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Like-Kind Exchanges of Mineral Interests

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Tax advisors encounter like-kind exchanges with ever-increasing frequency. As investors are acquiring income producing real estate at historically low capitalization rates, 1031 investors are searching for alternative real estate investments. An investment we are encountering more frequently is mineral interests as replacement property. The purpose of this article is to give the real estate tax lawyer unfamiliar with mineral interests an awareness of the terminology and some of the tax issues routinely encountered in an exchange of mineral interests.

When mineral interests are involved in a like-kind exchange, the initial inquiry begins with analyzing the type of mineral interest involved. In dealing with real estate, we often take as an axiom that all real estate interests are like-kind, yet this is an overstatement.[1] State law is not determinative of the status of a property interest as real estate for federal income tax purposes.[2] Yet, it remains important to understand the nature of mineral interests to determine their nature for the purposes of §1031.

Mineral interests are rights carved out from fee simple absolute ownership by grant of a mineral deed or a mineral lease. A mineral lease is the usual means of conveyance of mineral rights. A mineral lease grants the right to extract and produce minerals from the premises, while at the same time requiring the lessee undertake the burden of developing the resource, reserving to the lessor an interest in either the minerals or the profits derived from their sale. The mineral leasehold interest is frequently split up into lesser interests.

There are two different types of rights with respect to mineral interests in real estate. These two types of interests help distinguish the various types of mineral interests that a person may own or transfer. The two types of rights are (a) the right to enter upon, explore, develop, and produce the minerals (executive rights); and (b) the right to the minerals produced (possessory rights).

PART 1: TYPES OF MINERAL INTERESTS

A. OPERATING INTERESTS

"**Working Interests**" — The term "working interest" means an interest that includes the right to develop the minerals and an affirmative obligation to incur the expense of producing the mineral. The terms "leasehold interest," "operating interest," and "working interest" are often synonymous. The leasehold or working interest is often further divided up to secure funds for exploration or to secure financing. The owner of a working interest can create subordinate interests that possess executive rights (operating interests) or non-operating interests that grant an interest in the minerals produced. A working interest is an "economic interest" the cost of which may be recovered by depletion, and which qualifies the owner/operator to expense intangible drilling costs. A working interest is considered a real estate interest for federal income tax purposes.[3]

B. NON-OPERATING INTERESTS

"**Royalty Interests**" — The term "royalty interest" means a reserved interest in the future production of the entire property, rather than one limited by time or quantity of minerals extracted, and that is not encumbered by the obligation to develop the resource. Royalty interests that have the same term as the mineral lease are "economic interests" qualifying for depletion. There are different types of royalty interests:

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[1] *See, e.g.,* PLR 200404044, dealing with water rights being like-kind to a fee simple interest. Contrast PLR 8327003, holding that grazing rights of indeterminate life are not like-kind to a fee interest.

[2] *Burnet v. Harmel*, 287 U.S. 103 (1932).

[3] *Palmer v. Bender*, 287 U.S. 551 (1932).

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"**Underlying Royalty**" — An underlying royalty is created when the owner of the land (as opposed to the lessee) reserves a fractional interest in all minerals in place. The transfer of the mineral interest in land subject to a reservation of the right to receive a certain percent or fraction of the minerals produced will be considered the creation of a lease and *not* a sale. Therefore, the consideration received will be treated as an advance royalty payment from the lessee.[4]

"**Overriding Royalty**" — An overriding royalty is created when the mineral lessee (rather than the owner) subleases or carves out and conveys a working interest and retains a royalty. This interest is considered a real estate interest for federal income tax purposes.[5]

"**Production Payments**" — A production payment involves the purchaser making an up-front payment of cash to the producer for the right to receive future consideration based on production ("dollar-denominated"), or the right to receive a certain quantity of the mineral produced from the property for a period of time ("volumetric"). A dollar denominated production payment is not considered an interest in real property. Production payments are considered loans, unless they are pledged for future development of the property, in which case they are considered a contribution to a pool of capital.[6] Certain production payments can be reclassified as royalty interests.[7]

Example 1: Taxpayer owned a production payment and assigned a portion of the production in a sum certain with interest, in exchange for an interest in ranchland. The assignment conveyed an interest in cash derived from production, not a capital asset. Therefore, it was not an exchange of like-kind property.[8]

"**Profits Interest**" — A profits interest is an interest carved out of a working interest and is the right to a specified share of the profits free of production costs, but contingent on the grantor earning a profit. A net profits interest (NPI) is considered to be a type of royalty interest, a non-operating interest like a royalty interest differing in that its payment is subject to the payment of costs of production.[9] Profits interests are considered economic interests subject to depletion and are generally considered real property interests for federal income tax law. However, if limited in time or amount, they are not considered real property interests.

