

Mineral Rights in Section 1031 Exchanges

Certain types of mineral rights may be exchanged as real property under IRS §1031 tax deferred exchanges. Federal law, including IRS rulings, will determine whether a particular mineral right constitutes real property for §1031 purposes.

How Are Mineral Rights Conveyed?

Mineral rights are typically conveyed by either a mineral grant deed or a mineral lease.

Two Types of Mineral Rights:

(1) **Operating Interests** – These are the rights to develop and produce minerals, but with the obligation to pay the expense associated therewith. Operating interests, mineral leases and working interests are terms that are used interchangeably. Operating Interests are considered economic interests, which can result in taxable income and related deductions. The costs of development can be recovered by depletion (an income tax deduction similar to depreciation).

and

(2) **Non-Operating Interests** – These are the rights to minerals produced or the income from production. There is no obligation to develop the minerals or operate production.

QUALIFICATION UNDER SECTION 1031

Operating Interests? Yes.

Operating interests do qualify as an interest in real property for §1031 purposes. See Rev Rul 68-226, 1968-1 C.B. 362; Rev Rul 68-331, 1968-C.B. 352.

Non-Operating Interests? Only Some.

Only certain types of non-operating interests qualify as real property for §1031 purposes.

Non-Operating Interests that qualify as real property for §1031 purposes:

Royalties: A royalty is a reservation of an interest in future production, but with no obligation to bear any costs of production. Royalties last until the minerals are depleted. Royalty interests are created when either the fee owner transfers ownership of the land, but reserves a fractional interest in the minerals or when a lessee of the fee owner transfers a sublease and reserves an interest in the minerals. When the fee owner transfers land with the reservation, this is treated as a lease — not a sale — and the buyer's payment for this ownership interest is treated as an advance royalty payment. The buyer is the lessee and if that buyer subsequently transfers his ownership interest, this is treated as a sublease.

Two Types of Royalties:

(1) **Underlying Royalty:** A royalty that is reserved by the fee owner (not a lessee or sublessee), is referred to as an "underlying royalty".

(2) **Overriding Royalty:** A royalty that is reserved by a lessee (i.e. one who has leased mineral rights from the fee owner) or a sublessee (i.e. one who has leased mineral rights from the lessee) is referred to as an "overriding royalty".

Non-Operating Mineral Interests which MIGHT Qualify as real property under Section 1031

(1) **Net Profits Interests:** An interest in the net profits derived from operating the property, but with an obligation to share prorata (equal to interest in profits) in the expenses for developing and operating the property. Considered a type of royalty interest. **Caveat:** This is considered real property for §1031 purposes only if the profit interest is not limited in time or quantity. See Rev Rul 73-428, 1973-2 C.B. 303; Palmer v. Bender, 287 U.S. 551 (1931).

(2) Profits Interests: An interest in the profits, but without any obligation to share in the expense of development and operation of the property, and conditioned upon a profit being earned by the party who granted the interest. **Caveat:** This is considered real property for §1031 purposes only if the profit interest is not limited in time or quantity. See Rev Rul 73-428, 1973-2 C.B. 303; Palmer v. Bender, 287 U.S. 551 (1931).

Non-Operating Mineral Interests, which DO NOT QUALIFY as real property for §1031 purposes:

Production Payments are a non-operating interest that entitle the purchaser, in exchange for an up front cash investment, to receive at a future date, payment based on production. Under IRC §636 production payments may be considered a form of financing. Production payments are limited in time or amount and thus are generally **not** considered an interest in real property for §1031 purposes.

Consult with Your Tax or Legal Advisor. As with any exchange, taxpayers should discuss mineral rights transactions with their tax or legal advisor before proceeding with the disposition of the asset or the acquisition of the replacement asset, to not only determine the type of interest and whether it qualifies for §1031, but also to address some common tax issues, such as:

Tangible Personal Property. If the property disposed of includes tangible personal property, e.g. drilling equipment and other tangible personal property, a portion of the sales price should be allocated to that personal property and segregated from the real property exchange funds. And, if there is personal property that is included in the property being acquired in the exchange and the value of that personal property exceeds fifteen percent (15%) of the aggregate fair market value of the property being purchased, it must be separately identified and a separate personal property exchange might be contemplated. **Note**, if personal property is sold and not exchanged, the taxpayer may be required to recapture depreciation taken on that personal property. See IRC §1254.

Intangible Drilling and Development Costs. These costs are incurred when drilling an oil and gas well. Such costs can be deducted as ordinary business expenses or capitalized and recovered through depletion or depreciation. See IRC Code §263 (c); Treas. Reg. §1.612-4. Recapture rules under IRC §1254 are applicable if a mineral asset is sold or not exchanged for a like kind mineral asset (i.e. Natural Resource Recovery Property as defined by IRC §614. See, Treas. Reg. §1.1254-2(d)).

Depletion. Depletion is an income tax deduction similar to depreciation. While depreciation allows a taxpayer to recover the cost of property or assets, depletion (IRC §1254) is a tax deduction that mineral owners may take for the decrease in the value of their mineral interest due to depletion of the minerals. (IRC §611).

Tenancy in Common or Interest in Partnership. Some arrangements – for example, a mineral interest that is owned jointly with others – could be construed as a partnership interest rather than a tenancy in common or interest. Interests in partnerships are excluded from the non-recognition provisions of §1031. See §1031 (a)(2)(D). Check to see whether a valid IRC §761(a) election **not** to be treated as a partnership has been made.

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Taxpayers contemplating an exchange should always consult their tax or legal advisor.

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