

How Oil and Gas Working Interests Qualify as 1031 Replacement Property

A Step-by-Step Qualified Intermediary Coordination Guide for Commercial Real Estate, Multifamily, and Land Sellers

SECTION 1031 EXCHANGE | PATH A + PATH B | SUMMIT VENTURES

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Purpose & Scope

Purpose

This guide explains, in sequence, how a real estate seller under an active Section 1031 exchange can identify and close on a direct working interest in oil and gas real property as qualified replacement property, and how a parallel capital contribution strategy can offset tax exposure when an exchange cannot be completed or produces boot.

The purpose is operational: to show exactly what happens between the closing of the relinquished property and the filing of Form 8824, who is responsible for each action, and where most exchanges involving energy assets break down because the Qualified Intermediary or exchange attorney has never coordinated this specific asset class before.

Everything in this guide is procedural and educational. It is not tax or legal advice. Every exchanger should confirm applicability with a CPA, exchange attorney, and their Qualified Intermediary before acting on any statutory deadline described here.

This Guide Applies To

Commercial Real Estate Sellers

Office, retail, industrial, self storage, mixed use — who have sold or are under contract to sell.

Multifamily Property Sellers

Exiting apartment, workforce housing, or student housing assets.

Land & Development Sellers

Disposing of raw land, agricultural parcels, or development sites.

Two Distinct Paths

This guide covers two paths that a seller may pursue separately or in combination.

Path A — Direct 1031 Like-Kind Replacement

The exchanger identifies and closes on a direct working interest in a producing oil and gas lease as qualified replacement property within the statutory 45-day and 180-day windows, relying on the real property classification established in **Revenue Ruling 68-331**.

Path B — Tax Boot Mitigation

The exchanger has missed the identification window, cannot fully reinvest exchange proceeds, or will otherwise recognize boot. Capital is contributed directly into a working interest outside the exchange structure, generating an **Intangible Drilling Cost deduction under IRC Section 263(c)** that can be applied against the taxable gain in the year it is recognized.

This guide does not cover reverse exchanges, build-to-suit exchanges, or exchanges involving royalty interests, net profits interests, or fund/LP structures — none of which follow the same qualification logic described here.

Prerequisites & Required Inputs

Before Beginning Either Path, Confirm:

1 Productive Use Requirement

The relinquished property has been held for productive use in a trade or business or for investment, consistent with IRC Section 1031(a).

2 QI Engaged Before Closing

A Qualified Intermediary has been engaged and the exchange agreement executed **before** the relinquished property closes. A QI engaged after closing cannot facilitate a valid exchange.

3 Advisors Briefed on Asset Class

The exchanger's CPA and exchange attorney have been briefed that a working interest in oil and gas real property is being considered as a replacement property category, since many advisors have not encountered this fact pattern.

