# Interesting Transactional Issues In 1031 Exchanges

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# Agenda

- Disaster Extensions
- 1031s from Foreclosures
- 1031s and Options
- Partnership Structures
- Reverse Exchange Planning
- Using Related Parties
- Exchange Bifurcation
- Special Issues for Oil & Gas Transactions

# Disaster Extensions

# Federally Declared Disasters

- Rev. Proc. 2018-58 can extend the 45-day and 180-day deadlines in 1031 exchanges in the event of a federally declared disaster.
- IRS generally will issue a Notice identifying the "federally declared disaster" area and "affected taxpayers" who may utilize the relief.
- Typical disasters:  hurricanes, tornados, fires, severe storms, floods.
- Disaster area typically is listed by county; list may be updated
- Recent examples:
  - North Carolina – Hurricane Helene (September 25, 2024) – Sec. 6 extended deadline is September 25, 2025.
  - California – LA Wildfires (January 7, 2025) – Sec. 6 extended deadline is October 15, 2025.
  - Texas – Hill Country Flooding (July 2, 2025) – Sec. 6 extended deadline is February 2, 2026.

# Federally Declared Disasters

- Extension relief applies to:
  - An Affected Taxpayer – a person or entity with a residence or principal place of business in the disaster area.
    - Can choose between “Sec. 6” and “Sec. 17” relief.
  - A Non-Affected Taxpayer who has “difficulty meeting” the exchange deadlines for certain specified reasons, including that the relinquished property or replacement property was located in the covered disaster area.
    - Limited to Sec. 17 relief only.

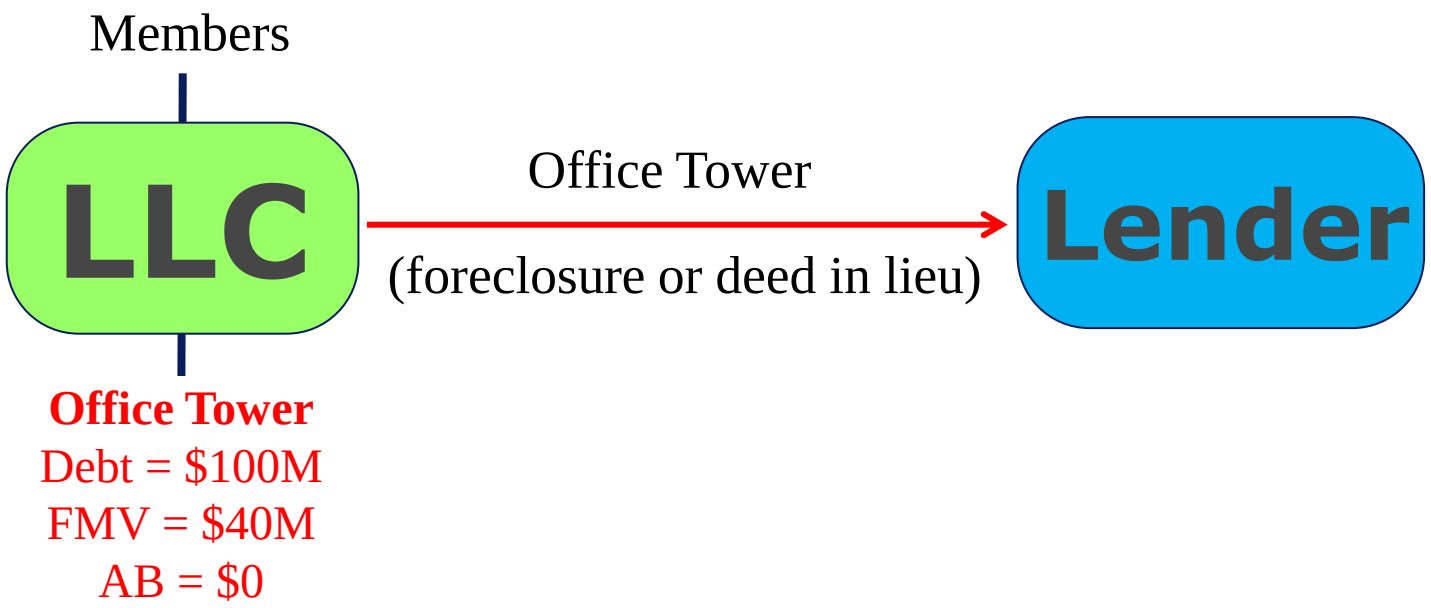
# Federally Declared Disasters

- Sec. 6 relief:
  - Extends 45-day and 180-day deadlines falling after the date of the disaster to the applicable date stated in the Notice.
  - Applies to 1031 exchanges started before or after the date of the disaster.
- Sec. 17 relief:
  - Extends 45-day and 180-day deadlines falling after the date of the disaster to the longer of the applicable date stated in the Notice, or the regular deadlines + 120 days.
  - Applies only to 1031 exchanges started before the date of the disaster.
  - If the 45-day ID period has already passed prior to the disaster date, the 45 days may not be extended unless the identified property was substantially damaged by the disaster, in which case the 45 days may be retroactively extended.

# Federally Declared Disasters

- QI Issues:
  - Most Exchange Agreements require TP to notify QI if TP intends to apply disaster relief to extend deadlines.
  - May also require amending Exchange Agreement to provide for extended deadlines.

# 1031s From Foreclosure




- Do nothing? Phantom gain = $100M; tax at 25% = $25M.
- **Or, 1031 is possible.** TP must acquire replacement property of $100M, funded with TP's cash or new debt. Ex.) TP pays $25M down, and incurs $75M new liability, on RP.
- Easiest path is to structure as a deed in lieu of foreclosure with the lender and agree to convey the property in full satisfaction of debt. TP's rights in the "Agreement in Lieu of Foreclosure" can be assigned to QI to start the process.
- If lender will not cooperate and judicial foreclosure ensues, TP should instead assign all rights under the deed of trust and any legal documents of conveyance and other court orders to the QI.

# Exchanging out of Foreclosure

- Treas. Reg. 1.1031(k)-1(g)(4)(iv) on how to get the QI involved: Either:
  - **QI Takes Title Theory**: (A) "… intermediary acquires and transfers legal title to that property …"
  - **QI Assignment Theory:**
    - (B) "intermediary … enters into an agreement with a person other than the taxpayer for the transfer of the relinquished property …"; (C) "intermediary … enters into an agreement with the owner of the replacement property for the transfer of that property …." For this purpose, "an intermediary is treated as entering into an agreement if the rights of a party to the agreement are assigned to the intermediary and all parties to that agreement are notified in writing of the assignment on or before the date of the relevant transfer of property".
- In a deed-in-lieu of foreclosure, normally there is an agreement that can be assigned. PLR 201302009.
- What about a judicial or involuntary foreclosure?
  - Does the QI have to take title?
    - Does that make a loan default? Does it make existing default worse?
  - Under IRC 1001, it's a *deemed* sale, but no actual agreement to sell. What can you assign?
    - Deed of Trust? Foreclosure proceeding itself (e.g., reference to court-assigned cause number)? Notice of Trustee Sale? Something else?

# 1031s and Options

# Sales of Options

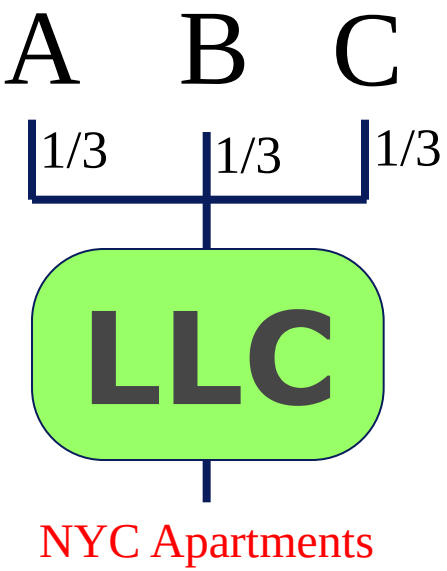
- Example: TP is a developer who has acquired an option to purchase a 20 acre site in Texas, close to a power generation facility that would be ideal for a battery storage site, at a $5M strike price (paying a $500,000 option premium). TP would like to develop the battery storage facility. However, a larger battery storage developer has offered TP $20M for the site. If TP accepts, can the transaction be structured as a 1031 exchange?
  - Possibly. Options to purchase real property are treated as real property now under 2020 final regulations. Treas. Reg. Sec. 1.1031(a)-3(a)(5)(i).
  - However, an open question exists as to whether options are of "like kind" to any other type of real property (such as a fee interest) or whether they are like kind only to other options. *See* Starker v. U.S., 602 F.2d 1341 (9th Cir. 1979) (exchange of contractual right to receive property for a fee interest); FSA 1995-12 (exchange of land for an option to acquire land).
  - TP has two primary options: (1) close, pay $5M for the land, and then immediately re-sell the land for $20M, or (2) sell the option to the developer for $15M. Which way is better?
  - Are rights to purchase under a PSA treated the same as an option?

# Partnership Structures

# Same Day Drop & Swap

- **In the Matter of the Petition of Hadar (DTA No. 850122)**
- **In the Matter of the Petition of Shomron (DTA No. 850123)**

**New York Division of Tax Appeals**
**June 12, 2015**

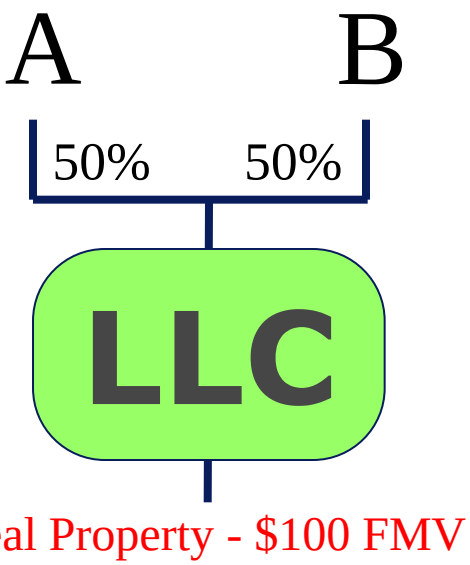



- Members desired to cause LLC to sell NYC apartments for $65M.
- A&B desired 1031; C had stepped-up basis and desired cash.
- A&B expressed a desire to 1031 from the outset, and distribution of TIC interests was always the plan, and buyer was aware. However, LLC entered into the PSA, which was assignable to the members.
- On date of sale, LLC distributed TIC interests to Members, who sold as TICs; deeds were filed, lender was notified, NY transfer tax forms were filed, the members entered into a TIC Agreement, and the PSA was assigned to the TICs. A&B did individual 1031s; C cashed-out.
- But TICs reported no property income or expenses (b/c same day).

