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An Intro to 1031 Energy Programs

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The presence of lower oil and gas prices presents opportunities for investors in non-traded energy products to capture acquisition-driven upside that might not have existed at higher commodity prices. Such is the investment theme of retail syndicated 1031 energy products designed to provide long-term income and growth to investors through strategic acquisitions of oil and gas minerals and royalties.

1031 Product Introduction

The 1031 energy program offers opportunities for retail investors to acquire direct fractional interests in oil and gas properties through like-kind exchanges, allowing the investors to sell conventional surface real estate and acquire interests in subsurface mineral-related assets on a tax-deferred basis (due to the status of mineral rights and royalties as real estate under federal tax law). In fact, most royalty acquisition programs offered within the non-traded retail sector over the past decade have been §1031 programs. These programs are marketed to accredited investors through private placements that are exempt from securities registration under Rule 506 of Regulation D. 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), (ii) sale proceeds being held though qualified intermediaries, and (iii) the closing of the replacement property within 180 days of the sale of the relinquished property, the sale gains attributable to the disposition of the relinquished assets can be deferred under federal tax law.

As working interests are the assets of tax-advantaged drilling programs, a logical question that follows is whether working interests can be purchased through 1031 programs. While working interests in oil and gas leases and associated production can technically qualify for like-kind exchange treatment under IRC §1031 of the federal tax code, a substantial majority of the assets acquired in 1031 energy programs are mineral interests, royalties and overriding royalties (due to the fact that income-producing assets are favored by the investors who participate in the offerings). As the underlying research and buying analytics involved in acquiring mineral and royalty assets tend to materially differ from those of a traditional E&P drilling company, this segment of the retail energy channel has been underserved over the past decade.

Program Structure

While the Delaware Statutory Trust is unquestionably the product structure of choice for surface-oriented 1031 real estate products, the tenant-in-common structure (TIC) prevails within the retail energy offerings that provide like-kind exchange opportunities. Generally, the sponsor 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 retail investors of the 1031 program as capital 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, the investors who want 1031 treatment can close on the investments at needed times to meet various IRS deadlines. 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 Schedule C 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.

Program Manager

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 on-going 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 tax advantages associated with real estate, as the program assets are titled directly to the investors.

Distribution of Cash Flow

As to program economics, 1031 energy programs don't have tiered/waterfall distribution provisions because they are direct title programs. This is because 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 1031 program). 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 percent of the interests from the seller, but issue 95 percent of the interests to the investors (i.e., Issuer LLC retains 5 percent of the properties for its own account). The Issuer LLC charges 100 percent of the purchase price to investors, but conveys title to 95 percent of the assets (thus passing some of the economics to the sponsor without running afoul of the partnership rules that apply to 1031 TIC/direct title transactions).

Offering Load and Fees

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. At the end of the day, investors should have a reasonable chance to earn high-single-digit to mid-teens return on a load-adjusted basis under average economic conditions (i.e., with 10 percent to 15 percent IRRs being the better opportunities after factoring load and sponsor compensation). To maintain reserves and cash flows, it is generally a good idea to have properties where future drilling is reasonably expected. Otherwise, distributions may fall quickly in a short amount of time. Other elements of the economic structure of these investments are explained below:

- Marketing and Due Diligence Costs: 8% of gross proceeds
- Organization and Offering Costs: 2% to 3% of gross proceeds
- Managing Dealer Fee: 2% of gross proceeds
- Acquisition Fee: 2% to 3% of gross proceeds (generally applies if the sponsor is buying assets from a third party and requires reimbursements for internal due diligence of the assets)
- Purchase Price: 85% to 88% of gross proceeds
- Annual Management Fee: 50 bps to 100 bps of gross proceeds

Due Diligence Considerations

The due diligence requirements imposed upon broker-dealers is explained in greater detail in FINRA's Regulatory Notice 10-22 and in Regulatory Notice 03-71. Short of providing a complete discussion of all guidelines in the notices, areas that we would analyze for 1031 energy investments are:

1 / Asset quality: Targeted assets of the program must generally present ample opportunity to capture upside from price escalation and future oil/gas reserve development. Conversely, assets with future drilling and growth potential may present challenges down the road from a return perspective. Independent analysis from a third-party engineering consultant that was not affiliated with the sponsor is also strongly encouraged.

2 / Has the sponsor acquired the asset, or if not, how long will the sponsor be given to raise funds to acquire? Is the breaking of escrow conditional on the sponsor's ability to raise enough capital to deliver clear title to the investors?

3 / Performance/experience. Is the sponsor a "Johnny come lately" that thought it would be great to syndicate an energy fund in a down market, or does the sponsor actually have personnel who have managed multiple programs like the one being syndicated? Look for patterns of success in the sponsor's prior acquisitions and programs.

4 / Investment process. Can the sponsor articulate an established process that it has used to source and evaluate its acquisitions in the past? Does the process require involvement from engineers and geologists with experience in the oil/gas basins in which the assets are actually located?

5 / Accountability. The sponsor's commitment to the retail investors can be observed in the way it has established its accountability and transparency obligations. For example, is the sponsor required to provide investors with reports and other financial information on a periodic basis?

6 / Does the program look too much like a partnership? This is the most critical inquiry. Exchanges into directly held minerals and royalties can qualify for like kind exchange treatment. However, exchanges whereby the program appears to be a common-law partnership cannot qualify. Certain factors that determine this issue include: (i) the structuring of the sponsor's compensation through a fixed management fee; (ii) the investor's ability to replace the sponsor as the asset manager if he or she so choses; and (iii) the investor's ability to sell its fractional interest in the program's mineral rights.

Conclusion

Historically, tax-advantaged drilling programs have accounted for a substantial majority of the capital raised for non-traded energy programs. Against the backdrop of lower oil and gas prices, however, we believe there is an opportunity for 1031 energy products to capture a greater share of the non-traded retail energy product market in 2021 and future years.

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The firm provides clients individualized legal opinions with an additional focus on project and fund structure, financing, valuation and exit analysis. We believe our experience allows us to assist our clients by understanding not only what the regulators require, but more importantly how a direct private placement product compares to its peer group and the likelihood of program performance.

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