

Mick Law P.C.

Real estate capital developments

by Bryan Mick, JD, MBA

As the U.S. economy gradually recovers from the clutches of COVID, we are seeing certain real estate product structures attracting retail- and institutional-based capital. This article summarizes these developments as they relate to IRC Sect. 1031 real estate products, qualified opportunity funds and conservation-oriented real estate.



“1031 tax advantages can make a good deal a great deal, but they cannot save a bad deal. At the end of the day, it’s all about the asset and its ability to deliver value to the investors.”

– Bryan Mick, Chairman and Founder

Sect. 1031 product developments

In 2021, the securitized IRC 1031 product market saw 42 sponsors raise a total of \$7.40 billion through 265 programs, according to a 2021 year-end report issued by Mountain Dell Consulting. This result more than doubled the previous \$3.65 billion high-water mark hit in 2006.

Inland Private Capital Corp. led the pack with 18 percent of the total capital raised, followed by Ares Real Estate Exchange (i.e., Black Creek Group) with 11 percent, Capital Square Realty Advisors (10 percent), Passco Companies (7 percent), Cantor Fitzgerald Investors (7 percent) and ExchangeRight Real Estate (7 percent). As was the case in 2020, multifamily properties accounted for the largest percentage of 1031 capital raised (\$3.62 billion/49 percent), with retail (\$0.98 billion/13 percent), industrial (\$1.33 billion/18 percent) and self-storage (\$0.49 billion/7 percent) programs also reporting healthy levels of raised capital.

Senior housing, hospitality and energy were the least-favored sectors, collectively accounting for less than 3 percent of the total. Notwithstanding the COVID headwinds that affected these three sectors, market fundamentals now bode favorably for the energy sector of the 1031 product market, with oil prices expected to average about \$80/bbl oil this year, according to Raymond James, and with global oil consumption expected to return to pre-COVID levels (i.e., 100 million bbls oil per day). Also, it’s worth mentioning that a new DST (Delaware Statutory Trust) sponsor, Energy Related Properties (ERP), is entering the retail/RIA channels in 2022 and is about to launch its first DST. Based in Midland, Texas, ERP is a real estate investment and

property management firm that specializes in acquiring and leasing warehouse properties to oil/gas goods and services companies. The addition of ERP to the retail channel should bolster 1031 product sales on the energy side of the product market.

Certain other findings of note from Mountain Dell’s 2021 year-end report include:

- While New York and California have the largest populations, these states only accounted for 18 of the 265 closed 1031 programs (approximately 7 percent).
- Texas, Florida, Georgia, Illinois and North Carolina accounted for 186 of the 265 closed 1031 programs (approximately 70 percent).
 - Offerings structured as DSTs: 247 (93 percent)
 - Offerings structured as TICs or direct title: 18 (7 percent)
 - Offerings registered as 506(b): 217 (82 percent)
 - Offerings registered as 506(c): 48 (18 percent)
 - Avg. year-one cash-on-cash: 4.49 percent
 - Avg. days on market: (107 days, with 69 days as the median)
- As of December 31, 2021, there remained 61 open offerings continuing to seek \$1.33 million of capital.

On a related note, ADISA is updating its 1031 product best practices to provide a DST-focused educational orientation. The older version of the best practices, TICA Alert 06-01, was published in 2006 to provide broker-dealers and RIAs with an educational resource that covered tenancy-in-common products in terms of their background, legal requirements, product structures and securities requirements. Our firm is actively participating in the redrafting process, and we anticipate that the updated 1031 best practices will be available to ADISA’s membership later in the first half of 2022.

Opportunity zones beyond 2022

– Are they still in play?

On January 1, 2022, the deadline passed for investors of Qualified Opportunity Funds (QOFs) to achieve the 10 percent step-up in the cost basis of their investments. As the 10 percent basis step-up expired, some may have felt that the clock had run out for new investments in QOFs. However, opportunities still remain for those seeking exposure to quality real estate assets and projects that happen to be located in QOFs, while at the same time deferring payments of their capital gains taxes through December 31, 2026. An industry report published by AI Insight in December 2021 suggests that there is a continuing pipeline of QOF products being offered by several QOF product sponsors. As of December 2021, AI

Insight covered 16 QOFs with an aggregate target capital raise of \$2.3 billion and an aggregate reported raise of \$860 million. The most recent of the QOF products to hit the retail channel was Griffin Capital Qualified Opportunity Zone III (December 2021), which is seeking to raise \$250 million. In addition to the deferral of capital gains taxes, the ability for investors to receive a fair market value basis after holding the investment for 10 years remains intact. Notwithstanding the tax benefits that remain, we continue to believe that, at the end of the day, it's all about the asset and its ability to deliver value to the fund investors. As was the case in 2018–2021, opportunity zones can make a good deal great, but a bad deal is a bad deal from an underwriting perspective.

