**Mick Law - Alts. News Bulletin**
**April 11, 2023**

In this edition of Alts. News Bulletin, we'll provide you with an update regarding EcoVest Capital LLC's settlement with the Department of Justice ("**DOJ**"), and we'll reshare with you some information regarding capital raising developments within the oil/gas sector. In this edition, we've also included an educational discussion regarding the income tax advantages of qualified small business stock issued by early-stage companies under IRC §1202. Finally, we'll conclude with a recap of industry events happening over the next couple of months.

*EcoVest Settles DOJ Lawsuit*

EcoVest Capital, LLC ("**EcoVest**"), a Georgia-domiciled sponsor of real estate investment programs and accused of participating in a tax scheme that generated $3 billion in charitable deductions for donated conservation land agreed to pay the U.S. government $6 million to settle the alleged claims. Under the settlement terms outlined in a private offer letter accepted by the DOJ, EcoVest and three of its key executives will not have to pay back profits realized from the programs. EcoVest and executives were "alleged" to have earned $131 million, according to a government court filing from 2022. The settlement terms also protect EcoVest and its executives (i.e., President/CEO Alan Solon, Chief Financial Officer Robert McCullough, and part-owner Ralph Teal Jr., who serves on the board of directors) from being hit with penalties by the Internal Revenue Service, according to the letter, which is dated Nov. 18. The terms protect them from penalties for promoting tax shelters, according to the letter.

*What this Means for CE Structured Programs*. Despite the arguably favorable terms of EcoVest's settlement (i.e., as the settlement was 0.20% of the alleged program tax deductions), **we remind** that the program syndication environment for conservation-oriented programs took an unfavorable turn earlier this year with the passage of the Omnibus Spending Bill (Dec. 2022). As a result of the Bill's passage, IRC §170(h) now limits an investor's charitable deductions pursuant to a "syndicated" conservation easement transaction to an amount that is 2.50 times the investor's relevant basis within the real estate partnership. The bill incorporates a new term "***relevant basis***," which is defined within the bill as "*the portion of such partner's modified basis in the partnership which is allocable…to the portion of the real property with respect to which the contribution…is made*." This means that regardless of the highest and best use of a property and any built-in gain based on a bargain sale, the Tax Court will now have to determine the value only as to whether the rights given up exceed 2.5 times the partners' total relevant basis. The Omnibus Spending Bill provides for one exception to this rule, which applied to real estate held by a partnership for three years. The three-year holding period requirement requires that the partnership itself has held the real property for at least three years and each partner's ownership interest in the partnership remain unchanged for at least three years. The three-year holding period applies to all partnerships, including tiered partnerships.

To structure certain programs around the amended version of IRC §170(h), we have come to learn that a number of sponsors are preparing to launch programs designed to provide similar income tax incentives to accredited investors through fee simple donations of real estate to qualified organizations. Acknowledging this trend, we warn you of the differing valuation rules that arguably apply to outright fee simple donations of real estate vs. transactions involving conservation easements (i.e., as a fee simple donation is predicated upon the arms-length fair market value of a donated asset per Treas. Reg. §1.170A-1 as opposed to a derivative of fair value method predicated upon the assets highest and best use per Treas. Reg. §1.170A-14(e)). We intend to address such valuation differences within our program level due diligence opinions issued over the next couple of months.

*Oil & Gas Fundraising – YE 2022*

Despite the headwinds from the left side of our Federal Government seeking to impose the *Green Agenda* to displace fossil fuels with more carbon-friendly sources (i.e., solar and wind), the U.S. E&P sector managed to hold its own in 2022 in terms of business growth, which was demonstrated through a year over year increase in onshore drilling activities, as well as a gradual increase in U.S. daily oil/gas production. As a result, oil/gas exploration and production ("**E&P**") capital raising within the retail financial sector saw a significant up-tick in 2022.

As was the case prior to COVID (2020), the fortunes for the E&P sector remain on a roller coaster ride into 2023, as oil prices, which reached $130 per barrel (bbl) in May 2022 have settled into a more stable pricing pattern (i.e., $77 bbl WTI, Feb. 8, 2023). As to the prospects for natural gas, prices in the short term have fallen from the prices observed through much of 2022 due to a pattern of unseasonably warm weather. On a cautious note, natural gas storage levels come March 2023 will likely test domestic U.S. gas prices through much of this year, which hinges upon whether the warmer weather stays from now until April. Notwithstanding, the need for U.S. natural gas abroad on a long-term scale should help to present opportunities for better pricing into 2024 and future years (i.e., due to a gradually increasing capacity to export gas to Europe, as well as the effects of the lingering Russian-Ukraine conflict that could affect gas supplies into 2024).

