



How Oil and Gas Working Interests Qualify as 1031 Replacement Property

A Step by Step Qualified Intermediary Coordination Guide Covering Identification Mechanics, Revenue Ruling 68-331, and Boot Mitigation Through IDC Elections

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Purpose & Scope

Why This Guide Exists

If you have recently closed the sale of a commercial building, a multifamily asset, or a parcel of land, two IRS clocks are already running: a **45 day identification window** and a **180 day closing window**, both measured from the date your relinquished property transferred.

This guide answers one specific, frequently overlooked question: can a direct working interest in a producing oil and gas well serve as qualified replacement property inside that window, and how does Qualified Intermediary coordination actually work for that asset category.

It also explains the parallel path available if the clock cannot be met or if cash boot is unavoidable, since that outcome has its own structured response rather than simply paying the tax.

What This Guide Covers

This guide covers using a direct working interest as 1031 replacement property under **Revenue Ruling 68-331**, the sequential steps of Qualified Intermediary coordination from engagement through Form 8824 reporting, and the separate Tax Boot Mitigation path available through an IRC Section 263(c) intangible drilling cost election when an exchange is not completed or only partially completed.

It applies to sellers of commercial real estate, multifamily property, and land or development parcels who are under contract, in escrow, or already closed and inside or approaching the 45 day window.

It does **not** cover Delaware Statutory Trust mechanics, which rely on a separate ruling and sit outside this guide's scope.

Prerequisites & Required Inputs

Confirm Before Starting

- The relinquished property was held for productive use in a trade or business or for investment — not as a personal residence or dealer inventory
- A sale has closed or has a scheduled closing date
- No proceeds have yet reached the seller directly
- A Qualified Intermediary has been or can still be engaged before that closing

⚠ The written exchange agreement between you and the intermediary has to be signed **before** the sale of your relinquished property closes. If proceeds have already been disbursed directly to the seller, the exchange is disqualified — you cannot receive or control the sale proceeds at any point; doing so constitutes "constructive receipt" and immediately disqualifies the exchange, resulting in full capital gains tax liability.

