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**Closing the Deal and Keeping the Taxman
Waiting: Use of I.R.C. Section 1031 in
Oil and Gas Acquisitions and Divestitures**

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**CLOSING THE DEAL AND KEEPING THE TAXMAN WAITING:
USE OF I.R.C. SECTION 1031 IN OIL AND GAS ACQUISITIONS
AND DIVESTITURES**

I. Introduction.

Complying with Internal Revenue Code Section 1031 (“Section 1031”), I.R.C. § 1031, and the regulations and revenue procedures promulgated thereunder provides an opportunity to minimize the federal tax income tax liabilities incident to acquisitions and divestitures of oil and gas properties. In the case of a “forward exchange” the starting place would be what would otherwise be a simple disposition of oil and gas properties, and in the case of a “reverse exchange” the starting point would be what would otherwise be a simple acquisition of oil and gas properties. Therefore, this article will be divided into two primary parts, treating respectively of forward exchanges and reverse exchanges.

II. Forward Exchanges.

For purposes of the analysis in this section, it will be assumed that an owner of mineral interests (for this purpose it is irrelevant whether such interests are oil and gas leasehold interests, fee mineral interests, royalty interests, or overriding royalty interests – so long as they are held either for “investment” or “for productive use in a trade or business”) wishes to dispose of such mineral interests (the “relinquished property” in Section 1031 lingo) for valuable consideration. In most circumstances, federal income tax gain will be recognized in an amount equal to any excess of the value of all consideration received for the disposition of the relinquished property (the “amount realized”) over the federal income tax basis of the party making the disposition (referenced as the “taxpayer” in the Section 1031 regulations) in the relinquished property.

If, however, the transaction is structured in such a way that “property of like kind” is received as all or part of the consideration for the transfer of the relinquished property by the taxpayer, then the value of the consideration received (or a portion thereof) may be eligible for exclusion in computing the taxable gain upon the disposition of the relinquished property. Therefore, the first determination to be made is whether any of the property received by the taxpayer for the disposition of the relinquished property qualifies as “like kind property.”

A. Definition of Like-Kind Property.

1. General Test. As a first test, both the relinquished property and the property received (the “replacement property”) must be either (i) held for productive use in a trade or business or (ii) held for investment. I.R.C. § 1031(a)(1). This rules out property held primarily for sale (in other words, inventory) and property held for personal use of the taxpayer.

2. Debt and Equity Interests. Stocks, bonds, notes, partnership interests, beneficial interests in trusts or similar vehicles, or other securities or evidence of indebtedness are categorically disqualified from being “like kind property.” Id. § 1031(a)(2).

3. Real Property. In general terms, real property held for productive use in a trade or business or for investment is like kind to other real property held for productive use in a trade or

business or for investment, regardless of how dissimilar the real property otherwise is. See Treas. Reg. § 1.1031(a)-1(b). In other words, shopping centers, hotels, apartments and office buildings are all of like kind to each other, and developed real property is of like kind to undeveloped real property. Most importantly to the scope of this article, pretty much any kind of real property is “of like kind” to any mineral interests which constitute real property and not personal property. This opens up the possibility for the taxpayer to avoid recognition of gain in disposing of mineral interests in exchange for income producing real estate or land as well as for different mineral interests. One important exception to this rule, however, is that real property located outside the United States is not considered of like kind to real property located within the United States. I.R.C. § 1031(h)(1).

4. Depreciable Tangible Personal Property. For Section 1031 purposes, personal property is not considered of like kind to real property. Further, personal property is of like kind to other personal property only if both the relinquished property and the replacement property are either of “like kind” or of “like class.” Treas. Reg. § 1.1031(a)-2(a). This rule broadens what would otherwise be an extremely narrow definition of “like kind” in the personal property realm (contrasting markedly with the broad meaning of “like kind” in the real property realm) by deeming property “of like class” to be “of like kind” even if not strictly “of like kind” under the more restrictive definition. For example, a copyright on a novel is considered to be of like kind to a copyright on a different novel, but not of like kind to a copyright on a song. Id. § 1.1031(a)-2(c)(3). However, depreciable tangible personal property is “of like class” (and therefore deemed to be “of like kind”) to other depreciable tangible personal property if the exchanged properties are within the same general asset classes as defined in Revenue Procedure 87-56 and Treasury Regulation Section 1.1031(a)-2(b)(2). Depreciable tangible personal property not within a general asset class is deemed to be of like kind to all other property within the same product class pursuant to the North American Industry Classification System (“NAICS”). Id. § 1.1031(a)-2(b)(3). Most oilfield depreciable tangible personal property would appear not to fall within any of the general asset classes (as set forth in Treasury Regulation Section 1.1031(a)-2(b)(2)) and to fall within product class 333132 (oil and gas field machinery and equipment manufacturing) under NAICS classifications.¹ (Notable exceptions are trucks and trailers, and electric generation systems, which do fall within defined general asset classes and are deemed of like kind only to other depreciable personal property within the same general asset class).

5. Intangible Personal Property and Non-Depreciable Personal Property. Intangible personal property does not fall within a general asset class or a product class and therefore must be strictly of like kind to the relinquished property to qualify for Section 1031 treatment. Id. § 1.1031(a)-2(c)(1). For example, a patent is not considered of like kind to a copyright, and goodwill or going concern value of one business is not considered of like kind to the goodwill or going concern value of another business. Id.

6. Asset Allocations in Oil and Gas Dispositions. Dispositions of oil and gas assets typically convey real property interests, tangible oilfield equipment and intangible contract rights. The allocation of the purchase price among these various components could have ramifications for Section 1031 treatment of the assets and should be given careful attention if Section 1031 treatment is desired.

¹ Note that product classes under the NAICS may be updated or otherwise modified from time to time.

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