

Oil, Gas & Mineral Rights

Consulting With Experts is Important in These Transactions

1031

Knowledge



Taxpayers who desire tax deferral on the sale or exchange of oil and gas interests may have the opportunity to reap the advantages under IRC Section 1031. As in any 1031 exchange, it is important to consult with tax and legal advisors regarding applicable state laws and the specifics of each transaction whenever oil, gas or mineral interests are involved.

Taxpayers and their advisors will want to analyze exactly the nature of the oil or gas interest to evaluate whether or not it might qualify for tax-deferred treatment under §1031. A production payment is usually considered personal property because it is treated as an assignment of income and, therefore, is not like-kind to a real property interest. [Comm. v. P.G. Lake, Inc. (1958).] However, a royalty is generally considered like-kind real property and can be exchanged for any other real property. [Anderson v. Helvering, (1940); Rev. Rul. 72-117 (1972)].

The primary distinction between these two types of interests is the duration of the respective interest. An overriding royalty interest continues until the oil or gas deposit is exhausted. On the other hand, a production payment usually terminates when a specified quantity of oil or gas has been produced or a stated amount of proceeds have been received.

MINERAL RIGHT ISSUES

Minerals transferred with a fee interest can also be considered part of the real estate and not a separate asset or inventory to the property owner. [Butler Consol. Coal Co. v. Comm. (1946).] Generally, a working interest or royalty interest can be exchanged for another working or royalty interest or other real property. However, the IRS may disallow an exchange if the investor sells a working interest and retains royalty interests or surface rights.

The following 1031 exchanges did qualify for tax deferral:

- Overriding royalty interest in oil, gas, and mineral rights for an undivided one-half of the fee in a parcel of improved real property. [Crichton, Kate (1940).]

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- An interest in a producing oil lease extending until the exhaustion of the deposit for a fee interest in an improved ranch. [Rev. Rul. 68-331 (1968).]
- Perpetual water rights for a fee interest in land, when local law treats water rights as real property rights and the water right is in perpetuity as compared to a specific amount of water. [Rev. Rul. 55-749 (1955).]

The following did not qualify for tax deferral:

- Limited oil payment right for an overriding oil and gas royalty where the oil payment was a limited interest and the overriding royalty was to continue as long as gas or oil might be produced. [Midfield Oil. Co. (1939).]
- Leasehold measured in terms of a fixed percentage of all oil that might be produced from leasehold measured in terms of a fixed number of barrels of oil. [Bandini Petroleum Co. (1951).]
- Carved out oil payment rights for a fee interest in a ranch, even though local law treated them all as interests in real property. [Fleming, William (1955).] .

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