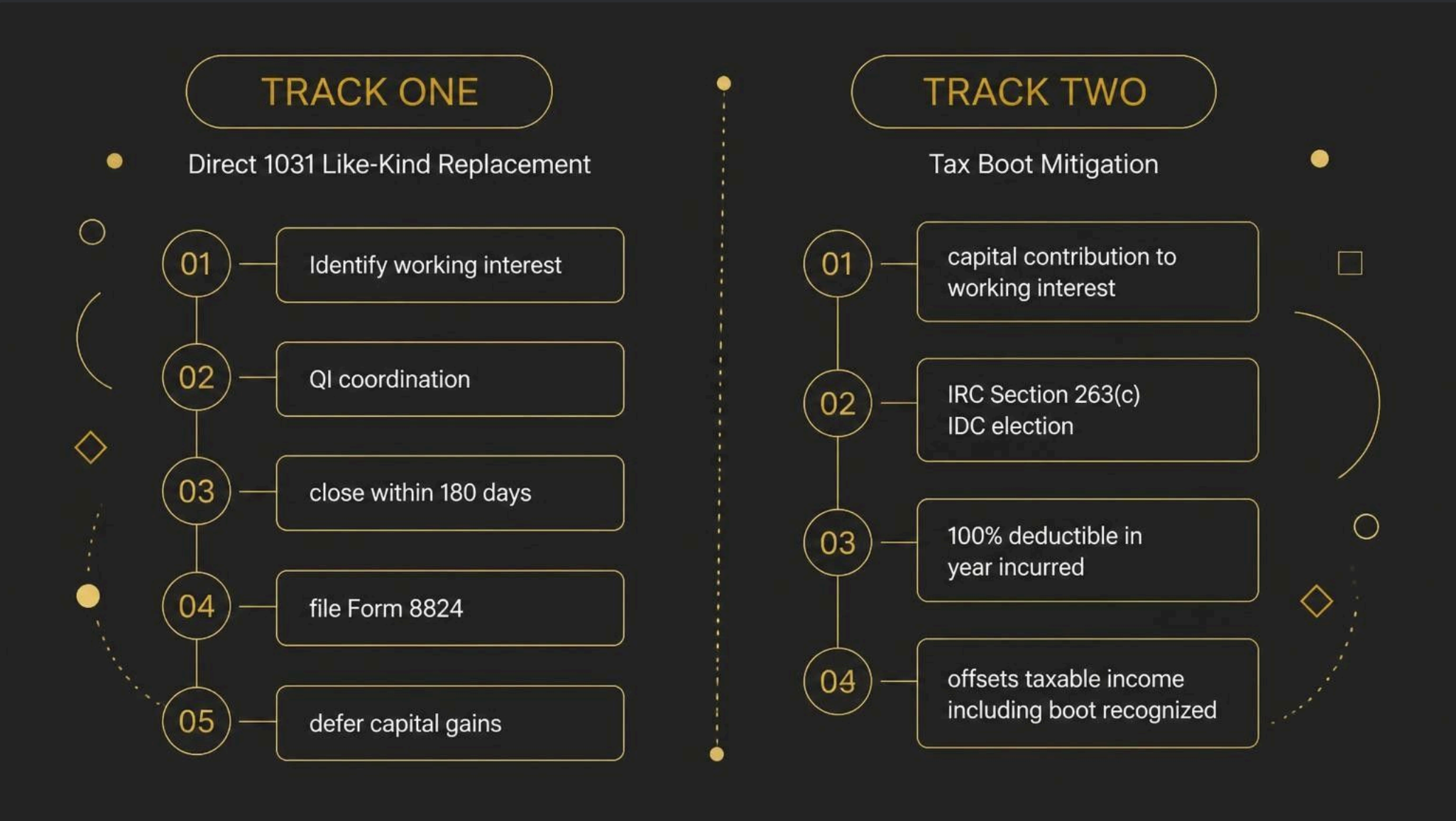
Required Inputs & Tools

- A signed Qualified Intermediary exchange agreement
- The closing date and settlement statement for the relinquished property
- A written identification template
- A target list of candidate working interests described with lease name, well name or number, API number, county, and state
- Access to tax counsel or a CPA familiar with Section 1031 and Section 263(c)
- The joint operating agreement and assignment documentation for any working interest under consideration

Process Overview: Two Parallel Tracks

This process runs on two tracks sharing the same starting point.

Track One Direct 1031 Like-Kind Replacement A producing working interest is identified and acquired within the statutory window as qualified replacement property. 1031 exchanges remain fully intact under current legislation, so investors can continue to defer capital gains taxes when reinvesting in qualifying real estate.	Track Two Tax Boot Mitigation A separate, non-exchange capital contribution into a working interest, used when the identification window cannot realistically be met, no suitable working interest can close in time, or some portion of proceeds will be received as taxable boot regardless of structure. Current tax legislation has not altered either path described below.
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Step-by-Step Process: Days 1–45

1 Before Closing — Engage and Vet the Qualified Intermediary

Without a QI, the exchange is disqualified, resulting in immediate tax liabilities. Engaging a knowledgeable QI early in the process secures your transaction's validity and success. Confirm the QI has handled resource-based replacement property before, since most intermediaries are accustomed to commercial or multifamily paper, not lease, well, and API documentation.

3 Days 1–30 — Source and Screen Direct Working Interest Candidates

In Rev. Rul. 68-226, the IRS ruled that the operating interest under an oil and gas lease is treated as real property for tax purposes, even if state law might call it an "interest in minerals" or a lease. Revenue Ruling 68-331 holds that the exchange of a leasehold interest in a producing oil lease, extending until the exhaustion of the deposit, held for productive use in trade or business or for investment, for the fee interest in an improved ranch, is an exchange of like-kind property under section 1031(a).

At this stage, confirm the candidate is structured as **direct title to a working interest**, not an interest in a partnership, LLC, or pooled entity that happens to own one. The working interests held by the Owners are not partnership interests — under Rev. Rul. 78-135, gain or loss realized on an exchange of general partnership interests does not qualify for nonrecognition under section 1031(a). A pooled entity or LP unit forfeits the real property classification regardless of what the entity itself owns underneath.

