

# Exchange Real Estate for Oil & Gas Royalties



In 1968, the IRS published Revenue Ruling 68-331 clarifying Section 1031 of the 1954 Act. The ruling established that real estate ownership interests, whether above or below the ground, met the definition of "like kind" for an exchange. This means investors can exchange traditional real estate holdings for producing oil and gas royalty interests while deferring capital gains taxes.

Oil and gas royalty investment began in the early 1900s. Owners of royalty assets receive monthly "mailbox money" from oil and gas companies who drill and operate wells on their property. Unlike oil and gas drilling investments, royalty owners do NOT invest in capital equipment or field operations. Royalty interest holders do NOT get billed for exploration, drilling, or operating wells, nor do they share in any of the risks or liabilities associated with that side of the industry.

Over the past four decades, court rulings have reaffirmed that oil and gas royalty interests qualify as "like kind" to all other forms of real property. Several Revenue Rulings and Private Letter Rulings have further established the "like kind" nature of royalties when exchanging out of traditional real estate.

## SUPPORTING LEGAL PRECEDENT

- Revenue Rule 55-526
- Revenue Rule 73-248
- Revenue Rule 73-2117
- Private Letter Ruling 8135048
- Crichton v. Commissioner, 122 F. 2d 181
- Palmer v. Bender, 287 U.S. 551

## Royalty Advantages

**Transaction Size Flexibility:** Royalty ownership is a 1031-Exchange alternative that allows you to customize your investment level. Whether you need \$100,000 or \$5,000,000 worth of replacement property, we can carve out the exact interest that fits your exchange.

**Superior Cash Flow Potential:** Royalty properties may offer different return characteristics than traditional real estate. Returns are not guaranteed and depend on production volume, commodity prices, and other factors.

**No Capital Calls:** Royalty owners do not have the risk of having to make capital calls. Investors in oil and gas drilling programs or tenant-in-common real estate do have the risk of having to make capital calls.

**Investor Independence:** Owners of undivided interests in royalty properties are not locked into an ownership structure that links them to other investors in the same property. Each owner is free to exercise control over holding period and exit strategy to suit individual investment objectives.

**Tax Savings:** 15% of royalty income is shielded from tax regardless of the carry-over basis from the previous property.

**Portfolio Diversification:** Cash flow from multiple producing wells and undeveloped acreage for potential future production can alleviate the risk of owning a single property or being over-concentrated in traditional real estate.

## Summary

Oil and gas royalties offer a compelling 1031 exchange alternative for real estate investors. Established by IRS Revenue Ruling 68-331 and reinforced by decades of court decisions, royalty interests qualify as "like kind" to traditional real property. Investors receive passive monthly income with no capital calls, no operating expenses, and full independence over their holding period and exit strategy. The 15% depletion allowance provides additional tax savings on top of the deferral benefits of a 1031 exchange.

*Royalty investments are illiquid, carry geological and market risk, and distributions may vary or cease.*

## Key Takeaways

IRS Revenue Ruling 68-331 and decades of court rulings confirm that oil and gas royalties qualify as "like kind" to traditional real estate for 1031 exchange purposes.

Royalty owners receive passive monthly income with no capital calls, no operating expenses, and no management responsibilities.

The 15% depletion allowance provides ongoing tax savings, while 1031 exchange eligibility allows investors to defer capital gains when transitioning from traditional real estate.

## Disclosures

### GENERAL DISCLOSURE

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### OIL & GAS INVESTMENT RISK DISCLOSURE

- Pricing and production variability: Oil and gas royalty income fluctuates with commodity prices and well production levels. A royalty owner's monthly income moves up and down as commodity prices and production levels fluctuate.
- No guarantee of reserves: There is no guarantee that estimated reserves will be fully recoverable or that production levels will meet initial projections.
- Market risk: A reduction in oil and gas prices, a decrease in demand, or a surplus of available supply can reduce or even eliminate investment returns.
- Liquidity risk: Although royalties are designed as a generational buy-and-hold asset with a healthy secondary market, there is no guarantee of liquidity. Owners can generally liquidate in 90 to 120 days, but this timeline is not assured.
- Political risk: Federal or local governments could enact regulations or legislation that could adversely affect the oil and gas industry, thereby negatively affecting your investment.
- Tax status changes: The income stream and depreciation schedule for any investment property may affect the property owner's income bracket and/or tax status. An unfavorable tax ruling may cancel deferral of capital gains and result in immediate tax liabilities.

### 1031 EXCHANGE RISK DISCLOSURE

- There is no guarantee that any strategy will be successful or achieve investment objectives including, among other things, profits, distributions, tax benefits, exit strategy, etc.
- Potential for property value loss: All real estate investments have the potential to lose value during the life of the investments.
- Change of tax status: The income stream and depreciation schedule for any investment property may affect the property owner's income bracket and/or tax status. An unfavorable tax ruling may cancel deferral of capital gains and result in immediate tax liabilities.
- Illiquidity: These assets are commonly offered through private placement offerings and are illiquid securities. There is no secondary market for these investments.
- Impact of fees/expenses: Costs associated with the transaction may impact investors' returns and may outweigh the tax benefits.
- Stated tax benefits: Any stated tax benefits are not guaranteed and are subject to changes in the tax code. Speak to your tax professional prior to investing.