SECTION 1031 IN THE OIL PATCH

SECTION 1031 EXCHANGES IN THE OIL & GAS SECTOR

Taxpayers considering entering into 1031 exchanges involving oil and gas interests should carefully evaluate the unique problems they may encounter.

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Domestic oil and gas exploration and production (E&P) is on the rise. For example, Texas is producing about 1.6 million barrels of oil per day now, which is nearly a 50% increase over production levels from 2011. [1] In October 2013, for the first time in nearly 20 years, the U.S. extracted more oil from the ground than it imported from abroad, with crude oil production topping 7.7 million barrels per day. [2] A recent study from Harvard University forecasts that shale-oil production in the U.S. could more than triple from 1.5 million barrels per day in 2012 to 5 million barrels per day by 2017, raising the total U.S. oil production

output to approximately 10.4 million barrels per day. [3] Add to this the prolific shale gas boom that has occurred over the last ten years, such as the Barnett, Haynesville, Marcellus, and Eagle Ford shale plays, and it becomes obvious that domestic E&P activity is very hot right now.

Naturally, the increase in E&P activity has been accompanied by a corresponding increase in oil and gas acquisitions and divestitures. In many cases, these transactions are structured (or intended to be structured) as tax-deferred, like-kind exchanges under Section 1031. Investors contemplating a 1031 exchange as a means to dispose of or acquire oil and gas properties should consider several key issues that can impact the transaction, including:

- The types of oil and gas interests and associated personal property that qualify for use in a 1031 exchange, including special issues regarding pipelines.
- Whether the transaction will be respected as an "exchange" or recast as a leasing transaction (and ineligible for 1031 exchange treatment).
- The impact of intangible drilling costs (IDC) and depletion recapture in the exchange.
- The presence of a "tax partnership" and the need to elect out of subchapter K to use a 1031 exchange.
- The effect of oil and gas unitizations under Section 1031.

Oil and gas interests in a 1031 exchange

As a general rule, gain from the sale or exchange of property must be recognized for federal income tax purposes. [4] The gain that must be recognized is the excess of the amount realized from the sale or exchange over the taxpayer's adjusted basis in the property sold or exchanged. [5] Section 1031(a)(1) provides an exception to the general rule for exchanges of "like-kind" properties held for productive use in a trade or business or for investment.

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Specifically, Section 1031(a)(1) states that "[n]o 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."

Thus, assuming that the properties to be exchanged are held for productive use in a trade or business or

for investment, the critical inquiry under Section 1031(a)(1)-particularly in the oil and gas context-is whether the properties are of "like-kind" within the meaning of the regulations and published guidance.

Real property exchanges.

Reg. 1.1031(a)-1(b) provides that, as used in Section 1031(a)(1), the term "like-kind" refers to the nature or character of the property, not to its grade or quality. [6] One kind or class of property may not be exchanged for property of a different kind or class. For example, a taxpayer cannot exchange real property for personal property because the nature or character of the property is not of like kind. Real property, however, is considered to be like-kind to all other real property, regardless of how different the property interests may seem. [7]

Example 1. Larry the Landman has worked diligently to assemble a 75% working interest in approximately 10,000 acres (comprised of hundreds of individual leases). Larry has decided that he wants out of the oil business and has negotiated to exchange the entire working interest for a ranch that he will hold for investment purposes. Can Section 1031 apply to the transaction?

The answer is yes. A working interest in oil and gas is considered an interest in real property and may be exchanged for other real estate in a 1031 exchange. On numerous occasions, the IRS has found that an unlimited economic interest in the minerals in place is a real property interest, so long as the interest is for an unlimited duration. [8] Generally, state law defines whether an interest in property is real or personal. [9] However, due to the dramatic disparities in state law treatment of mineral interests, multiple revenue rulings have decided that state law is not determinative of whether an oil and gas interest qualifies as real property for purposes of Section 1031. [10] Under these rulings, federal law, independent of state law considerations, determines the nature of an oil and gas interest. In so ruling, the IRS has determined that "economic interests" in oil, gas, and other minerals-including leasehold interests, working interests, royalty interests, and overriding royalty interests-are all considered real property for purposes of Section 1031, [11] regardless of the state law characterization. [12]

As real property interests, oil and gas interests may be exchanged for other oil and gas interests or other types of real property (e.g., land and buildings) on a tax-deferred basis pursuant to a 1031 exchange. The interest may be exchanged for other kinds of real property without recognition of gain. [13] Some examples from published guidance include:

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- An exchange of an undivided interest in a hotel for mineral properties. [14]
- An exchange of an undivided interest in unimproved real estate for an interest in overriding oil and gas royalties. [15]
- An exchange of one working interest in a lease for another. [16]
- An exchange of an interest in a producing lease of an oil deposit in place for a fee interest in an improved ranch. [17]
- An exchange of overriding royalties for unimproved real estate. [18]

Example 2. DrillCo finds itself in a liquidity crisis and does not have sufficient capital to develop the 75% working interest in approximately 10,000 acres that it acquired from Larry the Landman. Therefore, to provide Drillco with a steady stream of income, DrillCo has negotiated with Harold to exchange the entire working interest for "production payments" burdening Harold's other oil and gas wells. The terms of the production payment agreements provide that Drillco will receive a fixed percentage of all revenues from Harold's other wells until Drillco has received a total payment of $X, at which point the payments will cease. Can Section 1031 apply to DrillCo's transaction?

