

How Oil and Gas Working Interests Qualify as 1031 Replacement Property

A Step by Step Qualified Intermediary Coordination Guide for Real Estate Owners Facing the 45 Day and 180 Day Exchange Clock

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Purpose & Scope

Purpose

This guide explains, in procedural terms, how a direct working interest in an oil and gas lease can function as qualifying replacement property inside an IRC Section 1031 like kind exchange, and how a property owner coordinates that acquisition with a Qualified Intermediary (QI) inside the statutory 45 day identification window and 180 day closing window.

It also explains a second, separate path: what happens when the exchange clock cannot be met, or when taxable boot is unavoidable, and how a direct capital contribution into a working interest can be structured outside the exchange to address the resulting tax exposure through the Section 263(c) intangible drilling cost (IDC) election.

The guide is written for commercial real estate owners, multifamily property owners, and land or development property owners who are evaluating energy ownership as a documented alternative to another multifamily acquisition, a net lease property, or a Delaware Statutory Trust (DST) unit.

Scope

This guide covers the mechanics of working interest qualification under Revenue Ruling 68-331, the identification and closing timelines under Section 1031 and the Treasury regulations, the specific documentation a QI needs to accept a working interest as identified replacement property, and the coordination sequence between the exchanger, the QI, the closing attorney, the CPA, and Summit Ventures as the entrepreneurial joint venture (JV) counterparty.

It does not cover state specific title or recording requirements, which vary by county and should be confirmed with local counsel, and it does not provide individualized tax advice. Every tax position referenced here depends on the exchanger's specific facts and should be confirmed with a qualified CPA or tax attorney before the identification deadline.

Prerequisites Before You Begin

Before beginning this process, the property owner should confirm the following:

Relinquished Property Qualification

The relinquished property (the commercial, multifamily, or land asset being sold) is held for productive use in a trade or business or for investment, consistent with the "held for productive use in a trade or business or for investment" standard in Section 1031(a).

QI Engaged Before Closing

A Qualified Intermediary has been engaged and is in place before the relinquished property closes. Industry guidance is consistent on this point: if a QI is not engaged before or at closing of the relinquished property, the exchange is disqualified regardless of what happens afterward. Best practice, confirmed across multiple exchange facilitators, is to engage the QI as early as the original purchase of the relinquished property, not merely at the point of sale.

Direct Working Interest Requirement

The exchanger understands that a working interest must be held directly, in the exchanger's own name, a single member LLC, or a tenancy in common structure, rather than through a partnership, multi member LLC, or pooled fund unit. This distinction matters because an interest in an entity that owns qualifying real property is not itself qualifying real property. Revenue Ruling 78-135 confirms that a general partnership interest does not qualify for Section 1031 nonrecognition, even when the partnership's underlying assets would otherwise qualify. The exchanger needs title to the actual working interest, not a unit in a fund or limited partnership.

Tax Exposure Modeled in Advance

The exchanger has preliminary confirmation from a CPA that NIIT exposure (3.8 percent under IRC Section 1411), depreciation recapture (unrecaptured Section 1250 gain, capped at 25 percent federal), and the relevant state capital gains rate have been modeled for the no exchange scenario, so the cost of a failed or partial exchange is understood in dollar terms before the clock starts.

Required Inputs & Tools

The following inputs are needed before and during the process:

1 Signed QI Exchange Agreement

A signed Qualified Intermediary exchange agreement and assignment of the purchase and sale agreement for the relinquished property.

2 Relinquished Property Closing Date

The relinquished property's closing date, which starts both statutory clocks simultaneously.

3 Written Identification Document

A written, signed identification document meeting the "unambiguous description" standard: for a working interest, this means the lease name, well name or unit name, API number, county, and state, in the same way a real estate identification would list an address and legal description.

1 Working Interest Opportunity Access

Access to a working interest opportunity with a confirmed legal description, operating agreement, and title opinion, available for identification before day 45.