Part 2: MINERAL INTERESTS AS REAL PROPERTY FOR §1031

In like-kind exchanges, it is often said (and overstated) that any real estate interest can be exchanged for another real estate interest. Many mineral interests can be exchanged for fee interests in land.[10] In oil and gas tax law, the concept of "property" has a different meaning than it does under §1031, evolving from specialized Code provisions, such as §614 (definition of property for depletion). There is authority under §1031 for some, but not all, types of mineral interests.[11] For §1031, the perpetual [12] nature of an interest in real estate is perhaps the most important factor in determining whether one type of real estate interest can be exchanged for a fee simple interest in another parcel of real property. For mineral interests, the focus has been whether the owner has an interest in the "minerals in place extending to the life of the deposit." [13] Therefore, reliance on federal income tax pronouncements on mineral interests as real estate (outside of §1031) should be judged carefully to de-

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[4] *Crooks v. Comr.*, 92 T.C. 816 (1989). See also Rev. Rul. 73-428, 1973-2 C.B. 303, in which the taxpayer purchased a royalty interest in oil and gas in place from the fee owner of a tract subject to an oil and gas lease. This interest is a fee interest in mineral rights and real property for federal income tax purposes.

[5] *Palmer v. Bender*, 287 U.S. 551 (1932); PLR 8434134.

[6] §636.

[7] *See* Rev. Rul. 86-119, 1989-2 C.B. 81. The IRS has established ruling guidelines on whether an interest is a production payment. Rev. Proc. 97-55, 1997-2 C.B. 582.

[8] *Comr. v. P.G. Lake, Inc.*, 356 U.S. 260 (1958). Note that the holding of *P.G. Lake* as it pertains to production payments has been superseded by §636.

[9] See *Kirby Petroleum Co. v. Comr.*, 326 U.S. 599 (1946), which classified an NPI paid for the privilege of extraction a share of the gross production, measured by the net profits of operation.

[10] See *Comr. v. Crichton*, 122 F.2d 181 (5th Cir. 1951), in which the court held that an exchange of an undivided interest in minerals from certain land for an interest in an unimproved lot is an exchange of like-kind property.

[11] The most notable absence of authority is for net profits interests. The authorities for an NPI as real estate are *Kirby Petroleum* and Rev. Rul. 73-541, dealing with the status of an NPI as an economic interest for depletion.

[12] A "perpetual" interest is not required for a real estate interest to be like-kind to a fee simple interest in other real estate. For example, in Regs. §1.1031(a)-1(c), a leasehold of 30 years or more is like-kind to a fee interest. The term "perpetual" has been used to distinguish easements that are like-kind to a fee simple interest from rights of an indefinite term. See, for example, PLRs 8327003 and 200404044. Minerals in place are an exhaustible asset of finite duration. A distinguishing factor in looking at the nature and character of mineral interests is whether it extends for substantially all of the life of the mineral deposit. Rev. Rul. 68-331, 1968-2 C.B. 352.

[13] *Palmer v. Bender*, 287 U.S. 551 (1932).

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termine their applicability under §1031. See Chart 1 (Mineral Interests as Real Estate for §1031).

Part 3: MIXED REAL PROPERTY AND PERSONAL PROPERTY TRANSACTIONS

Working interests can be "producing" (oil or gas is being produced) or non-producing. A sale of a working interest for a producing property will include not only the real estate interest, but also personal property (such as casings, drill rigs, and other personal property used to extract the oil or gas). Consequently, the sale of a working interest is a multiple asset sale, subject to the "J" Regulations [14] and the like-kind standards for personal property. To the extent that the acquired replacement property does not include sufficient property that is both "like-kind" under Regs. §1.1031(a)-2, and §1245 property, there will be depreciation recapture. See the discussion below for other applicable recapture rules. Non-producing property is unlikely to have personal property of any significant value.

Part 4: THE SALE OR EXCHANGE ISSUE

Conveying a mineral interest can result in a sale or exchange under §1001, creation of a lease/sublease interest, a financing transaction, or a pooling of interest in a joint investment.

