Mick Law - Alts. News Bulletin
May 27, 2021

This is our third firm bulletin of 2021. For this bulletin, our focus will be placed upon developments pertaining to sponsor and program level due diligence reviews, as well as information that is relevant to conservation oriented real estate programs. We have included Q1 2021 market updates reflecting recent developments within the multifamily and self-storage real estate sectors. We will also talk about IRC Sect. 1031 legislation and the efforts of our industry associations to support our collective interests in respect to this important topic.

Mick Conference – Thank You

First and foremost, we wish to thank all clients that attended our energy and global alts. conference in Dallas, Texas on May 16-18. Our event was very well attended, with approximately 65 unique client firms (i.e., broker-dealers, registered investment advisors and pensions) in attendance, and with seventeen (17) product sponsors giving presentations we had 145 people registering for the conference. Panel educational sessions, including oil and gas, asset valuation, private equity underwriting and energy taxation were well received.

We look forward to serving you once again at our Real Estate Symposium to be held in Scottsdale, Arizona on October 24-26, 2021 at the Scottsdale Marriott at McDowell Mountains. **If you have feedback as to educational topics that you would like to see at this conference, please let us know**.

Sponsor Reviews – GAP Analysis, Ongoing Diligence
& Practices on Post Closing Due Diligence

On a topic related to our conference, we thank our clients that provided us with comments and feedback at the town hall meeting and closed-door sessions. Certain due diligence issues that were discussed during these meetings included: (i) the need for many product sponsors to update their sponsor level due diligence opinions in a timely manner; and (ii) the need for our industry to develop best practices in relation to verifying how offering proceeds are being deployed within specified energy and real estate asset programs (i.e., post-closing due diligence).

In respect to the first issue, note that we are in the process of preparing a list of sponsors that attended our conference, which will include dates of our firm's last

sponsor opinion. Please note that you may also call our office if you are either unsure as to whether (or not) a sponsor has undergone a sponsor opinion, or the date in which the last sponsor opinion for a company was completed.

In respect to the second issue, this has been referred to a task force of ADISA's Publications and Standards Committee for discussion. We will keep you informed of the outcome of the task force's discussion and recommended practices.

On a related note, be advised that the Alternative & Direct Investment Securities Association ("**ADISA**") has developed a preliminary draft of what is referred to as the "**GAP Analysis**" relating to sponsor-level due diligence best practices. The GAP Analysis focuses upon items of due diligence information that are sometimes overlooked within the sponsor level due diligence analysis, as well as suggested informational requests and other practices that can be used to help advisors/reps comply with FINRA NTM 10-22. ADISA has published a comment period through August 15, 2021, which gives firms time to review the analysis and provide feedback. Copies of the GAP Analysis can be provided to you upon request. Please direct such requests to Bradford Updike (bupdike@micklawpc.com).

Conservation Oriented Real Estate – Recent Developments

In view of the retail fund raising activities undertaken by sponsors of conservation oriented real estate programs, we offer the following series of articles.

CIC Services Case – Listing Notice Validity. The U.S. Supreme Court unanimously handed the IRS a loss regarding the ability of taxpayers to challenge a notice requiring the disclosure of reportable transactions. While the case involved captive insurance transactions, this case has relevance to the listed transaction notice for syndicated conservation easement transactions (i.e., IRS Notice 2017-10). This case could help pave the way for taxpayers to challenge IRS Notice 2017-10 in the future.

As was the case in relation to syndicated conservation oriented real estate programs, the IRS issued Notice 2016-66. This notice designated micro-captive insurance transactions as reportable transactions, which now requires special reporting of such transactions to the IRS. **CIC Services, LLC ("CIC Services") then brought a lawsuit to invalidate Notice 2016-66 on the grounds that the IRS failed to comply with the notice and comment procedures required under the Administrative Procedure Act (a fact that likewise applies to Notice 2017-10)**. The IRS responded that the CIC Services' challenge was blocked by the Anti-

Injunction Act because it sought to restrain the collection of a tax (i.e., the tax penalties due for failing to comply with the reporting requirements). The lower federal courts agreed with the IRS.

The Supreme Court did not reach the merits of the lawsuit, i.e., whether Notice 2016-66 violated the Administrative Procedure Act. **However, the Supreme Court remanded the primary issue to the lower courts for further consideration**. As a result of this, and the fact that the IRS failed to provide notice and a comment period in relation to Notice 2017-10, we may see one or more taxpayers seeking to invalidate Notice 2017-10 in the future.

The Supreme Court decision is arguably good news, although it does not change the foundational tax laws or regulatory requirements that must be followed to procure a charitable tax deduction for an easement. We will be following the progress of this case and possibly similar cases challenging Notice 2017-10 in the future.

Recent IRS Challenges to Tax Loss Insurance. **The IRS is now challenging the partnership tax status of certain conservation oriented real estate programs in cases where such programs acquired tax loss insurance**. This recent development was discussed in detail by attorney Hale Sheppard in his article *Three New IRS Challenges to Tax Insurance in Conservation Easement Disputes* (JOURNAL OF TAXATION, June 2021).