No. A production payment is generally considered to be personal property because it is simply an assignment of income. Therefore, a production payment is not of like kind to real property interests. [19] The main distinction between a production payment and a royalty is the duration of the interest. A royalty or overriding royalty continues until the mineral deposit is exhausted, whereas a carved-out oil production payment right usually terminates when a specified quantity of minerals has been produced or a stated amount of proceeds from the sale of minerals has been received.

In other instances in which the oil and gas interest to be exchanged is of limited duration, the IRS also has found that the interests *do not* qualify for 1031 exchange treatment. Specific examples include:

- An exchange of a limited oil payment right for an overriding oil and gas royalty reserved from the same lease. [20]
- An exchange of a leasehold measured in terms of a fixed percentage of all oil that might be produced from certain lands for a leasehold measured in terms of a fixed number of barrels of oil. [21]
- An exchange of carved-out oil payment rights *of limited duration* for a fee interest in a ranch. [22]

Oil and gas equipment and multiple property exchanges.

Oftentimes, the exchange of an oil and gas interest, such as a working interest, also involves the exchange of the personal property associated with the oil and gas property, such as oil and gas equipment, fixtures, and pipelines. Personal property exchanges are governed by a different set of rules and restrictions than real property. Therefore, it is important to understand how

such multi-property exchanges can affect a 1031 exchange.

Example 3. At the Wildcatters' Society annual poker tournament, Harold, Big Al, and Salty begin boasting about the wells they are producing. The next day, Harold visits the office of attorney Felix Harlan with several tax questions. Harold thinks that he can parlay his operating interest in Mediocre Well, a producing well, and all the associated well equipment in exchange for either (1) Big Al's operating interest in Spindletop, another producing well, and all the well equipment, or (2) Salty's operating interest in Waterworks, a producing well located offshore, and the drilling platform. Harold thinks it would be a wash and, therefore, neither exchange should have any tax consequences. Although Harold's response seems logical, Felix has some experience with 1031 exchanges. Felix hesitates to agree because of the personal property involved in the exchange. [23] As delineated above, the exchange of the operating interests should qualify as a 1031 exchange of real property, assuming the working interests are not limited as to duration. However, Felix is concerned with whether the well equipment also qualifies for 1031 exchange treatment or whether it will it be treated as taxable "boot" in the exchange.

Section 1031(a)(1) allows property (whether personal property or real property) held for productive use in a trade or business or for investment to be exchanged without recognition of gain or loss for like-kind property. Reg. 1.1031(a)-2 provides additional rules for determining whether personal property has been exchanged for property of a like kind. According to that regulation, "[p]ersonal properties of a *like class* are considered to be of a 'like kind' for purposes of section 1031." [24] Thus, as long as the personal properties are of "like class," they qualify as "like kind" properties in a 1031 exchange. It is important to note that the "like class" standard is simply a safe harbor, and that two types of properties may still meet the more general "like kind" test, even though they may not be of like class under the safe harbor. [25]

The regulations give further guidance on the meaning of "like class." Reg. 1.1031(a)-2(b)(1) states that "[d]epreciable tangible personal property is of a like class to other depreciable tangible personal property

if the exchanged properties are either within the same *General Asset Class* or within the same *Product Class.*" [26] Thus, all personal property within the same General Asset Class or within the same Product Class is considered to be of like class, and thus of a like kind. The General Asset Class categories are listed in Reg. 1.1031(a)-2(b)(2), while the Product Class categories are contained within the NAICS Manual. [27]

The General Asset Class categories are not useful in the oil and gas context because they generally do not apply to any oil and gas equipment or personal property used in oil and gas exploration or production (except for items such as trucks, furniture, and fixtures). [28] Therefore, one must look to the Product Class rules for useful guidance. Under the Product Class rules, to be like class (and thus like-kind), depreciable tangible personal property must be described within the same six-digit product class within Sectors 31, 32, or 33 (pertaining to manufacturing industries). [29] Examples of Product Class codes that are relevant to oil and gas personal property and equipment include:

- NAICS 333132, which covers oil and gas derricks, drilling rigs, oil and gas field-type machinery and equipment, water well drilling machinery, well logging equipment, rock drill bits, and Christmas tree assemblies.
- NAICS 333120, which covers all heavy construction equipment.
- NAICS 333911, which covers oil well and oil field pumps.
- NAICS 336611, which covers floating oil and gas drilling platforms, barges, cargo ships, container ships, towboats, and other marine vessels.

