

Landman
TAX

Keeping Uncle Sam Out of The Oil Patch

By Greg Lehrmann, Attorney

It is common knowledge that mineral interests are changing hands at a feverish pace. What is lesser known is that Uncle Sam does not always have to be a partner in these transactions. Both the seller and the buyer benefit when capital-gains taxes do not have to be subtracted from the sales price.

The general rule is that when people sell something for more than they paid for it, they have to pay income tax. Even for long-term capital gains, this taxation can remove 15 percent or more from the profits that otherwise would pass from the buyer to the seller. This impact can hinder and even halt negotiations. At a minimum, taxation detracts from the value of any offer. For people who have owned their property for decades, almost the entire sales



Two basic points are key to understanding the availability of this tool:

1. "Exchange" does not mean that the seller and the buyer exchange anything.
2. "Like-kind" does not mean that the seller of a mineral interest has to buy another mineral interest.

Exchange

Exchange means that the seller hires a 1031 qualified intermediary (QI) to produce exchange documents at the closing of the sale. The sale is taxable if proper procedures are not followed at closing.

The QI holds the proceeds from the sale. The seller identifies property to purchase within 45 days following the sale and closes on the purchase(s) within 180 days of the sale. A gap in the law is the lack of regulation of QIs by either the federal government or the state of Texas, despite the QIs' holding millions of dollars of sellers' funds. Corporate America and prudent individuals alleviate this risk by using national QI companies that are owned by heavily regulated major title companies.

In other words, an "exchange" does not involve a swap between the seller and buyer. Rather, exchanges are like retirement account rollovers, where funds are moved somewhat directly

About the Author



Greg Lehrmann is an attorney who is double-board certified in Commercial Real Estate Law and Residential Real Estate Law by the Texas Board of Legal Specialization. With more than 24 years of

experience in commercial and residential real estate law, Lehrmann is a leading national IRC §1031 qualified intermediary. He is the Texas division manager for Asset Preservation Inc., a subsidiary of Stewart Title Co.

price can be taxable. Sellers get to keep more wealth, and buyers can consummate more deals more quickly if they are knowledgeable about Section 1031 of the Internal Revenue Code.

Section 1031 states that *no gain or loss shall be recognized* (taxed) if property held for productive use in a trade or business or held for investment is exchanged solely for property of a like-kind to be held either for productive use in a trade or business or for investment. The tax is deferred at least until events occur that the seller is usually in control of, and often the tax is eventually eliminated altogether.

Landman
TAX

from one investment to another, with no actual or constructive receipt by the seller of the funds.

Like-Kind

Just as misleading as the term exchange is the term like-kind. Many people think a sale of a mineral interest must be followed by the purchase of another mineral interest. Not true. All real estate in the United States is considered to be like-kind to any other real estate in the country, as long as each property qualifies for the proper use. The only requirement to meet the "qualifying use" standard is that the property is held for use in a trade or business or for investment. Holding property for appreciation constitutes "held for investment." Thus, mineral interests that have been held for investment (not purchased for imminent sale after they were acquired) can be sold, and the proceeds can be used to purchase a ranch, residential rental properties, commercial buildings, resort investment property and so on. The following are examples of valid exchanges:

- Mineral interests for an investment resort property
- Interest in a producing oil lease extending until the exhaustion of the deposit for a ranch
- Overriding royalty for unimproved real estate
- Overriding royalty for an undivided interest in a parcel of improved realty
- Perpetual water rights for a fee interest in land

All of these examples can be interchanged, and the properties can be in different states. Interests that may not qualify are those limited in duration. When operating interests are exchanged, the well equipment must be analyzed separately from the exchange of leasehold interests.

Property owners can have their cake and eat it too if they check into §1031 exchanges. Check with your tax adviser to see if you qualify. ■

Competence and Integrity

B.R. ALLEN & ASSOCIATES, L.L.P.

A Texas Energy Law Practice

14080 Hwy. 90 W.

San Antonio, Texas 78245

Ph: 210.677.0225 Fax: 210.677.0777

—Comprehensive Statewide Legal Services—

Title examination, curative, due diligence, rights-of-way and easement acquisition, division orders, pooling/unitization agreements, seismic and lease negotiations and acquisitions, mineral receiverships

Portfolio available upon request
Not certified by the Texas Board of Legal Specialization