- **In the Matter of the Petition of Hadar (DTA No. 850122)**
- **In the Matter of the Petition of Shomron (DTA No. 850123)**

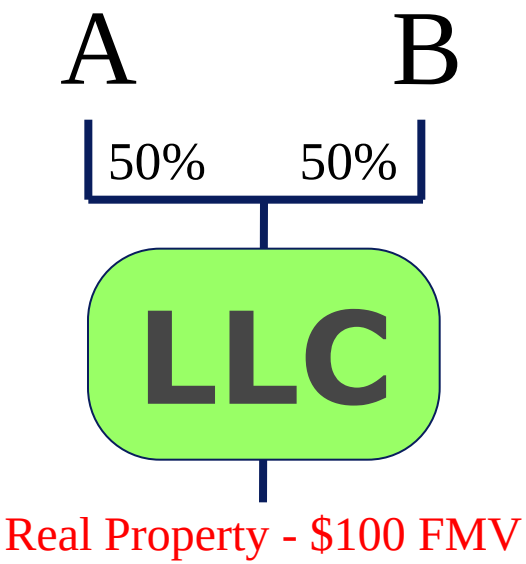
- NY asserted that the LLC was the true seller of the apartments, that the TICs needed to hold the TIC interests for a "minimum of a couple of months," and that the 1031 failed.
- Court disagreed and held for TPs, finding:
  - TICs had a brief holding period, but 1031 has no fixed holding period requirement.
  - 1031s preceded by tax-free contributions or distributions have been allowed in various contexts. *Bolker, Magneson, Maloney, Mason*.
  - "Held For" test not an issue because under *Bolker*, the intent to exchange property for like kind property meets the test.
  - Members had a good business purpose – to separate from each other and acquire individual assets.
  - Decision does not discuss *Court Holding* or *Cumberland*.

# 99-6 Transactions – Buy Side



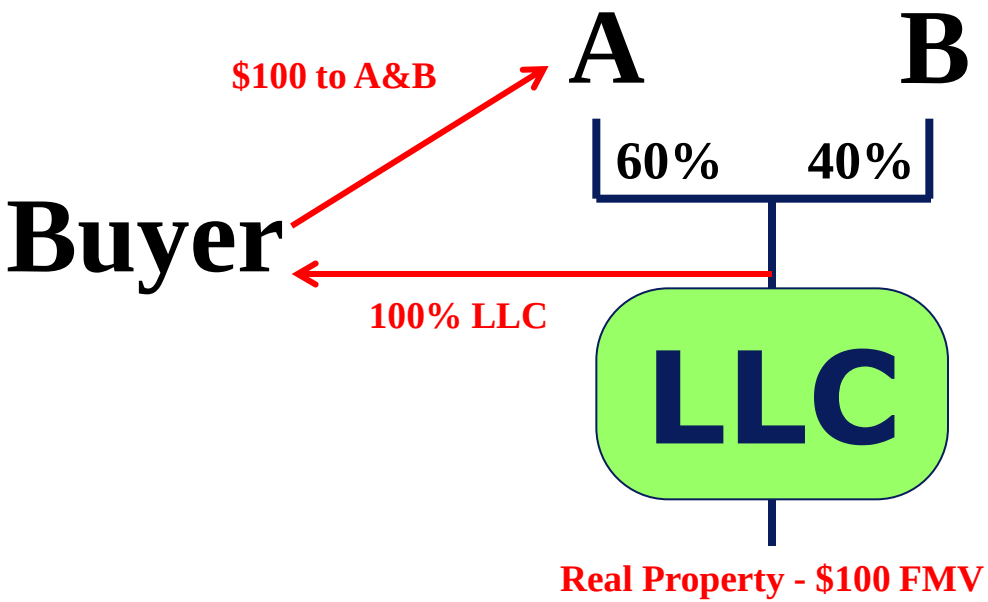

- A wishes to purchase B's 50% LLC interest for $50 using 1031 cash.
- Under Rev. Rul. 99-6, A is treated as purchasing an undivided 50% interest in the LLC assets, so this can be a good 1031 exchange for A. PLR 200807005.
- Can also be structured using a reverse exchange. PLR 200909008. If using a reverse, the EAT will become a real partner in LLC during the parking period. Income allocation may be an issue.

# 99-6 Transactions – Sell Side



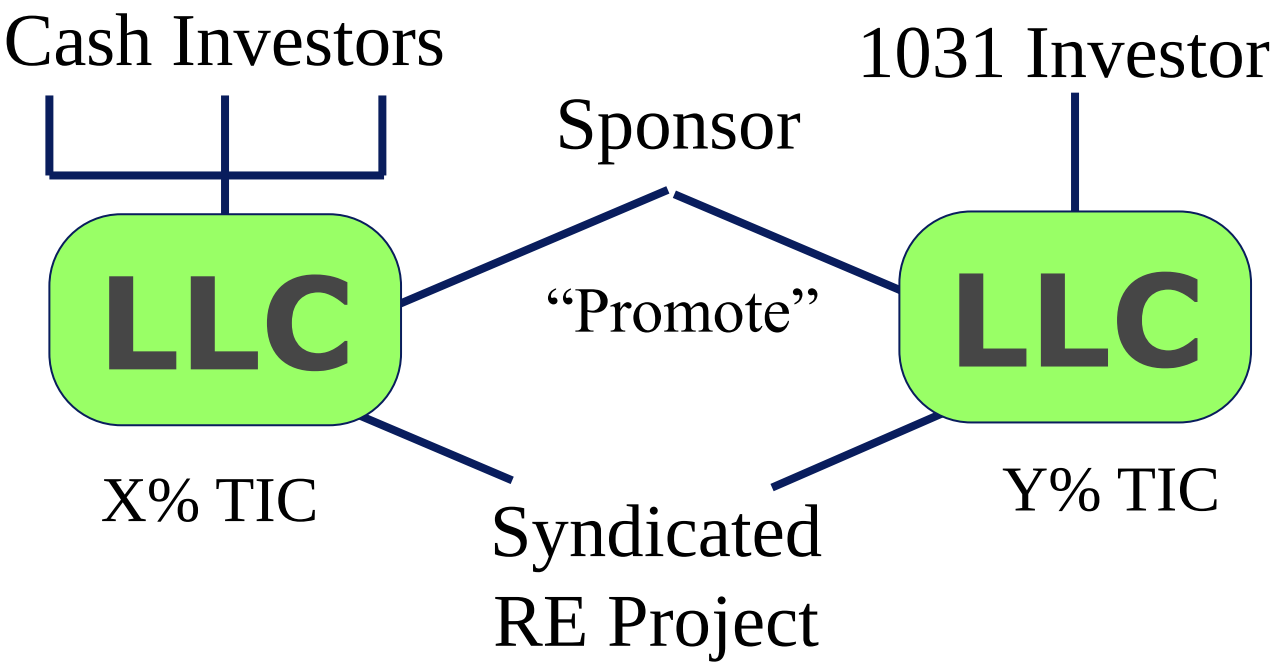

- B desires to purchase A's 50% LLC interest for $50, but A only wants to sell if structured as a 1031 exchange. Can this work?
  - Distribute 50% TIC interest to A, which A then sells to B? - Perhaps, but beware *Crenshaw v. U.S.*, 315 F. Supp 814.
  - Alternative: B contributes $50 to LLC, LLC purchases replacement property A desires, and then LLC distributes such property to A in complete redemption of A's interest under Section 731. See *Countryside Limited Partnership v. Comm'r*, TC Memo 2008-3.

# 99-6 Transactions – the "TopCo"




- Buyer wants to purchase the entire LLC from A and B for $100 for *ad valorem* tax reasons. However, A and B want to sell via a 1031 exchange. How can this work? (See Rev. Rul. 99-6 – A and B treated as selling partnership interests).
  - First, A and B form a mirror image "Newco" and contribute 100% of LLC to Newco. Newco is a "continuation" of prior LLC partnership, and LLC becomes a "disregarded entity" of Newco.
  - Second, Newco sells 100% of DRE LLC and starts a 1031 exchange.

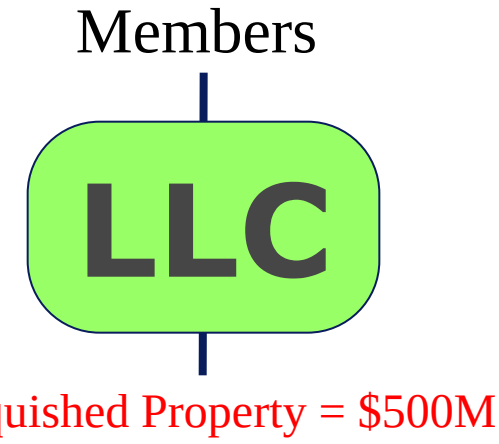
# Syndicated Transactions




- How to accommodate a 1031 investor into a syndicated RE offering typically structured as an LLC or LP investment?
  - Usually a TIC structure, at least initially, is the solution.
  - Will the lender consent?
  - Required roll-up after closing? How long must TP wait?
  - How to address the sponsor's promote?

