

How Oil and Gas Working Interests Qualify as 1031 Replacement Property

A STEP-BY-STEP QUALIFIED INTERMEDIARY COORDINATION GUIDE

This guide explains the complete coordination process for using a direct working interest in oil and gas real property as replacement property inside an IRC Section 1031 like-kind exchange — and the parallel path available when the 45-day clock, the 180-day clock, or property fit cannot be satisfied.

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Purpose & Scope

Why This Guide Exists

Real estate sellers under exchange pressure rarely hear about working interests as a qualifying asset class, largely because most qualified intermediaries (QIs) and real estate attorneys have never coordinated one. This guide closes that gap with a sequential, procedural walkthrough of exactly how the coordination works — from engaging a QI before closing through final Form 8824 reporting.

This Guide Applies To

- Commercial real estate sellers (office, retail, industrial, self-storage, mixed-use) under contract or recently closed on a sale
- Multifamily property sellers exiting active property management
- Land and development sellers who closed on raw land, agricultural parcels, or development sites sold to builders

This Guide Does Not Cover

General 1031 mechanics unrelated to oil and gas replacement property, nor does it substitute for individualized tax or legal advice.

Two Distinct Paths

Path A — Direct 1031 Like-Kind Replacement

Acquiring a working interest as qualified replacement property inside an active exchange, timed to the statutory 45-day identification window and 180-day closing window. Follows the statutory exchange sequence: engage the QI, close the relinquished property to start the concurrent clocks, identify a working interest in writing within 45 days, structure direct title, and close within 180 days.

Path B — Tax Boot Mitigation

A non-exchange capital contribution into a working interest, used when the exchange clock cannot be met, when suitable replacement real estate cannot be located, or when boot is already unavoidable. Structured to generate an IRC Section 263(c) intangible drilling cost (IDC) deduction that can offset the resulting taxable gain. This is **not** an exchange — it applies after the window has closed.

Both paths depend on the same foundational point of law: under **Revenue Ruling 68-331**, the exchange of a lessee's working interest in a producing oil and gas lease, held for productive use in a trade or business or for investment, for a fee interest in real estate, was held to be an exchange of like-kind property under Section 1031(a). This ruling remains the operative authority cited in exchange documentation today.

Prerequisites & Required Inputs

Before Beginning Either Path, Confirm:

1 Qualifying Hold

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

2 QI Timing

A qualified intermediary has not yet been engaged, or if engaged, has not yet closed on the relinquished property. Engagement timing is a hard gate addressed in Step 1.

3 Professional Team

The exchanger has, or is prepared to retain, a CPA and a real estate or tax attorney familiar with like-kind exchange mechanics.

4 Direct Title Requirement

The exchanger understands that any identified replacement property, including a working interest, must be held through direct record title or a qualifying co-ownership structure — not through a partnership, LLC membership, or fund interest, since entity interests do not qualify as like-kind real property under Section 1031 even when the underlying entity holds qualifying assets.

Required Tools & Documents

Closing Documents

Closing documents and anticipated closing date for the relinquished property.

QI Agreement

A qualified intermediary agreement with a QI who has documented experience with resource-based or mineral and working interest exchanges.

Working Interest Documentation

Offering documentation from the operator or JV sponsor, including lease name, well name, API number, and county and state of the producing asset — sufficient to satisfy the "unambiguously described" identification standard.

