Tax Traps in Oil and Gas Like-Kind Exchange Transactions

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§ 14.01 Oil and Gas Like-Kind Exchange Transactions after Tax Reform

[1] Background Considerations

The Tax Cuts and Jobs Act, Public Law No. 115-97, signed into law on December 22, 2017 (the "Jobs Act"), amended Section 1031 of the Internal Revenue Code of 1986, as amended (the "Code")[1] by limiting its application solely to exchanges of real property – exchanges of like-kind personal property no longer qualify for gain deferral. Because most forms of upstream oil and gas interests (e.g., operating and non-operating working interests and royalty interests) qualify as real property for federal income tax purposes, Section 1031 continues to be relevant from a federal income tax planning perspective.

This paper assumes a basic knowledge of and familiarity with Section 1031, and does not offer a comprehensive discussion of the requirements for tax-deferral under Section 1031 of the Code and the Treasury Regulations promulgated thereunder. Rather, this paper focuses on the key federal income tax traps commonly encountered in structuring like-kind exchange transactions involving oil and gas assets.

[2] Jobs Act Transition Rule for Personal Property Exchanges

Prior to the enactment of the Jobs Act, personal property could be exchanged for other "like-kind" or "like-class" personal property in a tax-deferred exchange under Section 1031. While the Jobs Act limitation generally applies to exchanges completed after December 31, 2017, there is a transition rule for deferred forward exchanges in which Relinquished Property[2] is disposed of on or before December 31, 2017, even if the Replacement Property[3] is acquired in 2018.[4]

[1] All references to Sections are intended as references to sections of the Code unless otherwise provided.

[2] Throughout this paper, "Relinquished Property" shall mean the real property that the taxpayer intends to dispose of in a transaction qualifying as a like-kind exchange under Section 1031 and the Treasury Regulations thereunder.

[3] Throughout this paper, "Replacement Property" shall mean the real property that the taxpayer intends to acquire in exchange for its Relinquished Property in a transaction qualifying as a like-kind exchange under Section 1031 and the Treasury Regulations thereunder.

[4] The Tax Cuts and Jobs Act, Pub. L. No. 115-97, § 13303(c)(2)(A) (2017).

A second transition rule applies to exchanges in which Replacement Property is "received" on or before December 31, 2017.[5] Congress may have intended this second transition rule to apply to reverse exchanges where Replacement Property was "parked" with an exchange accommodation titleholder (an "EAT") in 2017 even though the exchange is not completed until 2018. It is not clear, however, that this second transition rule applies to such reverse exchanges because, as a technical matter, the Replacement Property would not be treated as "received" by the taxpayer in 2017. Rather, the EAT would be treated as having received the property in 2017. The more conservative reading of the second transition rule is that it does not apply to such reverse exchanges begun in 2017 but completed in 2018.

§ 14.02 Does a Like-Kind Exchange Make Sense?

[1] How Much Gain Could be Deferred?

Taxpayers often spend considerable time and money attempting to structure into a forward or reverse like-kind exchange only to discover that little or no gain can be deferred. The first step in determining whether to undertake a like-kind exchange is to determine the total gain that would be realized with respect to the Relinquished Property (i.e., the fair market value ("FMV") of the Relinquished Property minus the taxpayer's adjusted tax basis therein) if such property were sold or otherwise disposed of in a taxable transaction. This is the maximum amount of gain that could be deferred in a like-kind exchange.

The general rule under Section 1031(a)(1) is that no gain or loss is recognized on the exchange of real property held for productive use in a trade or business or for investment if such property is exchanged solely for real property of like kind which is to be held either for productive use in a trade or business or for investment.

Section 1031(b) provides that if an exchange would be within the provisions of Section 1031(a) *but for* the receipt of money or other property ("boot") in addition to like-kind real property, then the gain, if any, realized on the exchange shall be recognized, but in an amount not in excess of the sum of the money and the FMV of the other property received.[6] In other words, built-in gain in the Relinquished Property is recognized to the extent of the boot received.