In 2022, we covered thirteen (13) companies which operate within the upstream sector of the energy value chain. This group collectively funded 22 private placement programs and raised $1.093 billion to support drilling and infrastructure, mineral rights acquisitions, and related E&P initiatives/projects within the retail investment channel. This represented a 96% year over year increase in private capital funding from what was reported by these companies in 2021 (i.e., ten sponsors, $555.974 million). This also resulted in the highest capital raise year from the E&P sponsor group that we cover since 2014.

Leading the way in terms of fundraising was U.S. Energy Development Corp. ("**U.S. Energy**"), at $332.68 million, which was followed by MDS Energy ("**MDS**"), at $225.0 million, and Mewbourne Development Corporation ("**Mewbourne**"), at $250.0 million. In terms of funding growth, eight of these sponsors reported year over year gains in fundraising, which helped to continue their capital raising momentum established in 2021 after the headwinds of the Pandemic began to loosen its grip (i.e., with $273 million being the capital raise from the E&P group in 2020

during the Pandemic year). A chart of the fundraising totals of the E&P sponsors we covered is provided below:

**Table 1 - Capital Raised**

| Company | Strategy | 2022 Raise | 2021 Raise | 2020 Raise |
|---|---|---|---|---|
| Mewbourne | *Drilling*-horizontal wells in the Permian Basin, Texas Panhandle, and Anadarko Basin | $250.00 MM | $119.80 MM | $55.31 MM |
| MDS | *Drilling*-horizontal wells in the Marcellus Shale Play | $225.00 MM | $146.919 MM | $60.0 MM |
| APX | *Drilling*-vertical Mississippian oil targets in the Illinois Basin | No raise 2022 | $19.0 MM | $12.0 MM |
| S.T.L. | *Drilling*- horizontal wells in the Marcellus Shale Play | $42.50 MM | $29.5 MM | $17.3 MM |
| U.S. Energy | *Drilling*-horizontal drilling in the Permian Basin, Powder River, and Eagle Ford Shale Plays; the QOF is also an opportunity fund seeking working interests and other upstream assets | $267.93 MM drilling; $56.65 MM QOF; $8.10 MM §1031 program | $145.0 MM drilling; and $45.0 MM QOF program | $64.0 MM drilling; and $20.0 MM QOF program |
| Waveland | *Opportunity Fund* targeting minerals and non-operated working interests in the Bakken Shale Play | $42.64 MM | $13.255 MM | $22.0 MM |
| Resource Royalty | *§1031 Programs* acquiring minerals and royalties in STACK Play of Oklahoma | $32.9 MM | $11.067 MM | $5.373 MM |
| Montego Minerals | *§1031 Programs* acquiring minerals and royalties in the Permian Basin and East Texas | $62.20 MM | $19.730 MM | $12.5 MM |
| JHO | *Drilling*-shallower vertical oil zones in Tennessee | $5.00 MM | $6.704 MM | $4.35 MM |
| White Hawk Energy | *Royalty Fund* acquiring mineral rights, royalties, and overriding royalties | $65.70 MM | NA | NA |
| Barrow Shaver Resources | *Drilling*-horizontal wells in the E. Texas Bossier and Cotton Valley Plays | $4.50 MM | NA | NA |
| Texakoma Resources | *Drilling*-horizontal wells in the Granite Wash Play in Texas | $30.00 MM | $20.00 MM | $15.00 MM |

<u>2022 E&P Capital by Strategy</u>

Total Capital: $1,093,340,000
Contributing Sponsors: 12[1]
Drilling: $824,930,000 (75%)
Opportunity Funds: $99,340,000 (9%) (includes a QOZ fund)

Minerals/Royalties: $168,900,000 (16%) (61% structured as direct interest)

Nine Internal Revenue Code ("**IRC**") §1031 eligible programs were wholly or partially funded in 2022 by Resource Royalty, Montego Minerals, and U.S. Energy. Overall, the §1031 energy program capital in 2022 ($103.20 million) increased from what was reported in 2021 ($31 million) and 2020 ($18 MM). Driving this upward trend in §1031 capital was the doubling of §1031 eligible offerings last year (i.e., nine offerings funded in 2022 vs. five in 2020), which was fueled by better oil/gas fundamentals coming out of COVID, as well certain acquisition related opportunities that have surfaced from the movement within the public E&P sector to monetize non-operated drilling location assets in response to ESG, as well as Wall Street's expectations in general (i.e., with shareholders placing pressure on companies to use cash flows to pay distributions as opposed to enhancing drilling budgets). Based upon current oil market fundamentals and perhaps *longer-term* natural gas pricing due to anticipated LNG exporting growth, this E&P sponsor group appears to be fairly positioned to achieve a respectable volume of capital raising in 2023 and 2024.