2 Tax Opinion Letter

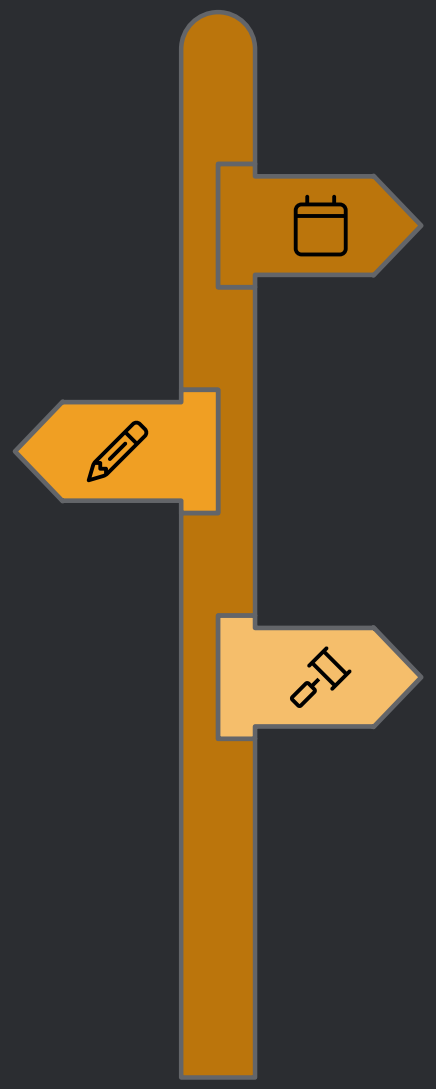
A tax opinion letter or memorandum addressing the like kind qualification of the specific working interest being acquired, prepared by the exchanger's counsel or the QI's counsel.

3 IRS Form 8824

IRS Form 8824, used to report the exchange on the exchanger's tax return for the year the relinquished property closed.

The Exchange Clock: Process Overview

The process runs on two statutory clocks that start on the same day, the closing date of the relinquished property, and run concurrently rather than sequentially. The exchanger has 45 calendar days to identify replacement property in writing, and a total of 180 calendar days (not 225) to close on the replacement property or the due date of the exchanger's tax return, whichever is earlier. There is no extension for weekends or holidays, and the only recognized extension is for a federally declared disaster under Revenue Procedure 2018-58. Within this structure, a working interest is treated procedurally the same way any other piece of identified real property would be treated: it must be identified in writing by day 45, and title must close by day 180.



Day 0: Relinquished Closes

Both exchange clocks start on the relinquished property closing date.

Days 1–45: Identify Replacement

Identify replacement property in writing; include working interest description.

Days 46–180: Close Replacement

Qualified intermediary releases funds and title is conveyed to complete the exchange.

⚠ The 45 day and 180 day periods run **concurrently**, not sequentially. The total is 180 days — not 225. There is no administrative extension except for a federally declared disaster under Rev. Proc. 2018-58.

Step-by-Step Process

01

Engage the QI Before Closing

Engage the QI before the relinquished property closes. Confirm in writing that the QI will hold the exchange proceeds and will accept a working interest as a category of identified replacement property. Not every QI has handled a resource based exchange before, so this is the point to confirm direct experience rather than assuming familiarity.

02

Close the Relinquished Property

This closing date is the trigger for both the 45 day and 180 day clocks. Confirm the exact closing date and calendar both deadlines immediately, since there is no administrative extension available absent a declared disaster.

03

Identify the Working Interest in Writing (Day 45)

The identification must be signed by the exchanger and delivered to the QI or another non-disqualified party before midnight on day 45. The description must be specific: lease name, well or unit name, API number, county, and state. A disqualified person — meaning the exchanger's attorney, CPA, employee, investment banker, or a real estate agent who performed services for the exchanger in the two years prior — cannot be the recipient of this identification.

04

Apply the Correct Identification Rule

The **Three Property Rule** allows identification of up to three properties of any value. The **200 Percent Rule** allows identification of any number of properties as long as their combined fair market value does not exceed 200 percent of the relinquished property's value. The **95 Percent Rule** allows identification of any number of properties without a value cap, but requires the exchanger to actually acquire at least 95 percent of the identified value, making it the highest risk approach and generally a last resort. An identification can be revoked and replaced at any time before day 45 closes.

05

Confirm Legal Qualification Under Rev. Rul. 68-331

Confirm legal qualification of the specific working interest under Revenue Ruling 68-331, which holds that an exchange of a lessee's interest in a producing oil lease, extending until exhaustion of the deposit, held for productive use in a trade or business or for investment, for a fee interest in improved real property, is an exchange of like kind property under Section 1031(a). The related classification of a lessee's interest in oil and gas in place as real property for federal tax purposes is addressed in the companion Revenue Ruling 68-226. Together, these rulings are the basis for treating a direct working interest as qualifying replacement property, and the exchanger's tax opinion letter should reference the specific fact pattern being relied upon.