For example, if a taxpayer's Relinquished Property had a FMV of $1,000,000 and an adjusted tax basis of $750,000, the maximum gain that may be deferred in an exchange would be $250,000. If the taxpayer acquires $1,000,000 (or more) of qualifying like-kind real property, all of that gain may be deferred (subject to the recapture discussion in § **14.02[2]**). However, if the taxpayer receives only $500,000 of like-kind Replacement Property and $500,000 of cash, then the taxpayer would recognize all of the $250,000 of gain. It is therefore important to determine the maximum amount of gain that may be deferred, and what portion of that gain is likely to be deferred, early on in the tax planning process.

[2] Tax Trap: Section 1254 Recapture

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[5] *Id.* at § 13303(c)(2)(B).

[6] However, no loss is recognized on such exchanges. I.R.C. § 1031(c).

[a] In General

Section 1254 applies to dispositions of "natural resource recapture property" as defined in Treasury Regulations Section 1.1254-1(b)(2) ("Section 1254 Property").[7] In general, if Section 1254 Property is disposed of, any intangible drilling and development costs ("IDCs") that were previously deducted and any depletion that reduced the adjusted basis of such property must be recaptured as ordinary income to the extent of any gain realized on the disposition (the "1254 Recapture Amount").[8]

[b] Operation of Section 1254 with Section 1031

The operation of Section 1254 is one potential tax trap to keep in mind in structuring a like-kind exchange transaction. Specifically, the recapture rules may require the recapture of more ordinary income than the gain that would otherwise be recognized under Section 1031 alone.

In a like-kind exchange under Section 1031, the 1254 Recapture Amount, if any, is recognized to the extent of the sum of (i) the amount of gain recognized under Section 1031 and (ii) the FMV of property acquired that is not Section 1254 Property and that is not taken into account under clause (i) (i.e., the FMV of like-kind real property that is *not* Section 1254 Property).[9] In other words, Section 1254 Property (e.g., a working interest in a developed oil and gas lease) cannot be exchanged into real property that is not also Section 1254 Property (e.g., a ranch) without triggering recapture of prior deductions.

[c] Undeveloped Acreage

There is some uncertainty about whether developed oil and gas acreage (with respect to which the taxpayer has properly deducted IDCs and depletion) may be exchanged for undeveloped oil and gas acreage without triggering Section 1254 recapture.

The Treasury Regulations define "natural resource recapture property" as:

> (i) property placed in service by the taxpayer after December 31, 1986 if expenditures described in Section 263, 616 or 617 are *properly chargeable* to such property or if the adjusted basis of such property includes adjustments for deductions for depletion under Section 611, and

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[7] "Natural resource recapture property" includes (i) "Section 1254 property," meaning property placed in service by the taxpayer after December 31, 1986 if expenditures described in Section 263, 616 or 617 are properly chargeable to such property or if the adjusted basis of such property includes adjustments for deductions for depletion under Section 611, and (ii) "oil, gas, or geothermal property" placed in service by the taxpayer before January 1, 1987 if any expenditures described in Section 263, 616 or 617 are properly chargeable to such property.

[8] *See generally* I.R.C. § 1254(a).

[9] Treas. Reg. § 1.1254-4(d)(1).

(ii) "oil, gas, or geothermal property" placed in service by the taxpayer before January 1, 1987 if any expenditures described in Section 263, 616 or 617 are *properly chargeable* to such property.[10]

The Treasury Regulations go on to provide, however, that "[a]n expenditure is *properly chargeable* to property if [t]he property is an operating mineral interest with respect to which the expenditure *has been deducted*…."[11] Interestingly, the depreciation recapture rules under Sections 1245 and 1250, which provide for a similar recapture regime as Section 1254, more generally refer to property "of a character subject to the allowance for depreciation."[12] The past-tense formulation in the Section 1254 Regulations (i.e., "has been deducted") creates some risk as to whether Replacement Property must be developed in order to avoid IDC and depletion recapture on the Relinquished Property in a like-kind exchange.[13]

