Comparing Real Estate and Energy Code Sec. 1031 Investment Products

By Bradford Updike and David Sengstock

Bradford Updike and David Sengstock compare and contrast investments in real estate and energy through tenant-in-common interests ("TICs") and Delaware Statutory Trusts ("DSTs").

Code Sec. 1031 allows an investor to sell a property, reinvest the proceeds of such sale in a new property, and defer recognition of gains and related federal income tax liability stemming the transaction, if properly structured. These benefits have made investments that qualify under Code Sec. 1031 for gain deferral ("§1031 products" or "§1031 programs") popular investment options over the past 20 years. Historically structured as direct fractional interests in real estate, or tenant-in-common interests ("TICs"), these Code Sec. 1031 products were restructured as Delaware Statutory Trusts ("DSTs") after the Great Recession for a number of reasons, including ease of administration and financing. Despite the challenges of the Great Recession, during which Code Sec. 1031 product sales dropped from $3.65 billion to $250 million annually (2006–2012), the DST version of the Code Sec. 1031 product has grown rapidly over the past several years, with annual equity sales of $1.5 billion to $3.5 billion reported from 2016 to 2019.[1] The Code Sec. 1031 product continues to live and breathe as an alternative for 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, and diversification.

Conventional real estate classes, including multifamily, single tenant net lease, and retail real estate, have predominated the Code Sec. 1031 product sector, with oil and gas minerals and working interests maintaining a sliver of the market share (<1% to 3% annually).[2] 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 Code Sec. 1031 product presents a niche avenue for investors with a steeper risk tolerance, as it presents an opportunity to achieve an outsized return driven through oil and gas mineral rights ownership and commodity market exposure.

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

Real Estate

While non-tax advantaged Code Sec. 1031 products investments (*i.e.*, cash subscriptions) can be justified by careful underwriting, many investors in Code Sec. 1031 products seek to defer real estate related capital gains through a continued interest in real estate. As mentioned above, if properly structured, a Code Sec. 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. Code Sec. 1031 allows for non-recognition of realized gains and losses when real estate held for business or for investment is exchanged solely for real estate of a like-kind that is also held for such purposes. For this purpose, the term "like-kind" refers to the nature or character of the property, rather than its grade or quality.[3] Therefore, no distinction is made between improved and unimproved real estate.[4] For this reason, bare farmland can be exchanged for a downtown office building, a storage facility can be exchanged for a factory, and vice versa.[5] 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 mean any type of real estate recognized under state law.[6]

Before we address the characteristics of Code Sec. 1031 products, we will review some basic principles of like-kind exchanges, which are found in Code Sec. 1031. For discussion purposes, references to a "relinquished" property refer to the real estate the exchanging taxpayer is selling (*i.e.*, the property that otherwise triggers a taxable gain in the absence of a like-kind exchange), and references to the "replacement" property refer to the real estate the taxpayer owns once the exchange is completed.

Code Sec. 1031 requires that the replacement property be acquired through an exchange of properties, rather than a sale and subsequent purchase.[7] Simply put, a taxpayer who is a seller of real estate cannot directly or constructively receive cash in a transaction and then use the cash to purchase a replacement property.[8] In a direct swap transaction, the exchange requirements are met because the deal simply involves the swapping of real estate. However, it is difficult in most cases to match parties for a direct swap exchange. Practicalities considered, potential parties to a real estate transaction will often not possess the kind of property suited to meet the other party's business or investment needs.