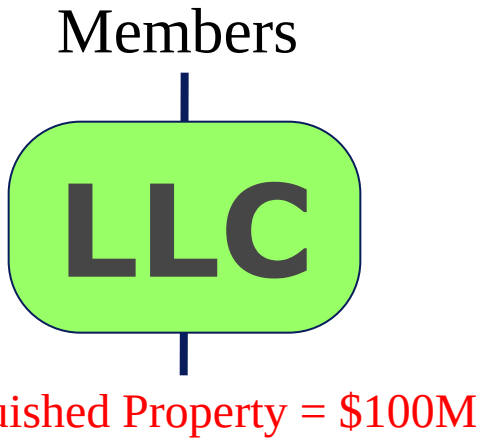
# Reverse Exchange Planning

# Combination Reverse & Forward Exchange

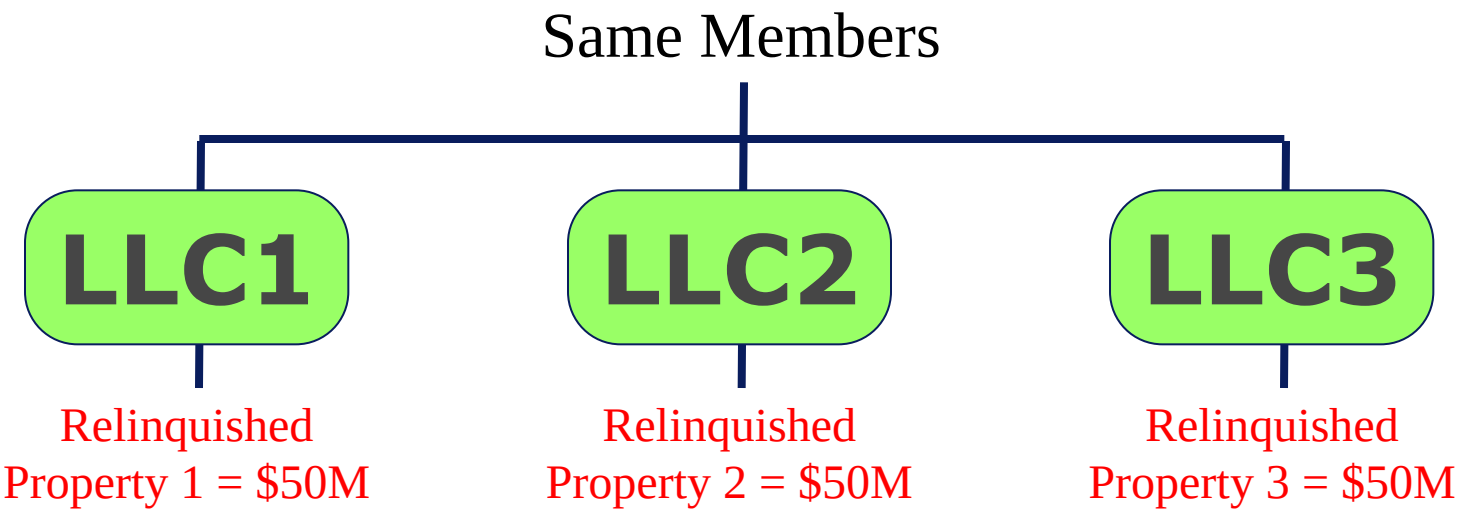



- TP desires to sell relinquished property for $500M in 5-6 months. TP can acquire potential replacement property now for $250M, but nothing else currently in the pipeline, but other properties may become available.
- Solution: Structure as a combination reverse and forward exchange. Step 1 – park $250M property with an EAT up to 180 days (Rev. Proc. 2000-37). Step 2 – within same 180 days, sell relinquished property for $500M, and use $250M immediately to purchase parked property. Step 3 - $250M remains in QI account for use in a normal forward exchange (with independent 180-day exchange period).
- See CCA 200836024

# Combination Forward & Reverse Exchange




- Similar situation as the last slide, but now TP sells RQ for $100, and identifies RP for $250, closing in 30 days. TP also anticipates selling a second, unrelated RQ in around 90 days for $150, and would like to structure this disposition as a 1031 exchange as well using the same RP. Can this be done?
- Solution: Structure as a combination forward and reverse exchange. Step 1 – TP closes exchange #1 by purchasing a 40% TIC interest in the RP. At the same time, TP funds EAT with $150 and EAT purchases the other 60% TIC interest in the same RP. Step 2 – on day 90, TP sells RQ #2 and uses the $150 proceeds to purchase the parked 60% TIC interest in RP from the EAT.

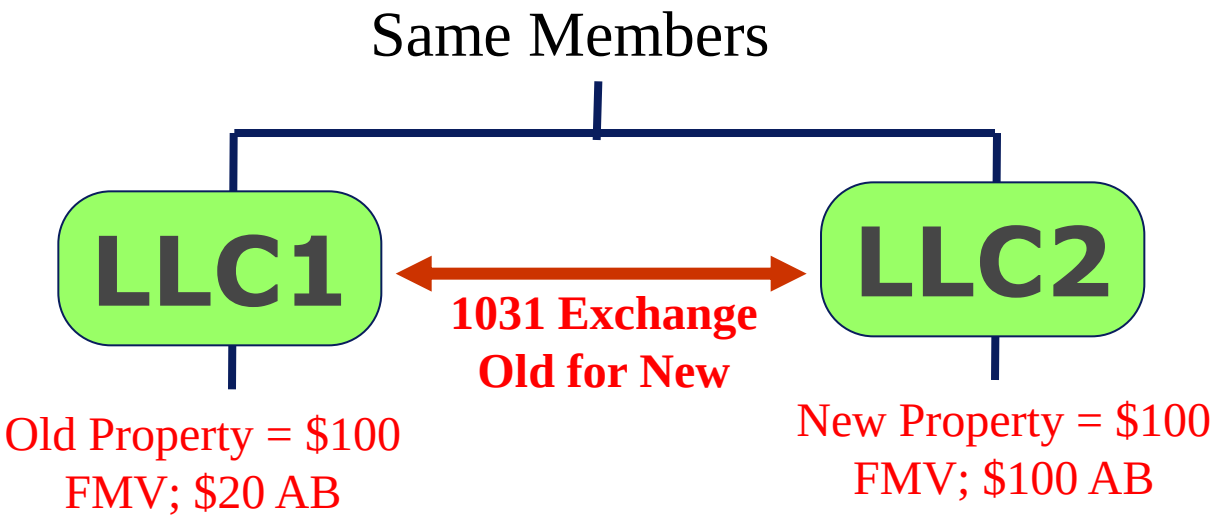



- Members control 3 separate, related taxpayer partnerships. Each has a potential RQ (FMV $50M) that may be sold in the near future. Members have identified a single RP (FMV $50M) that they intend to purchase within the next 30 days, before any RQ can be sold. Can the transaction be structured as a reverse 1031 exchange for all three LLCs?
- Solution: Structure using concurrent QEAAs. Each affiliate enters into a separate QEAA with the same EAT for the same parked property. Each QEAA acknowledges the other QEAAs and provides that the first affiliate to provide notice to execute with the EAT terminates the alternate QEAAs of the other affiliates.
- See PLRs 201242003, 201416006.

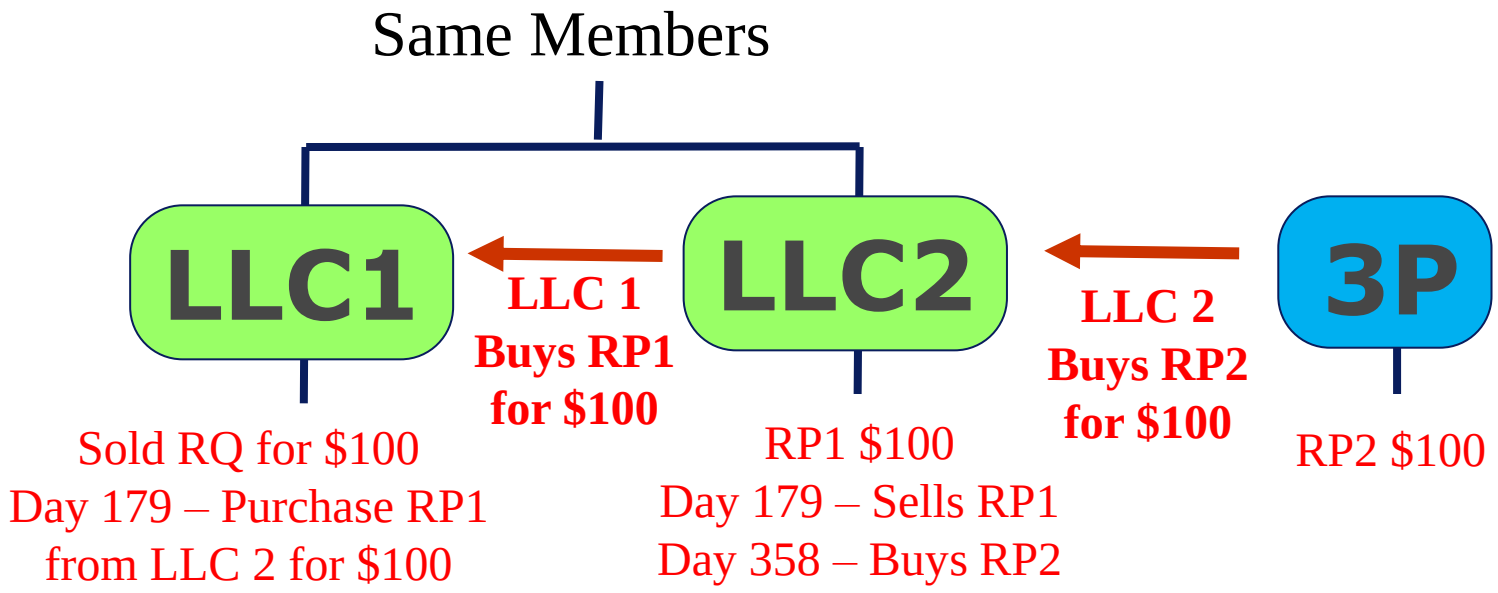
# Reverse Exchanges – Remember *Bartell v. Commissioner*

- 2016 Tax Court decision.
- Relied heavily on 9th Cir and 5th Cir precedents.
- Very similar facts as allowed under Rev. Proc. 2000-37.
- However, intermediary was permitted to park the replacement property (upon which a new building was constructed) for up to 17 months!
- Key Lessons:
  - Must intend to do a 1031 exchange;
  - Don’t take title;
  - Use an intermediary.
- IRS chose not to appeal, but also issued an “action on decision” rejecting the legal analysis employed.