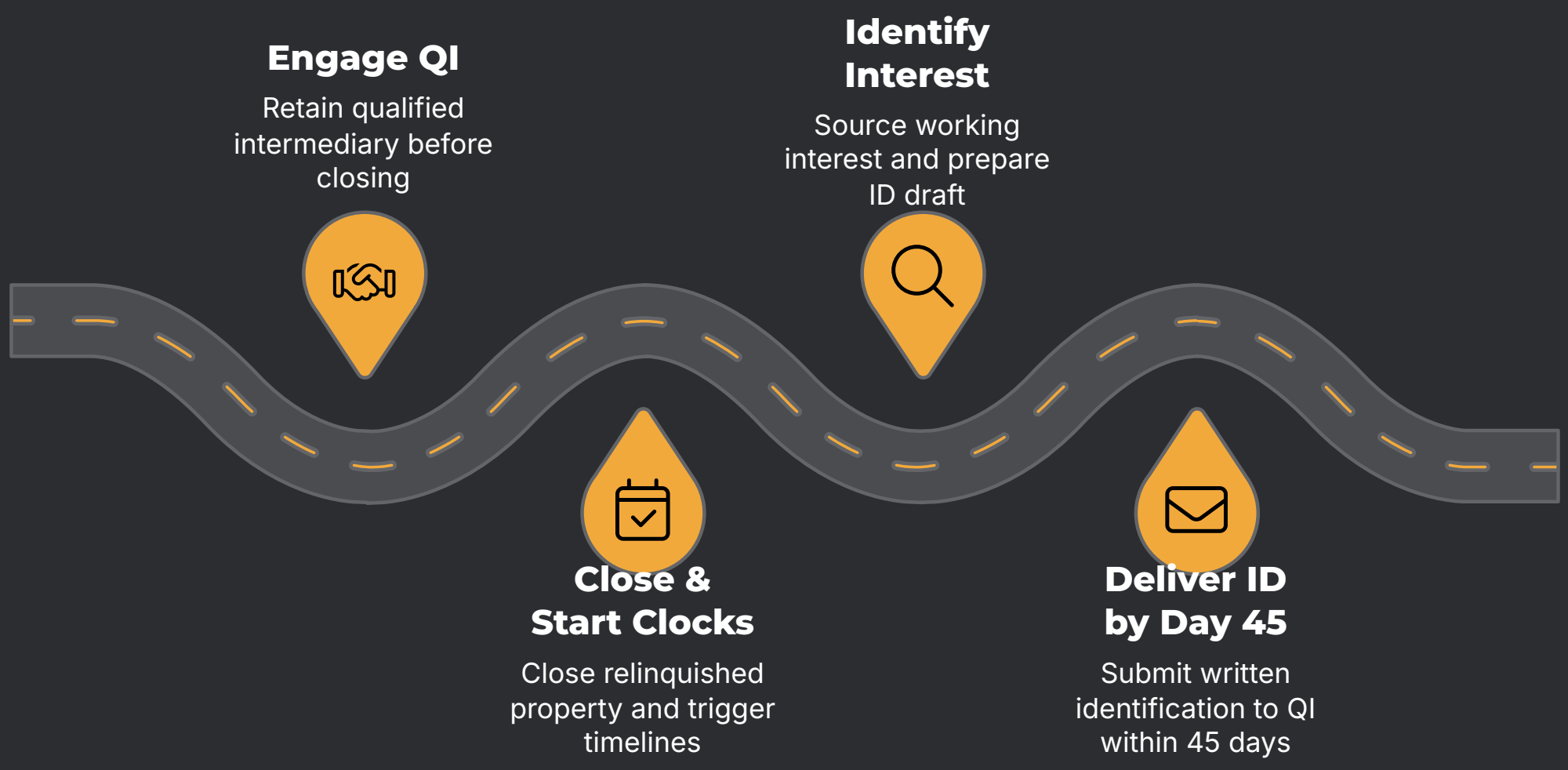
Identification Notice Template

A written, signed identification notice template for delivery to the QI or another non-disqualified party.

Form 8824

Like-Kind Exchanges form for year-end reporting, plus access to a CPA for gain, boot, and IDC calculations under either path.

Step-by-Step Process: Path A



01

Engage and Vet the Qualified Intermediary Before Closing

The QI must be in place before, or at the latest at, the closing of the relinquished property. An exchange cannot be structured retroactively once the seller has received or controlled the sale proceeds. When vetting a QI for a working interest replacement, ask directly whether the firm has handled a resource-based exchange before. Many QIs have not, which is why this guide treats QI experience as a distinct, named decision point rather than an assumption.

02

Close the Relinquished Property and Start the Concurrent Clocks

The 45-day identification period and the 180-day closing period both begin on the same calendar day — the day the relinquished property closes. These are concurrent, not sequential, periods, meaning the exchanger does not get 45 days to identify followed by an additional 180 days to close. Both clocks run from day one, calendar days with no extension for weekends or holidays, except in the case of a federally declared disaster under the relevant IRS revenue procedures.

03

Source the Working Interest and Draft the Identification

Work with the JV sponsor or operator to obtain documentation that unambiguously identifies the candidate working interest — meaning the lease name, well name, API number, and county and state. This level of specificity is what separates a valid identification from one that can be challenged. At this stage also select the applicable identification rule: the Three-Property Rule, the Two Hundred Percent Rule, or the Ninety-Five Percent Rule.