For this reason, most like-kind real estate exchanges are conducted as "deferred exchanges."[9] A deferred exchange involves a transaction in which the taxpayer sells the original property and purchases a replacement property through a qualified intermediary, which is an entity that acts as an "assigned in" seller and buyer for the taxpayer during the sale of the relinquished property and the purchase of the replacement property.[10] If the proper procedures are followed, the maximum deferral time that can be achieved between the sale of the relinquished property and the purchase of the replacement property is 180 days.[11] However, care must be exercised to ensure that (i) the replacement property is identified within 45 days of selling the relinquished property,[12] and (ii) that the taxpayer's access to the proceeds from the sale of the relinquished property is restricted during the deferral period.[13] The proceeds must remain within the qualified intermediary's possession during the deferral period and should be exclusively earmarked for the future purchase of the replacement property.[14]

On a final note regarding the core rules of Code Sec. 1031—it is important to note that like-kind exchange treatment is afforded to taxpayers that hold a "direct interest" in the underlying real estate. Interests in real estate held through partnerships do not qualify for like-kind exchange treatment.[15] For this reason, Code Sec. 1031 product structures, such as TIC and DSTs, have been used by product sponsors to help facilitate holding scenarios whereby the investor's interest is deemed to be a direct interest in real estate for federal income tax purposes. Acknowledging that Code Sec. 1031 excludes interests in "securities" for purposes of like-kind exchange treatment,[16] the legislative intent of Code Sec. 1031 was designed to exclude publicly traded securities as opposed to direct interest investments that are technically considered to be securities under federal securities laws.[17] As such, the fact that a DST or TIC is a security under federal securities law does not disqualify it for like-kind exchange treatment.

Suitability

As to customer specific suitability, a common type of investor for a Code Sec. 1031 product is one that owns real estate 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 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, these investors may also believe, based on the current market considerations, that the time is right to realize the value built up in their current real estate over several years. These investors must also be "accredited investors" under federal securities laws, which requires the investor to have either (i) a minimum net worth of $1 million, or (ii) an income of $200,000 or more over the past two tax years (which is raised to $300,000 if the investors are a husband and wife).[18]

As the economic performance of the underlying real estate is driven by market forces that affect real estate-related cash flows (*e.g.*, rents as to conventional real estate and royalties as to oil/gas mineral rights), these products are suited only for accredited investors who understand and appreciate the market risks of these assets and that are not in need of the liquidity that might otherwise be provided had the investor maintained 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 also 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 Code Sec. 1031 product market was 2006, with approximately $3.65 billion in equity raised.[19] Prior to the Great Recession, a substantial majority of Code Sec. 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 Rev. Proc. 2002-22, a TIC product offering is subject to certain restrictions including, among others, (i) a maximum of 35 owners, (ii) each TIC investor having to be separately underwritten by the lender, and (iii) each TIC investor having to form a special purpose entity to hold his or her fractional ownership.[20] Also, major decisions, such as lease renewals, refinancing, and selling of the property require unanimous approval of the TIC investors. In bad times, the TIC structure can be cumbersome, expensive, and a risk to the investment.[21]

Post Great Recession, the DST addressed some of the deficiencies of the TIC structure, and as a result, became the investment platform of choice for Code Sec. 1031 products that hold conventional real estate. The DST is a separate legal entity created as a trust under Delaware's statutory law. Under Rev. Rul. 2004-86 (the "2004 Ruling"), the IRS classified a DST as a trust rather than a business for purposes of Code Sec. 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),[22] (ii) sale proceeds held though qualified intermediaries,[23] and (iii) closing of the replacement property within 180 days of the sale of the relinquished property,[24] the sale gains attributable to the disposition of the relinquished asset can be deferred in a like-kind exchange under the DST structure.

Despite structuring these offerings as Code Sec. 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.

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 primarily manage the DST's business. The sponsor of a DST offering, or an affiliate of the sponsor, typically serves as the signatory trustee. A DST is generally structured with multiple trustees. In addition to the signatory trustee, an independent trustee typically serves to protect the interests of the lender or the beneficiaries. Also, a third trustee that maintains a physical Delaware address serves to prevent the DST from winding up should the signatory trustee become unable to serve the DST. The signatory trustee is permitted to act as the Delaware trustee if 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.[25] Investors in the DST may be at risk of losing their Code Sec. 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 mineral rights in producing properties with limited future drilling potential, and which makes a DST cumbersome for working interests[26] in oil and gas properties);
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 Code Sec. 1031 product cumbersome for mineral interest and working interest owners of oil and gas properties);
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 working interests in oil and gas properties due to the depleting nature of oil and gas wells and the need for working interest owners to maintain production cash flow levels through future drilling of wells);
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 these restrictions, 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 a limited liability entity. Second, the lender is only required to qualify the DST as a borrower rather than each investor, which means that each investor need not gather and provide his or her detailed financial and income 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 interest rates than for a comparable TIC offering. In addition, environmental indemnity obligations for principals, which are required in most TIC transactions, are not required for DST transactions. Further, because the number of investors 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, because 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 supervise the property's business throughout the holding period.

