Comparing Real Estate and Energy Section 1031 Exchanges

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Section 1031 ("§**1031**") of the United States Internal Revenue Code (the "**Code**") allows an investor to sell a property, reinvest the proceeds of such sale in a new property, and defer recognition of capital gains and related federal income tax liability stemming the transaction, if properly structured. The benefits of structuring a series of transactions in accordance with §1031 has led to mainstream alternative investment appeal over the past 15 years. Historically marketed as direct fractional interests in real estate, or tenant-in-common interests ("**TICs**"), these products transitioned to a Delaware Statutory Trust ("**DST**") structure after the Great Recession for a number of reasons, including ease of administration and financing. Despite the challenges of the Great Recession and the ensuing period of product reconstruction in which §1031 product sales dropped from \$4 billion to \$250 million annually (2006-2012), the DST version of the §1031 product reclaimed mainstream status as a non-traded alternative, with annual equity sales of \$1.5 to \$2.5 billion reported from 2016 to 2018. The §1031 product continues to live and breathe as an alternative for Baby Boomers and for other accredited investors who do not want to directly manage real estate, but desire to maintain direct legal ownership in real estate for income tax deferral, cash flow, capital preservation and growth, as well as diversification reasons.

Conventional real estate classes, including multifamily, single tenant net lease, and retail real estate, have predominated the §1031 product sector, with oil and gas minerals and working interests maintaining a sliver of the market share (<1% to 3% annually). While the conventional asset-based products continue to present opportunities for stable cash flows, long-term capital preservation, and in some cases, growth over a six- to 10-year hold period, the energy §1031 product presents a niche avenue for investors with a steeper risk tolerance, as well as an opportunity to achieve an outsized return driven through oil and gas mineral rights ownership and commodity market exposure.

This article discusses the contrasting segments of the real estate DST and energy-based §1031 product sectors.

Real Estate

While direct investments of cash can be placed within §1031 products if justified by careful underwriting, many investors in §1031 products seek to defer real estate related capital gains through a continued interest in real estate. As mentioned above, if properly structured, a §1031 exchange allows an investor to sell directly-owned real estate and subsequently reinvest the proceeds of such sale into a new real estate asset, deferring capital gain taxes resulting from the sale of the relinquished property. The §1031 provisions of the Code require non-recognition of realized gains and losses when real estate held for business or for investment is exchanged solely for real estate that is also held for such purposes.

For §1031 purposes, the term "like-kind" refers to the nature or character of the property, rather than its grade or quality. Therefore, no distinction is made between improved and unimproved real estate. For this reason, bare farm land can be exchanged for a downtown office building, a storage facility can be exchanged for a factory, and vice versa. The like-kind rules have also historically extended beyond traditional fee-simple interests to include leasehold interests in real property, perpetual water rights, and oil and gas mineral rights. As a general matter, like-kind real estate has been recognized by the courts and the Internal Revenue Service (the "**IRS**") to essentially mean any type of real estate recognized under state law.

Suitability

As to customer specific suitability, a common type of investor for a §1031 product offering is one that owns real estate for which he or she (i) has sold pursuant to a deferred like-kind exchange (and in which case the 45-day identification period window remains open), or (ii) wishes to sell. While some of these investors will want to maintain some of the financial benefits associated with real estate ownership on a passive basis without being required to manage the property, the benefits of which may include on-going cash flow, opportunities for long-term investment growth, and a continuing investment exposure to real estate, others simply may believe that, based on the then-current market considerations, the time is right to effectuate a realization of the value built up over years of ownership.

As the economic performance of the underlying real estate is driven by market forces that affect real estate-related cash flows (i.e. rents and royalties), these products are suited only for those investors who understand and appreciate the market risks of their assets and that are not in need of the liquidity that might otherwise be provided had the investor placed its sales proceeds in cash or publicly-traded securities. As DST programs acquiring conventional forms of real estate almost always use leverage to finance the purchase, the suitable investor will need to understand the loan structure and default risks associated with the financing of a real estate asset.