A. "Pooling of Capital"

When the grantor transfers an operating interest or a non-operating interest and the consideration is contributed to a pool of capital, then the transaction will not be a taxable sale, but rather a contribution to the pool of capital.[15] The IRS has limited the application of the pooling of capital principle in certain situations.[16] Creating a pool of capital can create a partnership for federal income tax purposes, unless the taxpayers make a proper election out of Subchapter K under §761.

Example 2: Transfer of Working Interest—No Sale. A owns an oil and gas leasehold. A and B agree that A will transfer to B the entire working interest in the specified drilling site with A, reserving an overriding 1/16 royalty, in exchange for B's drilling of a well. If successful, B would be required to equip the well for production, and if unsuccessful, B would be required to plug and abandon it. The well is successful, and A transfers to B the entire working interest in the site, reserving the underlying royalty. Under the "pooling of capital" principle, A is not considered to have sold a capital interest in the property, but rather to have given B a right to share in production in consideration of A's investment.[17]

Example 3: Transfer of Working Interest—Sale. A owns two tracts of land, tract 1 and tract 2. A and B agree that A will transfer an undivided 50% working interest *in tract 2* in exchange for B's drilling of a well on tract 1. If successful, B would be required to equip the well for production, and if unsuccessful, B would be obligated to cap and abandon the well. The well on tract 1 is successful, and A transfers to B an undivided 50% working interest in tract 2. Here, A is considered to have sold an interest in tract 2 to B in exchange for B's performance of services, and A is taxed on the fair market value of the working interest.[18]

B. Sale or Lease

When the grantor transfers an operating interest and retains a non-operating interest that continues for the entire term of the lease, the transaction is a lease, not a sale.

Example 4: Taxpayer owned oil and gas leases, and conveyed a fraction of the working interest in the leases in consideration of a cash bonus, a future payment of up to $1 million out of one-half of the production, and a 1/8 excess royalty. Taxpayer was considered to have retained an interest in the underlying capital investment. The advance payment reduced its investment and adjusted basis for depletion, but Taxpayer has not severed its investment in the asset.[19]

Example 5: Taxpayer owned a farm and transferred a mineral deed to an oil company in exchange for the fee interest in two other farms, some personal property, and retention of a 1/4 interest in the oil and gas to be produced from the farm. Taxpayer claimed that it sold the

[14] Regs. §1.1031(j)-1.

[15] GCM 22730, 1941-1 C.B. 214. This GCM's rationale was reiterated in Rev. Rul. 77-176, 1977-1 C.B. 77.

[16] See Rev. Rul. 83-46, 1983-1 C.B. 16, which denies the application of the pooling of capital doctrine to such services as finding property, title searching and abstracting, and administrative duties.

[17] Rev. Rul. 77-176.

[18] Rev. Rul. 77-176.

[19] *Palmer v. Bender*, 287 U.S. 551 (1933).

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farm and acquired like-kind property. The Tax Court held that the taxpayer created an oil and gas lease by retaining a ¼ royalty interest, and consequently, the property received was the payment of an advance lease bonus.[20]

However, if the grantor transfers an operating interest, and the retained interest does not last for the duration of the term, the transaction is considered a sale.[21] The consideration received by the grantor is an advance royalty. When the grantor transfers all or part of a non-operating interest for consideration, the transfer is considered a sale to the extent of the interest sold, even if the grantor retains a portion of the interest.[22]

C. Production Payments: Financing Transaction, Sale, or Contribution to Pool of Capital

Production payments are frequently used to raise capital. Code §636, adopted in 1969, settled the treatment of production payments. Under §636, granting a production payment is considered a financing transaction, not a sale or exchange.[23] However, when a production payment is pledged for use in exploration or development, it will be considered a contribution to the pool of capital and not a financing transaction.[24] The following examples illustrate how production payments are treated.

Example 6: Taxpayers acquired various mineral interests for a deferred cash payment accruing at 6% per annum. The seller retained the right to collect its payment from 50% of the proceeds derived from the production or sale of the interests. Taxpayers received the profits from the mineral interests and transferred to the sellers 50% of what they received. The transfer was of the entire mineral interest, notwithstanding the retained production payment, and taxpayers were responsible for the tax on all profits received from the mineral interests, notwithstanding their obligation to pay and subsequent payment of 50% of the production proceeds to the seller.[25]