In view of the restrictions imposed upon the DST signatory trustee, the DST's contractual lease assets are typically structured as master leases or as long-term triple-net leases. In the case of a master lease, the master tenant (generally an affiliate of the Code Sec. 1031 product 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 product sponsor). In general, the master tenant is empowered to do everything that an owner of the property would be empowered to do. This structure avoids committing any of the seven deadly sins mentioned above, while providing a degree of operational flexibility because the master tenant is not bound by the same restrictions as the DST. In addition to satisfying the requirements of federal tax law, a master tenant/master lease arrangement can be viewed as attractive to institutional lenders, and it eliminates the need for unanimous consent of investors that existed in TIC products for certain management related 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. This incentivizes the master tenant to cover short-term operating deficits to help protect the targeted investor return, as well as its business reputation with investors and financial service firms.

The DST was designed as a Code Sec. 1031 product intended to hold an assortment of conventional real estate asset classes. At year-end 2019, Mountain Dell Consulting reported that approximately 65 Code Sec. 1031 programs were open for investment, with 39% of the available equity of such programs offered in DSTs that acquire multi-family assets, 12% in DSTs acquiring senior housing properties, 12% in DSTs acquiring hospitality properties, 10% in DSTs acquiring retail properties, 9% in DSTs acquiring student housing properties, and 5% in DSTs acquiring office, self-storage and industrial properties.[27] For 2019, approximately $3.5 billion was raised by 38 product sponsors offering 171 programs.[28]

As to the economics of DSTs, we start with the general premise that no two Code Sec. 1031 products are the same. The sponsor will charge the investors various fees for syndicating the Code Sec. 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 Code Sec. 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 the disposition of the property. Table 1 provides a breakdown of the average range of costs and other economic considerations commonly associated with DSTs.

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 Code Sec. 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.

TABLE 1.

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
Target Distribution:	4.75% to 6.5% (cash-on-cash)
Syndicated LTV:	45–65%

From the mentioned sources of information, one can understand the economics associated with a property in a private placement. A properly-structured Code Sec. 1031 product offering will include sponsor-provided basic return metrics, such as cash-on-cash returns 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 future property value, including 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, please note that the master tenant is often not sufficiently capitalized in its own right 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* (*see* Table 2).

Energy

While the DST is unquestionably the structure of choice for surface oriented Code Sec. 1031 real estate products, the TIC prevails within the energy program offerings that provide like-kind exchange opportunities. 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 Code Sec. 1031 energy products offers opportunities for accredited investors to acquire direct fractional interests in oil/gas properties through like-kind exchanges, allowing accredited investors to sell conventional surface real estate (*e.g.*, multi-family, retail) and acquire interests in subsurface mineral-related assets on a tax-deferred basis.[29] In fact,