DSTs

The peak of capital raising activities within the §1031 product market was 2006, with approximately $3.65 billion in equity raised. Prior to the Great Recession, a substantial majority of §1031-eligible real estate programs were structured as direct fractional interests in real estate, or TICs. The credit crisis that hit in 2007 to 2008, and the deep economic recession that followed in 2009 and 2010, exposed certain deficiencies of the TIC structure. Pursuant to IRS Revenue Procedure 2002-22, a TIC program was subject to certain restrictions including, among others, a maximum of 35 owners, each TIC owner having to be separately underwritten by the lender, and each TIC owner having to form a special purpose entity to hold his or her fractional ownership. Also, major decisions, such as lease renewals, refinancing, and selling of the property required unanimous approval of the TIC owners. In bad times, it could be cumbersome, expensive, and a risk to the investment.

Post Great Recession, the DST addressed some of the deficiencies of the TIC structure, and as a result, has universally become the entity of choice for the §1031 product that holds conventional real estate. The DST is a separate legal entity created as a trust under Delaware's statutory law. Under Revenue Ruling 2004-86 (the "**2004 Ruling**"), the IRS classified the DST as a trust rather than a business for purposes of §1031 exchange qualification. As long as the fundamental like-kind exchange rules are followed with respect to (i) replacement property identification (i.e. 45 days from the sale of the relinquished property), (ii) sale proceeds held though qualified intermediaries, and (iii) closing of the replacement property within 180 days of the sale of the relinquished property, the sale gains attributable to the disposition of the relinquished asset can be deferred under federal tax law under the DST structure.

In general, an organization constitutes a trust for income tax purposes if it is an arrangement whereby trustees take title to property for the purpose of protecting or conserving it for the beneficiaries. A signatory trustee is the individual or entity appointed to manage the DST. The sponsor of a DST offering, or an affiliate of the sponsor, typically serves as the signatory trustee. A DST is often structured with three trustees. In addition to the signatory trustee, an independent trustee typically serves for the benefit of the lender or the beneficiaries in the event the signatory trustee should fail or not act in the best interest of the lender or the DST, and a Delaware trustee maintains a physical Delaware address to prevent the DST from winding up should the signatory trustee be unable to continue serving the DST. The signatory trustee is permitted to also act as the Delaware trustee provided it meets the legal requirements of a Delaware trustee.

While the 2004 Ruling confirmed that beneficial interests in a DST may qualify as replacement property in a like-kind exchange, the ruling sets forth seven restrictions, commonly referred to as the "seven deadly sins," that must be followed for the DST to qualify as replacement property. Investors in the DST may be at risk of losing their §1031 tax deferral should any one of these requirements not be followed:

1. no future contributions may be made to the DST by existing or new investors once the offering is closed (which effectively limits the DST's oil/gas applications to passive interests in mineral rights);
2. the trustee may not modify or renegotiate the terms of an existing loan, nor can it borrow new funds from any other party (except where a property tenant is bankrupt or insolvent);
3. the trustee may not enter into new leases or renegotiate current lease(s), except where a property tenant is bankrupt or insolvent (which makes this form of §1031 structure cumbersome for minerals and working interest owners);
4. the trustee may not sell the real estate and reinvest or use the proceeds to purchase new real estate;
5. the trustee may only make capital expenditures with respect to the property for normal repair and maintenance, minor non-structural improvements, and those required by law (again, making the DST structure cumbersome for ownership in working interests);
6. the trustee must distribute all cash, other than necessary reserves, on a current basis as defined by the terms of the DST agreement (i.e., monthly, quarterly, etc.); and
7. any cash held by the trustee between distribution dates may only be invested in short-term debt obligations which will reach maturity prior to the next distribution date.

