

Barnett Shale factor

Laws can help buyers, sellers benefit

It is common knowledge that Barnett Shale mineral interests are changing hands at a feverish pace. But few people know that Uncle Sam does not always have to be a partner in these transactions. Both the seller and the buyer benefit when capital-gains taxes do not have to be subtracted from the sales price.



Greg Lehrmann
Guest Column

The general rule is when someone sells something for more than they paid for it, they have to pay income tax. Even for long-term capital gains, this taxation can remove 15 percent or more from the profits that otherwise would pass from the buyer to the seller. This impact can hinder and even halt negotiations. At a minimum, taxation detracts from the value of any offer. For people who have owned their property for decades, almost the entire sales price can be taxable. Sellers get to keep more wealth, and buyers can consummate more deals more quickly if they are knowledgeable about Section 1031 of the Internal Revenue Code.

Section 1031 says *no gain or loss shall be recognized* (taxed) if property held for productive use in a trade or business or held for investment is exchanged solely for property of a like-kind to be held either for productive use in a trade or business, or for investment. The tax is deferred at least until events occur that the seller is usually in control of, and often the tax is eventually eliminated altogether.

Two basic points are key to understanding the availability of this tool:

- “Exchange” does not mean that the seller and the buyer exchange anything.
- “Like-kind” does not mean that the seller of a mineral interest has to buy another mineral interest.

Exchange

“Exchange” means the seller hires a 1031 Qualified Intermediary (QI) to produce Exchange Documents at the closing of the sale. The sale is taxable if proper procedures are not followed at closing. The QI holds the proceeds from the sale. The seller identifies property to purchase within 45 days following the sale and closes on the purchase(s) within 180 days of the sale. A gap in the law is the lack of regulation of QIs by either the federal government or the

State of Texas, despite the fact that QIs hold millions of dollars of sellers’ funds. Corporate America and prudent individuals alleviate this risk by using national QI companies that are owned by heavily regulated major title companies.

In other words, an “exchange” does not involve a swap between the seller and buyer. Rather, exchanges are like retirement-account rollovers, where funds are moved somewhat directly from one investment to another, with no actual or constructive receipt by the seller of the funds.

Like-kind

Just as misleading as the term “exchange” is the term “like-kind.” Many people think a sale of a mineral interest must be followed by the purchase of another mineral interest. Not true. All real estate in the United States is considered to be like-kind to any other real estate in the country, as long as each property qualifies for the proper use. The only requirement to meet the “qualifying use” standard is that the property is held for use in a trade or business or for investment. Holding property for appreciation constitutes “held for investment.” Thus, mineral interests that have been held for investment (not purchased for imminent sale after they were acquired), can be sold, and the proceeds can be used to purchase a ranch, residential rental properties, commercial buildings, resort investment property and so on. The following are examples of valid exchanges:

- Mineral interests for an investment resort property;
- Interest in a producing oil lease extending until the exhaustion of the deposit for a ranch;
- Overriding royalty for unimproved real estate;
- Overriding royalty for an undivided interest in a parcel of improved realty;
- And perpetual water rights for a fee interest in land.

All of the above can be interchanged, and the properties can be in different states. Interests that may not qualify are those limited in duration. And when operating interests are exchanged, the well equipment must be analyzed separately from the exchange of leasehold interests.

Property owners can have their cake and eat it too if they check into 1031 exchanges. Check with your tax adviser to see if you qualify.



PHOTO BY NICK BURATTO

Greg Lehrmann is an attorney who specializes in 1031s. He is board certified in commercial and residential real estate law by the Texas Board of Legal Specialization, and is Texas Division Manager for Asset Preservation Inc., a national 1031 qualified intermediary. He can be reached at 817-300-3851 or greg@apiexchange.com.