04

Deliver the Written Identification by Day 45

The identification must be in writing, signed by the exchanger, and delivered to the QI or another party involved in the exchange who is not a disqualified person, before midnight of the 45th day. Disqualified persons include the exchanger's attorney, CPA, employee, investment banker or broker, real estate agent who performed services for the exchanger within the prior two years, and certain relatives. An identification can be revoked and replaced any time before the Day 45 deadline.

05

Structure Direct Title to the Working Interest

Confirm with tax counsel that the replacement interest will be held through direct assignment of record title or a qualifying co-ownership arrangement — not through a partnership, LLC membership, or fund unit. This is the single most common point of confusion in resource-based exchanges: an interest in an entity that owns qualifying oil and gas property does not itself qualify as like-kind real property. Many practitioners request a tax opinion letter at this stage given the specialized nature of mineral and working interest exchanges.

06

Close Within 180 Days and Report on Form 8824

The QI directs the exchange funds to close on the replacement working interest, with the deed or assignment of record title typically running directly from the original interest holder to the exchanger, since the QI generally takes no title itself and holds no economic interest beyond its exchange fee. The transaction is then reported on Form 8824 for the tax year in which the exchange was completed.

Parallel Path: Tax Boot Mitigation (Path B)

If the 45-day window lapses without a suitable identification, if no qualifying property can be closed within 180 days, or if boot is already unavoidable, the exchanger shifts to a direct capital contribution into a working interest outside the exchange structure.

How It Works

This path does not defer the gain the way a completed exchange does. Instead, it works by generating a current-year deduction under IRC Section 263(c), which allows the election to currently expense intangible drilling costs (IDC) rather than capitalize them.

What It Offsets

That deduction is applied against the exchanger's taxable income for the year, directly offsetting the gain or boot that would otherwise be subject to federal and state capital gains tax, the 3.8 percent Net Investment Income Tax under IRC Section 1411, and depreciation recapture.

Important Caveat

The applicable IDC deduction amount depends on the specific drilling cost structure of the well, the exchanger's individual tax circumstances, and the elections made in consultation with a qualified tax professional, and should **never** be assumed at a flat percentage.

Decision Points & Timeline

Day 0–10

1

Confirm QI engagement and begin evaluating whether a direct exchange (Path A) or a boot mitigation contribution (Path B) is the realistic fit, given how much suitable real estate replacement property already exists in the pipeline.

Day 45 — Hard Deadline

2

If no written identification has been delivered to the QI or a non-disqualified party by midnight, Path A is no longer available for this exchange and Path B becomes the relevant discussion with the CPA.

Identification Rule Selection

3

Three-Property, 200 Percent, or 95 Percent — chosen based on how many candidate properties are being identified and their combined value relative to the relinquished property.

Title Structure Confirmation

4

Direct assignment or qualifying co-ownership versus a fund, LLC, or partnership interest — confirmed before the replacement property closing, not after.

Day 180 — Hard Deadline

5

Hard deadline for closing on the identified replacement working interest. No extensions except federally declared disaster relief.

Identification Rule Reference

Rule	Criteria	Best Used When
Three-Property Rule	Up to three properties identified regardless of value	Fewer, higher-value candidates
200 Percent Rule	Any number of properties; combined FMV ≤ 200% of relinquished value	Multiple candidates within value range
95 Percent Rule	Any number of properties; at least 95% of identified value must be acquired	Higher-risk; last resort when first two don't fit

Roles & Responsibilities

Exchanger (Seller/Taxpayer)

Drives timing decisions, signs and delivers the identification notice, and makes the final call on title structure and capital deployment.

Qualified Intermediary

Holds exchange proceeds, cannot be a disqualified person, receives the identification notice, and coordinates the closing mechanics of the replacement property acquisition.

CPA or Tax Advisor

Confirms gain and boot calculations, evaluates the Section 263(c) IDC election under Path B, and prepares Form 8824.

Real Estate or Exchange Attorney

Reviews title structure, co-ownership documentation, and related-party considerations under Section 1031(f).

JV Sponsor / Operator (Summit Ventures)

Provides the working interest documentation needed for identification (lease name, well name, API number, county and state), governance rights disclosure, and participation agreement terms, and coordinates directly with the exchanger's QI and attorney on direct-title documentation.

Common Problems & Quality Checks

⚠ Common Problems to Avoid

Engaging the QI After Closing

Once the exchanger has received or controlled sale proceeds, the exchange is disqualified. This must happen before or at closing, not after.