[d] Examples

Base Case: Taxpayer exchanges a working interest in one oil and gas lease with an adjusted tax basis of $0 and a FMV of $100 for a working interest in another oil and gas lease of the same FMV. Both of the oil and gas leases are developed. Taxpayer had taken $80 of IDCs and $20 of depletion on the relinquished lease. No gain is recognized in the exchange, and no amount of IDC or depletion recapture is triggered. The entire 1254 Recapture Amount is carried over to the Replacement Property.[14]

Base Case with Boot: Taxpayer exchanges a working interest in one oil and gas lease with an adjusted tax basis of $0 and a FMV of $100 for a working interest in another oil and gas lease with a FMV of $80 and $20 cash. Both of the oil and gas leases are developed. Taxpayer had taken $80 of IDCs and $20 of depletion on the relinquished lease. Taxpayer recognizes gain to the extent of the $20 of cash boot received, and all $20 is recaptured as ordinary income under Section 1254.

Base Case with Boot and Non-Section 1254 Property: Taxpayer exchanges a working interest in one oil and gas lease with an adjusted tax basis of $0 and a FMV of $100 for a working interest in another oil and gas lease with a FMV of $50, an interest in ranch land held for investment with a FMV of $40 and $10 cash. Both of the oil and gas leases are developed. Taxpayer had taken $80 of IDCs and $20 of depletion on the relinquished lease. Under this set of facts, the taxpayer would recognize $10 of gain under Section 1031, and would be required to recapture $50 as ordinary income under Section 1254 notwithstanding that the $40 interest in ranch land is real property that is like-kind to the taxpayer's Relinquished Property. The result

[10] Treas. Reg. § 1.1254-1(b)(2)(i) (emphasis added).
[11] Treas. Reg. § 1.1254-1(b)(2)(iv)(A)(1) (emphasis added).
[12] Treas. Reg. §§ 1.1245-3(a)(1) (defining "section 1245 property"), 1.1250-1(e)(1) (defining "section 1250 property").
[13] Tax practitioners recognize this risk and several commentators have discussed the issue. *See, e.g.*, MARY B. FOSTER & JEREMIAH LONG, TAX-FREE EXCHANGES UNDER SECTION 1031 § 4:20 (2016-17) (suggesting that, because the amount of development is not specified under Section 1254 or the Treasury Regulations thereunder, the seller of Replacement Property "may be able to expend a small amount on drilling costs so that the mineral interest would be considered developed" for purposes of Section 1254).
[14] Treas. Reg. § 1.1254-3(d).

likely would be the same if, instead of acquiring ranch land, the taxpayer acquired an undeveloped oil and gas lease.

§ 14.03 Real Property

[1] In General

As briefly discussed in **§ 14.01**, the Jobs Act amended Section 1031, limiting its application solely to exchanges of real property.

Real property is generally considered to be like-kind to other real property despite significant differences in the nature of the properties.[15] For example, an exchange of like-kind real property was found in the following scenarios:

> (i) an exchange of an undivided interest in unimproved real estate for an interest in overriding oil and gas royalties;[16]
>
> (ii) an exchange of mineral properties for an undivided interest in a hotel;[17]
>
> (iii) an exchange of working interests in two leases;[18] and
>
> (iv) an exchange of an interest in a producing lease of an oil deposit in place for a fee interest in an improved ranch.[19]

While many forms of oil and gas interests qualify as real property for U.S. federal income tax purposes,[20] not all oil and gas interests are treated as real property for federal income tax purposes, even if the particular interest *is* treated as real property under applicable state law.[21]

[2] Tax Trap: Production Payments and Other Limited Mineral Interests

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[15] *See Comm'r v. Crichton*, 122 F.2d 181 (5th Cir. 1941) (stating that the statute "was not intended to draw any distinction between parcels of real property however dissimilar they may be in location, in attributes and in capacities for profitable use"). Section 1031(h) provides an exception to this rule—real property located in the United States and real property located outside the United States are not property of a like kind.

