MICK QUARTERLY

Alts. News Bulletin

New Development at Mick

In a continued effort to provide exceptional service to our client base, we offer this news bulletin, which is intended to inform you of recent news concerning alternative investments. This bulletin also provides industry announcements of importance.

Today's News

In this edition, we'll discuss President Biden's tax proposals for 2025, and we'll discuss capital raising developments for DSTs and oil/gas products. We'll also provide a summary of the agenda topics for ADISA's Summer Due Diligence Conference in Boston July 23-24.

IN THIS ISSUE

Summer ADISA Due Diligence Forum

Brad Updike of Mick Law is again co-leading the educational sessions planning for ADISA's 2024 Summer Due Diligence Forum. The 2024 event has an outstanding line-up of sessions and speakers, and the sessions will cover many securities compliance topics affecting non-traded alternative investments. An agenda for this event includes the following:

Monday, July 23

- Alts. Sector Reports (from AI Insight, Stanger, and Mountain Dell)
- Reg. BI:Best Practices & Enforcement
- Sourcing, Diligence, and Practice Tools/Resources for RIAs
- Sponsor Due Diligence: Financial Statements and Prior Performance
- Sponsor Due Diligence Part 2: Site Visit Interview Exercise

Tuesday, July 24

- Alts. Marketing Best Practices: Reg. 506 and FINRA Rule 2210
- Market Developments Affecting Assets: Real Estate and Oil & Gas
- What a Viable Product Educational Platform Looks Like
- Legislative & Regulatory Update

We hope to see you in Boston, MA.

Greenbook 2025: Biden Administration Keeps U.S. Real Estate and Oil & Gas In its Crosshairs

On March 11, 2024, the Biden Administration released its $5.0 trillion proposed budget for federal spending next year. This proposal serves as a fiscal blueprint for the Administration's policy priorities, and the proposal signals to Congress what the Administration endeavors to accomplish over the coming years.

As has been the case since his un-welcomed victory in 2020, several of President Biden's tax proposals appear again to take dead aim at multiple tax preferences that were intended to stimulate spending and investments within the real estate and oil/gas sectors.

Proposed IRC Section 1031 limitations

As most of us know, owners of appreciated real property used in a trade or business or held for investment can defer capital gains on the exchange of the property for real property of a like-kind nature. As a result, the income tax on the capital gain is deferred until a later recognition event, provided that certain requirements set forth in Internal Revenue Code ("**IRC**") Section 1031 ("**§1031**") are met. This provision of the federal tax code is arguably the most significant to us given its possible future impact upon retail offerings of Delaware Statutory Trust interests (or "**DSTs**," which accounted for approximately $5 billion in alternative product sales in 2023, despite the other headwinds occasioned by Biden's economic agenda (inflation and higher interest rates).

The President's proposal would allow the deferral of capital gains up to an aggregate amount of $500,000 for each taxpayer (or $1 million in the case of married individuals filing a joint return) each year for real property exchanges that are like-kind. Any gains from like-kind exchanges of more than $500,000 ($1 million for married individuals) would be recognized by the taxpayer in the year the taxpayer transfers the real property subject to the exchange. The proposal would be effective for exchanges completed in taxable years beginning after 2024.

On a somewhat comforting note, the proposal does not eliminate the use of like-kind exchanges for many accredited retail investors with capital gains not exceeding the above-mentioned gain deferral thresholds. As many DST product subscriptions are lower than the $500,000/$1 million limits, the proposal, if passed, would not eliminate the use of DSTs and other IRC §1031 eligible products by financial representatives and advisors (i.e., because the average DST subscription is between $300,000 and $400,000).

Notwithstanding, the President's proposal is curious to say the least, given its likely chilling effect upon (i) U.S. GDP (projected to fall $8.1 billion, if passed), (ii) investments (projected to fall $7 billion), and labor income (projected to fall $1.4 billion) (Source: Ernst & Young Report).

On a final note, IRC §1031 has been a part of the U.S. tax code since 1921, and several prior efforts by past administrations to curb or eliminate its use have fallen short. In view of IRC §1031's overall popularity and usefulness within many segments of our economic system, the prospects for legislative change appear doubtful.

