



Like-Kind (1031) Exchange: Mineral Interest for Rental Real Estate?

by Ryan Duffy

You have been approached with an offer you simply can't refuse to sell your working interest in your minerals in western Oklahoma. While the revenue checks have certainly been good to you, you would like to diversify your holdings. Your accountant runs the numbers for you, and indicates you may face substantial taxable capital gains should you proceed with the sale of mineral interest. The accountant indicates that you may be able to defer or defray the consequences through a "like kind" or "1031" exchange. How do you proceed?

Swapping into another mineral interest is an option, but does not meet your diversification goals. Your tax professional indicates that the IRS allows certain mineral interests to be exchanged for business-use real property, perhaps a rental property.

The IRS does liberally construe interests in real property as "like kind" for the purposes of tax-deferred exchanges. That being said, exchanging certain mineral interests, or sometimes referred to as Section 1254 property (an ode to the Internal Revenue Code Section), may result in recapture of prior tax deductions. This may result in a large tax bill the following year. The recapture problem would not apply to a mineral owner who has never participated in drilling activity.

If a taxpayer seeks to exchange 1254 property, such as a working interest in minerals, for non-1254 property, such as rental real estate, the taxpayer must recognize recapture of certain prior tax deductions as ordinary income. These include intangible drilling costs (IDCs) and other development deductions taken in prior years.

Among other traps, the taxpayer should make sure the rental property is "business use" and not "taxpayer vacation". Excessive personal use of such rental property can void the like-kind exchange, resulting in immediate income recognition, along with additional penalties and interest.

Utilizing like-kind exchanges with mineral interests can be a great way to diversify your holdings. That being said, an ill-conceived exchange can saddle the taxpayer with a big tax bill. Consulting with your accountant or other tax professional can avoid these unwanted traps. If you have resolved the recapture situation and want to exchange but can't locate a suitable replacement, ask your broker or check the internet for "tenant in kind" properties where you can acquire a fractional interest in a building on a long term lease to a well capitalized tenant.