4 Direct Working Interest Only

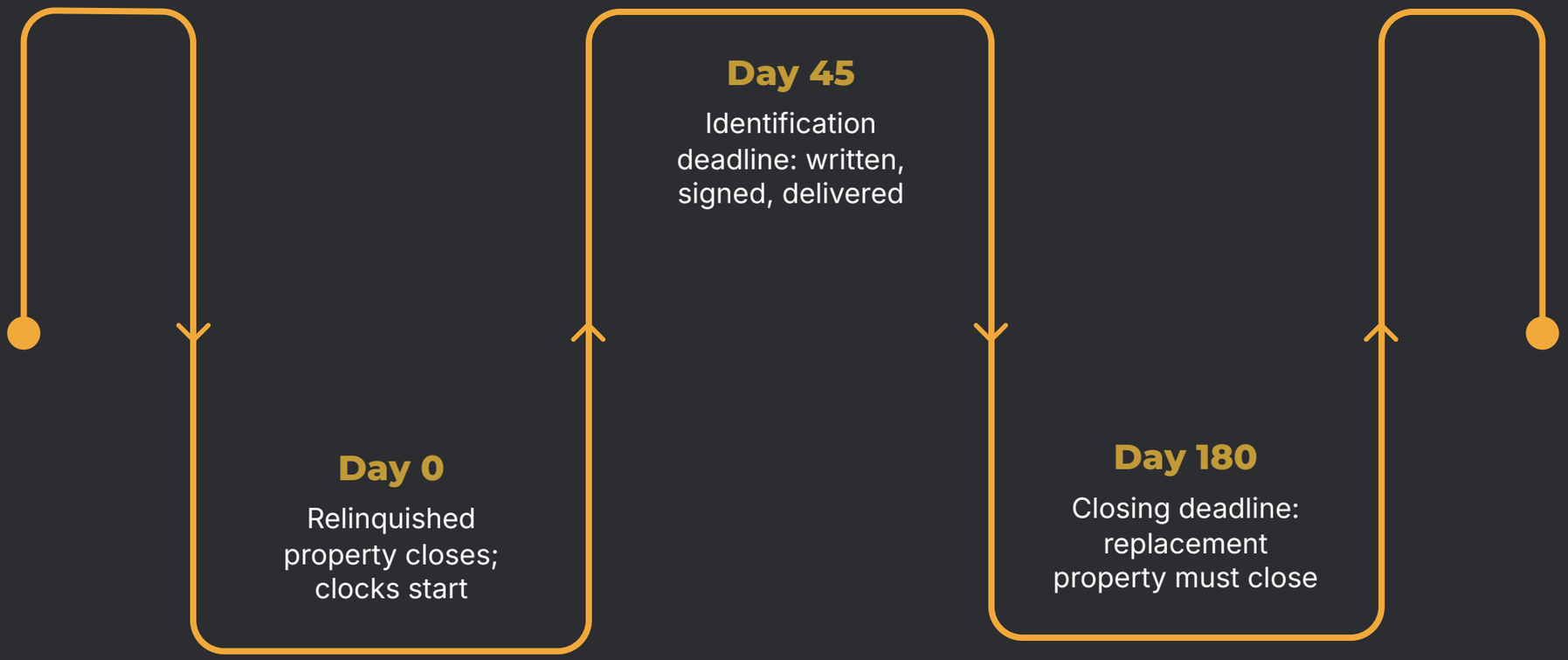
Only a direct working interest — held in the exchanger's own name, through a disregarded single-member LLC, or a tenancy-in-common with a proper IRC Section 761(a) election — will qualify. An interest in a fund, limited partnership, or multi-member LLC does not qualify.

Required Tools & Documents

- Relinquished property closing statement and closing date (starts both statutory clocks)
- Executed Qualified Intermediary exchange agreement
- Written identification letter template meeting the "unambiguous description" standard
- Working interest property package from Summit Ventures: lease name, well name or proposed well name, API number where assigned, county and state, and the percentage working interest being offered
- Joint Operating Agreement (JOA) and title opinion for the subject lease
- Form 8824 (Like-Kind Exchanges) for the year of the exchange
- For Path B: a CPA's written analysis of projected boot, gain character, and the available 263(c) election

The Exchange Clock: Process Overview

The exchange clock is a single, continuous countdown. Both the 45-day identification period and the 180-day closing period begin on the same date — the day the relinquished property closes — and they run **concurrently rather than sequentially**. There is no extension available outside a federally declared disaster under Revenue Procedure 2007-56. Every step below is sequenced against that single starting date.



⚠ Both the 45-day and 180-day periods run concurrently from the same closing date — not sequentially. This means the replacement property closing deadline is considerably tighter than it first appears once the identification period has elapsed.

Step-by-Step Process: Path A

Step 1: Engage the QI Before Closing

The QI exchange agreement must be signed, and exchange proceeds must be assigned to flow directly to the QI, before the relinquished property transaction closes. A QI brought in after closing cannot cure the exchange. Inform the QI in writing that a direct working interest in oil and gas real property is a candidate replacement property.

Step 2: Close Relinquished Property — Mark Day 1

The closing date of the relinquished property is Day 0. Day 45 (identification deadline) and Day 180 (closing deadline) are both calculated from this single date, counted in calendar days, including weekends and holidays.

Step 3: Identify the Working Interest in Writing by Day 45

The identification must be in writing, signed by the exchanger, and delivered by midnight of Day 45 to the QI or another permitted, non-disqualified party. The description must be "unambiguous" — including the lease name, well name or planned well name, API number if assigned, county and state, and the percentage working interest. A generic reference to "an oil and gas investment" or "an energy fund" does not meet this standard.

Step 4: Complete Due Diligence and JV Onboarding

In parallel with identification, the exchanger reviews the Joint Operating Agreement, title opinion, and lease records with their exchange attorney, and completes Summit Ventures' member onboarding so that closing documents can be prepared without delay once identification is finalized. This step confirms the exchanger will take direct title to the working interest, preserving the real property classification required by Revenue Ruling 68-331.