Elimination of tax breaks for the E&P sector

Currently, our federal tax code provides many tax preferences to accredited investors that place capital in drilling partnerships, mineral/royalty acquisition programs, and programs engaged in surface mining. These tax preferences include:

- Immediate expensing of intangible drilling costs ("**IDCs**") per IRC §263 (i.e., enabling some investors to write-off 60-80% of their subscriptions in the year of investment);
- Using the percentage depletion rules in IRC §613 to reduce gross income from oil/gas production by 15% per annum (which can be taken even after the investor's basis has been reduced to zero);
- Two-year expensing of geological and geophysical costs per IRC §167(h);
- Procurement of active losses for IDCs, tangible equipment deductions, and other E&P capital costs per the working interest exception to the passive activity rules in IRC §469; and
- Immediate expensing of mining exploration and development costs.

The President's proposal eliminates each of these income tax preferences. While there would continue to be income tax rules in place to allow investors to recover their capital investments through cost recovery deductions (e.g., through 5-year IDC expensing and using cost depletion rules), these proposals, if passed, would probably become a game-changer in respect to how future retail programs would be structured.

This proposal also comes at a curious time, as press statements from the White House and the Department of Energy indicate a recognition, albeit begrudgingly, that more drilling may be needed to balance the world's oil/gas supply and demand problems (as the energy output from renewable sources are falling way short of President Biden's expectations). As is the case with respect to IRC §1031, the E&P and mining sectors appear to be fairly positioned to defend the continuation of the above-mentioned income tax preferences.

Other proposals of interest

The President's tax proposal also contains many other tax law changes that, if passed, will affect the income tax consequences of investors, sponsors, and the financial investment community at large. A summary of certain of these income tax proposals is provided below:

- Increasing the income tax rate for corporations from 21% to 28%;
- Increasing the highest marginal tax rate for individuals to 39.6% (for families with taxable incomes over $450,000 and single filers with taxable incomes above $400,000);
- Eliminating the capital gains preference for taxpayers with taxable income exceeding $1 million;
- Imposing a minimum income tax of 25% upon total income, inclusive of capital gains, for taxpayers with a net worth more than $100 million;
- Requiring 100% recapture of depreciation as ordinary income for certain depreciable property (i.e., IRC §1250 assets);

- Taxing the carried interest income and gains of program sponsors and fund managers as ordinary income (i.e., applicable if the taxpayer's taxable income from all sources exceeds $400,000);
- Applying the net investment income tax ("**NIIT**") to nonpassive income allocated from partnerships and S-Corporations and raising the tax rates for both the NIIT and SECA taxes;
- Making permanent the excess business loss limitations previously imposed for non-corporate taxpayers ($305,000 for single filers and $610,000 for married filers);
- Imposing the $1 million deduction limitation for employee compensation upon all privately held C-Corporations (as well as public companies)
- Eliminating the fair market value step up in cost basis for transfers by gift and at death;
- Treating sales of property between a grantor and a trust that is not fully revocable as taxable transactions for federal income tax purposes;
- Imposing a new $50,000 annual gifting limit per donee (i.e., applicable in addition to the $18,000 gifting limit per taxpayer per donee, which would effectively reduce the number of annual exclusion gifts that can be made per year to a donee)

Where will this all go?

While parts of the President's tax proposals are uncomforting to many, it's important to understand that, at the end of the day, **Congress controls the purse strings.** The government is funded through 12 appropriations bills that need to be passed by both chambers and signed into law by the President. Those spending bills can be passed along party lines in the House, where Democrats control a majority. However, they need 60 votes in the Senate, which is split 50-50 at this time.

Time will tell where these proposed tax measures end up. **What is certain, however, is that the Biden Administration is showing no signs of supporting tax policies that are otherwise intended to promote the entrepreneurial spirit of the U.S. through real estate and through ownership of oil/gas related assets.** As Biden's war on capitalism continues, we must also be vigilant in supporting political candidates that are willing to continue tax support for real estate and mid-stream oil/gas.

Energy 2023 Recap & 2024 Sentiment

In 2023, we covered 14 sponsor companies which operate within the upstream ("**E&P**") oil/gas sector and raise money from retail investors. This group of sponsors collectively funded 24 private oil/gas programs that raised $1.226 billion to support drilling and E&P infrastructure, mineral interest acquisitions, and related projects. This represented a 12.17% year-over-year increase in capital funding from what was reported by these sponsors in 2022 (i.e., $1.093 billion). This also resulted in the highest capital raise year from the E&P sponsor group that we cover (i.e., since 2005).

Leading the way in terms of fundraising was U.S. Energy Development Corp. ("**U.S. Energy**"), at $483.0 million, which was followed by MDS Energy ("**MDS**"), at $196.0 million, and Mewbourne Development Corporation ("**Mewbourne**"), at $180.0 million. Collectively, and as was the case in 2023, these three sponsors accounted for approximately 70% of the capital raised by the E&P sponsor group we cover.