[16] G.C.M. 34651 (Oct. 20, 1971).

[17] *Crichton*, 122 F.2d 181.

[18] Rev. Rul. 68-186, 1968-1 C.B. 354.

[19] Rev. Rul. 68-331, 1968-1 C.B. 352.

[20] *See, e.g.*, *Palmer v. Bender*, 287 U.S. 551 (1933) (royalty interest); Rev. Rul. 73-428, 1973-2 C.B. 303 (royalty interest); Rev. Rul. 72-117, 1972-1 C.B. 226 (overriding royalty interest); Rev. Rul. 68-226, 1968-1 C.B. 362 (interest of a lessee in oil and gas in place).

[21] *See, e.g.*, Rev. Rul. 68-226, 1968-1 C.B. 362 (stating that federal tax law is not subject to state law unless express language provides otherwise or the necessary implication of the section involved so requires).

Production payments and other oil and gas interests that are limited in duration are not considered real property for federal income tax purposes and do not qualify for deferred tax treatment under Section 1031. Rather, production payments are generally treated as debt obligations.[22]

In distinguishing between oil and gas interests that are characterized as real property and those that are not, one important factor is the duration of the interest. Royalty interests, working interests, and other similar interests discussed in **§ 14.03[1]** only expire when the mineral deposit is exhausted and represent an economic interest in the minerals in place.[23] Oil and gas interests that expire before the mineral deposit is exhausted, such as interests that expire upon (i) the receipt of a definite sum of money, (ii) the production of a specified quantity of minerals, or (iii) any other event that results in an interest of limited duration, are not real property for federal income tax purposes.[24] For example, interests that do not qualify as like-kind real property for purposes of a Section 1031 exchange include the following:

> (i) an exchange of a limited oil payment right for an overriding royalty reserved from the same lease;[25]
>
> (ii) an exchange of carved-out oil payment rights of limited duration for a fee interest in a ranch;[26] and
>
> (iii) an exchange of a lease for a stated amount of oil to be recovered from other lands or leases of the other parties to the transaction.[27]

As a result, taxpayers should be cautious in effecting a Section 1031 exchange where the Relinquished Properties or the Replacement Properties may include such limited interests.

§ **14.04 Tax Trap: Tax Partnerships**

[1] In General

Section 1031 does not apply to exchanges of partnership interests.[28] By default, jointly owned operating oil and gas interests are treated as held by a tax partnership for federal income tax purposes, unless a valid election is made for such an arrangement to be excluded from the application of Subchapter K of the Code under Section 761.[29] Therefore, diligence should be undertaken to confirm that the Relinquished Property is not (and that the Replacement Property will not be) treated as held in a tax partnership prior to effecting a 1031 exchange.

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[22] *See* I.R.C. § 636; *Comm'r v. P.G. Lake, Inc*., 356 U.S. 260 (1958).

[23] *See Palmer v. Bender*, 287 U.S. 551 (1933).

[24] *Koch v. Comm'r*, 71 T.C. 54, 65 (1978) (pointing out the differences between an overriding royalty interest (a real property interest) and a carved-out oil payment (not a real property interest)).

[25] *Midfield Oil Co*., 39 B.T.A. 1154 (1954).

[26] *Fleming v. Comm'r*, 24 T.C. 818 (1955).

[27] *Bandini Petroleum Co*., 10 CCH TCM 999 (1951).

[28] I.R.C. § 1031(a)(2).

[29] I.R.C. § 761(a).