Identifying an Entity Interest Instead of Direct Title

Identifying a fund, LLC, or partnership interest instead of direct working interest title is the most frequent and most damaging mistake in resource-based exchanges, since entity interests are not like-kind real property regardless of what the entity itself owns.

Treating the Clocks as Sequential

The 45-day and 180-day periods run concurrently from the same closing date. Miscalculating this leads exchangers to believe they have more time than they actually do.

Vague Property Identification

A description lacking the lease name, well name, API number, or county and state can be challenged as not "unambiguously described."

Related-Party Structuring

Exchanges involving related parties carry additional scrutiny under Section 1031(f) and have been challenged in prior litigation; this requires attorney review before proceeding.

Assuming a Flat IDC Deduction Percentage

The applicable deduction depends on the well's cost structure and the exchanger's individual tax circumstances, not a universal figure.

✓ Quality Checks

- ☐ Confirm in writing that the QI was engaged before the relinquished property closing
- ☐ Confirm the identification notice is signed, dated, and delivered to the QI or a non-disqualified party before the Day 45 deadline
- ☐ Confirm the property description includes lease name, well name, API number, and county and state
- ☐ Confirm the applicable identification rule (Three-Property, 200 Percent, or 95 Percent) and that it is being followed correctly
- ☐ Confirm title to the replacement working interest will be held directly or through a qualifying co-ownership structure, not a fund, LLC, or partnership interest
- ☐ Confirm the closing on the replacement working interest occurs before the Day 180 deadline
- ☐ Confirm Form 8824 is prepared and reviewed with the CPA for the applicable tax year
- ☐ Under Path B, confirm the Section 263(c) IDC election and resulting deduction amount have been reviewed and documented with the CPA before year-end

Expected Outcomes, Key Questions & Sources

Expected Outcomes

Path A Outcome

A correctly coordinated exchange results in a completed like-kind exchange into a directly held working interest, with capital gains, Net Investment Income Tax, and depreciation recapture deferred consistent with Section 1031 treatment, while the exchanger moves from property management obligations into a working interest ownership position with governance rights and operational transparency from the operator.

Path B Outcome

A documented, CPA-reviewed Section 263(c) IDC election applied against the taxable boot or gain for the year the capital was contributed, reducing the current-year tax exposure created by the failed exchange or unavoidable boot.

Key Questions to Ask Before Moving Capital

- How many days remain in the identification window, and has the QI confirmed receipt of a written, signed identification notice?
- Has the working interest been described with the lease name, well name, API number, and county and state needed to satisfy the identification standard?
- Will the replacement interest be held through direct title or a qualifying co-ownership structure, and has this been confirmed with tax counsel before closing?
- If the 45-day window has already lapsed or will lapse, has the CPA been engaged to evaluate the Section 263(c) IDC election under the boot mitigation path?
- Has the QI been specifically asked about prior experience coordinating resource-based or mineral and working interest exchanges?
- Are there any related-party considerations under Section 1031(f) that require attorney review before proceeding?
- Has the exchanger confirmed with a CPA how the resulting working interest income, depletion, and IDC treatment will be reported in future tax years?

Sources & References

Revenue Ruling 68-331

Holding that a lessee's interest in a producing oil and gas lease, held for productive use in a trade or business or for investment, exchanged for a fee interest in real estate, qualifies as like-kind property under Section 1031(a). Verified against primary text via Tax Notes and Asset Preservation Inc.

IRC Section 1031(a)

Statutory basis for like-kind exchange nonrecognition treatment.

IRC Section 263(c)

Statutory basis for the election to currently deduct intangible drilling costs.

IRC Section 1411

Statutory basis for the 3.8 percent Net Investment Income Tax.

IRC Section 1031(f)

Related-party exchange rules.

IRS Form 8824

Like-Kind Exchanges form and accompanying instructions: reporting mechanism for completed like-kind exchanges.

Industry Resources

Equity Advantage, Anchor1031, JTC Group, and EPC1031 educational resources on QI engagement timing, identification mechanics, and the distinction between entity interests and direct working interest title for resource-based exchanges.

The timeline pressure built into Section 1031 rewards exchangers who move early and coordinate precisely. A working interest in a producing oil and gas lease is not a theoretical replacement property category — it has been recognized as like-kind real property under Revenue Ruling 68-331 for decades.

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