2 Day Zero — Close and Start the Concurrent Clocks

The 45-day identification period starts the day the relinquished property sale closes. The 180-day exchange period runs from that same closing date. These periods run at the same time, not back to back, so count both from the identical closing date.

4 Days 30–45 — Prepare and Deliver Written Identification

The identification must be: in writing, signed by you the taxpayer (your agent, attorney, or broker cannot sign for you), delivered before midnight on Day 45 to either the person obligated to transfer the replacement property or any other person involved in the exchange other than you or a disqualified person, and unambiguously described.

For a working interest, the unambiguous description is the **lease name, well name or number, API number, and county and state** — the functional equivalent of a street address. If you want to identify more than three properties, the combined fair market value of everything on your list cannot exceed 200% of the value of the property you sold. If your identifications blow past both the three-property rule and the 200% cap, you're in 95% territory: you can identify any number of properties at any value, but you must actually acquire at least 95% of the total identified value — a rule rarely used because falling even slightly short invalidates the entire exchange. If a candidate falls through before Day 45, identifications made during the 45-day window can be canceled and substituted with new ones within the identification period.

Step-by-Step Process: Days 45–180 & Reporting

1 Days 45–180 — Close the Replacement Working Interest Through the QI

As long as both interests qualify as real property and the exchange is structured correctly through a Qualified Intermediary, the investor can defer paying capital gains taxes under Section 1031. Coordinate the assignment, confirm the acquisition value and any associated debt meet the equal or greater value standard needed to avoid boot, and close no later than day 180 or the extended due date of the tax return for the year of sale, whichever is earlier.

2 After Closing — Report the Exchange

Report the exchange to the IRS on **Form 8824** with your annual tax return. Retain the identification notice, QI settlement statements, and the working interest assignment and joint operating agreement as the supporting file.

Parallel Track — Tax Boot Mitigation (Any Point the Window Is at Risk)

If sourcing a direct working interest in time is not realistic, or a portion of proceeds will be received as cash boot regardless of structure, a capital contribution into a working interest supports a current year deduction election under **IRC Section 263(c)**. The deduction for Intangible Drilling Costs has not been cut — it remains 100% deductible in the year incurred. The One Big Beautiful Bill Act didn't result in any changes to the favorable expensing provisions for intangible drilling costs and percentage depletion.

This path is **not** a 1031 exchange and does not require a Qualified Intermediary. It is a direct capital contribution, and the resulting deduction — up to 100% of the intangible drilling cost portion depending on the well's specific IDC and TDC allocation and the exchanger's individual circumstances — can offset taxable income in the same filing year, including gain or boot recognized on the property sale. Applicable tax treatment should be confirmed with a qualified tax professional before the contribution is made.

Decision Points

Days 15–20

Is a 1031 qualified working interest realistically sourceable and closeable before Day 180? If sourcing has stalled, begin evaluating the Boot Mitigation track in parallel rather than waiting until Day 44.

Offer & Title Review

Is the opportunity a direct assignment of a working interest, or an interest in a partnership, LLC, or pooled vehicle? Only direct title preserves the real property classification Section 1031 requires.

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Day 45

Does the written identification satisfy the Three Property Rule, the 200 percent Rule, or the stricter 95 percent standard, and has it been delivered to the QI or another non-disqualified party before midnight?

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Before Boot Mitigation

Has the CPA confirmed the IDC and TDC allocation for the specific well and the exchanger's own basis, at risk, and income profile? The deduction's practical value depends on those individual facts.

Roles & Responsibilities



The Exchanger

The seller of the relinquished property holds ultimate responsibility for meeting both deadlines, signing the identification notice personally, and directing the transaction with professional input.



Qualified Intermediary

Holds the sale proceeds, prepares exchange documentation, receives the written identification, and coordinates the closing of the replacement working interest so the exchanger never takes actual or constructive receipt of funds.



CPA or Tax Counsel

Confirms both properties meet the held for business or investment standard, reviews identification language for specificity, and separately evaluates any IDC election under Section 263(c) if the Boot Mitigation track is used.