We note that the size of the E&P sponsor group that we cover has been stable over the past couple of years (e.g., ten to twelve sponsors in 2017-2022), with drilling programs outpacing royalties and opportunistic funds in terms of fundraising. Due to the numerous pricing cycles we have dealt with, the fundraising of this sponsor group has been incredibly choppy since 2017 ($330 MM 2017, $401 MM 2018, $369 MM 2019, $273 MM 2020, $556 MM in 2021, and $1.1 billion 2022). This choppiness was caused by multiple headwinds that included severe market volatility, coupled with the fact that the sector continues to seek the reestablishment of investor trust that was lost because of performance failures by several companies that no longer raise capital in the retail channel. Based upon current oil market fundamentals in the near term, as well as longer term natural gas fundamentals, the E&P sponsor group appears to be reasonably positioned to maintain its momentum going into this year.

*Capital Gains Exclusion for PE Investors*
*Under IRC §1202: How it Works*

This article comes from a whitepaper that we authored alongside Justin Reich and David Cohen, who are the managing principals of Seedbrite Ventures, LLC. This article addresses the capital gains exclusion rules pertaining to venture capital and early-stage companies that issue qualified small business stock under IRC §1202.

As transactional advisers and taxpayers, we are all aware of the most prominent capital gains deferral and exclusion provisions offered by the Internal Revenue Code of 1986, as amended ("**Code**" or "**IRC**"), which include like kind exchanges of real estate (IRC §1031), programs that invest capital into blighted business areas known as Qualified Opportunity Zones (IRC §1400), and others.

Despite these well-known tax provisions, however; there is a provision of the Code that many have not heard of, which is IRC §1202. This provision offers a significant income tax break to investors who invest in qualified stock of certain venture capital ("**VC**") and early-stage businesses. This article will discuss certain income tax consequences associated with IRC §1202(c), which provides

income tax forgiveness on long-term capital gains realized from investments in qualified small business stock (“**QSBS**”).

IRC §1202 was introduced as part of the Small Business Job Protection Act of 1996. The primary objective of this provision was to encourage investment in small businesses. The provision offers tax incentives to investors who hold QSBS for a specific period. The initial version of IRC §1202 allowed investors to exclude 50% of the gain from the sale of QSBS held for more than five years. However, the provision has undergone several changes over the years. In 2010, the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act modified IRC §1202 to allow investors to exclude 100% of the gain from the sale of QSBS held for more than five years. This change was made to encourage investments in small businesses during the Great Recession. The 100% exclusion was further extended in 2015 under the Protecting Americans from Tax Hikes (PATH) Act, which made the provision permanent.

IRC §1202 provides a tax incentive for investors who invest in QSBS. QSBS is stock issued by a domestic C corporation that meets certain requirements. The issuing company must have gross assets of less than $50 million at the time of issuance, and at least 80% of its assets must be used in an active trade or business. Investors who hold QSBS for more than five years can exclude a portion of their gains from the sale of the stock. The amount of the exclusion depends on the date the stock was acquired. For stock acquired after September 27, 2010, investors can exclude 100% of their gains from the sale of QSBS held for more than five years. For stock acquired before that date, the exclusion is 50%.

There is also a cap on the amount of gain that can be excluded. The cap is the greater of $10 million or 10 times the taxpayer's basis in the QSBS. This means that if an investor holds QSBS with a basis of $1 million for more than five years and sells the stock for $20 million, the maximum amount of gain that can be excluded is $10 million.

Despite the compelling tax incentive for QSBS issuing companies, there are several rules that must be strictly followed to qualify for the capital gains forgiveness. These requirements are set forth within the following paragraphs.

1. **Stock is not QSBS unless acquired from a C corporation and <u>sold</u> while the issuer is a C corporation**. Also, such C corporation status must be maintained from the date of issuance to the date of sale. Although this requirement seems straightforward, it can present exit complications in cases where a buyer requires an exit transaction to be structured as an asset sale. As such, and while we are aware of VC oriented private equity programs out there seeking to differentiate themselves through QSBS focused investments, please note that it is possible that some or many of the portfolio companies’ exits from such programs will fall outside of this requirement.

2. **Any stockholder, other than a C corporation, can qualify for claiming IRC §1202’s benefits, including individuals, trusts, partnerships, and S corporations**.

3. **QSBS must be acquired directly from the subject corporation for cash, property or services.** Property contributed for QSBS may include intellectual property contributed by the founders. Property (non-cash consideration) is also deemed to be contributed by equity

owners upon the conversion of a limited liability company to a corporation, or upon an exchange of membership interests for QSBS. Stock issued by a corporation as a grant to an employee or director also qualifies as QSBS, so long as the stock is vested when issued or the recipient makes an IRC §83(b) election. On a related note, QSBS transferred upon the death of the stockholder, or transferred as a gift during the stockholder's life, retains its status as QSBS in the hands of the recipient.