In Harold's first proposed exchange with Big Al, assuming that each site has similar well equipment of equivalent fair market values, and that such equipment falls into the same Product Class (as listed above, most likely code 333132), the equipment will be of "like class" and thus of "like kind." The analysis can become more complex, however, if the package of equipment exchanged falls into multiple product classes. For example, Big Al's equipment may include some oil pumps, while Harold's equipment may have no equivalent pumps, in which case the pumps received would not be of "like class" to Harold's relinquished equipment. If the pumps also were not of "like kind," the value of the pumps would be taxable "boot" in the exchange. [30]

Notably, Harold's second proposed exchange of onshore drilling equipment for Salty's offshore drilling platform would *not* qualify for 1031 exchange treatment. Although the equipment and the offshore drilling platform are

both classified as personal property, such properties fall under different Product Class codes and, therefore, are not of like class. Moreover, it is doubtful that such assets could be considered like-kind under the general standard. Therefore, the drilling platform received from Salty should be treated as taxable "boot" in the exchange, resulting in recognition of gain on that portion of the exchange.

Pipelines and distribution systems.

Pipelines and distribution systems pose a particularly difficult issue with regard to 1031 exchanges because state law classification rules for pipelines vary dramatically. In Texas, for example, pipelines that are buried underground are considered real property, while in Oklahoma, pipelines are considered personal property. Historically, this state law disparity had the potential to cause identical property to be treated differently based on its location, thus thwarting the intent of Section 1031. Moreover, federal personal property classifications do not assist in alleviating this tension because pipelines are not listed in any of the General Asset Class or Product Class categories discussed above. Recent IRS guidance may provide some relief, however.

Example 4. Two natural gas pipelines are exchanged. One, in State A, is constructed along a right-of-way on real property and is classified as personal property. The other, in State B, is constructed along a right-of-way on real property and is classified as real property. The rights of way associated with the exchanged pipelines in State A and State B are also exchanged. Is this a valid 1031 exchange?

The answer is yes. According to a recent internal legal memorandum (ILM) released by the IRS, the pipelines are considered like-kind property, regardless of their state law classification as real or personal property, because they have the same basic nature and character. [31] This is an example of how the IRS has tried to alleviate some of the tension between state law classifications for 1031 exchanges. According to the memorandum, "state law property classifications, while relevant for determining if property is real or personal property, are not determinative of whether properties are of the same nature and character," which is the essential inquiry under Section 1031. Rather, all facts and circumstances should be considered in determining whether properties are of the same nature and character and thus are of like kind. While this ILM cannot be cited as precedent by other taxpayers, its applicability will likely be much more far-reaching than just to pipelines, and it provides a flexible and favorable position for taxpayers looking to utilize 1031 exchanges of energy-related infrastructure. For example, it would be logical to

extend the ruling to cover gas pipeline gathering lines, which are similar assets that may be classified differently under state law.

The 'sale vs. lease' issue

Of all the "gotchas" in 1031 exchanges involving oil and gas, the sale vs. lease question is probably the most important. In many situations, a transaction that for all purposes seems to be structured as a sale or 1031 exchange of the property will instead be recast as a leasing transaction for federal tax purposes. If recast as a lease, any up-front consideration is ordinary income that must be recognized immediately and is ineligible to be used in a 1031 exchange. It is paramount to understand the circumstances in which an exchange may be recast as a lease, and the steps that can be taken to prevent this result.

Example 5. Drillco owns a 75% working interest in approximately 10,000 acres (comprised of hundreds of individual leases). Drillco has negotiated a deal to sell the entire working interest to Buyer for $100,000,000. Drillco will retain an overriding royalty (ORRI) equal to 25% less all landowner royalties burdening the leases. Thus, for example, on leases burdened by a 20% landowner royalty, the retained ORRI will equal 5%, but on leases burdened by a 25% landowner royalty, Drillco will retain no ORRI. Drillco intends to reinvest the entire $100,000,000 in like-kind property pursuant to a 1031 exchange. Is this a valid 1031 exchange?

The answer is yes and no, because the answer is determined on a lease-by-lease basis. [32] The answer is yes for any lease for which Drillco retains no ORRI. However, the answer is no for any lease upon which Drillco retains the ORRI. [33] The reason is that, with respect to any leases upon which Drillco retains an ORRI, the transaction will be treated as a leasing transaction, not as a sale or exchange, for federal tax purposes. [34] Because the transaction is treated as a lease, the portion of the $100,000,000 payment allocable to the leasing transaction will be treated as lease bonus, which is ordinary income.

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Many clients in this situation are surprised to learn that, by retaining an ORRI on a purported sale of working interests, the transaction becomes ineligible for 1031 exchange treatment and the gain on sale is no longer long-term capital gain, but instead is ordinary income in its entirety. The rationale for this treatment is simple. Drillco, by reserving the ORRI in one or more of the leases, merely grants Buyer exclusive exploitation privileges, and retains a "horizontal slice" of its share of the oil and gas in place that portion which, freed of the burdens of development and operation costs, has a value equivalent to the

value of the entire interest subject to such burdens. [35] Therefore, Drillco is not regarded as having disposed of a capital asset, and the up-front consideration is viewed as ordinary bonus income.