Step 5: Close on the Working Interest by Day 180

The QI releases exchange funds directly to the closing of the working interest acquisition. The deed or assignment typically runs directly from the seller of the working interest to the exchanger, since the QI generally does not take title itself — it only holds and directs the funds. Closing must occur by Day 180, or by the due date of the exchanger's tax return for the year of the relinquished property sale, whichever is earlier.

Step 6: File Form 8824 with the Tax Return

Form 8824 documents the relinquished property, the replacement working interest, the dates of each transaction, and any recognized gain or boot. This is prepared by the CPA using the closing statements from both transactions and the QI's final settlement statement.

Identification Rules & Path B: Boot Mitigation

The Three Identification Rules

If identifying more than one property, the exchanger must apply one of three IRS identification rules:

1

Three-Property Rule

Up to three properties of any value. The most straightforward and commonly used rule.

2

200% Rule

Any number of properties, provided their combined fair market value does not exceed 200% of the relinquished property's value.

3

95% Rule

Any number of properties, but the exchanger must actually acquire at least 95% of the identified value — making it the highest-risk option procedurally.

Identification can be revoked and resubmitted any time before Day 45 closes.

Parallel Path — Boot Mitigation Through IDC Deduction

If the 45-day window has already lapsed, if no suitable working interest can be identified in time, or if a portion of the exchange proceeds will remain as unreinvested boot, the exchanger's CPA evaluates a direct capital contribution into a working interest outside the exchange.

Under **IRC Section 263(c)**, the intangible drilling cost portion of that contribution may be deducted — potentially up to 100% of the applicable IDC amount — depending on the specific drilling cost structure of the well, the exchanger's individual tax circumstances, and the elections made on that year's return.

This deduction is evaluated against the taxable gain, which, left unaddressed, is exposed to:

- Federal and state capital gains tax
- The 3.8% Net Investment Income Tax under IRC Section 1411
- Unrecaptured Section 1250 depreciation recapture

⚠ A CPA should model the specific offset before any capital is contributed.

Decision Points & Roles

Key Decision Points

By Day 30–35

Is a working interest likely to be fully identified and documented before Day 45? If not, the exchanger and CPA should begin modeling the Path B boot mitigation alternative in parallel — rather than waiting until Day 44.

At Identification

Will the exchanger identify a single working interest (Three-Property Rule), several working interests plus other replacement candidates (200% Rule), or rely on the higher-risk 95% Rule? This choice should be made with the exchange attorney based on how many replacement candidates genuinely exist.

At Structuring

Will the exchanger take the working interest directly, through a disregarded single-member LLC, or through a tenancy-in-common arrangement with a Section 761(a) election? Each preserves like-kind treatment; a multi-member LLC or fund interest does not.

At Closing

If full reinvestment is not achievable by Day 180, how much boot will be recognized, and should a Path B capital contribution be sized to offset that specific amount?

Roles & Responsibilities

Exchanger (Taxpayer)

Holds the exchange timeline, signs the identification letter, makes the final decision on which working interest to acquire, and retains ultimate responsibility for tax reporting accuracy.

Qualified Intermediary

Holds exchange proceeds, prepares and receives identification documentation, coordinates the flow of funds at both closings, and confirms the exchanger never takes constructive receipt of funds.

Exchange Attorney / CPA

Reviews identification language for the "unambiguous description" standard, confirms disqualified-person rules are observed, prepares Form 8824, and models the 263(c) deduction if Path B applies.

Summit Ventures

Provides the working interest property package (lease, well, API, county, state, working interest percentage), coordinates title transfer documentation with the QI and closing agent, and supports member onboarding and governance rights as the active JV member takes their working interest position.

Title Company / Closing Agent

Executes the deed or assignment directly from the seller of the working interest to the exchanger, consistent with standard delayed-exchange practice.

Common Problems & Quality Checks

Common Problems to Avoid

Engaging the QI Too Late

If the exchange agreement is signed after the relinquished property has already closed, the exchange is disqualified from the outset.

Vague Identification Language

Describing the replacement property as "an oil and gas interest" or "an energy asset" without the lease name, well name, API number, and location fails the unambiguous description requirement and can invalidate the identification.

Confusing a Fund or LP Unit with a Direct Working Interest

Many real estate attorneys and QIs are unfamiliar with this asset class and may treat a fund, limited partnership, or multi-member LLC interest as equivalent to a direct working interest. It is not. Only direct title to the working interest itself, or a properly structured tenancy-in-common with a 761(a) election, preserves real property classification.