Conservation-oriented real estate product developments

Real estate programs that utilize conservation as a component of their fund strategy also experienced significant capital volume in 2021. Within the retail financial services channel, six product sponsors raised \$320 million across 33 programs. Despite the tumultuous tax regulatory environment faced by these products, last year's volume represented an increase from the capital raised by such programs in 2020.

Despite this product sector's capital volume in 2021, it must be understood that the tax regulatory climate has been tumultuous based upon the IRS' disdain for syndicated real estate programs utilizing conservation easements and the very high percentage of these programs that are being selected for audit (i.e., more than 90 percent). On this point, the Charitable Conservation Easement Program Act continues to be contemplated in the House (H.R. 4164, nine co-sponsors), as well as the Senate (S. 2256, 12 co-sponsors). If passed, this legislation would deny a charitable contribution deduction for any easement transaction in which the deduction exceeds 250 percent of a taxpayer's "relevant basis" in the pass-through entity that donated the easement (with the relevant basis tied to the cost basis of the donated real estate). As further evidence of the IRS' aggressive posture, it's worth noting that the IRS is seeking to hire 200 attorneys to assist with its crackdown enforcement efforts on programs involving easement transactions.

It's worth mentioning that a favorable taxpayer settlement was recently reached with the IRS in a syndicated easement transaction that occurred in 2014. In his article published in *Tax Notes Federal* on Jan. 3, 2022, Hale Sheppard reported about a recent case (Little Horse Creek Property, T.C. No. 7421-19) in which the IRS settled with the taxpayer for 85 percent of the claimed charitable deduction (i.e., \$18.34 million of the \$22.26 million appraisal value). While some might be inclined to view this as a favorable development, there are some cautionary points to consider. First, the settlement came seven years after the easement was filed on the real estate. On this point, the IRS fought aggressively to attack the easement on several "foot-fault" arguments prior to relenting to a settlement in September 2021. Second, and based upon Sheppard's article, the IRS actually agreed with the taxpayer regarding the property's highest and best use

(HBU), which was consistent with applicable zoning laws relating to the property's location (with procurement of entitlements not appearing to be an issue in the case).

Barring a significant change in the law, capital-raising activities in this sector are likely to continue. For those firms that participate in raising capital within this sector, confirming a property's (i) conservation values and (ii) reasonableness of proposed development must be at the forefront of their due diligence. As to the conservation purpose relating to natural habitats (which is perhaps the highest claimed conservation purpose), a claimed habitat must qualify as a "significant" habitat to qualify as a valid purpose. Unfortunately, we're seeing an uptick in properties in which the validity of the conservation purpose has been questionable (e.g., pastures, farm ground and/or patches of forests that provide habitats to common species and that have limited scenic appeal). As to confirming the viability of an asserted HBU, certain facts and circumstances that are germane to this inquiry would include: (i) the ability of the program to fund the development with cash reserves or debt, (ii) whether the zoning and other entitlement laws support the asserted HBU, (iii) supply and demand fundamentals relating to the asserted HBU (i.e., is the asserted use actually needed within the applicable market), and (iv) reasons why the original property owner acquired the property in question (i.e., to commercialize it or to flip for an inflated sale gain). As such, a property's "developable attributes" will arguably establish the programs/projects that present "the better" alternatives from a tax defense perspective — and that's assuming the client is in the highest federal tax bracket and is comfortable with the extremely high audit risk.



Mick Law, P.C., based in Omaha, Nebraska, is a specialty law firm focused on broker-dealer, registered investment adviser, family office and bank/trust company representation, as well as real estate finance. The firm's due

diligence representation includes reviewing and opining on offerings of various asset classes encompassing: DSTs, real estate equity funds, REITs, qualified opportunity zones (QOZ), cryptocurrency, oil and gas/alternative energy, private equity, development/conservation, life settlements, equipment leasing, managed futures, and hedge funds.

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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