Despite the restrictions, and for the substantial majority of §1031 product offerings involving the acquisition of conventional real estate, the DST structure offers many benefits over its TIC predecessor. First, the investor is not required to create its own special purpose entity, as he or she will simply own a beneficial interest in the DST (which itself is a bankruptcy remote, special purpose entity). This helps to shield the investor from potential liability with respect to the property without the added complexity, cost, and time commitment of forming an entity for each investor. Second, the lender only must qualify the DST as a borrower rather than each investor.

This means that each investor need not gather and provide his or her detailed financial and tax information for the lender. Since the DST is the sole borrower, each investor's potential personal liability is greatly reduced and, with less complexity in the lending process, lenders may be able to offer more favorable loan terms and rates than for a comparable TIC offering. In addition, environmental indemnity obligations for principals, as required in most TIC transactions, are not required for DST transactions. Further, because the number of interests is not limited to 35, as with a TIC, a DST may allow a smaller minimum investment from each investor, thereby opening the door for more investors. Finally, while investors in a DST are not entitled to vote on the management of the DST, the threat of a holdout or a rogue investor is eliminated. This stability of management may also have the effect of reducing lender concerns as the lender can anticipate that the trustee will continue operating or managing the property throughout the holding period.

In view of the restrictions imposed upon the DST signatory trustee, a master lease or a long-term triple-net lease is required for economic realization purposes. In the case of a master lease, the master tenant (generally an affiliate of the sponsor) will sublet the property to residential or commercial tenants. The master tenant also handles maintenance and repairs, and contracts with a management agent (also often an affiliate of the sponsor). In general, the master tenant is empowered to do everything that an owner of the property would be empowered to do. A master tenant/master lease arrangement satisfies the requirements of the federal tax law, can be seen as very attractive to institutional lenders, and eliminates the concern raised in TIC transactions as to how to ensure the unanimous consent of the tenants in common to certain necessary management actions.

The master lease will generally provide for rent to be paid by the master tenant to the DST in a set amount equal to debt service plus a market rate of return. The master lease structure economically incentivizes the master tenant to maximize the mortgaged property's net operating income because the master tenant retains some net operating income over and above debt service and rent payments under the master lease, and incentivizes the master tenant to cover short-term operating deficits to protect its desired return, as well as its valuable investor reputation in the industry.

The DST was designed as a §1031 product intended to hold an assortment of conventional real estate asset classes. At year-end 2018, Mountain Dell Consulting reported within its *§1031 DST/TIC Market Equity Update* that approximately 50 §1031 programs were open for investment, with 55% of the available equity of such programs offered in DSTs that acquire multi-family assets, 24% in DSTs acquiring office properties, 13% in DSTs acquiring retail properties, and 5% in DSTs acquiring industrial assets and senior housing properties. For 2018, approximately $2.5 billion was raised by 28 product sponsors offering 53 programs.

As to the economics of DSTs, we start with the general premise that no two §1031 products are the same. The sponsor will charge the investors various fees for syndicating the §1031 product private placements, including upfront acquisition/loan fees, operational property management and asset management fees, and disposition fees. As the clear majority of syndicated §1031 products are sold through Financial Industry Regulatory Authority ("**FINRA**")-registered broker-dealers, sales commissions and marketing related expenses are added to the investors' acquisition cost for the property. Therefore, a property's performance must be underwritten with the acknowledgement that these fees and expenses funded from investor proceeds must be recouped at disposition of the property. The following provides a breakdown of the average range of costs and other economic related considerations commonly associated with DSTs:

Load as a % of Equity:	15-20%
Selling Costs and Expenses:	8-10% of equity
Acquisition Fee:	2% of purchase price/5%-8% of equity
Annual Asset Management Fee:	1-2% of adjusted gross revenue
Annual Property Management Fee:	3-4% of adjusted gross revenue
Disposition Fee:	2-3% of gross sales price
Cash-on-Cash:	5.0% to 6.0% (year one)
	5.50-6.50% (average cash-on-cash)
Syndicated LTV:	50-65%

Please note that a developing trend is for sponsors to subordinate disposition fees, or a portion thereof, until investors have received 100% of invested equity.