As a practical matter, the procurement of insurance to cover income tax benefits that could be lost from an IRS audit is hardly a novel concept. For example, policies that are intended to cover audit related tax losses sustained from investments in historic buildings or renewable energy tax credit programs have been around for decades. Within the context of conservation oriented real estate programs, we are aware that such policies have existed since about 2016. Of the six sponsors that offer conservation oriented real estate programs to retail investors, two have provisions that enable program investors to procure tax loss policies.

The IRS challenge to the procurement of tax loss insurance stems from the idea that once such a policy is procured, a taxpayer's downside exposure as an equity holder of the program is eliminated. The tie-in with the validity of a program's partnership tax status is that a taxpayer must be exposed to three levels of risk for the program entity to be a valid partnership, which include: (i) enterprise risk; (ii) capital risk; and (iii) tax risk. Thus, as one of the three necessary levels of

partnership risk are eliminated, the investment appears in substance to be more like a debt obligation than an equity position.

Mr. Sheppard's article presents five well-reasoned challenges to the IRS' position on tax loss insurance. One challenge is the IRS' past acquiescence to the procurement of tax loss coverage by taxpayers seeking to take advantage of federal tax credits for historic buildings and renewable energy equipment. Within the confines of historic tax credit programs, the IRS, in fact, advised in Rev. Proc. 2014-12 that the procurement of tax loss coverage within historic tax credit programs will not cause the partnership to lose its tax status upon economic substance grounds if the taxpayers procure such insurance. It is perhaps noteworthy that nine years earlier (2003), the IRS removed tax loss insurance transactions from its list of reportable transactions.

Our firm has published guidance regarding the procurement of tax loss coverage within the confines of several prior opinions relating to conservation oriented real estate programs. We have advised within these opinions that the procurement of such coverage ***might*** be defendable if the investors are making the decision to procure the coverage. For investors seeking to protect some of their tax deduction through the insurance, we have advised that the procurement of an insurance proposal should not be undertaken until a program is funded and a vote is undertaken by investors in relation to a property's future use. We have also advised that such investors must be given material information concerning the policy's features and coverage exclusions prior to voting. We will monitor this issue as underlying tax cases develop.

Recent IRS Enforcement Cases. In addition to the above-mentioned article, Mr. Sheppard recently published an article underlying the IRS' efforts to bring enforcement actions against promoters of conservation programs. Mr. Sheppard's article is titled *20 Recent IRS Enforcement Actions in Conservation Easement Disputes: Awareness and Preparation are Key* and was published by the JOURNAL OF TAXATION in March 2021.

In addition to mentioning the enforcement cases, the article discusses several other tactics the IRS has used to discourage the capital raising activities of conservation oriented real estate programs. Such tactics include (among many others): (i) designating such transactions as listed transactions; (ii) attacking easements within syndicated transactions on technical grounds (i.e., as opposed to allowing these cases to proceed on the issue of valuation, which is supposed to be the IRS' main gripe about such programs); (iii) engaging in a "name calling"

campaign within the media to disparage such transactions; and (iv) engaging in other conduct of a questionable legal nature (e.g., by engaging in conduct intended to undermine the attorney client privilege, and by depriving partnerships of a review by the Appeals Office).

The author of the article, Mr. Sheppard, is a respected tax defense litigator and partner of Chamberlain Hrdlicka in Atlanta. His firm defends several programs whose charitable deductions are being challenged by the IRS. We recommend the article to those seeking some background regarding the IRS' position concerning syndicated real estate programs and related transactions.

Multifamily Update

Despite forecasts from mid-year 2020, which had foretold a multi-year substantial decline in multifamily occupancy, occupancy rates rose by just 50 basis points between the first quarter of 2020 ("**Q1 2020**") and the first quarter of 2021 ("**Q1 2021**"). The Q1 2021 national vacancy rate was 4.7%, which is a low level of vacancy from a historical perspective. In addition, apartment unit turnover, the percentage of total units not renewed, fell from 47.5% in 2019 to 42.1% in 2020, the lowest level over the past 20 years. On this point, turnover costs can vary between 50% to a full month's worth of rent, or 4% to 8% of annual revenue for a particular unit. The net result for many landlords is that the net income from their properties did not change materially because of the COVID-19 pandemic. Looking forward, CBRE anticipates a decline in vacancy during the second and third quarter of 2021 due to stronger seasonal leasing during the spring, summer, and fall months, as well as a strengthening job market.

The average rental rate fell approximately 4.2% between Q1 2020 and Q1 2021. Three gateway markets (i.e., New York, San Francisco, and San Jose) led the decline. Removing these three key markets, the national decline in rental rate was just 1.1%, a much better reflection of the resilience of the multifamily market during the COVID-19 pandemic.