[2] Election Out

Section 761(a) provides that co-owners of operating oil and gas assets may, if certain requirements are satisfied, elect to be excluded from the provisions of Subchapter K (an "election out"). If a valid election out is in place, a co-owner may exchange its jointly held assets in an exchange that qualifies under Section 1031.[30]

In order to be eligible to make an election out, (i) the parties must own the property as co-owners, (ii) the parties must have the right to separately take in kind or dispose of its share of any property produced, extracted or used, (iii) any delegations of authority to sell a co-owner's share of property produced or extracted must be only for such reasonable periods of time as are consistent with the minimum needs of the industry, but in no event for a period in excess of one year, and (iv) if the property will produce natural gas, any imbalances must be resolved using the cumulative gas balancing method.[31]

An election out is made on a statement filed with a properly executed blank Form 1065, containing only (i) the names, addresses and identification numbers of all the co-owners, (ii) a statement that the organization qualifies to make the election, (iii) a statement that all of the co-owners elect that the organization be excluded from all of Subchapter K, and (iv) a statement indicating where a copy of the agreement under which the organization operates is available.[32]

There is some risk that an election out made on the eve of a like-kind exchange, or as part of a plan to undertake a like-kind exchange, may not be respected by the IRS. The IRS has challenged certain exchange transactions in which the taxpayer received the Relinquished Property as a distribution from an entity prior to the exchange on the basis that the Relinquished Property was not "held for productive use in a trade or business or for investment" at the time of the exchange.[33] However, the IRS generally has not been successful in challenging such exchanges.[34]

§ 14.05 Tax Trap: Retaining an Overriding Royalty Interest

In connection with the disposition of a working interest, it is not uncommon for a taxpayer to retain an overriding royalty interest ("ORRI"). In some cases, the taxpayer may do this in order to retain an interest in the upside of the oil and gas play. In other cases, the retention of an ORRI is an efficient way to reduce the conveyed net revenue interest ("NRI") to a certain target NRI desired by prospective acquirers. However, employing this strategy may jeopardize the taxpayer's ability to use the transaction proceeds to effect a like-kind exchange. In general, the retention of an ORRI in connection with the sale of a working interest causes the

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[30] I.R.C. § 1031(e).

[31] Treas. Reg. §§ 1.761-2(a)(3), 1.761-2(d)(2).

[32] Treas. Reg. § 1.761-2(b)(2).

[33] *See, e.g.*, Rev. Rul. 77-337, 1977-2 C.B. 305 (concluding that "a prearranged plan" to liquidate the taxpayer's wholly owned corporation in order to exchange the property received in the liquidation for other like-kind property did not qualify for nonrecognition under Section 1031).

[34] See Richard M. Lipton, Samuel P. Grilli & Samuel Pollack, The 'State of the Art' in Like-Kind Exchanges-2015, 124 J. TAX'N 5 (2016) and Richard M. Lipton & Leah J. Gruen, The 'State of the Art' in Like-Kind Exchanges, 2012, 116 J. TAX'N 246 (2012) for a thorough discussion of this risk and analysis of the relevant authorities.

purported sale to be treated as a lease or sublease for federal income tax purposes, and the upfront proceeds received are treated as advanced royalties/lease bonus.[35] Recall that one of the key requirements of a like-kind exchange is that the property be exchanged for like-kind property – a leasing transaction is not an exchange for this purpose and therefore cannot qualify for deferral under Section 1031.

The lease-versus-sale determination is made on a lease-by-lease basis.[36] In other words, in a disposition of two oil and gas leases in which an ORRI is retained on one but not both leases, the transfer of the lease on which an ORRI is retained will not qualify as Relinquished Property in a like-kind exchange, but the other lease will continue to qualify. Thus, the leasing "taint" does not disqualify both leases – just the lease or leases with respect to which an ORRI is retained.