Missing Day 45 Due to Calendar Miscounting

The 45 days are calendar days, not business days, with no weekend or holiday extension outside a federally declared disaster.

Assuming Sequential Periods

Both the 45-day and 180-day periods run concurrently from the same closing date — which means the replacement property closing deadline is considerably tighter than it first appears once the identification period has elapsed.

Waiting Too Long for Boot Mitigation

The IDC deduction analysis under Path B should begin as soon as it becomes clear the exchange may not be fully completed — not after the 180-day window has already closed.

Quality Checks

- Confirm the QI exchange agreement bears a date and signature prior to the relinquished property's closing date.
- Confirm the identification letter includes lease name, well name or planned well name, API number where assigned, county and state, and the specific percentage working interest.
- Confirm the identification letter was delivered to the QI or a properly permitted, non-disqualified party before midnight on Day 45.
- Confirm which of the three identification rules (Three-Property, 200%, or 95%) applies and that the identified properties fit within it.
- Confirm the acquisition structure (direct title, disregarded entity, or 761(a) tenancy-in-common) with the exchange attorney before closing documents are drafted.
- Confirm the working interest closing occurs on or before Day 180 or the exchanger's tax filing deadline, whichever is earlier.
- Confirm Form 8824 reconciles the relinquished property's adjusted basis, the replacement working interest's basis, and any recognized gain or boot.
- For Path B, confirm the CPA has calculated the projected IDC deduction against the specific boot or gain amount before capital is contributed.

Expected Outcomes, Key Questions & Sources

Expected Outcomes

Path A — Successful Exchange

A correctly coordinated Path A exchange results in the exchanger holding a direct working interest in a producing or development oil and gas lease, with the capital gain from the relinquished property deferred under Section 1031(a), Form 8824 filed accurately, and governance rights and operational transparency in place as an active JV member alongside Summit Ventures and the well operator.

Path B — Boot Mitigation

A correctly coordinated Path B outcome results in a documented, CPA-reviewed 263(c) IDC deduction applied against the specific boot or gain recognized in the year of sale, reducing the net tax exposure that would otherwise apply in full — including ordinary capital gains tax, the Net Investment Income Tax, and depreciation recapture.

Key Questions to Ask Before Acting

- Has the Qualified Intermediary been formally engaged, in writing, before the relinquished property closes?
- Does the exchanger's CPA and exchange attorney have direct experience with oil and gas working interests as 1031 replacement property, or will this be their first exposure to the asset class?
- Is the identification letter specific enough to include lease name, well name, API number, county, and state — rather than a general description?
- Which identification rule — Three-Property, 200%, or 95% — fits the number and value of properties being identified, and has that choice been confirmed with the exchange attorney?
- Will the working interest be acquired through direct title, a disregarded single-member LLC, or a 761(a) tenancy-in-common, and has that structure been confirmed in writing before closing?
- If the timeline is already at risk of missing Day 45, has a parallel Path B boot mitigation analysis been started with the CPA?
- Has the CPA modeled the specific IDC deduction amount against projected capital gains tax, Net Investment Income Tax, and depreciation recapture exposure?

Sources & References

IRC Section 1031(a)

Governing nonrecognition of gain on exchanges of real property held for productive use in a trade or business or for investment.

Revenue Ruling 68-331

Holding that a lessee's working interest in a producing oil and gas lease is like-kind to a fee interest in real property for purposes of a Section 1031 exchange.

IRC Section 263(c)

Intangible drilling cost election provisions.

IRC Section 1411

The Net Investment Income Tax.

IRC Section 761(a)

Permitting certain co-ownership arrangements to elect out of partnership classification.

Revenue Ruling 78-135

Confirming that general partnership interests do not qualify for Section 1031 nonrecognition.

Revenue Procedure 2007-56

Providing the sole basis for extension of exchange deadlines in the case of a federally declared disaster.

IRS Form 8824

Like-Kind Exchanges, and accompanying instructions.

Real estate sellers facing an active 1031 clock rarely have the luxury of a long research cycle, and the working interest replacement category described in Revenue Ruling 68-331 is still unfamiliar to many exchange attorneys and Qualified Intermediaries — which is precisely why early, specific coordination matters more than it would with a conventional property-to-property exchange. Whether the path forward is a direct like-kind replacement or a boot mitigation strategy built around an IDC deduction, the mechanics above are designed to be reviewed alongside a CPA, an exchange attorney, and Summit Ventures before any statutory deadline is at stake, so that the decision is made with full information rather than under time pressure.

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