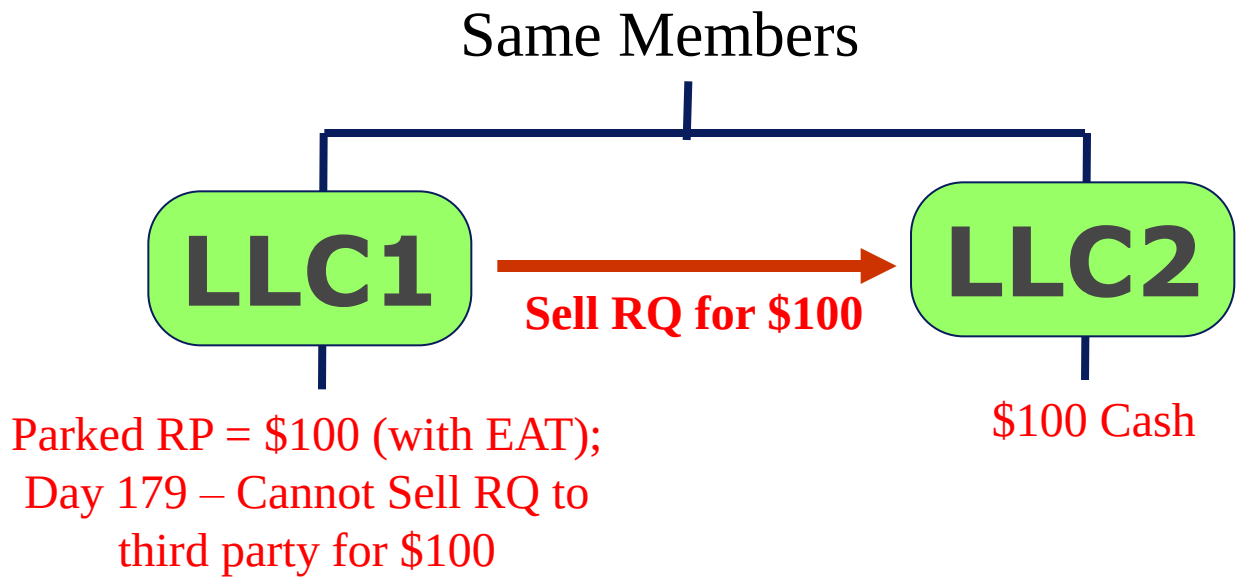
# Proactively Using Related Parties in 1031 Exchanges



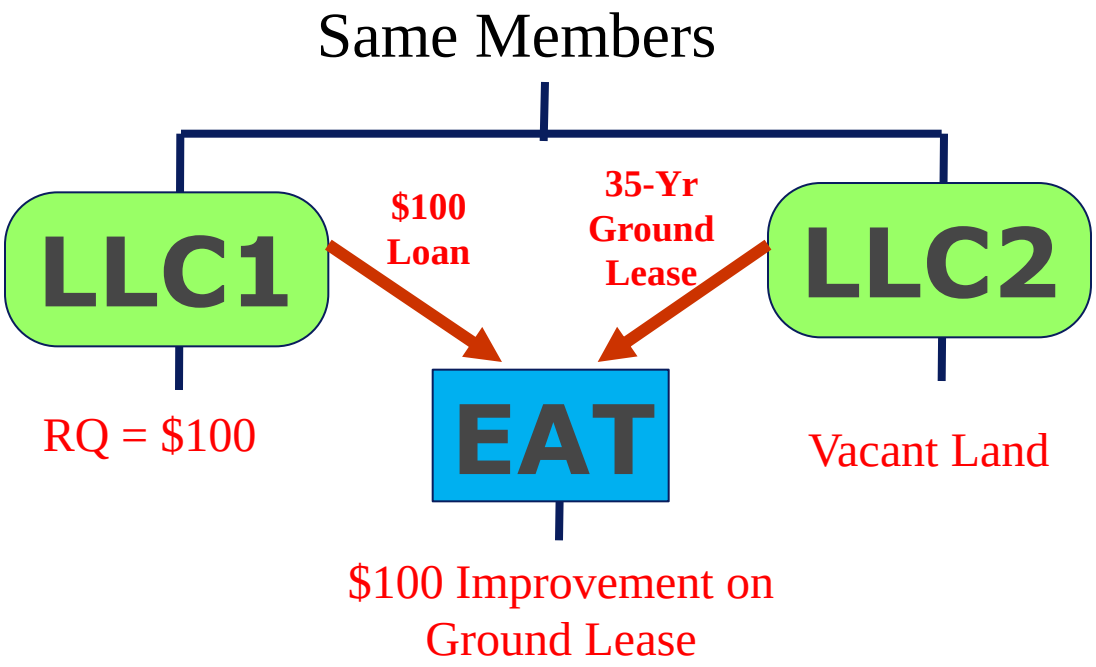

- LLC 1 and LLC 2 are related parties. LLC 1 anticipates marketing "Old Property" for sale some time in mid to late 2027. In anticipation of this sale, LLC 1 and LLC 2 exchange properties so that LLC 2 now owns "Old Property" with AB of $100 (i.e., basis has shifted).
- The 1031 exchange can be valid if LLC 1 and LLC 2 both remain invested in their respective replacement properties for at least 2 years. 1031(f)(1)(C).
- Parties must also beware 1031(g)(1) – substantial dimunition of risk (e.g., entering into a binding PSA prior to the required 2 years).



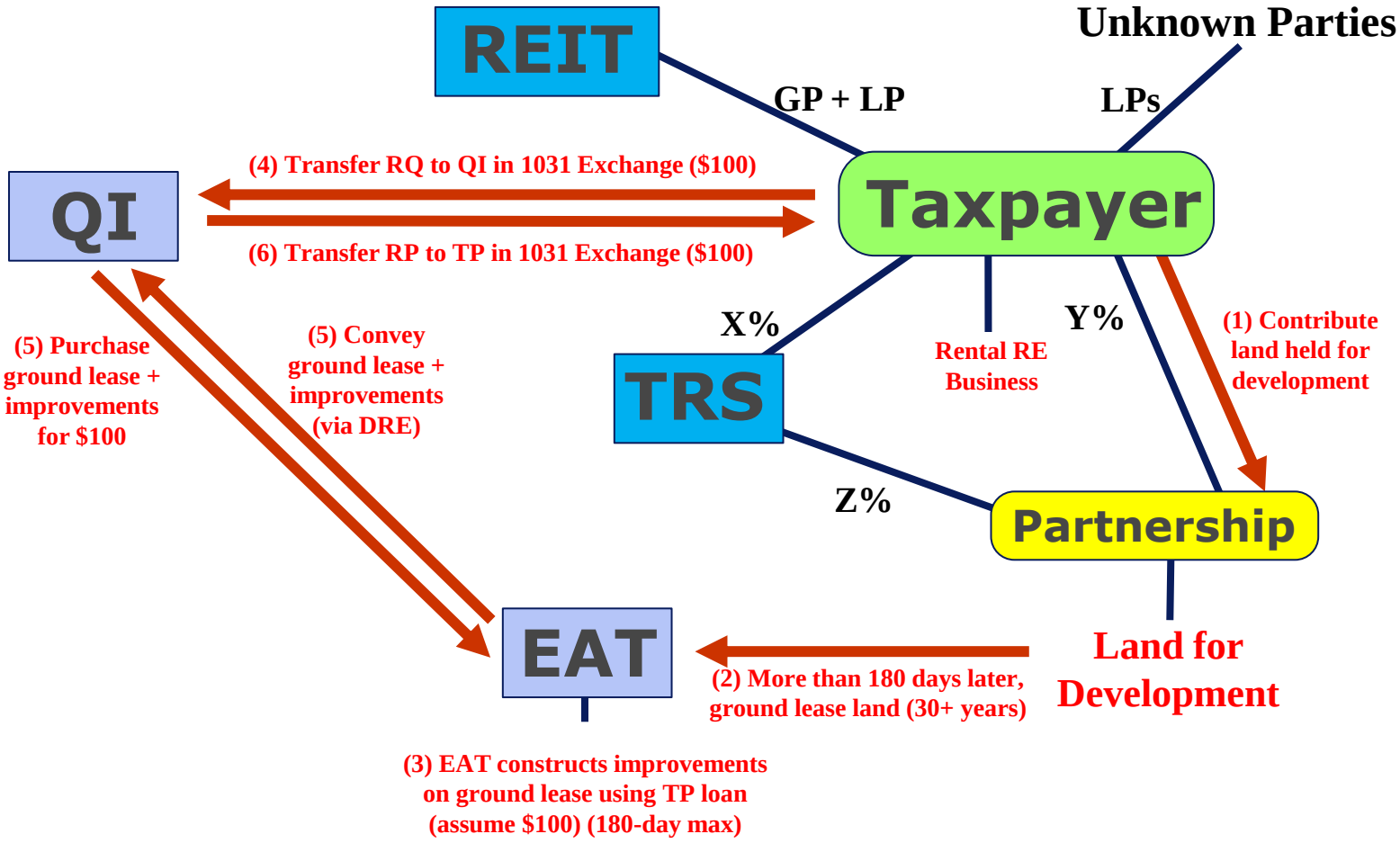

- LLC 1 and LLC 2 are related parties. LLC 1 started a forward 1031 exchange 179 days ago, identified 3 RPs (RP1 owned by LLC 2), and has failed to close yet.
- So, on day 179, LLC 1 will purchase RP1 from LLC2 to complete the 1031 exchange.
- Normally purchasing RP from a related party results in a failed 1031 exchange. Rev. Rul. 2002-83.
- However, if LLC 2 does its own back-to-back 1031 exchange and purchases RP2 for $100 from an unrelated third party, and LLC 1 and LLC 2 each remain invested in their RPs for 2 years, LLC 2 also can have a good 1031 exchange.
- See PLRs 201220012, 201216007, 201048025, 200820025, 200820017.




- LLC 1 and LLC 2 are related parties. LLC 1 started a reverse 1031 exchange 179 days ago, and has a $100 RP parked with an EAT. LLC 1 has been unable to sell its identified RQ for $100.
- So, on day 179, LLC 1 sells the RQ to LLC 2 (related party) for $100, which goes to the QI account, which then funds the purchase of parked RP for $100.
- See PLRs 200709036, 200712013, 200728008, 201027036.
- Note that this structure works for an “exchange last” reverse where the replacement property is parked with the EAT, but does not work for an “exchange first” reverse where the relinquished property is parked with the EAT.

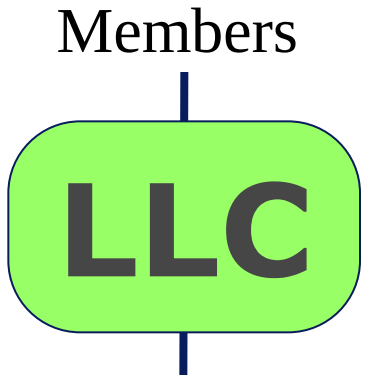



- LLC 1 desires to sell RQ for $100 and use $100 to build a new plant or rental property. LLC 1 cannot build on land it already owns. *Bloomington Coca-Cola Bottling Co. v. Comm'r*, 189 F.2d 14 (7th Cir. 1951).
- But LLC 1 can build on land owned by LLC 2 if structured as a ground lease of more than 30 years. See PLRs 200251008, 200329021, 201408019.



# Exchange Bifurcation

# Bifurcating a 1031 Exchange




Relinquished Property = 5 Industrial Buildings (FMV $20M each; AB $4M each)

- TP has a deal to sell a package of 5 discrete industrial properties to a single buyer at a total price of $100M (each site is valued at $20M). Basis is $20M ($4M per site). Should TP structure as a single $100M exchange? Or as 5 separate $20M exchanges?
- Why bifurcate? Key benefit is flexibility to allow some of the exchanges to fail and become taxable sales, with full basis offset per site.
- Factors favoring bifurcation:
  - Breaking up the transaction into multiple PSAs;
  - Staggering the closing dates;
  - Sales to different buyers;
  - Separate facilities acquired at separate times;
  - Using different QI for each 1031 exchange.

