



# Oil & Gas

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## The Big Picture:

Section 1031 of the US Tax Code provides that no gain is taxed when real property held for business or investment is exchanged for other real property held for business or investment. That is, so long as certain procedures are followed, taxes will be deferred. A growing number of sellers and buyers of mineral interests are enjoying the benefits of this tax-saving tool.

## Why It Matters:

The general rule is that when people sell an asset for more than they paid for it, they have to pay income tax. For capital gains, this taxation can remove up to 23.8% of the gain from the sales proceeds that otherwise would pass from the buyer to the seller. This impact can hinder and even halt negotiations. Even if the sale consummates, taxation detracts from the value of any offer. Both the seller and the buyer benefit when capital gain taxes do not have to be subtracted from the sales price. Section 1031 permits non-recognition of gain when one performs an "exchange" of "like-kind" property.

The two keys to availing oneself to the benefits of this tool are:

1. "Exchange" does not mean the seller and buyer actually exchange anything, and
2. "Like-Kind" includes a broad array of interests in real property.

## Definitions:

"Exchange" means that the seller (exchanger) retains a 1031 qualified intermediary (QI) to produce exchange documents at the close of the sale. The QI holds the proceeds from the sale, and within 45 days after closing, the seller identifies potential property(ies) to purchase. Within 180 days after the closing of the sale, the exchanger purchases property(ies) from that list. In other words, an "exchange" does not involve a swap between the seller and buyer. Rather, exchanges are more akin to rollovers, where funds are moved from one or more investments to one or more other investments, conditioned on there being no actual or constructive receipt by the exchanger of funds from the sale(s).

Just as misleading as is the term "exchange" is the term "like-kind". Many people think that a sale of mineral interests must be followed by a purchase of mineral interests, and that a sale of brick and mortar must be followed by a purchase of brick and mortar. Not true. All real property in the US is like-kind to any other real property in the country as long as it is held for use in a business or for investment. Holding property for income or appreciation constitutes "held for investment". Thus, mineral interests that have been held for investment (not purchased for immediate sale after they were acquired) can be sold, and the proceeds can be used to purchase a ranch, residential rental property, commercial buildings, resort investment property or other investment real estate. The following are examples of valid exchanges:

- Mineral interests for investment resort properties.
- Interests in a producing oil lease extending to the exhaustion of the deposit for a ranch.
- Overriding royalties for unimproved real estate.
- Overriding royalties for an undivided interest in a parcel of improved realty.
- Perpetual water rights for a fee interest in land.

## Qualified intermediaries (QIs)

Section 1031 refers to the entity that facilitates a 1031 exchange as a qualified intermediary. There are no federal regulations of QIs. Therefore, no rules govern the ethical or legal duties of QIs or how the exchanger's funds must be secured. So, paramount to every exchange is the security of funds held by the QI. Important questions for prudent investors to ask any QI are:

Are the funds are being held in a reputable and insured financial institution?

In whose name are the funds being held?

What are the requirements for deposits and withdrawals?

What security mechanisms are provided to the exchanger in writing?

How financially stable is the QI?

How financially stable is the QI's accountable parent if one exits?

## The Takeaway

Property owners can have their cake and eat it too if they check into 1031 exchanges. It behooves sellers and buyers of mineral interests to learn why, when and how to perform 1031 exchanges.

## About Us

Greg Lehrmann is the founding member of Excel 1031 Exchange with 42 years of experience in commercial and residential real estate. For the past three decades he has dedicated his career to 1031 exchange work and has handled tens of thousands of exchanges throughout the country.

Mr. Lehrmann is a distinguished attorney double board certified in commercial and residential real estate law by the Texas Board of Legal Specialization. Only 2% of attorneys in Texas meet this exacting standard. He has a B.B.A with honors in accounting from The University of Texas and a J.D. from The University of Texas School of Law.

Mr. Lehrmann and his wife, Texas Supreme Court Senior Justice Debra Lehrmann, have two sons, Gregory & Jonathan, practicing attorneys, and two beautiful grandchildren, Jack (age 4) and Haley (age 2).



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