One potential avenue for avoiding the leasing or subleasing characterization is to retain a production payment rather than an ORRI. The key distinction between a production payment and a royalty or ORRI is that a production payment is treated as a debt obligation or a loan rather than an economic interest in the minerals in place. In retaining a production payment, the taxpayer retains a right to receive a specified percentage of all oil and gas produced (or the proceeds from such production) for a period of time *short of* the full economic life of the mineral deposit.[37] The risk in taking the position that the retained interest is a production payment rather than a royalty is that the taxpayer must establish that the production payment is "not reasonably . . . expected to extend in substantial amounts over the entire productive life of such mineral property."[38]

Another potential structuring alternative that may be considered is to carve-off an ORRI on the taxpayer's leases having an NRI above a certain threshold and convey it to a separate regarded affiliate of the taxpayer – well in advance of the sale or exchange transaction. This structure should only be undertaken if the taxpayer can establish a meaningful non-tax business purpose for holding royalty interests or ORRIs in a separate legal entity. There is very little authority on this structure, and there are no bright lines or guideposts available. For instance, it is not clear how much time must elapse between the conveyance of an ORRI and the disposition of the working interest burdened thereby. Nor is it clear what types of non-tax business purposes may substantiate this type of separation of ORRIs and working interests. The risk is that the IRS applies substance-over-form or step transaction principles to collapse the retention of the ORRI with the later disposition of the working interest and challenge the structure as nevertheless resulting in a leasing transaction. Taxpayers exploring this option should engage their tax advisors early on in the process.

§ 14.06 Identification Traps

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[35] *Crooks v. Comm'r*, 92 T.C. 816, 818 (1989) ("When a mineral interest is assigned for a lump-sum cash consideration and the assignor retains a right to receive a specified percentage of all oil and gas produced for the economic life of the mineral deposit, the transaction is a lease and payments received under such lease are ordinary income.").

[36] *Cullen v. Comm'r*, 118 F.2d 651 (5th Cir. 1941).

[37] Treas. Reg. § 1.636-3(a)(1).

[38] Rev. Rul. 86-119, 1986-2 C.B. 81.

[1] Tax Trap: Unambiguously Identifying Oil and Gas Properties

Final Treasury Regulations in the forward exchange context (the "Forward Exchange Regs")[39] require the identification of potential Replacement Properties in a forward exchange to be made in a written document that is signed by the taxpayer and sent to the qualified intermediary ("QI") prior to the end of the 45-day identification period. The description must unambiguously describe the property. In general, real property is unambiguously described if a legal description is provided, an address is provided, or it is described by a distinguishable name.

In describing oil and gas assets, the property (or package of assets) should not be mistaken for another property (or package of assets), but there are no specific guidelines as to how oil and gas assets must be identified. Taxpayers should generally provide the same level of specificity that the leases and wells exhibits to a standard purchase agreement would provide. Alternatively, depending on the facts and circumstances, the taxpayer may be able to unambiguously describe the Replacement Property as all of the taxpayer's leases in a particular area outlined on an aerial map, or in a particular county or counties, for example.

[2] Tax Trap: Identifying Multiple Replacement Properties in a Forward Exchange

The Forward Exchange Regs provide two key rules for identifying multiple or alternative Replacement Properties in a deferred forward exchange:

> **Three Property Rule**: Taxpayer may identify up to three properties of any value as part of the same deferred exchange (regardless of the number of properties relinquished).
>
> **200% Rule**: Taxpayer may identify any number of properties as long as their aggregate FMV as of the end of the 45-day identification period does not exceed 200% of the aggregate FMV of all the relinquished properties as of the date the relinquished properties were transferred by the taxpayer.

Acquisitions and dispositions of oil and gas properties may involve tens or hundreds of leases spanning multiple counties and even multiple states, and it is not clear what a single "property" means for purposes of Section 1031. In an acquisition involving multiple leases, is each lease a separate property?

Unfortunately, there is no on-point authority on this issue in the Section 1031 context. In the depletion context, Section 614 defines "property" as "each separate interest owned by the taxpayer in each mineral deposit in each separate tract or parcel of land."[40] Section 614 further provides that in the case of oil and gas wells, "all of the taxpayer's operating mineral interests in a separate tract or parcel of land shall be combined and treated as one property, and the taxpayer

[39] Treas. Reg. § 1.1031(k)-1.
[40] I.R.C. § 614(a).

may not combine an operating mineral interest in one tract or parcel of land with an operating mineral interest in another tract or parcel of land."[41]

It may be possible for taxpayers to look to the Section 614 construct of "property" in order to attempt to satisfy the Three Property Rule in a like-kind exchange transaction, but given the lack of authority in the like-kind exchange context around the meaning of "property" for purposes of applying the identification rules, taxpayers should be wary of relying on the Three Property Rule. The more prudent approach is to identify an amount of replacement properties meeting the 200% Rule.