TABLE 2. CHARACTERISTICS OF 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 Investment Return	A 100% return of capital at disposition (5-10 years) and 4.75% - 6.5% cash flow annually (subject to performance risks)
Tax Consequences	• Code Sec. 1031 eligible if the seven deadly sins mentioned in the 2004 Ruling are avoided • Income/expenses are reported on a Schedule E • Depreciation (27.5-39 years) from the underlying property and interest on indebtedness are allocated pro rata to DST interest holders, which may shelter some 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 – Due Diligence Emphasis Recommend	• *Property Occupancy:* Are the occupancy assumptions reasonable for the property's market, and will the asset's projected future occupancy support future investor distributions? • *Creditworthiness:* Will tenants make payments in full and when due? • *Lease Duration:* When do the leases end and do reasonable lease renewal options exist (lease expirations of which could disrupt rental income and investor distributions if the leases are not renewed or if a replacement tenant is not identified)? • *Financing Risks:* Does the debt have a variable or fixed interest rate, and is the debt principal amortized or interest only (both of which could affect the ability of the property to return capital to the investors in 5-10 years when the property is sold)? • *Lease Rent Terms:* Do the rental payments have escalation clauses (which could affect the property's net operating income and future value if operating expenses increase in the future)?
Value Related Risks and Considerations	• Unlike oil/gas §1031 products, the vast majority of DSTs use leverage to acquire the real estate, enhancing the return potential but presenting debt related risks. • Does the debt principal amortize, and what is the pace of principal pay down (which may affect the property's ability to return investor capital)? • Is the debt interest rate fixed or variable in nature? • What is the property's occupancy at exit (which will affect the property's value and ability to return capital to the investors in 5-10 years)? • A property's condition may deteriorate if sufficient reserves are not established from the investor proceeds, which could affect the property's value at exit. • Cap rate movements in the market where the property is located could decrease the property's value and ability to return investor capital.
Interest Termination	• Foreclosure risk and loss of the underlying real estate if the mortgage is not paid

a majority of the leased minerals and royalty acquisition programs offered within the non-traded retail sector over the past 20 years have been Code Sec. 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 Code Sec. 1031, 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 with observable cash flow are often favored by the investors who participate in the offerings). As the research and buying analytics involved in acquiring minerals 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 Code Sec. 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 Code Sec. 1031 energy products is small compared to that of DSTs (*i.e.*, $60 million in 2019),[30] the product does address a niche opportunity for certain investors seeking higher returns associated with oil and gas mineral ownership.

In an oil/gas oriented Code Sec. 1031 product, the sponsor generally 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 accredited investors of the Code Sec. 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 tax deferral under Code Sec. 1031 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 E 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 income tax advantages associated with real estate as the program assets are titled directly to them. Notwithstanding, 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. This is required in order to prevent the investor group from being classified as a partnership, as manager kick-out rights are often limited in most investment partnerships.

As to economics, Code Sec. 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 Code Sec. 1031 product).[31] 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 Code Sec. 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 acquire properties where future drilling is expected. Otherwise, distributions may fall quickly in a short amount of time. Table 3 provides a breakdown of the average range of costs and other economic related considerations commonly associated with Code Sec. 1031 energy investments.

TABLE 3.

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 Code Sec. 1031 energy products are (*see* Table 4):

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

TABLE 4. 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 right holder being the lessor in the oil and gas lease 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 the royalty income is **not** subject to drilling costs or lease operating costs (*i.e.*, IDC, tanks, water disposal, utilities, well tending, and maintenance).
Target Yield	Subject to the risks described below, low- to mid-teen IRRs for "*development*" royalties with limited present cash flow but very high future drilling potential, with high single digit IRRs for "*legacy*" royalties with pre-existing cash flow but limited future drilling potential.
Tax Consequences	• Royalties are generally derived from mineral interests and are real estate per IRS revenue rulings.[1] • 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:* Commodity price volatility could affect investor returns. • *Operator risk:* Are the 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 Related Risks and Considerations	• Unlike DSTs, there is usually no leverage used in §1031 programs that acquire oil and gas assets. • A profitable exit is contingent on future oil and gas cash flows and future market forces. • Value is derived from the net present value of the oil and gas cash flow from the interest, so developments that affect income will affect value. • The present value discount rate (*i.e., "PV"* rate) used by an investor to value an estimated future stream of royalty cash flow is similar in nature to the cap rates for real estate. The PV rates for oil/gas properties tend to correspond to the strength of their reserves, with PV rates of 8-12% often applied to producing properties with royalties. Conversely, acceptable PV rates associated with undeveloped (*i.e.*, undrilled) oil/gas properties are much higher (which could range from a PV rate of 20-50% for proven undeveloped minerals situated next to producing properties, to possibly no value if the properties are situated miles from producing properties, or if the properties are considered to carry exploratory type risks). Similar to DSTs that acquire income producing conventional real estate, lower PV rates may be tolerated by investors of royalties in strong commodities markets.
Interest Termination	• A royalty does not terminate if the royalty owner holds the mineral rights. Note that overriding royalties do terminate after the wells stop producing oil and gas.