# Special Issues for Oil & Gas 1031 Exchanges

# Oil & Gas Interests = Real Property Examples of “Like Kind”

- Mineral properties for undivided interest in hotel (Comm’r v. Crichton, 122 F.2d 181 (5th Cir. 1941));
- Undivided interest in unimproved real estate for interest in overriding oil and gas royalties (General Counsel Memorandum 34651);
- Working interests in two leases (Revenue Ruling 68-186);

# Examples, cont'd

- Interest in a producing lease of an oil deposit in place for a fee interest in an improved ranch (Revenue Ruling 68-331);
- Overriding oil and gas royalties for unimproved real estate (Revenue Ruling 72-117).
- Note that the above examples are unlimited "economic interests" in oil and gas in place. *See* Palmer v. Bender, 287 U.S. 551 (1933); Rev. Rul. 68-226.

# Exceptions

- Production payments are treated as loans and are not “like kind” to other real property.
- Recapture items may not be deferred (*e.g.*, depletion recapture cannot roll over into a fee interest in real property).

# Key Issues in Oil & Gas Exchanges

1. Identification
2. Sale vs. Lease
3. Recapture
4. Tax Partnerships
5. Royalty Trusts
6. Unitizations and 1031(f)

# Identifications

# Identifications

- Forward and reverse exchanges both must adhere to 45-day identification rules.
- Generally requires property to be specifically described by metes and bounds or street address.
  - ✓ For oil & gas, taxpayers generally should attach the same exhibit they would use to describe the purchased assets in an LOI or PSA. These are generally described by county, section, block, survey, oil & gas formation, lessor/lessee, and even by specific well locations.
  - ✖ A description of "certain oil & gas leases in Reeves County, Texas", would be too ambiguous.

Must be careful of 3-property and 200% rules because most oil & gas deals involve many individual "properties"

# Key issue: unit of "property"

## Section 614(a) "property"

- Each Separate Interest in
- Each Mineral Deposit in
- Each Separate Tract

## Section 614(b)

- Unless an election is made to treat them as separate properties, all of the operating mineral interests in one tract of land are combined and treated as one property.
- But cannot combine operating interest in one tract with operating interest in a different tract.

***Taxpayers typically buy and sell large "packages" of leases and royalties, so assume 200% rule usually applies.***

# Identification example

- Taxpayer sells a package of Utica leases for $10M and identifies replacement property consisting (1) a package of Permian leases valued at $10M, (2) a package of Eagleford leases valued at $10M, and (3) a package of Haynesville leases valued at $10M.
- Assuming each of the foregoing packages of leases consists of hundreds of individual properties, the taxpayer is in violation of both the 3-property rule and the 200% rule.

Therefore, the taxpayer can have a valid 1031 exchange here only if the taxpayer either:

- Acquires one of the identified packages of leases prior to the expiration of the 45-day identification period, or
- Acquires at least 95% of all identified assets (by FMV) prior to the end of the 180-day exchange period.

***If the taxpayer here intends to rely on the 95% rule, beware of individual properties falling out of the deal for title defects!***

# Sale vs. Lease

## Sale vs. lease: Crooks v. Commissioner, 92 T.C. 816 (1989)

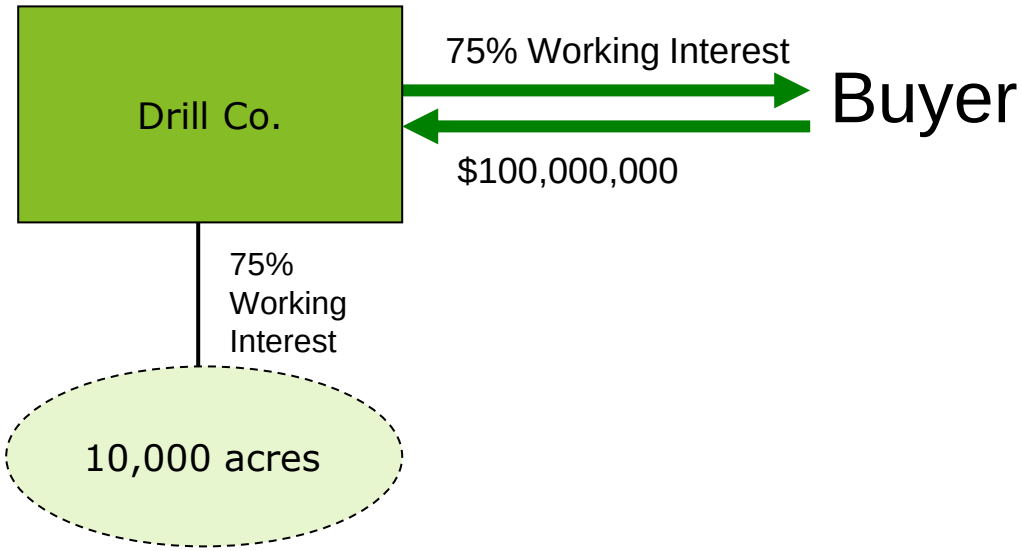
- Taxpayer owned a farm under which oil & gas was discovered.
- Taxpayer exchanged the mineral rights to an oil & gas development company in exchange for (1) four other farms and (2) a retained 25% royalty on all production achieved on the mineral rights conveyed.
- Held: Because the taxpayer retained the royalty interest on the mineral rights disposed of, the transaction was a lease of the mineral rights, not a complete disposition, and therefore Section 1031 did not apply.
  - As a lease, in a non-1031 transaction, all up front cash received by the taxpayer is ordinary income and not long-term capital gain.

***Rule: If a taxpayer retains a continuing non-operating interest in oil & gas mineral or working interests conveyed, the transaction is a leasing transaction, not a sale or exchange, for tax purposes***

# Example 1a

- DrillCo" owns a 75% working interest in approximately 10,000 acres (comprised of hundreds of individual leases).
- DrillCo has negotiated to sell the entire working interest to a purchaser ("Buyer") for $100,000,000.

***Can Section 1031 apply to DrillCo's transaction?***



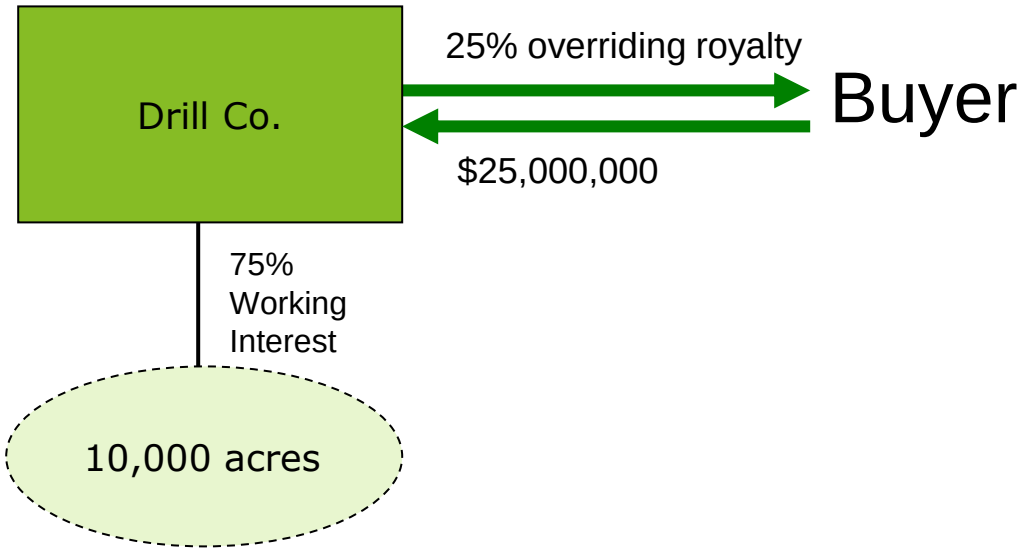
# Example 1a - authorities

- ***The answer is yes.*** See GCM 39572 ("[b]ecause 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."); Rev. Rul. 68-226 ("the interest of a lessee in oil and gas in place . . . is an interest in 'real property' for Federal income tax purposes . . . ."); Rev. Rul. 88-78 ("the disposition of oil rights is the disposition of an interest in real property."); Rev. Rul. 73-428 ("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 34033 (An "overriding royalty and . . . working interest are both considered interests in real property for purposes of the Federal income tax."); Rev. Rul. 72-117 ("[O]verriding oil and gas royalties are interests in real property.").
- See also Comm'r v. Crichton, 122 F.2d 181 (5th Cir. 1941) (exchange of undivided interest in hotel for mineral properties); GCM 34651 (exchange of undivided interest in unimproved real estate for interest in overriding oil and gas royalties); Rev. Rul. 68-186 (exchange of working interests in two leases); Rev. Rul. 68-331 (exchange of interest in a producing lease of an oil deposit in place for a fee interest in an improved ranch); Rev. Rul. 72-117 (exchange of overriding royalties for unimproved real estate).
- What result upon a disposition of a lesser fraction of the working interest (e.g., 50% of the 75%, for a 37.5% NRI?) This also should work fine. See Berry Oil Co. v. U.S., 25 F. Supp. 96 (Ct. Cl. 1938); Ratliff v. Comm'r, 36 B.T.A. 762 (1937).

# Example 1b

- Continue assuming that DrillCo owns the 75% working interest, but now DrillCo instead agrees to sell only a 25% overriding royalty in the leases to the Buyer for $25,000,000.