This trap is also present in the reverse exchange context, where the taxpayer may identify multiple potential Relinquished Properties, which may consist of multiple leases.[42]

§ 14.07 Reverse Exchanges under Revenue Procedure 2000-37

[1] In General

In a deferred forward exchange, the taxpayer first disposes of Relinquished Property and then acquires Replacement Property in accordance with the specific procedures and safe harbors set forth in the Forward Exchange Regs. Often, however, the taxpayer may have negotiated a purchase agreement for the acquisition of property that could serve as qualifying Replacement Property in an exchange, before they have even identified potential Relinquished Property to sell as part of an exchange transaction. Other times, the taxpayer may have negotiated both an acquisition and a disposition agreement but, for commercial reasons, the closing of the disposition is delayed and cannot occur until after the closing of the acquisition transaction.

In general, a reverse exchange is a transaction in which Replacement Property that the taxpayer wants to acquire is "parked" with an EAT until the taxpayer is able to sell like-kind Relinquished Property and is in a position to effect a simultaneous or forward like-kind exchange using the Relinquished Property proceeds to acquire the parked Replacement Property from the EAT.

Internal Revenue Service Revenue Procedure 2000-37 (the "Rev. Proc.")[43] established a safe harbor for reverse exchanges. Specifically, if the requirements set forth in the Rev. Proc. 2000-37 are followed, the EAT that acquires the Replacement Property will be treated as the owner of such "parked" property for federal income tax purposes until the taxpayer has identified and sold Relinquished Property and used the proceeds to acquire the parked Replacement Property from the EAT in a qualifying like-kind exchange.[44] In order to ensure that a reverse

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[41] I.R.C. § 614(b)(1). Note, however, that under Section 614(b)(2), the taxpayer may be able to elect to treat one or more operating mineral interests in a single tract or parcel of land as separate properties for purposes of computing depletion.

[42] The Rev. Proc. does not provide a separate set of identification requirements for identifying potential Relinquished Properties in a reverse exchange; instead, the Rev. Proc. relies on, and incorporates by reference, the identification requirements under Treasury Regulations § 1.1031(k)-1(c).

[43] *See* Rev. Proc. 2000-37, 2000-40 I.R.B. 308 (Sept. 15, 2000), *modified by* Rev. Proc. 2004-51, 2004-30 I.R.B. 294 (July 20, 2004).

[44] *Id.* at § 2.06.

exchange qualifies as a like-kind exchange under Section 1031, it should be undertaken pursuant to, and in compliance with, the requirements of the Rev. Proc.[45]

[2] Tax Trap: Developing "Parked" Acreage

A reverse exchange is fairly straightforward if the parked Replacement Property consists of solely non-operating interests, but it becomes significantly more complex when the Replacement Property consists of operating interests or if the taxpayer intends to develop the property during the parking period.

Under the Rev. Proc., Replacement Property may be "parked" with the EAT for up to 180 days, and, during such time, the EAT is treated as the beneficial owner of the Replacement Property. One of the consequences of this treatment is that the taxpayer is not entitled to deduct IDCs or depletion or to take depreciation deductions with respect to the property until after the Replacement Property is acquired by the taxpayer. This is admittedly less a "trap" and more a consideration to take into account in determining the potential cost and complexity of structuring into a reverse like-kind exchange.

§ 14.08 Summary

Section 1031 continues to be relevant in the upstream oil and gas space—even after the Jobs Act—but like-kind exchange transactions involving oil and gas properties require careful planning around a number of unique tax traps.

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[45] The specific requirements of the Rev. Proc. are outside the scope of this paper. *See, generally,* FOSTER & LONG, supra note 13.