It is of upmost importance to independently underwrite the property or properties involved in a §1031 product offering. When analyzing a property, primary sources of information include: Rent Roll/Tenant Leases; Historical Operating Expenses; Market Reports/Market Information; Capital Markets Report; Market Operating Expense Information; Sales/Lease Comparables; and Loan Documents/Commitments. As further confirmation of value, due diligence materials may include an appraisal, as well as other sources of information to support the long-term viability of the offering: Property Condition Report; Demographic Information; General Economic Information; and Tenant Interviews/Estoppel Certificates. The utilization of third-party information providers is also key to understanding historical, current, and future macro and micro economic trends/predictions specific to the property and its asset class.

From the mentioned sources of information, one can understand the economics associated with a property in a private placement. A properly-structured §1031 product offering will include sponsor-provided basic return metrics such as cash-on-cash return and internal rate of return ("**IRR**") calculations, as well as a disposition analysis. Real estate underwriting is often built on the concept that investors will want to receive a return on each dollar invested into the offering as well as a return of capital. A residual value calculation following a stated hold period will often edify investors as to the possibility of a return of their original capital. While difficult to calculate given the innumerable variables impacting the future underwriting, as well as capital market conditions, we find it valuable to independently demonstrate the likelihood investors will receive a return of their capital upon the ultimate disposition of the property. Additionally, while a master lease structure may "guarantee" a stated annual return, the master tenant is often not sufficiently capitalized to pay such a return should the underlying property not generate sufficient cash flows. Therefore, we often see sponsors utilize property reserves collected from offering proceeds (investor equity) to supplement the annual cash flows to investors, which often signals an underperforming property.

DSTs/Conventional Real Estate	
Nature of Interest	A DST that holds an interest in real property used for multi-family, retail, office, industrial, storage, hospitality, or health care purposes
Nature of Income	Derived from tenant rentals
Target Yield	No less than a 100% return of capital at disposition (5-10 years) and 5.0% - 6.5% cash flow annually
Tax Consequences	• §1031 eligible if Revenue Procedure 2004-86 is followed • Income/expenses reported on a Schedule E • Depreciation (27.5-39 years) and loan interest allocated pro rata to DST interest holders that can shelter some level of income from taxation • Property taxes, insurance, and maintenance costs may sometimes be paid by, and therefore deductible to, the tenants, depending upon the form of lease(s) used
Income Risks	• *Property Occupancy* – will projected future occupancy support future distributions? • *Proximal Competitive Product* • *Creditworthiness* of the tenants • *Lease Duration* – When do leases end? Renewal options exist? • *Financing Risks – Variable interest rate? Amortized debt?* • *Lease Rent Terms* – Do rental payments have escalation clauses?
Value Risks	• Leverage is most often used to acquire the real estate, enhancing return potential • Amortization of the mortgage and pace of principal pay down • Interest rate movement on loans • Occupancy at exit • Condition of the property at exit • Sufficient reserves established for property maintenance • Cap rate movements in market where the property is located
Interest Termination	• Foreclosure risk if mortgage is not paid

Energy

While the DST is unquestionably the structure of choice for surface oriented §1031 real estate products, the TIC prevails within the energy program offerings that provide like-kind exchange opportunities.[1] This observation is driven by the 2004 Ruling, which prevents DSTs from modifying leverage or from entering into new leases or renegotiating old leases.

Subject to the aforementioned identification period and closing deadline rules, the TIC structure for §1031 energy products offers opportunities for retail investors to acquire direct fractional interests in oil/gas properties through like-kind exchanges, allowing the investors to sell conventional surface real estate and acquire interests in subsurface mineral-related assets on a tax-

[1] See Exchange Quarterly 3/16 (estimating DST activity at about $1.5 billion for 2016).

deferred basis.[2] In fact, a majority of the leased minerals and royalty acquisition programs offered within the non-traded retail sector over the past 10 years have been §1031 products structured as TICs.