***Can Section 1031 apply?***



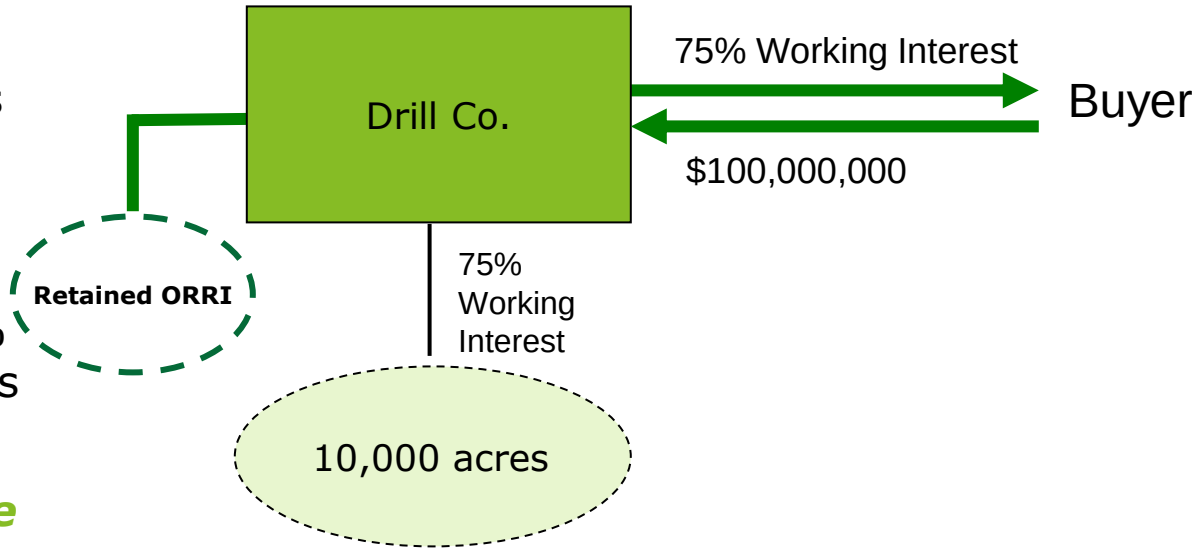
# Example 1b - authorities

- ***Probably so.*** See PLR 8237017 (exchange of working interests for overriding royalty interests in the same properties qualified as a Section 1031 exchange); G.C.M. 38907 (carved out net profits interest is not an assignment of income); G.C.M. 39181 (sale of carved out royalties).
- Any issue with the "held for" test?
  - ***Probably not.*** See Fleming v. Comm'r, 241 F.2d 78 (5th Cir. 1957), rev'd sub nom. Comm'r v. P.G. Lake, 356 U.S. 260 (1958). In this situation, the overriding royalty is derived from the interest of the lessee and, thus, may be viewed as an exchange of a portion of the working interest (which clearly meets the "held for" requirement) with the stipulation that the assigned portion be free of development and operation costs.

# Example 1C

- Now assume DrillCo negotiates a better deal to sell the 75% working interest to Buyer for
- (A) $100,000,000 and
- (B) Drillco retains an overriding royalty (an "ORRI") equal to 25% less all other landowner royalties on the leases.
- Thus, for example, on leases burdened by a 20% landowner royalty, DrillCo's retained ORRI will be 5%.

***Can the $100,000,000 be used to acquire "like kind" replacement property in a Section 1031 exchange?***



# Example 1c - authorities

- The answer is determined on a lease-by-lease basis. See Cullen v. Comm'r, 118 F.2d 651 (5th Cir. 1941) (whether a sale or lease occurs must be determined on a property-by-property basis).
  - ***The answer is "no"*** for any leases upon which DrillCo retains an ORRI. See Crooks v. Comm'r, 92 T.C. 816 (1989) (retention of a royalty in the "sale" of mineral interests converts the transaction into a lease for federal income tax purposes; Section 1031 is not available); Rev. Rul. 69-352.
  - ***The answer is "yes"*** for properties upon which DrillCo does not retain an ORRI.
- **Also affects ordinary income vs. LTCG on sale.**
- ***This is a huge issue that clients and advisors miss frequently.**

# Example 1c (cont'd)

Can DrillCo change the business deal and fix the problem?

- ***Probably so.*** Some possibilities are:
  - –Don't retain an ORRI and instead ask for more cash or other consideration.
  - –Re-define the retained "ORRI" so that it is not a "royalty" for federal income tax purposes (e.g., use a term shorter than the expected life of the burdened properties).
  - –See Cullen and PLR 9437006 (re. retained production payments).

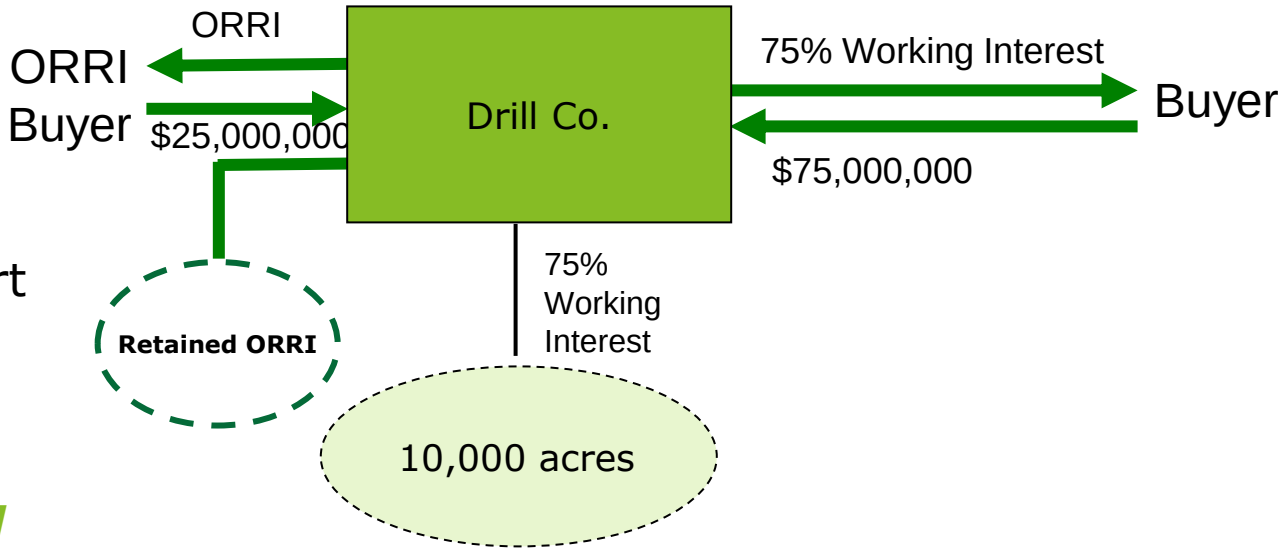
***Beware retained production payment on "wildcat" (i.e., previously unexplored) acreage!***

***See Watnick v. Comm'r, 90 T.C. 326 (1988) – the interest may still be a royalty.***

# Example 1d

- Now assume instead that Drillco sells
  - 75% working interest to Buyer for $75,000,000 plus reservation of the ORRI, and at closing
  - ORRI to a third party for $25,000,000 as part of an integrated plan.

***Can Drillco use the $100,000,000 total consideration in a Section 1031 exchange?***



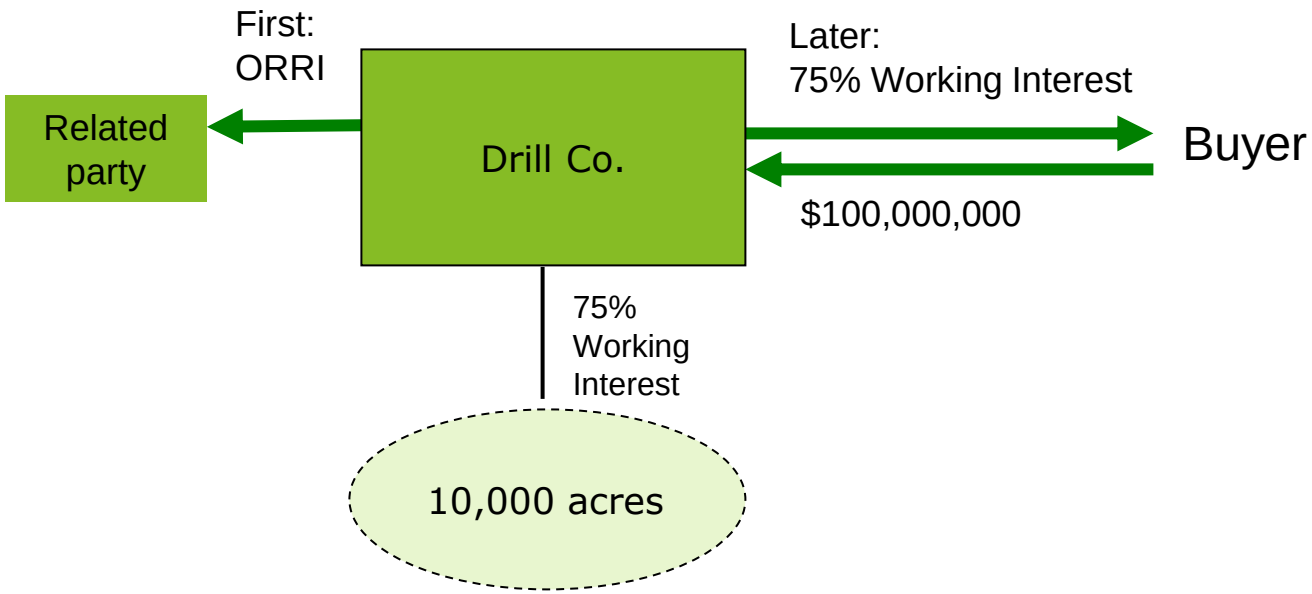
# Example 1d - authority

- Because DrillCo has disposed of its entire interest in the leases in one transaction, ***the answer should be yes, but is not clear***. *See* FSA 1999-819 (sales of working interests to third parties, coupled with reservation of ORRIs and contemporaneous conveyance of ORRIs to trust for benefit of seller's children, respected as sales of the working interests for federal income tax purposes).

# Example 1e

- Assume that DrillCo wants to preserve the ORRI as part of the deal with Buyer. Thus, prior to entering into discussions with Buyer, DrillCo separates the ORRI from the working interest and assigns it to a separate, related entity ("Related Party") for a business reason.
- Later, DrillCo negotiates the same deal with Buyer, except that DrillCo's sale to Buyer now is "subject to" the pre-existing ORRI held by Related Party (instead of DrillCo reserving the ORRI).

***Can DrillCo use a Section 1031 exchange?***



# Example 1e - authorities

- ***The answer clearly is yes*** under the form of the transaction because DrillCo has sold a working interest and has not "retained" an ORRI as part of the transaction with Buyer.
  - –Cf. Badger Oil Co. v. Comm'r, 118 F.2d 791 (5th Cir. 1941).
  - –Instead, the ORRI is a pre-existing interest owned by a separate taxpayer (Related Party).
  - –Query whether the transaction may be attacked on substance over form or step transaction grounds? Provided DrillCo has a bona fide business purpose and the assignment has economic substance, DrillCo's Section 1031 exchange should be valid. See FSA 1999-819.
- What business purposes might suffice?
- Can Drillco do this 1-day before closing?