Upon learning this information, Drillco asks its tax counsel what can be done to fix the situation and allow Drillco to structure the disposition as a 1031 exchange. At this stage, the likely choices are to restructure the business deal, such that Drillco either (1) retains no ORRI and the parties increase the cash consideration commensurately, (2) retains no ORRI and sells a smaller working interest for the same cash consideration, or (3) redefines the terms of the retained ORRI such that it is no longer treated as a "royalty" for federal tax purposes (e.g., use a term shorter than the expected life of the burdened properties, such that the ORRI will be treated as a production payment instead of a royalty). [36]

Example 6. The facts are the same as in Example 5, but now assume that Drillco has pre-negotiated a deal to sell the retained ORRI at closing to a separate buyer for a separate $25,000,000 payment. Can Drillco use the entire $125,000,000 in a 1031 exchange?

The answer should be yes. Because Drillco will dispose of its entire interest in the leases pursuant to an integrated transaction, the transaction should be respected as a single sale or exchange for tax purposes, instead of being treated as a lease. [37]

Example 7. The facts are the same as in Example 5, but assume that Drillco instead negotiates a deal to sell 50% of its 75% working interest (i.e., a 37.5% working interest) to Buyer for $50,000,000, thereby retaining a 37.5% working interest. Drillco intends to reinvest the $50,000,000 proceeds in a 1031 exchange. Can this work?

Yes. Although Drillco has retained 50% of the working interest, it has disposed of the entire 37.5% working interest sold to Buyer, and has not retained any economic interest in the portion that was transferred. [38] Thus, the situation is distinguishable from *Crooks* [39] and other cases involving a retained royalty. The difference is that Drillco has sold a "vertical slice" of the entire working interest, and has retained no economic interest in the vertical slice that was sold, whereas in Example 5, Drillco retains a horizontal slice of the economic interest burdening the interest conveyed to Buyer. As a result, in Example 7, Drillco may initiate a 1031 exchange with the sale proceeds and defer tax recognition on the transaction. [40]

Recapture

Oil and gas interests raise special recapture issues in the Section 1031 context. While oil and gas properties generally are of like kind to any other type of real property, including land and

buildings, oil and gas properties typically carry special recapture attributes that may be deferred only when the replacement property consists of other oil and gas properties that are also subject to recapture. Thus, where oil and gas properties are exchanged for real estate in a 1031 exchange, recapture becomes a significant issue.

Example 8. Mr. Y. K. Doodle owns a working interest upon which he previously drilled three operating wells. Doodle previously took intangible drilling cost (IDC) deductions of $500,000 and depletion deductions of $600,000 with respect to the working interest. At a time when Doodle's adjusted basis in the working interest is $0, Buyer offers to purchase the working interest from Doodle for $2,000,000. Doodle finds the price particularly attractive, but would prefer to reinvest the sales proceeds in another producing oil and gas property on a tax-free basis. On the other hand, his wife, Mrs. Y. K. Doodle, has her eye on a Montana ranch. Furthermore, their son, Junior Doodle, proposes that the family invest in a recently discovered (and yet undeveloped) shale gas play (he is very bullish on natural gas prices). Doodle calls tax attorney Felix Harlan to discuss his options under Section 1031.

Recall that Doodle previously took IDC deductions of $500,000 and depletion deductions of $600,000 with respect to the working interest. If he sells the working interest for cash, he will recognize gain of $2,000,000 under the general recognition rules of Section 1001. Furthermore, $1,100,000 of that gain will be recaptured as ordinary income under Section 1254, which requires recapture in an amount equal to the lesser of prior deductions ($1,100,000) or gain from the sale ($2,000,000). [41] The remaining $900,000 of gain will be taxed as long-term capital gain, assuming Doodle has held the property for investment for more than one year. [42] (Note that if Doodle receives cash at any point, even if it is later reinvested in other property, he cannot utilize Section 1031 to defer recognition of the gain and, thus, recapture of the previously deducted amounts at ordinary income rates.)

Alternatively, assume that Doodle sells the working interest and deposits the $2,000,000 with a "qualified intermediary" for use in a 1031 exchange. Doodle intends to invest all $2,000,000 in another producing working interest. Here, Doodle would recognize no gain pursuant to the 1031 exchange. With respect to

recapture, there is an exception if both the relinquished and replacement properties qualify as "Section 1254 property." Section 1254 includes property that has been subject to IDC or depletion deductions. Under the exception, because the relinquished property and the replacement property are both producing working interests that qualify as Section 1254 property, Doodle will recognize no recapture at the time of the sale under Reg. 1.1254-2(d). Instead, the recapture will be deferred and carried over to the replacement property under Reg. 1.1254-3(d). Note that if only $1,900,000 were reinvested in the replacement working interest, the remaining $100,000 of cash boot received would be ordinary income under the Section 1254 recapture rules, and deferred recapture of $1,000,000 would carry over to the replacement working interest under Reg. 1.1254-3(d).

