

# Diversity in the 1031 Exchange Market

**T**wo of the most significant developments over the past few years in broadening investment options for accredited investors are the explosive growth of the real estate tenant in common offering industry and almost equally explosive growth of the offering of direct investments in oil and gas royalties and working interest. The simultaneous growth of these two investment options is not an accident but rather a response to the same circumstances, i.e. the predicament of real estate like kind exchange investors.

Prior to 2002 real estate investors found themselves in a quandary. Because there were many more dollars chasing too few good suitable investments, real estate investors either were forced to sit on the sidelines and watch good offers pass by or were left to scramble under strict IRS 1031 exchange timelines to find a suitable replacement property that was the right "size" so that they could completely reinvest their proceeds and match the debt and equity components of their exchange. The



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results were that investors either held on to properties, not maximizing their selling opportunities, or they ventured hurriedly into the competitive marketplace to find properties that were below their standards just to avoid paying the high capital gains tax.

## The IRS Opens the Door

All of this changed in 2002 when the IRS came forward with Revenue Procedure 2002-22. In this the IRS set forth guidelines for structuring like kind real estate investments involving multiple real estate investors. The structure the IRS suggested using was the "Tenancy in Common" structure as opposed to a multi tenant LLC or various partnership structures, which they expressed did not qualify under IRS 1031 rules.

Like the REIT industry, real estate groups saw this as an opportunity to use the Tenant in Common (TIC) structure to bring forth a diversified line up of properties that many investors may otherwise not have an opportunity to invest in. To date investors have been exposed to TIC offerings involving high rise offices, multi family apartments, industrial properties, retail strip centers, malls, triple net leases, hotels, and even golf clubs and marinas. This has given investors the opportunity to invest in a diverse slate of properties both by asset class and geography.

## Some Advantages of TIC Properties

In addition to the diversity of offerings a tenant in common ownership interest has a number of advantages, such as:

- \* Flexible size to match an investors needs
- \* Pre arranged financing
- \* No management hassles
- \* Economies of scale
- \* May be identified and closed in a timely manner

## Oil and Gas Investments for a 1031 Exchange?

So what does this have to do with oil and gas investments? Because the TIC industry tapped into the pent up demand for diverse offerings by 1031 exchange investors some organized selling groups of oil and gas investments brought forth a practice of exchanging bricks and mortar for oil and gas properties. Based on several court rulings, some of which date back to the 1940's, investors embraced yet another

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option for 1031 exchange investing. Although working interest and royalty interest in existing oil and gas properties qualify for a 1031 exchange it is the royalty interest investments that seem to be the most popular for this space.

**Why are Oil and Gas Royalties a Popular 1031 Exchange Investment?**

There are several reasons. Below are a few:

\* Simplicity - Oil and gas royalties typically do not have to be structured with the same complexity as do TIC offerings since they are not required to comply with the rigorous demands of revenue ruling 2002-22.

\* Exposure - Unlike real estate or working interests in oil and gas, royalty interest holders are not exposed to any liability issues and will never incur any expenses.

\* No Leverage - Oil and gas royalties typically do not have financing thus simplifying the process significantly. This also means that there is no chance of a foreclosure by a bank or lender.

\* Low Minimums - The minimums for oil and gas royalties are usually around \$100,000 and like TICs are flexible which gives investors the opportunity to put excess exchange money into a royalty offering should their other investment not match their entire exchange size.

\* Diversification - Oil and gas royalties are also diversified assets to those investors who feel over exposed to the real estate market.

**Satisfying a 1031 Exchange with a Balance of Both Energy and Real Estate**

What often happens with those 1031 exchange investors who are exposed to energy royalties and find it a suitable investment is that they usually do an exchange with a balance of both energy and real estate often times using TIC properties as their real estate choice. Royalties are not a replacement for real estate rather a compliment. Each investment has a specific set of benefits and risks. Both investments can help investors retain what they have earned while giving them monthly cash flow with little effort. Investing in both allows investors to diversify

their exchange and spread out their risk by putting some of their funds into a commodity that has a very low correlation to the real estate markets, the national economy and interest rates.

TICs and Energy Royalties may not be suitable for every investor. It is important that you consult with an investment professional and determine what is suitable for you and your unique situation. However, if it is determined that these investments are suitable then you as an investor have opened the door to new 1031 exchange options.

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that can change - and only be changed not through documents to which the seller is a party - is that the buyer's assignment of its obligations produces an additional obligor and a guarantor.

What this all seems to be saying is that as long as a structured sale plays by the same rules as installment sales, the concept of adding the feature of assignment from the structured settlement world should work. As with all things legal, and all things tax, running your situation by a professional with lots of letters after his name is recommended.

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