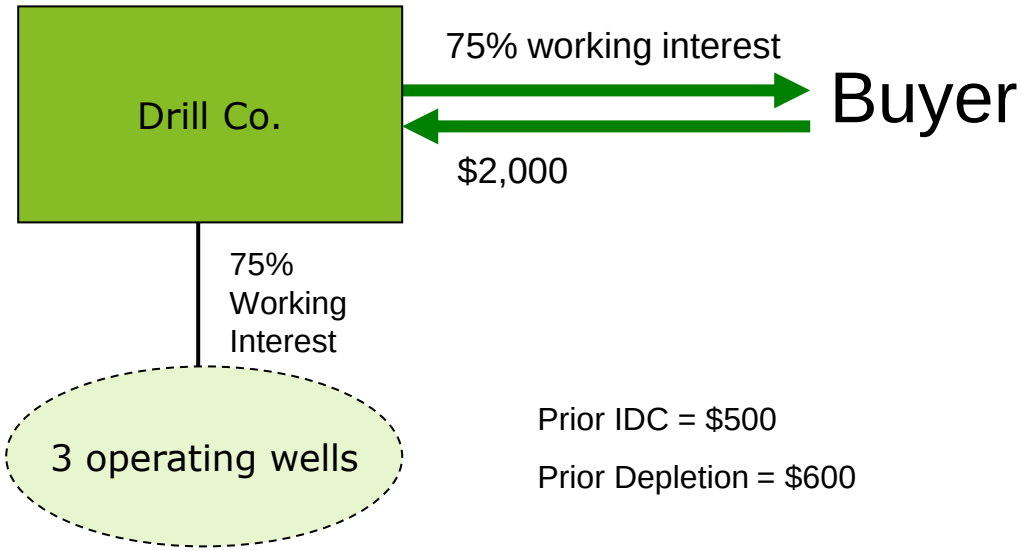
# Sec. 1254 Recapture

# Recapture

## Example 2a

- Assume DrillCo owns a working interest upon which DrillCo has 3 operating wells.
- Drillco previously has taken IDC deductions of $500 and depletion deductions of $600.
- At a time when Drillco's adjusted basis in the working interest is $0, Drillco sells the working interest to Buyer for $2,000.

***What result?***



# Example 2a - authorities

- Drillco recognizes gain of $2,000.  IRC § 1001.  $1,100 of such gain is recaptured as ordinary income (37%).  IRC § 1254.
- $900 balance is long-term capital gain (23.8%).

# Example 2b

- Recall that DrillCo contemplates selling working interests subject to $500 of IDC recapture and $600 of depletion recapture.
- Now assume that Drillco is investigating a possible Section 1031 exchange of the working interest for the following property interests (each valued at $2,000) and asks you what recapture it might face in the exchange:

**Other working interests with producing wells?**

- Drillco recognizes no gain pursuant to the Section 1031 exchange and is not required to recognize any recapture. Treas. Reg. § 1.1254-2(d). Instead, the recapture of $1,100 rolls over and remains preserved in the replacement properties. Treas. Reg. § 1.1254-3(d).
- Reason: No recapture required if "Sec. 1254 property" is exchanged solely for other "Sec. 1254 property."
- Exception: Must still recapture to the extent of boot and other like kind property received that is not Sec. 1254 property.

# Example 2b (cont'd)

**Royalties burdening operating working interests (worth $1800) and cash of $200?**

- Must recapture $200 (i.e., to the extent of cash boot).

**A ranch in Montana?**

- Drillco recognizes no gain pursuant to the Section 1031 exchange but must recapture all $1,100 of prior deductions because the ranch is not "section 1254 property." Treas. Reg. §§ 1.1254-2(d), 1.1254-1(b)(2).
- In other words, depletion and IDC recapture cannot roll over and remain preserved in "regular" real estate.

**Other working interests with producing wells ($1,500) and a ranch in Montana ($500)?**

- Again, Drillco recognizes no gain pursuant to the Section 1031 exchange but must recapture $500 of prior deductions because the ranch is not "section 1254 property." Treas. Reg. §§ 1.1254-2(d), 1.1254-1(b)(2).

# Example 2b (cont'd)

## Undeveloped leases in a recently-discovered shale play?

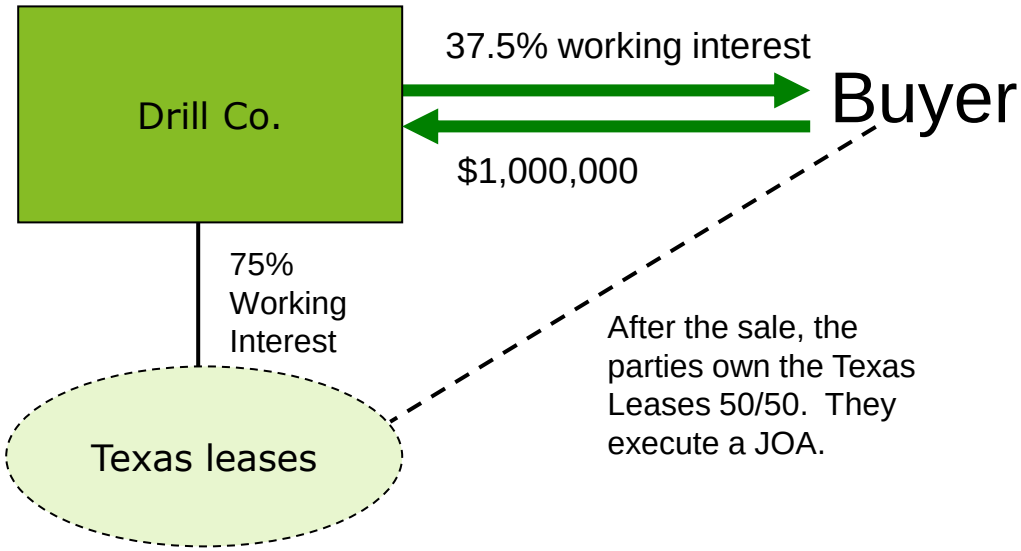
- The answer depends on whether undeveloped leases constitute "section 1254 property." See Treas. Reg. § 1.1254-2(b)(2)(iv)(A)(defining property as Sec. 1254 property in part if the property "is an operating mineral interest with respect to which the expenditure [i.e., IDC] ***has been deducted***.") (emphasis added). The past-tense language implies that only operating interests that previously have generated some IDC deductions qualify. BNA Portfolio 605 at A-35 advises recapture: "Accordingly, a like-kind exchange of developed property (a § 1254 property) for undeveloped property, or an interest in developed property for an interest in undeveloped property will trigger § 1254 recapture."
- Contrast § 1245 and § 1250 recapture which define "section 1245 property" and "section 1250 property" as property "which is or has been property of a character subject to the allowance for depreciation . . . ." These definitions would cover new items of depreciable property that, although not previously subject to depreciation, will be subject to depreciation in the hands of the taxpayer once placed in service.
- In other words, there is some risk that Taxpayer must recapture prior depletion and IDC upon a 1031 exchange of developed minerals for undeveloped minerals.

# Tax Partnerships

# Example 3a

- DrillCo owns a 75% working interest in Texas leases.
- DrillCo sells an undivided 50% interest in the leases to Buyer for $1,000,000.
- DrillCo and Buyer execute a joint operating agreement appointing DrillCo operator.
- The first well is a gusher. New Investor then seeks to purchase DrillCo's 37.5% working interest for $10,000,000.

***Can DrillCo structure the deal as a 1031 exchange?***



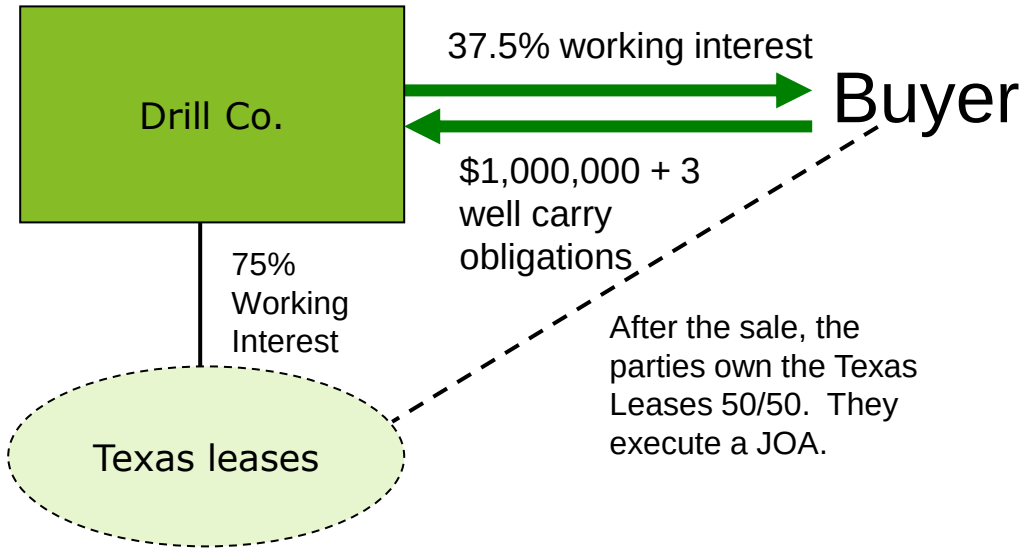
# Example 3a - authorities

- ***The answer is yes,*** unless the 37.5% working interest is subject to a tax partnership. Treas. Reg. Sec. 1.1031(a)-3(a)(5)(i)(C). Here, by default, the working interest jointly owned and operated by Drillco and Buyer creates a tax partnership between Drillco and Buyer. See Bentex Oil Corp. v. Comm'r, 20 T.C. 565 (1953) (joint operating agreement creates a partnership for federal income tax purposes); I.T. 2749, XIII-1 C.B. 99 (1934) (same).
- And Sec. 1031 excludes partnership interests (including tax partnerships!)
- Notwithstanding the tax partnership, Drillco and Buyer may jointly elect out of subchapter K, in which case Drillco may proceed with a Section 1031 exchange. See IRC § 761(a), IRC § 1031(e).
  - Election out effective as of first day of taxable year for which the election is filed.

# Example 3b

- Now assume that the consideration paid by Buyer for half of Drillco's working interest is
  - (A) $1,000,000 plus
  - (B) Buyer's obligation to pay 100% of the cost of the first 3 wells to be drilled on the property ("cash and carry").
- Buyer and Drillco will divide all revenues 50/50.