Mrs. Doodle shows Felix pictures of the Montana ranch, and Mrs. Doodle says Felix should come visit. The Doodles are on the fence about the ranch. Updating the facts, assume that Mr. Doodle sells the working interest and utilizes a 1031 exchange to reinvest all $2,000,000 of proceeds in the ranch, which he intends to hold for investment purposes. As before, he would recognize no gain pursuant to the 1031 exchange because the relinquished working interest and the Montana ranch are like kind real property. Nevertheless, he would be required to recapture as ordinary income all $1,100,000 of prior IDC and depletion deductions because the ranch is not Section

1254 property. [43] Mrs. Doodle is crushed because she knows they do not have enough liquidity to cover the tax due on a 1031 exchange for the ranch.

Given this result, Mr. Doodle asks whether he can roll $500,000 into the Montana ranch using a Section 1031 exchange, with a mortgage for the balance of the $2,000,000 purchase price. This would leave $1,500,000 of sales proceeds to exchange into another producing working interest. Doodle asks how the recapture rules apply in this scenario. The answer is that he would now recognize no gain in connection with the 1031 exchange, because the relinquished working interest and replacement property (consisting of the Montana ranch and the working interest as a single exchange) are of like kind. As before, Mr. Doodle would be required to recapture as ordinary income $500,000 of prior IDC and $600,000 of depletion deductions related to the Montana ranch because the ranch is not Section 1254 property. [44] On the other hand, because $1,500,000 of the replacement property is a producing working interest (and, thus, Section 1254 property), the remainder of the recapture ($600,000) will be deferred and will remain preserved in the replacement working interest under Reg. 1.1254-3(d).

Finally, Mr. Doodle asks you about Junior's idea. Junior Doodle has been attending seminars on

emerging shale gas plays, and Junior thinks there are tremendous opportunities in acquiring undeveloped "wildcat" leases rather than producing working interests. Based on his conversations with Felix so far, Doodle assumes that the exchange would qualify under Section 1031, and that he could avoid any recapture. Felix, though, is less confident. The answer depends on whether *undeveloped* leases constitute Section 1254 property. The primary authority is Reg. 1.1254-2(b)(2)(iv)(A), which defines "Section 1254 property" in part as property "if any expenditures described in paragraph (b)(1)(i)(A) of this section (relating to costs under section 263, 616, or 617) are *properly chargeable to such property.*" [45] The costs referred to include IDC and depletion deductions. Furthermore, the regulations instruct that an expenditure (such as IDC) "is properly chargeable to property if-(1) The property is an operating mineral interest with respect to which the expenditure *has been deducted.*" [46] The use of past-tense language may mean that undeveloped working interests that have never had any IDCs associated with them may not qualify as Section 1254 property. Thus, if such property serves as replacement property in Doodle's 1031 exchange, recapture may be required.

Tax partnerships

Section 1031(a)(2)(D) specifically excludes partnership interests from the realm of a 1031 exchange. Many oil and gas working interests are owned via tax partnership arrangements. Thus, caution is warranted in determining the status of working interests when contemplating their use in a 1031 exchange.

Example 9. Drillco owns a 75% working interest in Texas leases. Drillco sells half of the leases to Buyer for $1,000,000. Drillco and Buyer execute a joint operating agreement appointing Drillco as the operator of the leases. The first well is a gusher, and Investor approaches Drillco to purchase Drillco's 37.5% working interest for $10,000,000. Drillco is interested in selling, but only if it can defer gain via a 1031 exchange. Is this possible?

On the face of the transaction, the disposition of a 37.5% working interest appears to be eligible for 1031 exchange treatment, assuming the other requirements of Section 1031 are satisfied. [47] However, by default, the working interest jointly owned and operated by Drillco and Buyer creates a partnership for federal tax purposes. [48] Thus, by selling the 37.5% working interest, Drillco in fact will be viewed as selling a partnership interest for federal tax purposes, which prevents it from structuring the disposition as a 1031 exchange.

Notwithstanding the tax partnership, however, Drillco and Buyer may jointly elect out of subchapter K under Section 761(a), in which case Drillco may proceed with a 1031 exchange. [49] The election out will be effective on the first day of the tax year for which the election is made. Under Reg. 1.761-2(b)(1), the election must be made on the partnership return for the "first taxable year for which exclusion from subchapter K is desired." [50] Here, if Drillco and Buyer make the election on its 2014 return, the election is considered to be effective on 1/1/14. Thus, provided the disposition occurs after such date, the disposition should be eligible for 1031 exchange treatment.

Example 10. Assume that the facts are the same as Example 9, but now assume that the consideration paid by Buyer for the initial assignment of half of Drillco's working interests consisted of $1,000,000 plus Buyer's obligation to pay 100% of the cost to drill the first five wells on the leasehold. Buyer and Drillco will divide all revenues produced from such wells 50/50. As a practical matter, will Buyer consent to Drillco's request to elect out of subchapter K in order to facilitate Drillco's 1031 exchange?