While working interests in oil and gas leases and associated production can technically qualify for like-kind exchange treatment under §1031 of the Code, a substantial majority of the oil and gas assets acquired in these programs tend to be mineral interests, royalties, and overriding royalty interests (due to the fact that income producing assets are generally favored by the investors who participate in the offerings). As the underlying research and buying analytics involved in acquiring mineral and royalty assets tend to materially differ from those of a traditional upstream drilling company, this segment of the retail energy channel has been underserved in the past few years. The energy sponsors in this product space in recent years are Resource Royalty, LLC, whose §1031 product platform was launched toward the end of 2014, U.S. Energy Development Corp., which initiated an overriding royalty program in 2016, and Montego Minerals, which initiated a royalty direct interest program in 2018. While the level of capital raised in §1031 energy products is small compared to that of DSTs (i.e., $60 million in 2018), the product does address a niche opportunity for certain investors seeking higher returns associated with oil and gas mineral ownership.

Generally, the sponsor sets up an issuer entity structured as a limited liability company ("**Issuer LLC**") that will acquire the minerals, royalties, and/or overriding royalties from a seller and that will take title to the assets. The Issuer LLC eventually will transfer title to the retail investors of the §1031 energy product offering as money is raised. In many cases, the Issuer LLC will also reserve a right in the offering documents to conduct multiple closings during the offering period so investors who want §1031 treatment can close on the investments at needed times to meet the 180-day closing period deadline. As the underlying investments are direct interests in real estate, investors will receive Form 1099s from the manager and will account for their pro rata share of the income and expenses on a Schedule C of the Form 1040. The subscription documents signed by investors contain special provisions that prohibit an investor from treating his/her investment as a partnership interest.

An affiliate of the program sponsor will fulfill the role of asset manager and will enter into an asset management agreement with each investor. As program manager, the sponsor affiliate performs accounting and administration functions on behalf of the investors and is paid an on-going management fee. Such ongoing administrative services include: (i) execution of leases, development agreements, and division orders; (ii) collecting and accounting for production revenues paid by the oil and gas purchasers to the property holders; (iii) paying expenses relating to the interests; (iv) distributing revenues and accounting information to investors; and (v) preparing tax returns. Thus, while the nature of the investment is rather passive, investors are afforded the tax advantages associated with real estate as the program assets are titled directly to the investors. Additionally, each investor must be given a right in the management agreement to terminate the sponsor's status as the manager and to assume the asset management duties if he or she so chooses.

[2] *IRS Revenue Rulings* 55-526, 68-331, 73-428, and 88-71.

As to economics, §1031 energy products do not have tiered or waterfall distribution provisions because they are direct title programs (tiered or waterfall distribution provisions violate the income tax rules that determine whether a TIC is a partnership for tax purposes, as the sponsor's compensation cannot be profit on asset performance in a §1031 program).[3] Note, however, that the way to pass through some of the property economics and upside to the sponsor is to have the Issuer LLC buy 100% of the interests from the seller, but issue 95% of the interests to the investors. The Issuer LLC charges 100% of the purchase price to investors, but conveys title to 95% of the assets (thus passing some of the economics to the sponsor without running afoul of the partnership rules that apply to §1031 TIC/direct title transactions so long as the purchase price is reasonable).

From a due diligence perspective, the investor group's acquisition price should be based in substantial part upon what a reasonable buyer would pay for the properties to achieve a return that is commensurate with the investment risks (i.e., fair market value). At the end of day, investors should have a reasonable chance to earn a high single digit to mid-teens return on a load adjusted basis under average economic conditions (with 8-15% IRRs being the better opportunities after factoring load and sponsor compensation). To maintain reserves and cash flows, it is almost always a good idea to have properties where future drilling is expected. Otherwise, distributions may fall quickly in a short amount of time. Other elements of the economics of these investments are explained below:

Marketing/Due Diligence Costs:	8% of Offering Proceeds
Organization/Offering Costs:	2-3% of Offering Proceeds
Managing Dealer Fee:	2% of Offering Proceeds
Acquisition Fee:	2-3% of Offering Proceeds
Purchase Price:	85%-88% of Offering Proceeds
Annual Management Fee:	0.50-1% of Offering Proceeds

As is the case with DSTs, the due diligence requirements imposed upon broker-dealers and their representatives are explained in greater detail in FINRA's Regulatory Notice 10-22 and also in Regulatory Notice 03-71. Short of providing a complete discussion of all guidelines in the notices, areas that should be analyzed for §1031 energy investments are:

- *Asset quality*. Targeted assets of the program must generally present ample opportunity to capture upside from price escalation and hydrocarbon reserve development. Conversely, assets with limited growth potential may present challenges down the road from a return perspective. A target IRR of high single digits to mid-teens on a load adjusted basis is a reasonable underwriting metric provided conservative pricing and future development scenarios are used. *Independent analysis from a third-party engineering consultant that was not paid by the sponsor is also strongly encouraged*.
- *Has the sponsor already acquired the asset, or if not, how long will the sponsor be given to raise funds to acquire*? The breaking of escrow must be conditioned on the raise of enough capital to deliver clear title to the investors.
- *Investment process*. Can the sponsor articulate a proven process to source and evaluate oil and gas acquisitions? Does the process require involvement not only from technical experts

[3] See *Culbertson v. Commissioner,* 337 U.S. 733 (1949).

but also from people within other business disciplines with experience in managing business risks (e.g., accountants and legal advisors)?

TICs/Energy Assets	
Nature of Interest	Derived from the mineral interest in real estate, with the royalty established by an oil and gas lease (the royalty owner being the lessor in the transaction)
Nature of Income	Owners of royalties are entitled to a percentage of oil, gas, and natural gas liquids production revenues less severance taxes, and income is not subject to lease operating costs (i.e., water disposal, utilities, well tending, and maintenance)
Target Yield	Subject to risks described below, low- to mid-teen IRR for development royalties, with high single digit IRR for legacy royalties
Tax Consequences	• Royalties are derived from mineral interests and are real estate per IRS revenue rulings • Income/expenses reported on a Schedule E • Depletion expenses shelter approximately 15% gross royalty income from taxation
Income Risks	• *Depletion risk*: Will oil/gas production decline in a manner consistent with the engineering projections relied upon? • *Oil/gas market risks* • *Operator risk*: Are operators of the leases financially viable? • *Drilling risks*: Applicable to royalties in undrilled acreage (i.e., developmental royalties). • *Reservoir risk*: Also applicable to royalties in undrilled acreage. Does the oil/gas reservoir extend into the area of drilling?
Value Risks	• Usually no leverage in royalty programs • The path to an exit is contingent on property cash flow and future market forces • Value is derived from the net present value of the income from the interest, so developments that affect income can affect value • The present value discount rate required by an investor that drives an acquisition value is akin to cap rates for real estate. Lower present values are tolerated by investors in strong commodities markets.
Interest Termination	A royalty does not terminate if the royalty owner holds mineral rights

Closing Thoughts

While market activity in conventional §1031 real estate has increased significantly in recent years, helping it to reclaim its spot at the head of the non-traded retail syndicated alternative investments table, capital raises within the products acquiring oil and gas related assets will take some time to reach critical mass. Despite this, there are bona fide opportunities for sponsors and firms to prudently capitalize upon the §1031 energy product concept given the world's continued appetite for oil and the desire of U.S. domestic operators to feed that appetite.

In writing this article, it is our hope to provide a trusted resource that can be used by broker-dealers, investment advisors, and family offices to better understand the contrasting features of §1031 product offerings in conventional real estate and in oil and gas assets. Despite structuring these offerings as §1031 eligible products, understanding the economics as well as the tax consequences of these products is a critical key to investment success. To that end, the value of property underwriting cannot be overstressed.

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