***As a practical matter, will Buyer consent to Drillco's request to elect out of Subchapter K?***



# Example 3b - authorities

- ***Not likely.*** Here, parties do not satisfy the "complete payout" rule (which is typical). See Rev. Rul. 70-336; Rev. Rul. 71-207.
- Thus, Buyer needs the tax partnership to remain in place in order to deduct 100% of the IDCs funded by Buyer on the first 3 wells. Thus, Drillco probably cannot obtain Buyer's consent to elect out, meaning Drillco cannot dispose of the 37.5% working interest in a Section 1031 exchange.

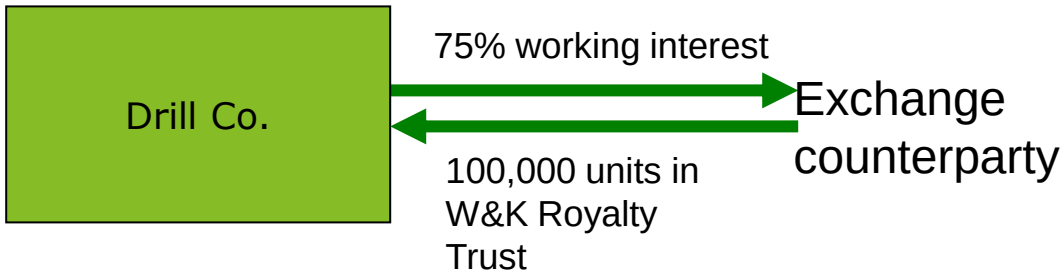
# Royalty Trusts

# Royalty trusts

## Example 4

- DrillCo desires to exchange a 75% working interest (valued at $5,000,000) for 100,000 units in the W&K Royalty Trust (valued at $5,000,000).
- The W&K Royalty Trust
  - (a) is publicly traded on the NYSE
  - (b) is a "grantor trust" for federal tax purposes, and
  - (c) owns only interests classified as oil and gas royalties for federal tax purposes.

***Are the properties "like kind"?***



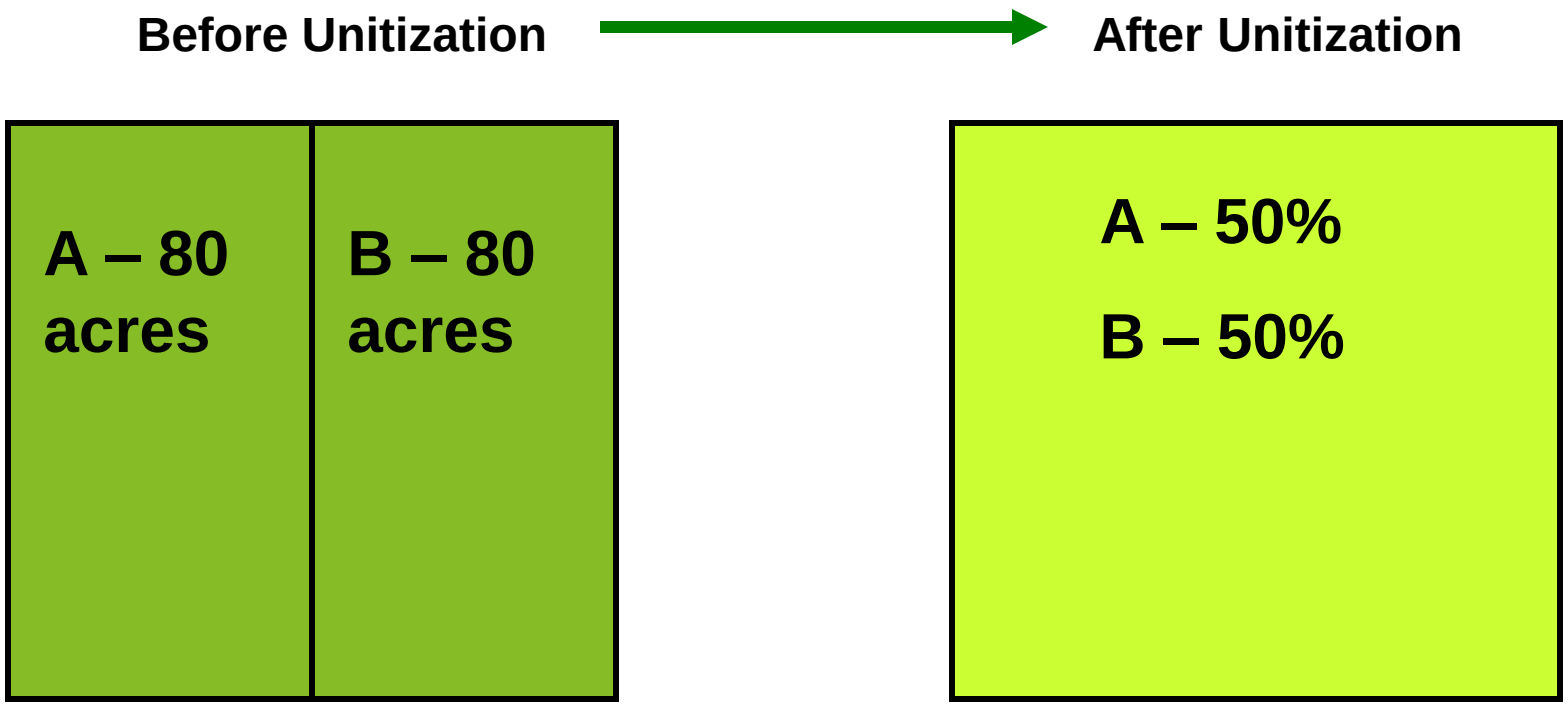
# Example 4 - authorities

- Prohibited interest in a trust?  See Rev. Rul. 2004-86 (look through interests in grantor trusts to underlying assets).  However, facts were limited to non-public DST.
- Prohibited security?  See G.C.M. 35242 (whisky warehouse receipts were not "securities" for purposes of Section 1031); Plow Realty Co. of Texas v. Comm'r, 4 T.C. 600 (1945) (mineral deeds were not securities under predecessor to Section 543 even though they were considered securities under the securities laws).
- Eligible real property?  Must carefully evaluate underlying assets of the particular royalty trust to verify that it owns only royalties and not production payments.
- IRS opinion of this deal?

# Unitizations and Related Parties

# Example 5

A and B each own 80 acres of contiguous mineral property, each with a FMV of $100 and basis of $0. State implements a unitization program and forces A and B to combine their 80 acre tracts into one 160-acre unit. A and B each receive a 50% interest in the 160-acre unit. Is this a 1031 exchange?



# Example 5 – Authorities

Unitization qualifies as a 1031 exchange.

- *See* Rev. Rul. 68-186 (unitization of oil and gas interests was a 1031 exchange); GCM 33536 (same).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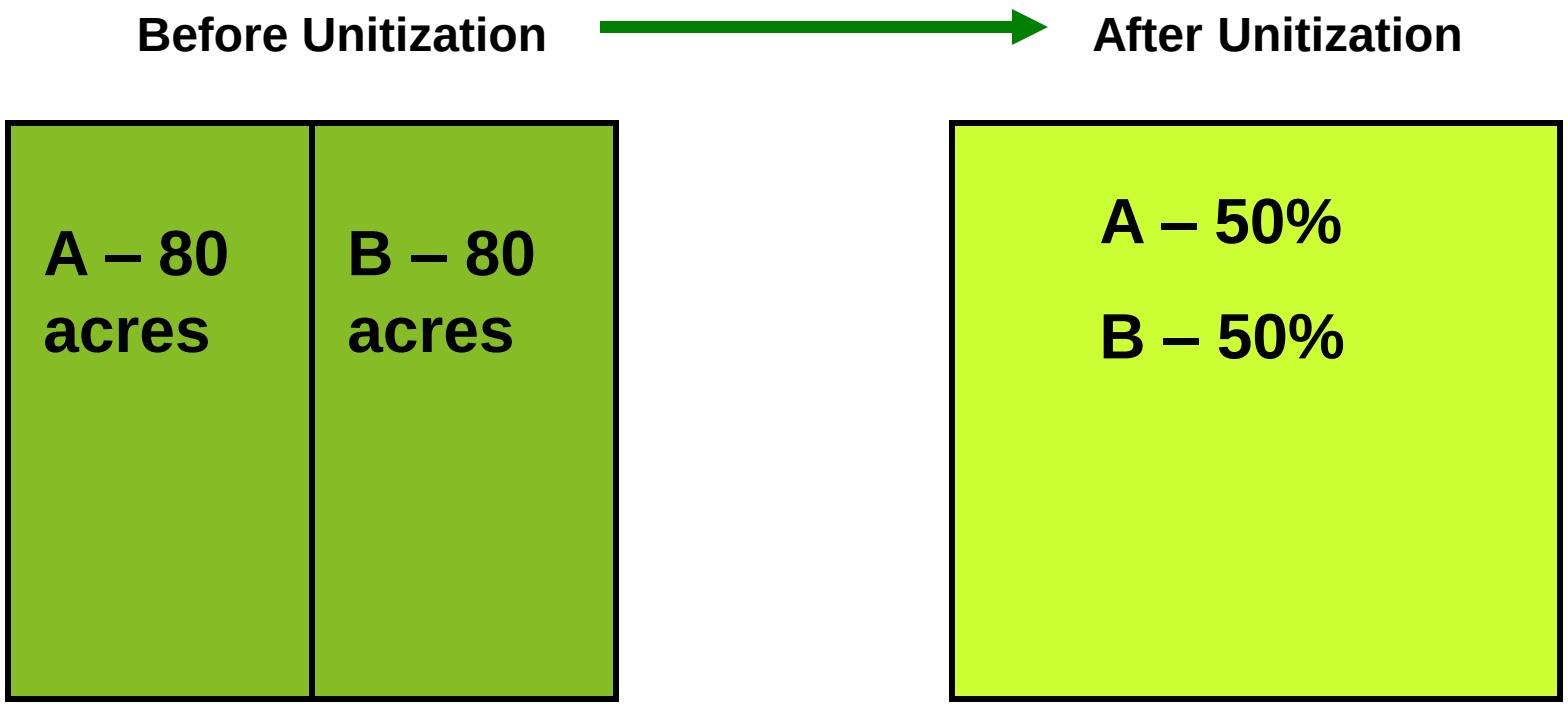
# Example 5b

Same question as 5a, but now assume that A and B are father and son, and that one year later A sells his 50% interest in the unit for $200.



# Example 5b – Authorities

- The original 1031 exchange may no longer be valid. *See* IRC 1031(f)(1).
- Does the "no tax avoidance purpose" exception apply? *See* IRC 1031(f)(2)(C).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