In terms of funding growth, about half of the sponsors from the E&P group reported year-over-year gains in fundraising, which helped to continue the capital raising momentum that was established in 2021-2022 after the headwinds of COVID subsided (i.e., with $273 million being the capital raise from the E&P group in 2020 during the Pandemic year).

2023 E&P Capital by Strategy

Total Capital:	$1,226,666,905
Contributing Sponsors:	14
Drilling:	$909,400,600 (74%)
E&P Opportunity Funds:	$174,482,305 (14%) (includes a QOZ fund)
Minerals/Royalties:	$142,792,000 (12%) (84% were structured as direct interest)

Ten IRC §1031-eligible programs were wholly or partially funded in 2023 by Resource Royalty, Montego Minerals, and U.S. Energy. Overall, the §1031 energy capital raised last year ($121.592 million) increased from what was reported in 2022 ($103.20 million) and 2021 ($31.0 million). Based upon relatively stable oil pricing, as well as longer-term natural gas market developments, we think this segment will hold serve in 2024.

DST Sector Sentiments

Despite the continuance of headwinds occasioned by high interest and continued inflation, 54 DST sponsors managed to raise $1.311 billion in equity across 90 programs through Q1 2024. This level of program activity is generally consistent with capital volumes raised by §1031 product sponsors through most of last year. Assuming this trend continues, the §1031 real estate product sector would be positioned to be at about the $5.0-$5.50 billion in equity raised in 2023.

Through Q1, 2024, the top DST sponsor in terms of capital raised was Ares Real Estate Exchange ($263 million, 20% of the DST market), followed by Inland Private Capital ($171 million, 13%), JLL Exchange ($118 million, 9%), ExchangeRight Real Estate ($82 million, 6%), Hines Real Estate ($72 million, 6%), Passco Companies ($62 million, 5%), and NexPoint Securities ($52 million, 4%). These seven companies accounted for over 60% of the DST capital raised through Q1 2024.

In terms of sector coverage, multi-family assets continue to account for the highest percentage of the DST equity (43%), which was followed by industrial (23%), office (14%), retail (7%), and senior housing (3%). A breakout of equity sought, loan-to-values, days on market, and year-one cash-on-cash returns among the various real estate sectors in terms of open programs is provided in the following table:

Sector	Available Equity	Avg. Loan to Value	Days on Market	Cash on Cash
Oil & Gas*	$3.815 million One reported deal	No Leverage	NA	NA
Hospitality	$40 million Two open deals	0%	295	5.53%
Industrial	$603 million 19 open deals	28%	271	4.38%
Multi-Family	$1.099 billion 28 open deals	37%	358	4.58%
Multi-Manufactured	$3.0 million One open deal	20%	546	4.00%
Multi-Student Housing	$112 million Four open deals	49%	117	4.81%
Office	$367 million Five open deals	29%	511	4.43%
Office/Medical	$4.8 million Two open deals	40%	272	4.71%**
Retail	$182 million 17 open deals	23%	315	4.83%
Self-storage	$27 million Three open deals	17%***	215	5.02%
Housing	$76 million Six open deals	19%	289	5.47%
Other****	$52 million Three open deals	0%	107	5.33%

*Oil & Gas 1031s are structured as fractional interest programs
** Zero coupon offering excluded from the average
***Average debt affected by two deals with zero leverage
****Includes farmland and other assets previously not specified

Of the 90 §1031 deals that were open at the end of Q1 2024, the average days on the market was 300 and the average year-one cash on cash return was 4.71%. Also, of the open §1031 products on the market, about 40% (i.e., 34 of 90 deals) are reporting that they are all cash with no leverage used. Of the deals that are using leverage, a substantial majority are using it at loan-to-values from 30% to 50%.

Upcoming Events Calendar

ADISA 2024 Summer Due Diligence Forum
July 23-24 at the Boston Marriott Copley Place, Boston MA

2024 Mick Law Real Estate Symposium
October 20-22 at the Westin Tempe Hotel, Tempe AZ

Mick Law Website

Please note that our website provides you with “direct access” to numerous white papers and educational materials relating to alternative investments. The website also enables you to put in requests for opinions. Please note the following links:

Opinion Requests
https://micklawpc.com/request-an-opinion/

Articles & Newsletters
https://micklawpc.com/firm-articles-and-educational-materials/

Educational Materials About Life Settlements and Private Placement Life Insurance
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