Example 7: Taxpayer owned an oil and gas lease on 311 acres. He transferred his leasehold to an oil company for $54,000, reserving a production payment of $10,000 per acre, payable out of 5% of the production of all the leased property. The leasehold would therefore need to produce over $62,000,000 to pay out the production payment. There was no commercial oil and gas production in the area. Taxpayer claimed a sale occurred, producing long-term capital gain. The remote possibility of ever satisfying the production payment from the leasehold made the production payment the equivalent of an underlying royalty, applicable to all minerals in place, making the transaction a lease rather than a sale, resulting in ordinary income in the form of an advance royalty payment.[26]

Part 5: SPECIAL RECAPTURE RULES

When disposing of a mineral interest, recapture provisions may recharacterize the recognized gain as ordinary, and override other nonrecognition provisions such as §1031 and §1033. Two principal tax incentives benefiting owners of mineral interests are the ability to deduct intangible drilling and development costs and the ability to recover basis through deductions for depletion. These benefits are subject to the recapture provisions of §1254, and may override §1031 or §1033. These recapture rules are in addition to recapture under §1245, to the extent applicable.

"**Intangible Drilling and Development Costs (IDC)**" — To encourage development of mineral resources, the owner of a working interest in a mineral lease may deduct in the current year amounts expended for intangible drilling and development costs of the leasehold.[27] Eligible IDC expenses are those costs expended for drilling or developing a well for production that have no salvage value.[28] Salvageable items, such as the pipes, valves, and fittings used to control the flow of oil or gas are not IDC and must be capitalized and depreciated.

"**Depletion**" — Depletion deductions are available to the owner of an economic interest of minerals in place, including the lessor owning an overlying royalty interest, the lessees owning a working interest, and the sublessors holding an overriding royalty interest or net profits interest. The depletion method used

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[20] *Crooks v. Comr.*, 92 T.C. 816 (1989).

[21] *See* Regs. §1.636-1(a).

[22] *Ratliff v. Comr.*, 36 B.T.A. 762 (1937).

[23] When a production payment is considered a financing transaction, the debt obligation created is subject to the original issue discount rules of §1272 *et seq.*

[24] §636(a); Rev. Rul. 92-38, 1992-1 C.B. 197.

[25] *Anderson v. Helvering*, 310 U.S. 404 (1940). The *Anderson* holding is also superseded by §636.

[26] *Watnick Est. v. Comr.*, 90 T.C. 326 (1988).

[27] §263(c); Regs. §1.612-4(a).

[28] Rev. Rul. 70-314, 1970-2 C.B. 132.

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for oil and gas properties is cost depletion.[29] The depletion deduction is equitably apportioned among those owning economic interests.

"**§1254 Recapture**" — When a mineral interest is sold or otherwise disposed of, both IDC and depletion are subject to recapture under §1254. Not all dispositions trigger §1254 recapture. Exceptions exist for a number of transfers, such as financing transactions, creation of a lease or sublease, establishment of a pooling or unitization arrangement, or expiration of a term interest.[30] Transfer of a non-productive well is not subject to recapture, with one exception.[31] Conveying a portion of the property will result in a proportionate amount of the §1254 recapture being allocated to the property conveyed.[32]

Section 1254 recapture applies to "Natural Resource Recapture Property" (NRRP). NRRP includes both "§1254 property" and "Oil Gas or Geothermal Property." Section 1254 property is property: (i) placed in service after 1986; (ii) that meets the definition within the meaning of §614; and (iii) IDC is properly chargeable to the property, *or* the basis of the property was adjusted by depletion. "Oil, Gas or Geothermal Property" is property (within the meaning of §614) placed in service before 1987, the basis of which was adjusted by depletion. IDC is "properly chargeable" to a property when the property is an operating interest, a non-operating interest burdening an operating interest (an NPI or overriding royalty), or a retained non-operating interest in which the owner previously held the operating interest (i.e., an underlying royalty).

Properties that will be considered NRRP include the following:

- A working interest in a producing property on which the lessee elected to expense IDC.
- An underlying royalty interest the basis of which includes adjustments for depletion.
- A working interest in a non-producing property received in a like-kind exchange for a working interest in property on which IDC was deducted.

[29] §611 *et seq.*

[30] Regs. §1.1254-1(b)(3)(ii). There is also a special rule for "carried interests" under which the §1254 recapture liability follows the interest of the carrying party. Regs. §1.1254-1(b)(3)(iii). A "carried interest" is a working interest in which the operating expenses are "carried" by a party and paid out of production until the carried expenses are satisfied, at which time the interest converts or reverts to its normal share.