The answer is probably not. Under these facts, the arrangement does not satisfy the "complete payout" rule, so Buyer would be unable to deduct 100% of the costs it funds to drill the first five wells (and instead would be limited to deducting only 50% of those costs). [51] By keeping the tax partnership in place, however, that partnership is able to specially allocate 100% of the costs of the first five wells to Buyer in the partnership agreement. That means Buyer needs the tax partnership to remain in place to deduct 100% of the IDCs it funds for the initial wells. Therefore, as a practical matter, Drillco probably will be unable to obtain Buyer's consent to the election out of Subchapter K, meaning Drillco cannot presently dispose of the 37.5% working interest in a 1031 exchange and the transaction may result in recapture.

Unitization

A natural gas reservoir may extend over several hundred acres. The related mineral interests may be held by multiple owners, who together may have leased such interests to several lessees. To reduce waste and maximize production, many state conservation laws compel lessees within a specified spacing unit to pool their interests in a unitization. Furthermore, lessees holding rights on adjoining tracts commonly form unitizations voluntarily under pooling agreements to maximize production within a given area. Whether under state statute or by voluntary agreement, unitization raises special issues in the context of a 1031 exchange.

Example 11. Dorothy Oil recently leased the 300 acre West tract in Wicked for a one-eighth royalty. Toto Oil is negotiating a lease for the contiguous 900 acre East tract in Wicked for a one-sixth royalty. Toto Oil approached Dorothy Oil about entering into a unitization agreement to voluntarily pool the Wicked West tract with the Wicked East tract to maximize production from a single underlying mineral deposit. Auntie Em, president of Dorothy Oil, calls trusty attorney Felix Harlan at 5 o'clock on a Friday to ask if she will encounter adverse tax consequences by signing the pooling agreement. Felix asks her to e-mail him a copy of the agreement, and promises to try and respond by e-mail over the weekend.

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Under the agreement, the Wicked East tract and the Wicked West tract would be unitized under a participation formula that allocates 25% of unit production to the Wicked West tract (300 West acres divided by 1,200 total acres) and 75% of unit production to the Wicked East tract (900 East acres divided by 1,200 total acres), in each case burdened by the applicable one-eighth or one-sixth royalty. Dorothy Oil would be asked to cover its share of the operating costs under the same formula (25%). In essence, the agreement calls for Dorothy Oil to hedge its risk by exchanging its lease for a share of production from the entire 1,200 acre tract. Does the unitization qualify as a 1031 exchange?

Generally, yes. [52] A unitization generally results in an exchange of a taxpayer's interest in a smaller property for an undivided interest in the overall unit. Unitization usually includes not only the mineral interest but also depreciable equipment. Generally, a party to a unitization agreement will have a leasehold cost (i.e., the basis in the original tract), which will become the basis for the participating interest in the new unit. If the working interest owner has depreciable equipment, the adjusted basis of the depreciable equipment becomes the basis of its interest in the unitized equipment. Any boot (cash or non-like kind property) received upon the unitization exchange is considered to be for a sale of property. Gain must be allocated between the equipment and the leasehold. [53]

Example 12. The facts are the same as in Example 11, but now assume Dorothy Oil is a disregarded entity owned entirely by Auntie Em, and Toto Oil is a disregarded entity owned entirely by Auntie Em's brother, Uncle Ozzie. Thus, Auntie Em and Uncle Ozzie are treated as owning the Wicked West tract and the Wicked East Tract directly under the "related party" rules. [54] One year after the unit is formed, Toto Oil sells the Wicked East tract to a third party in a fully taxable sale.

Because Auntie Em and Uncle Ozzie are siblings, the subsequent disposition within two years of the exchange implicates Section 1031(f), which is a special accelerated recognition rule that applies to related parties. Generally, under Section 1031(f), where related parties (such as Em and Ozzie) engage

in a 1031 exchange, if either related party disposes of the property received in the exchange within two years following the exchange, nonrecognition of gain under Section 1031 no longer applies with respect to the exchange. [55]

Notwithstanding the general rule, Section 1031(f)(2) contains exceptions to the accelerated recognition rule in Section 1031(f)(1). For example, under Section 1031(f)(2)(C), the accelerated recognition rule does not apply if the taxpayer can establish that neither the exchange nor the subsequent disposition had as one of its principal purposes the avoidance of federal income tax. Legislative history clarifies that the non-tax avoidance exception under Section 1031(f)(2)(C) generally will apply when a transaction involves an exchange of undivided interests in different properties that results in each taxpayer holding either the entire interest in a single property or a larger undivided interest in any of such properties. [6] Although unitization is basically the inverse situation-i.e., an exchange of single contiguous properties that results in each taxpayer holding an undivided interest in the combined unit-the underlying nontax avoidance purpose is analogous. Thus, a strong argument can be made that the accelerated recognition rule in Section 1031(f)(1) should not apply. Given the uncertainty, Auntie Em should consider obtaining a private letter ruling from the IRS, if certainty is required.