06

Close on the Working Interest (Day 180)

Close on the working interest within 180 calendar days of the relinquished property's closing date, or by the tax return due date for that year, whichever is earlier. The QI releases funds directly for the acquisition, and title to the working interest is conveyed, consistent with the standard delayed exchange structure in which the QI never takes title itself. Form 8824 is then prepared with the exchanger's return to report the exchange.

Parallel Path: Tax Boot Mitigation via Section 263(c)

If the 45 day window has already passed without a usable identification, if a suitable working interest cannot be identified in time, or if a portion of the sale proceeds will be received as boot (cash or debt relief not reinvested), the exchanger can separately evaluate a direct capital contribution into a working interest outside the exchange structure.

This is not a 1031 transaction. It is a standalone acquisition timed to the same tax year as the boot or the failed exchange gain. The working interest's intangible drilling costs can be the subject of a Section 263(c) election, which permits certain drilling costs to be deducted in the year incurred rather than capitalized, up to 100 percent 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.

This deduction does not erase the exchange failure, but it directly offsets ordinary or capital income in the same return, which is the mechanism most property owners are unaware of when they are only told to "find another property" after the 45 day window closes.

Key Code Sections to Review with Your CPA

A CPA should confirm whether the exchanger's involvement meets the direct holding requirement under **IRC Section 469(c)(3)**, which treats a working interest held directly, without a form limiting liability, as exempt from the passive activity loss limitation, allowing the deduction to offset active or portfolio income rather than being trapped as a passive loss.

The **IRC Section 465** at-risk rules and the **Section 57(a)(2)** alternative minimum tax preference for excess IDC should also be reviewed with the exchanger's CPA before the contribution is finalized.

- The IDC deduction offsets income in the **same tax year** as the gain or boot — timing the contribution correctly is essential.

Decision Points & Roles

Five Critical Decision Points

1

Day 0 — QI Engagement

Is a QI already in place before the relinquished property closes? If not, the exchange cannot proceed under Section 1031 regardless of later steps.

2

Day 1–45 — Working Interest Identification

Can a working interest meeting the exchanger's diversification and cash flow objectives be identified in writing, with a complete legal description, before midnight on day 45? If the answer becomes no as day 45 approaches, this is the point to evaluate the Tax Boot Mitigation path rather than forcing an identification that cannot be supported.

3

Identification Rule Selection

Does the exchanger's situation call for the Three Property Rule, the 200 Percent Rule, or the 95 Percent Rule? This decision affects how much flexibility remains if a specific working interest falls out of contract after identification.

4

Day 46–180 — Closing Monitoring

Will title close and will the QI release funds before day 180 or the tax return due date, whichever is earlier? Extensions are not available outside a federally declared disaster, so this decision point is really a monitoring function rather than a true choice.

5

Boot Exposure Modeling

If any boot is unavoidable, either by design or because full value could not be reinvested, has the exchanger modeled the combined exposure to federal capital gains, NIIT, and depreciation recapture, and compared that figure against the available IDC deduction from a direct working interest contribution?

Roles & Responsibilities

The Exchanger (Property Owner)

Confirms the relinquished property's closing date, signs the identification document within 45 days, reviews the working interest's legal description and title, and directs the CPA to confirm all tax positions before the deadlines.

The Qualified Intermediary

Holds the exchange proceeds, receives or is named in the identification document, confirms the identification meets the applicable rule, and releases funds at closing on the replacement property. The QI does not take title to either property and has no economic interest in the transaction beyond its exchange fee.

The Exchanger's CPA or Tax Attorney

Confirms the working interest's qualification under Revenue Ruling 68-331, prepares or reviews the tax opinion letter, models NIIT and depreciation recapture exposure, evaluates the Section 469(c)(3), 465, and 57(a)(2) considerations for the IDC election, and prepares Form 8824.

Summit Ventures (JV Counterparty)

Provides the working interest's legal description, lease documentation, and operating agreement needed for identification, coordinates directly with the exchanger's QI and counsel on title and closing timing, and maintains operational transparency on the asset through governance rights built into the joint operating agreement once the exchanger becomes an active JV member and working interest owner.