[1] Rev. Rul. 55-526, 1955-2 CB 574 (1955) (explaining that that a royalty interest in oil and gas in place constitutes real property for federal income tax purposes); Rev. Rul. 68-331, 1968-1 CB 352 (1968) (an exchange of a leasehold interest in a producing oil lease that is held for productive use in trade or business or for investment, for a fee interest in an improved ranch to be held for productive use in trade or business or for investment is an exchange of property for property of a like-kind) Rev. Rul. 73-428, 1973-2 CB 303 (1973) (explaining that royalty interests in minerals constitute real property for federal income tax purposes); Rev. Rul. 88-78, 1988-2 CB 330 (1988) (explaining that royalty interests in minerals constitute real property for federal income tax purposes).

Closing Thoughts

While market activity in conventional real estate Code Sec. 1031 products has increased significantly in recent years, helping them to reclaim their spot near the head of the non-traded retail syndicated alternative investments table, capital raises within the products acquiring oil and gas assets may take time to reach critical mass. Despite this, there are bona fide opportunities for sponsors and firms to prudently capitalize upon the Code Sec. 1031 energy product concept given the world's continued appetite for oil, the desire of U.S. domestic operators to feed that appetite, and the return opportunities associated with oil and gas assets. Acknowledging of course that commodity prices are low in relation to what was the case in 2014 and prior years, we believe that this development translates well for buyers of oil and gas assets given the opportunity to capitalize upon lower asset acquisition costs in a market where asset price discovery has taken hold over the past couple of years (*i.e.*, allowing buyers of mineral assets to "buy low and sell higher" *vs.* the opposite paradigm from 2011 to 2014).

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 Code Sec. 1031 product offerings in conventional real estate and in oil and gas assets. Despite structuring these offerings as Code Sec. 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.