Conclusion

Section 1031 exchanges in the oil and gas sector have been popular in recent years, and all indications are that this trend will continue into the foreseeable future. Taxpayers considering entering into 1031 exchanges involving oil and gas interests should carefully evaluate the unique problems that may be encountered in this area. Taxpayers are advised to consult with reputable tax counsel to help navigate and avoid the various traps they may encounter when exchanging oil and gas assets.

[1]

See Haines, "Construction Cranes Per Rig," 33 Oil and Gas Investor 8 (August 2013).

[2]

See "In Key Shift, U.S. Oil Production Tops Net Imports," MSN Money (11/13/13), available at http://money.ca.msn.com/investing/news/business-news/in-key-shift-us-oil-production-tops-net-imports.

[3]

Maugeri, "The Shale Oil Boom: A U.S. Phenomenon," Harvard Kennedy School, Discussion Paper #2013-05 (June 2013). Available at http://belfercenter.ksg.harvard.edu/files/draft-2.pdf.

[4]

Section 1001(a).

[5]

Id.

[6]

Reg. 1.1031(a)-1(b).

[7]

Crichton, 27 AFTR 824, 122 F2d 181, 41-2 USTC ¶9638 (CA-5, 1941).

[8]

See Palmer v. Bender, 11 AFTR 1106, 287 US 551, 77 L Ed 489, 3 USTC ¶1026, 1933-1 CB 235 (1933); Rev. Rul. 68-226, 1968-1 CB 362.

[9]

Aquilino, 363 U.S. 509, 5 AFTR2d 1698 (1960).

[10]

Rev. Rul. 68-226, 1968-1 CB 362; Rev. Rul. 88-78, 1988-2 CB 330.

[11]

See GCM 39572, 12/1/86 ("because this standard has been liberally construed, the replacement of one real property interest held for productive use in trade or business or for investment by another that is

similarly held generally would be deemed to fall within the definition of a like-kind exchange"); see also Rev. Rul. 68-226, 1968-1 CB 362 ("the interest of a lessee in oil and gas in place ... is an interest in 'real property' for Federal income tax purposes..."), Rev. Rul. 88-7, 1988-2 CB 330 ("the disposition of oil rights is the disposition of an interest in real property"), Rev. Rul. 73-428, 1973-2 CB 303 (a "royalty interest in oil and gas in place is a fee interest in mineral rights and real property for Federal income tax purposes"), GCM 34,033, 2/3/69 (an "overriding royalty and ... working interest are both considered interests in real property for purposes of the Federal income tax"), Rev. Rul. 72-117, 1972-1 CB 226 ("overriding oil and gas royalties are interests in real property").

12

IRM (Oil and Gas Handbook) 4.41.1.4.1. Moreover, the Internal Revenue Manual provides that "[a]n interest in an oil and gas lease is an interest in 'real property' for federal income tax purposes (Rev. Rul. 68-226). This ruling applies in all cases, regardless of how the oil and gas lessee's interest is treated under state law."

13

However, if relinquished property constitutes a developed interest in mineral reserves and the replacement property is not a similar interest, the recapture of prior intangible drilling costs and depletion deductions cannot be deferred. See the discussion of Section 1254 recapture, below.

14

See Crichton, *supra* note 7.

15

GCM 34651, 10/20/71.

16

Rev. Rul. 68-186, 1968-1 CB 354.

17

Rev. Rul. 68-331, 1968-1 CB 352.

18

Rev. Rul. 72-117, 1972-1 CB 226.

19

See Section 636; See also P.G. Lake, Inc., 1 AFTR 2d 1394, 356 US 260, 2 L Ed 2d 743, 58-1 USTC ¶9428, 1958-1 CB 516 (1958).

20

Midfield Oil. Co., 39 BTA 1154 (1939).

21

Bandini Petroleum Co., (1951).

22

Fleming, 24 TC 818 (1955) (stating a "horizontal" carve-out would be an anticipatory assignment of income from a contractual arrangement, not an exchange of an economic interest in the property).

23

Although it is explicitly stated in this example, it should be noted that most transfers of an operating interest in a producing well will (implicitly or explicitly) involve the transfer of the equipment used to operate the well. In a transfer of a producing working interest for non-producing property, practitioners should be careful to consider the tax implications of equipment, which may be treated as "boot" in the exchange.

24

Reg. 1.1031(a)-2(a) (emphasis added).

25

Reg. 1.1031(a)-2(a).

26

Reg. 1.1031(a)-2(b)(1) (emphasis added).

27

North American Industry Classification System, U.S. Census Bureau (12/18/12), available at www.census.gov/eos/ww/naics/ (hereinafter the "NAICS Manual").

