TIC arrangement and not a partnership), a taxpayer considering the purchase of a non-operating interest should consult with his or her tax advisor to determine whether interest qualifies as a real property interest for the federal tax purposes.

3. Oil, gas and mineral production payments. There are two types of production payments: carved out and retained. A carved out production payment is created when the owner of mineral property sells a portion of his future production. A retained production payment is created when the owner of a mineral interest sells the working interest but reserves a production payment for himself. An exchange for a production payment will not qualify under section 1031.

Carved-out interests are treated differently than royalty interests and other interests because of the duration of the interests: a royalty interest continues until the mineral deposit is exhausted, whereas a carved-out oil payment right terminates usually when a specified quantity of minerals has been produced or a stated amount of proceeds from the sale of minerals have been received.

Qualifying the purchase of a mineral interest for 1031 purposes can be tricky as there are various types of interests and not all qualify. Generally, however, both operating and non-operating interests do qualify. Conversely, production payments do not qualify as replacement property for 1031 purposes.

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