Construction starts are expected to slow dramatically in 2021. The combination of higher lumber prices and decreasing skilled labor availability are forecast to lower new construction starts. As of the end of Q1 2021, construction starts are down 11% year-over-year and permit activity is down 19.9% year-over-year. Furthermore, investors are dealing with higher loan rates as the 10-year treasury topped 1.50%, up 100 basis points from the mid-2020 lows.

Self-Storage Developments

While the self-storage sector was not immune to the market disruption caused by the COVID-19 pandemic, the sector recovered quickly in the second half of 2020 and reached a new vacancy low. More demand has come from college students who had to pack up their dorms early and return home, and from office workers who have required greater space needs because of working remotely. To make space for these changes, more people are finding a need to move personal belongings into a separate storage unit. Widespread sequestering has also temporarily brought family and friends, who do not normally live together, into the same household. These factors have put space at a premium, bolstering the self-storage sector amid a broader health crisis and economic downturn. Between May and December 2020, the national vacancy rate fell 280 basis points to 7.3% as of year-end 2020. Many metros achieved record-low vacancy rates. *The low vacancy rate is anticipated to remain low.*

New construction ground to a halt in early 2020. Temporary work stoppages and new safety procedures substantially slowed the pace of construction from March through June. Less than 14 million square feet of space was delivered in the second quarter of 2020, the lowest quarterly delivery since mid-2017. Construction picked up again heading into fall, but total completions for 2020 reached 60 million square feet, down 14% from 2019 and short of the record 70 million square feet delivered in 2018.

Entering 2020, multiple years of strong construction weighed on rent growth as operators leveraged lower asking rates to support occupancy. During the pandemic, operators were reluctant to raise rents, creating a slight decline in rental rates during the second quarter. This trend reversed during the balance of the year, however, as rental rates grew 3.5% in 2020.

Sect. 1031 Developments

As we stated in our last newsletter, President Biden's economic plan proposes to substantially limit the capital gains tax deferral benefits associated with real estate like kind exchanges conducted under IRC Sect. 1031. Closing that tax benefit, which has existed within the Federal Tax Code since 1921, is part of President Biden's $1.9 trillion spending package for new social programs. The current law allows investors to defer paying tax on real-estate gains if they reinvest the proceeds

in other properties within six months of the sale. President Biden's proposal would limit IRC Sect. 1031 exchanges on real-estate profits of more than $500,000.

The DST sector of real estate, which has been an active retail program segment over the past several years, experienced approximately $3.2 billion in sales in 2020. Based upon industry sources we have spoken with, the average DST subscription is approximately $300,000, with most tickets falling within a range of $300,000 to $500,000. We note that the impact of President Biden's proposal, while *not* necessarily fatal to the DST program sector, would present a headwind for sponsors who have been successful in procuring larger subscriptions from sophisticated investors.

We note that our industry's primary trade associations, i.e., ADISA and the Institute for Portfolio Alternatives ("**IPA**"), are taking proactive steps to advocate our position in respect to President Biden's tax proposal. In this regard, ADISA has met with fourteen U.S. Congressmen over the past couple months to educate these leaders concerning the downfalls of President Biden's proposal. In response to a misguided article published by the Wall Street Journal ("**WSJ**") that backed President Biden's proposal, John Harrison, ADISA's Executive Director, published a written response on May 10, 2021 in which he explained the importance of IRC Sect. 1031 to many types of taxpayers and stakeholders, which include farmers, small businesses and local governments. Certain excerpts from this article are provided below:

> *"According to a study by Profs. David C. Ling and Milena Petrova, nearly 88% of exchanged properties are sold after one round, often resulting in higher paid tax amounts over time than would have otherwise been due. This reinvestment accelerates the velocity of money and prevents extended holding periods that lead to stagnation. Furthermore, the study states that the repeal of section 1031 would harm tenants, property owners and the economy overall with a decrease in real-estate prices and long-term rent increases, to name a few.*
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> *The administration's proposed changes to 1031 exchanges have huge implications for small farmers whose property values have risen because development has changed the best use of their property. If these farmers wish to sell their farms so they may continue farming in a more appropriate location, the 1031 property-exchange provision allows them to continue their life work elsewhere. Farmers are a*

significant part of our economy. Government should never be in the position of creating roadblocks to their success."

In similar fashion, the IPA has also been active in advocating our position on the Hill in Washington, D.C. The IPA is sponsoring a 1031 Advocacy Workshop on June 3, 2021 in Dallas, Texas. The event will include discussions from industry thought leaders regarding: (i) specific policy positions; (ii) action plans; and (iii) resources needed to support our industry's position regarding Sect. 1031 exchanges.
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In summary, we applaud the effort of our industry's associations in taking proactive measures to help support our interests in keeping IRC Sect. 1031 a viable tax planning alternative for millions of accredited investors. We encourage you to reach out to your local Congressmen regarding the benefits of IRC Sect. 1031 and the need to prevent the passage of President Biden's proposal.

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