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As the working interest operator and joint venture sponsor, provides the lease, well, API, county, and state detail the identification notice requires, structures participation as direct working interest title rather than a pooled entity interest, and maintains the governance rights and operational transparency supporting the exchanger's ongoing involvement as an active JV member once the position closes.

Common Problems & Quality Checks

⚠ Common Problems to Avoid

Late QI Engagement

Engaging the Qualified Intermediary after the relinquished property has already closed is fatal and cannot be corrected after the fact.

Wrong Entity Structure

Identifying a pooled entity interest, LP unit, or royalty trust share instead of direct title to a working interest. Royalty trusts or fund shares can't be exchanged directly — you need direct ownership. The same logic applies to working interests held through pooled vehicles.

Disqualified Recipient

Delivering the identification notice to a disqualified person. The regulation defines a disqualified person as anyone who has acted as your agent during the two years before the exchange begins — which rules out your attorney, your accountant, your real estate broker, and any of your employees.

Vague Identification

Writing a vague identification — naming a general field or basin instead of the specific lease, well, and API number an unambiguous description requires.

Confusing the Two Tracks

Treating Boot Mitigation as a substitute for, or continuation of, the exchange itself. The two paths use different mechanics, different documentation, and a different filing position, and should be executed as distinct decisions with professional guidance.

Assuming Deadline Relief

The IRS provides no extensions or exceptions for missing either deadline, except when formal relief is granted under a federally declared disaster or emergency.

✓ Quality Checks

Before Day 45

The identification notice is in writing, signed personally by the exchanger, delivered to the QI or another non-disqualified party, and describes each candidate by lease name, well name or number, API number, county, and state.

Before Day 45

The number and combined value of identified properties satisfies the Three Property Rule or the 200 percent Rule, with the 95 percent standard reserved as a last resort.

Before Closing

The working interest assignment conveys direct title, not a partnership, LLC, or pooled entity interest, and the acquisition value and any debt assumed meet the equal or greater value standard.

Before Filing

Form 8824 is prepared, with the identification notice, QI settlement statements, and working interest assignment retained as supporting documentation.

If Boot Mitigation Is Used

The CPA has reviewed the specific IDC and TDC allocation for the well, the exchanger's at risk basis, and how the resulting deduction interacts with the gain or boot recognized on the original sale, before the contribution is finalized.

Expected Outcomes & Closing Perspective

Track One: Direct 1031 Like-Kind Replacement

A correctly coordinated Direct 1031 Like-Kind Replacement results in a completed exchange, a deferred capital gain reported on Form 8824, and ownership transitioned from a managed real property asset into a direct working interest position with governance rights and operational transparency as an active JV member.

Track Two: Tax Boot Mitigation

A correctly coordinated Tax Boot Mitigation contribution — used when the window cannot be met or boot is unavoidable — results in a current year IDC deduction election under Section 263(c) that directly offsets taxable income in the filing year, including gain or boot otherwise due, with the specific amount depending on individual circumstances and the applicable tax treatment confirmed by a qualified tax professional.

A 45 day window moves quickly once the relinquished property has closed, and most of the pressure sellers feel in that window comes from a narrow view of what counts as qualified replacement property. A producing working interest, held directly and described with the same specificity as a street address, has been treated as real property eligible for like kind exchange since 1968.

Where the clock cannot be met, or boot is unavoidable, the Section 263(c) election offers a separate, well established mechanism to address the resulting tax exposure directly rather than simply accepting it. Either path benefits from early coordination among the exchanger, the Qualified Intermediary, tax counsel, and the working interest operator — well before Day 45 arrives.

Key Authorities

- **IRC Section 1031(a)** — statutory basis for the 45 day and 180 day periods
- **Revenue Ruling 68-331** — working interest as qualified replacement property
- **Revenue Ruling 68-226** — operating interest as real property for federal tax
- **Revenue Ruling 78-135** — partnership interests do not qualify under 1031
- **Treas. Reg. § 1.1031(k)-1** — identification rules and disqualified persons
- **IRC Section 263(c)** — IDC election for Tax Boot Mitigation path
- **IRS Form 8824** — required reporting for completed like-kind exchange

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