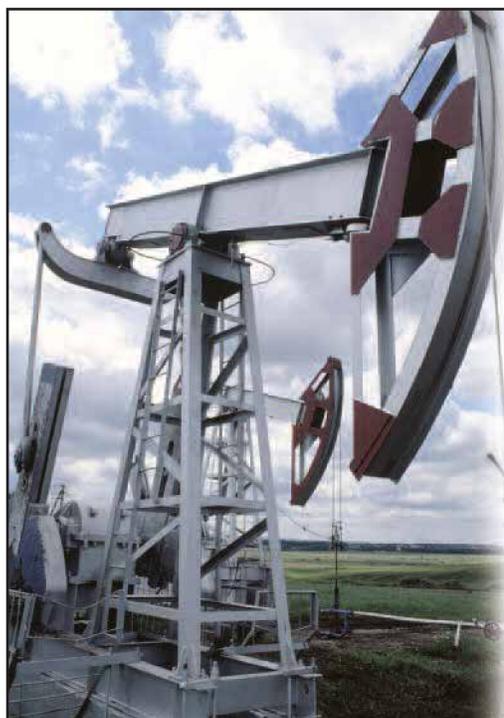
LISKOW & LEWIS

ONE SHELL SQUARE
701 POYDRAS STREET, SUITE 5000
NEW ORLEANS, LA 70139
PHONE (504) 581-7979
FAX (504) 556-4108

822 HARDING STREET
P.O. BOX 52008
LAFAYETTE, LA 70505
PHONE (337) 232-7424
FAX (337) 267-2399

FIRST CITY TOWER
1001 FANNIN STREET, SUITE 1800
HOUSTON, TX 77002
PHONE (713) 651-2900
FAX (713) 651-2908

WWW.LSKOWCO.COM



Cow River Inc.

- Title Research
- Lease Checks
- Seismic Permits and Options
- Mapping
- Reports
- Drill Site Research
- Pipeline Research
- Leasing

Shawn Egg
Professional Landman
118 W. MAIN B
EDNA, TEXAS 77957
TELEPHONE (361) 782-5626
FAX (361) 782-2837
MOBILE (361) 935-2807

Top 10 Oil and Gas Like-Kind Exchange Cases

(Chosen subjectively and listed in no particular order.)

Palmer v. Bender, 287 U.S. 551 (1933)

"Economic interest" concept adopted by U.S. Supreme Court. "The allowance for depletion is not made dependent upon the particular legal form of the taxpayer's interest in the property to be depleted" but instead turns on the presence of an "economic interest" in the minerals in place.

Revenue Ruling 68-226

The interest of a lessee in oil and gas in place is an interest in "real property" for federal income tax purposes and is (except with respect to property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business) real property used in the trade or business of the taxpayer within the meaning of section 1221 of the Internal Revenue Code of 1954.

Revenue Ruling 68-331, 1968-1 C.B. 352

A working interest in a producing oil lease that extends to the exhaustion of the mineral deposit is "like-kind" to a fee simple working interest in real property.

Revenue Ruling 72-117, 1972-1 C.B. 226

The acquisition of an interest in overriding oil and gas royalties with proceeds from the sale of unimproved real estate under threat of condemnation is a replacement with like-kind property qualifying for nonrecognition of gain under section 1033 of the code.

Commissioner v. Crichton, 122 F2d 181 (CCA5 1941)

Overriding royalty interest in oil, gas and mineral rights in certain lands for an undivided one-half of the fee in a parcel of improved realty is like-kind under section 1031. "For the regulation and the interpretation under [the predecessor to section 1031], leave in no doubt that no gain or loss is realized by one, other than a

dealer, from an exchange of real estate for other real estate, and that the distinction intended and made by the statute is the broad one between classes and characters of properties, for instance, between real and personal property. It was not intended to draw any distinction between parcels of real property however dissimilar they may be in location, in attributes and in capacities for profitable use."

Private Letter Ruling 8237017

Working interests and overriding royalty interests are like-kind within the meaning of section 1031. The IRS expressly made no ruling concerning what portion, if any, of the royalty interest received by an owner was in exchange for lease equipment.

Midfield Oil Co., 39 BTA 1154 (1939)

A limited oil payment right is not like-kind to an overriding oil and gas royalty reserved from the same lease.

Bandini Petroleum Co., PH TCM 51310, 10 CCH TCM 999 (1951)

A leasehold interest measured in terms of a fixed percentage of all oil that might be produced from certain lands for a leasehold interest measured in terms of a fixed number of barrels of oil are not like-kind.

Wm. Fleming and Bessie M. Fleming, et al. v. Commissioner, 24 T.C. 818 (1955)

Carved-out oil payment rights are not like-kind to a fee interest in a ranch.

Commissioner v. P.G. Lake Inc., et al., 356 U.S. 260 (1958), Ct. D. 1823, C.B. 1958-1, 516

A production payment is not like-kind to any real property interest, as a production payment is generally considered to be personal property because it is simply an assignment of income. Therefore, a production payment is not like-kind with real property.