Common Problems & Quality Checks

Common Problems to Avoid

- Engaging a QI after the relinquished property has already closed, which disqualifies the exchange entirely regardless of any later identification.
- Identifying a fund unit, limited partnership interest, or multi member LLC interest in an entity that owns working interests, rather than the working interest itself. Under Revenue Ruling 78-135 and related guidance, an entity interest does not qualify as like kind real property even when the entity's underlying assets would.
- Delivering the identification to a disqualified person, such as the exchanger's own attorney or CPA, which can invalidate an otherwise timely identification.
- Treating the 45 day and 180 day periods as sequential (producing a mistaken 225 day total) rather than concurrent, which leads exchangers to believe they have more time than they actually do.
- Waiting until day 40 or later to begin evaluating working interest opportunities, leaving no time for the title opinion, operating agreement review, or tax opinion letter that a defensible identification requires.
- Assuming a flat percentage IDC deduction without confirming the actual drilling cost structure, elections made, and the exchanger's individual tax position with a CPA.

Quality Checks by Stage

Before Day 45

Confirm the identification document is signed, dated, and delivered to the QI or a non-disqualified party, and that the working interest description includes lease name, well or unit name, API number, county, and state. Confirm which identification rule (Three Property, 200 Percent, or 95 Percent) applies and that the identified value or property count stays within that rule's limits.

Before Closing

Confirm the tax opinion letter addresses the specific working interest and cites Revenue Ruling 68-331 (and 68-226 where the real property classification itself is at issue) against the exchanger's actual fact pattern, not a generic template. Confirm the exchanger will hold the working interest directly or through a single member LLC or tenancy in common, not a multi member LLC, partnership, or fund unit.

After Closing

Confirm Form 8824 is prepared consistent with the QI's closing statement and the exchanger's basis records.

If Tax Boot Mitigation Path Is Used

Confirm the capital contribution and the IDC election are documented in the same tax year as the gain or boot being offset, and that the CPA has confirmed the Section 469(c)(3) direct holding standard is met.

Expected Outcome & Next Steps

When this process is followed correctly, the exchanger completes a Section 1031 exchange in which the relinquished commercial, multifamily, or land asset is replaced with a direct working interest in a producing or development oil and gas lease, deferring recognition of the capital gain, depreciation recapture, and NIIT that would otherwise be due in the year of sale. The exchanger becomes an active JV member and working interest owner with governance rights under the joint operating agreement, rather than a passive unit holder in a pooled structure, and exits the ongoing property management responsibilities associated with the relinquished real estate.

Where the exchange clock cannot be met or boot is unavoidable, the exchanger instead completes a direct capital contribution into a working interest in the same tax year, supported by a Section 263(c) IDC election that offsets a measurable portion of the taxable gain, with the specific deduction amount confirmed by the exchanger's CPA based on the well's actual drilling cost structure.

Key Questions Before You Proceed

- Has the QI been engaged and confirmed in writing before the relinquished property closes?
- Does the exchanger have a specific lease name, well or unit name, API number, county, and state ready to include in a written identification before day 45?
- Will the working interest be held directly, through a single member LLC, or through tenancy in common, rather than through a partnership or fund unit?
- Has the CPA modeled the combined federal capital gains, NIIT, and depreciation recapture exposure under a no exchange scenario, so the Tax Boot Mitigation path can be compared on a dollar basis if needed?
- Has the tax opinion letter been reviewed against Revenue Ruling 68-331 and the specific facts of this working interest, rather than a generic exchange template?
- Is there enough time remaining before day 45 to complete title review and operating agreement review on the identified working interest?

Closing Perspective

A working interest is one of a narrow set of asset classes that can satisfy the statutory like kind standard under Section 1031 while also offering a documented path out of the recurring management obligations tied to another real estate acquisition. The identification and closing clocks do not pause for due diligence, so the coordination sequence between the exchanger, the QI, and the working interest counterparty has to start before the relinquished property closes, not after.

Property owners who understand both paths — the direct exchange route under Revenue Ruling 68-331 and the Section 263(c) boot mitigation route when the clock or the inventory does not cooperate — are in a stronger position to make a documented decision rather than a rushed one.

The next step is a direct conversation with a CPA or exchange attorney to confirm how these mechanics apply to a specific relinquished property, timeline, and tax position, followed by a working session with Summit Ventures to review available working interest opportunities, lease documentation, and the joint operating agreement governing active participation.

Key Legal References

IRC §1031(a) · Rev. Rul. 68-331 · Rev. Rul. 68-226 · Rev. Rul. 78-135 · IRC §263(c) · IRC §469(c)(3) · IRC §465 · IRC §57(a)(2) · IRC §1411 · Treas. Reg. §1.1031(k)-1 · Rev. Proc. 2018-58 · IRS Form 8824

Schedule a Working Session with Summit Ventures

Review Available Working Interests