28

The general asset classes include: (1) office furniture, fixtures, and equipment (asset class 00.11); (2) information systems (computers and peripheral equipment) (asset class 00.12); (3) data handling equipment, except computers (asset class 00.13); (4) airplanes (airframes and engines), except those used in commercial or contract carrying of passengers or freight, and all helicopters (airframes and engines) (asset class 00.21); (5) automobiles, taxis (asset class 00.22); (6) buses (asset class 00.23), (7) light general purpose trucks (asset class 00.241); (8) heavy general purpose trucks (asset class 00.242); (9) railroad cars and locomotives, except those owned by railroad transportation companies (asset class 00.25); (10) tractor units for use over-the-road (asset class 00.26); (11) trailers and trailer-mounted containers (asset class 00.27); (12) vessels, barges, tugs, and similar water-transportation equipment, except those used in marine construction (asset class 00.28); and (13) industrial steam and electric generation and/or distribution systems (asset class 00.4).

29

Reg. 1.1031(a)-2(b)(2).

30

For further explanation, see the multiple property exchange examples provided in Reg. 1.1031(j)-1.

31

ILM 2012238027.

32

See Cullen, 26 AFTR 887, 118 F2d 651, 41-1 USTC ¶9364 (CA-5, 1941) (whether a sale or lease occurs must be determined on a property-by-property basis).

33

See Crooks, 92 TC 816 (1989).

34

Id.; see also Rev. Rul. 69-352, 1961 CB 34.

35

For a detailed discussion of this theory, see GCM 22730, 1941-1 CB 214.

36

See, e.g., Cullen, *supra* note 32 (sales of leases coupled with retained production payments respected as sales for federal tax purposes); Ltr. Rul. 9437006 (retained production payments). However, caution should be exercised if retaining a production payment on "wildcat" acreage, because the production payment in that instance will likely be treated as a retained royalty for federal tax purposes. See Watnick, 90 TC 326 (1988).

37

See FSA 1999-819, Vaughn #223 (sales of working interests to third parties, coupled with reservation of ORRIs and contemporaneous assignment of the ORRIs to a trust for the benefit of the seller's children, respected as a sale of the working interests for federal tax purposes). Notably, with proper structuring, a similar technique may be employed to carve off the ORRI from the working interest well in advance of negotiating the sale to Buyer, convey the ORRI to a separate but related entity for valid business purposes, and later sell or exchange the working interest subject to the now pre-existing ORRI existing in the separate entity. Using this technique, and if properly structured, the rationale of *Crooks* should no

longer apply to prevent sale or exchange treatment.

38

See Berry Oil Co., 25 F. Supp. 96 (Ct. Cl., 1938); see also Ratliff, 36 BTA 762 (1937).

39

Note 33, *supra.*

40

It should be noted that the same would be true if Drillco instead were to sell 50% of a royalty, instead of a working interest. See Ratliff, *supra* note 38 (sale of half of a royalty respected as a sale and not treated as a leasing transaction). Again, the fundamental point is that the interest being sold is a fractional interest identical with the fractional interest (or vertical slice) being retained (except as to the quantity being sold), such that no "economic interest" is retained with respect to the interest being sold.

41

Section 1254(a)(1).

42

Section 1222(3).

43

Regs. 1.1254-2(d), 1.1254-1(b)(2).

44

Id. Note that under taxpayer-favorable ordering rules, the replacement working interest ($1,500,000) is first matched against the relinquished working interest ($2,000,000) in the 1031 exchange to minimize the potential for recapture. See Reg. 1.1254-2(d)(2). Here, the ordering rules leave only $500,000 subject to recapture.

45

Reg. 1.1254-1(b)(2)(ii) (emphasis added).

46

Reg. 1.1254-1(b)(2)(iv)(A)(1) (emphasis added).

47

See, e.g., Rev. Rul. 68-331, 1968-1 CB 352.

48

See Bentex Oil Corp., 20 TC 565 (1953); IT 2749, XIII-1 CB 99IT 2749, XIII-1 CB 99.

49

See Section 1031(a)(2)(flush language) ("an interest in a partnership which has in effect a valid election under section 761(a) to be excluded from the application of all of subchapter K shall be treated as an interest in each of the assets of such partnership and not as an interest in a partnership.").

50

Reg. 1.761-2(b)(1); Rev. Rul. 83-129, 1983-2 CB 105.

51

See Rev. Rul. 70-336, 1970-1 CB 145; see also Rev. Rul. 71-207, 1971-1 CB 160.

52

Rev. Rul. 68-186, 1968-1 CB 354; GCM 33536, 6/19/67.

53

See IRM (Oil and Gas Handbook) 4.41.1.4.5.

[54]

Section 1031(f)(3) cross references the definition of "related party" provided in Sections 267(b) and 707(b).

[55]

See Section 1031(f)(1).

[6]

See H. Rep't No. 101-247, 101st Cong., 1st Sess. 1340-41 (1985); *reprinted in* 1989 U.S. Code Cong. & Admin. News 1906, 2810-11; Ltr. Rul. 200820017.

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