[1] *See Market Report Securitized 1031 Industry: Year End Report 2019*, Mountain Dell Consulting, LLC (reporting sales activities from 2002 to 2019).
[2] *Id.*
[3] Reg. §1.1031(a)-1(b).
[4] *Id.*
[5] *Cf.* Reg. §1.1031(a)-1(c).
[6] *See* Rev. Rul. 55-526, 1955-2 CB 574 (1955) (explaining that that a royalty interest in oil and gas in place constitutes real property for federal income tax purposes); Rev. Rul. 68-226, 1968-1 CB 362 (1968) (explaining that an interest in an oil lease is real property for federal income tax purposes); Rev. Rul. 73-428, 1973-2 CB 303 (1973) (explaining that royalty interests in minerals constitute real property for federal income tax purposes); Rev. Rul. 88-78, 1988-2 CB 330 (1988) (explaining that royalty interests in minerals constitute real property for federal income tax purposes).
[7] Code Sec. 1031(a); Reg. §1.1031(a)-1(a).
[8] Reg. §1.1031(k)-1(f)(1) (explaining that a gain or loss is recognized if a taxpayer actually or constructively receives money or other non-like-kind property on the sale of the relinquished property before receipt of the like-kind replacement property).
[9] Paul R. McDaniel, et al, FEDERAL INCOME TAXATION: CASES AND MATERIALS, at 1039 (5th ed. 2004).
[10] Reg. §1.1031(k)-1.
[11] Code Sec. 1031(a)(3)(B).
[12] Code Sec. 1031(a)(3)(A).
[13] Reg. §1.1031(k)-1(f).
[14] Reg. §1.1031(k)-1(g)(4)(v) (explaining that the qualified intermediary is treated as the party to the agreement if the rights of the taxpayer are assigned to the qualified intermediary and written notification of the assignment is given to all parties to that agreement on or before the date of the relevant transfer of property).
[15] Reg. §1.1031(a)-1(a)(1)(iv).
[16] Reg. §1.1031(a)-1(a)(1)(iii).
[17] *See, e.g., Plow Realty Co. of Texas*, 4 TC 600, Dec. 14,328 (1945) (holding, that while certain mineral rights were considered under Federal *securities* laws to be securities, such rights were not deemed to be securities under prevailing Federal *tax* laws applicable to certain surtaxes imposed upon personal holding companies at that time). For a discussion regarding the legislative history of Code Sec. 1031, see Bradford Updike, *Exploring the Frontier of Non-traditional Real Estate Investments: A Closer Look at 1031 Tenancy-In-Common Arrangements*, 40 CREIGHTON LAW REV. 271, 317–325 (2007).
[18] 17 CFR §230.501(a)(5).
[19] *See Market Report Securitized 1031 Industry: Year End Report 2019*, Mountain Dell Consulting, LLC (reporting sales activities from 2002–2019).
[20] Rev. Proc. 2002-22, 2002-1 CB 733 (2002) (providing guidelines for requesting advance rulings from the IRS on whether co-ownerships of rental real property in an arrangement classified as a TIC will be treated as a partnership or as a direct interest in real estate for federal income tax purposes).
[21] Updike, *supra* note 17 (providing a discussion of the challenges presented by the DST structure at 297–325).
[22] Reg. §1.1031(k)-1(b)(2)(i).
[23] Reg. §1.1031(k)-1(g)(4).
[24] Reg. §1.1031(k)-1(b)(2)(ii).
[25] Rev. Rul. 2004-86, 2004-2 CB 191 (2004) (explaining the circumstances under which a DST may be characterized as a partnership as opposed to a trust for federal income tax purposes, in which case the investors would not be afforded like-kind exchange treatment under Code Sec. 1031).
[26] A working interest is an interest in an oil and gas lease, that gives the owner of the interest the right to drill and produce oil and gas on the leased acreage. It requires the owner to pay a share of the costs of drilling and production operations. The share of production to which a working interest owner is entitled will always be smaller than the share of costs that the working interest owner is required to bear, with the balance of the production accruing to the owners of royalties. For example, the owner of a 100% working interest in a lease burdened by a landowner's royalty of 12.5% would be required to pay 100% of the costs of a well but would be entitled to retain 87.5% of the production. As the working interest bears the financial burden under an oil and gas lease for capital costs and operating costs, this restriction could make it very difficult for the working interest holder to improve or even maintain the property in future years.
[27] *See Market Report Securitized 1031 Industry: Year End Report 2019*, Mountain Dell Consulting, LLC (reporting sales activities for 2019).
[28] *Id.*
[29] Rev. Rul. 55-526, 1955-2 CB 574 (1955) (explaining that that a royalty interest in oil and gas in place constitutes real property for federal income tax purposes); Rev. Rul. 68-331, 1968-1 CB 352 (1968) (an exchange of a leasehold interest in a producing oil lease that is held for productive use in trade or business or for investment, for a fee interest in an improved ranch to be held for productive use in trade or business or for investment is an exchange of property for property of a like-kind) Rev. Rul. 73-428, 1973-2 CB 303 (1973) (explaining that royalty interests in minerals constitute real property for federal income tax purposes); Rev. Rul. 88-78, 1988-2 CB 330 (1988) (explaining that royalty interests in minerals constitute real property for federal income tax purposes).
[30] *See Market Report Securitized 1031 Industry: Year End Report 2019*, Mountain Dell Consulting, LLC (reporting sales activities for 2019).
[31] *See W.O. Culbertson*, SCt, 49-1 USTC ¶9323, 337 US 733, 69 SCt 1210.