[31] When the disposition is an abandonment or a foreclosure of a nonrecourse mortgage on a non-productive well, §1254 recapture will apply. Regs. §1.1254-1(b)(1)(vi).

[32] *See* §1254(a)(2); Regs. §1.1254-1(c).

Interface of §1254 and §1031 — If the taxpayer disposes of "Natural Resource Recapture Property" in a §1031 exchange, then the gain recognized under §1254 may not exceed the sum of the gain recognized (determined without regard to under §1254), plus the fair market value of property received that is qualifying property under §1031, but not NRRP.[33]

Example 8: T exchanges a working interest in Tract A worth $200,000 with X for an overriding royalty interest in X's Tract B worth $150,000, Tract C worth $25,000 (a residential lot), and $25,000 in cash. T claimed $2000 of IDC on Tract A. T's basis in Tract A was $100,000. T had deducted $50,000 in depletion. T's realized gain under §1001 is $100,000. The working interest in Tract A is like-kind to the overriding royalty interest in Tract B and to Tract C, and all are qualifying property under §1031. However, Tract C, while qualifying property for §1031, is not NRRP. The gain recognized under §1031 is $25,000. Under §1254, the gain recognized is $50,000, the sum of the gain recognized under §1031 ($25,000) plus the amount of property received that is qualifying property but is not NRRP (the $25,000 value of Tract C).

Part 6: SPECIAL PROBLEMS

Forward Exchanges

Single or Multiple Exchanges — Oil and gas exchanges raise many of the same issues raised in other exchanges. One threshold issue is whether a disposition of a number of properties is a single exchange or multiple exchanges. The same strategies can be employed to address this issue.

Direct Ownership or Partnership — Many times the property exchanged is a fractional interest owned in common with others who share the cost of production. This arrangement can sometimes constitute a partnership for federal income tax purposes. Also, aside from fractional ownership, many times adjacent or contiguous owners are required by state law to combine their production as a single unit, in order to better extract the minerals. Unitization or pooling arrangements may also be considered tax partnerships. In the natural resource area, there is increased use of the §761 election out of subchapter K.

Identification Issues — The replacement property must be "particularly described" in the identification.

[33] Regs. §1.1254-2(d).

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This should require not only that the land, but also the interest in the land (type of interest and percentage), be described.

Sale/Purchase Procedures — Oil and gas interests are sold at private sale and auction. For auction sales, the assignment and notification procedures must be incorporated into the auction procedure to satisfy the regulations' requirements.

Reverse Exchanges

Acquiring "Qualified Indicia of Ownership" — The exchange accommodation titleholder (EAT) must acquire title to the parked property either directly or through a disregarded entity or by some other method recognized by commercial law. Most oil and gas interests are acquired by recorded instrument. Typically the EAT or an LLC owned by the EAT will become the titleholder.

EAT Ownership of Parked Property for Federal Income Tax Purposes — A mineral interest may generate income and/or expense that is allocated to the owner of the interest. The EAT must be treated as the owner of the parked mineral interest for federal income tax purposes. This arrangement produces issues that both the taxpayer and EAT must address. While there are solutions for these issues, they will require significant cooperation and procedures to incorporate the taxpayer's and EAT's interests into the commercial realities of how income and expenses are paid, collected, and reported. Non-producing properties are easier to "park" under Rev. Proc. 2000-37 than producing properties.

CONCLUSION

Tax practitioners can expect to see more activity in exchanges of oil and gas properties. There are certainly several unique issues specific to oil and gas properties. A real estate tax lawyer familiar with exchanges can be reasonably confident that exchanges involving mineral interests will not be significantly more complicated or difficult than other exchanges.

CHART 1

MINERAL INTERESTS AS REAL ESTATE FOR §1031

The following chart illustrates the status of most oil and gas interests as real estate for federal income tax purposes with respect to §1031 exchanges:

Type of Interest	Real Estate (Y/N)	Authority
Working Interest	Yes	Rev. Rul. 68-226, 1968-1 C.B. 362; Rev. Rul. 68-331, 1968-1 C.B. 352
Underlying Royalty	Yes	*Palmer v. Bender*; Rev. Rul. 73-428, 1973-2 C.B. 303
Overriding Royalty	Yes	Rev. Rul. 73-428, 1973-2 C.B. 303
Production Payment	No	§636
Profits Interest	Depends	See Rev. Rul. 73-541, 1973-2 C.B. 206 (net profits interest is considered royalty interest for depletion).

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