4. **QSBS can be voting or nonvoting common or preferred stock**. Nonvested stock (subject to substantial risk of forfeiture under IRC §83) is not treated as "*stock*" until it vests unless the recipient makes an IRC §83(b) election. Also, stock options and warrants do not qualify as stock for federal income tax purposes.

5. **If QSBS is sold before a stockholder achieves a five-year-holding period, it is possible to reinvest the proceeds in replacement QSBS under IRC §1045**. QSBS can also be exchanged for QSBS or non-QSBS as part of an IRC §351 nonrecognition exchange or in an IRC §368 reorganization. *The holding period for QSBS starts on the date of issuance*.

6. **Because QSBS must be acquired through an original issuance, and because QSBS retains its status when transferred if (i) it is a gift during the stockholder's life, (ii) a transfer upon the stockholder's death, or (iii) a distribution by a partnership to a partner, the original holder usually ends up being the ultimate seller**. If QSBS is transferred to a partnership, and the partnership subsequently sells the stock, the contribution will be a nonrecognition exchange under IRC §721, *but neither the partnership nor the contributing partner will be eligible to claim the capital gains exclusion*.

7. **For an issuance of stock to qualify as QSBS, the $50 million gross assets test must be passed immediately after issuance, considering the cash or other property contributed to the corporation in exchange for the stock**. For purposes of satisfying this rule, "**gross assets**" include cash plus the adjusted income tax basis of other assets on the subject corporation's balance sheet. Please note that there are two aspects of this requirement. First, the corporation must be primarily engaged in one or more business activities that are not excluded businesses under IRC §1202(e)(3). Second, at least 80% of the corporation's assets (considering the assets of any majority-owned corporate subsidiaries) must be used in business activities that are qualified trade or business activities ("**80% Test**"). The corporation must have satisfied these requirements for substantially all of the QSBS' holding period (i.e., which has been suggested as 80-90% of such holding period). IRC §1202(e)(3) defines "**qualified trade or business**" to be any trade or business **<u>other than:</u>**

   - any trade or business involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees;
   - any banking, insurance, financing, leasing, investing, or similar business;

- any farming business (including the business of raising or harvesting trees);
- any business involving the production or extraction of products of a character with respect to which a deduction is allowable under section 613 or 613A (e.g., oil/gas exploration), and
- any business of operating a hotel, motel, restaurant, or similar business.

In view of the restrictions in place with respect to the disqualified business activities, it begs the question as to what types of businesses can qualify for the IRC §1202 capital gains exclusion. Despite the restrictions that apply to finance, oil/gas, banking, insurance, farming, real estate, and personal professional services, there are many sectors of the U.S. economy whose activities fall within the scope of permitted commerce. Among the permitted activities are manufacturing, technology, research and development, and software design and development.

Addressing whether a corporation is engaging in an excluded activity is often the most significant issue associated with QSBS planning or with vetting the eligibility of a stockholder to claim the gain exclusion. Even if the corporation's principal activities qualify, it is still necessary to make sure that the corporation continuously satisfies the 80% Test. This requires monitoring whether at least 80% of the corporation's assets (by value) are used in qualified business activities, which exclude assets used in non-qualifying activities, investment assets, non-qualifying real estate, and cash not required for working capital needs. The activities of a majority-owned subsidiary are considered in administering the 80% Test.

Although IRC §1202 offers a significant tax break to QSBS investors, most retail investors don't have access to it. There are several reasons for this. First, IRC §1202 applies only to QSBS. Not all small businesses issue QSBS, and not all QSBS meet the requirements of IRC §1202. To be eligible for IRC §1202, a company must have gross assets of less than $50 million at the time of issuance, and at least 80% of its assets must be used in an active trade or business. Most broker-dealer or RIA retail investors are unlikely to directly come across QSBS opportunities that meet these requirements. Additionally, QSBS is not widely traded, as most QSBS is held by the founders and early investors of a company. As a result, it is difficult for retail investors to acquire QSBS on an intelligent basis.

Acknowledging that IRC §1031 compatible products and QOF oriented funds have dominated the tax product alts space in recent years, we believe that the economic headwinds facing private real estate will no doubt motivate tax minded advisors to seek outsized tax efficient returns in sectors outside of commercial real estate (e.g., such as private equity, infrastructure, energy, and structured finance). Accordingly, this backdrop could present opportunities for certain PE sponsors to leverage IRC §1202 to capture market share for their early-stage PE/VC portfolio companies (i.e., which we note is being pursued by the Seedbrite PE program).

*AI Industry Announcements*

2023 Mick Law Energy & Global Alts Symposium
May 7-9, 2023
Dallas/Plano Marriott at Legacy Town Center

ADISA’s Spring 2022 Conference
April 24-26, 2023
Marriott Marquis San Diego Marina

IPA Summit 2023 Hill Day and Due Diligence Symposium
April 26-28, 2023
Washington, DC