Emerging trends for 1031 investors

BY BRANDI SMITH

Because of the increased interest in 1031 exchanges, we invited a group of industry experts to talk about the trends they're seeing in the market, including trading into Delaware Statutory Trusts (DSTs) and how to exchange oil and gas.

"... you want the diversification ..."

The first topic out of the gate was umbrella partnership REITs (or UPREITs). An alternative to 1031 exchanges, UPREITs offer a way for an investor who is looking to liquidate some real estate to defer taxes. You would sell or contribute that property to the REIT.

"That REIT gives you operating partnership units, then you can control the liquidity. There are no taxes on that whatsoever until you transfer those operating partnership units to shares of the stock. Once you transfer that share stock, that's not real property and you're going to be taxed there," explained Jay Dobbs, senior managing partner of Effective 1031 Planning.

In doing so, Dobbs said you're basically creating an installment sale for yourself.

"Maybe you want the diversification from your one property into the 50 or 100 properties that you have in the REIT. Maybe you want the diversification of the different sectors or geographic locations in that REIT," he said.

UPREITs do come with a warning from Dobbs, though. Once you pass your property to an UPREIT, you will not be able to do any more tax-deferred swapping. It is the end of the line, so to speak.

"The swap-til-you-drop process, that's over," said Dobbs. "So the downside of the UPREIT transaction is that it does not secure your ability to continue to do an exchange. If you UPREIT, that opportunity is gone."

That's why he emphasized how important it is to have that conversation with a client.

"We make really sure that if we're looking at an UPREIT, it's an option that they are not forced to take," Dobbs said.

"... defend that transaction ..."

The value of an UPREIT or 1031 exchange is that the property owner is able to defer capital gains taxes when a sale is made. Otherwise, they would have to turn over a huge chunk of any profit made compared to the acquisition cost.

Answering a question from an attendee, Craig Brown, senior vice president and regional manager of IPX1031, offered an illustrative example. An investor goes out with fresh cash and buys a piece of artwork for $100,000. He sells that for $500,000, deferring the $400,000 gains in a 1031 exchange, which he uses to buy a $1 million piece of artwork. The difference is $600,000, the basis for the new piece of art.

> It's important to clarify that mineral interest is different than royalty interest.

"Now when I sell this piece of artwork, I have to recognize gains," Brown explained. "If I sell it for $1,500,000, I have to pay taxes on the $900,000 gain."

The same is generally true for any kind of asset, real property included, but it can be harder to track if the asset has depreciated.

"In that case, you establish what we call the substitute basis in the replacement property and start your depreciation schedule based on that new substitute basis," said Brown. "You have to track the gain that you lost."

Another question frequently asked about tax-deferred investments is "How long do I have to hold it?" You may get a different answer depending on whom you ask, pointed out moderator Greg Lehrmann, North Texas division manager and vice president of Asset Preservation, Inc.

"That detail is not in the tax code, therefore it's kind of nuanced," he said. "All the facts and circumstances are relevant."

Brown echoed that, saying it really all boils down to intent.

"As an example, we have a taxpayer who owns 10 properties. They've never sold a property in less than five years. They buy their 11th property, it's consistent with all their other holdings. It looks like a property that they're going to hold indefinitely. They're not marketing the property for resale. Somebody comes along and knocks on the door three months after they acquire it and make an offer that they cannot pass up," he said. "I think most tax attorneys are going to be pretty comfortable with that transaction because given the totality of the facts and circumstances, we feel like we're going to be able to defend that transaction even though it's only been three months."

The intent is important because, our panelists pointed out, it can be used by the IRS if the exchange is ever audited. That's why Brown cautioned investors to be careful with any paper trail.

"Don't think out loud in writing. Have verbal conversations with your tax advisor because when the IRS sits down with you, they're going to look at everything they possibly can to try to argue that your intent was not pure in that transaction," he stressed. "Be very careful about it."
That's something Lehrmann admitted to realizing

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several years into his career. Although he is an attorney, if he's helping facilitate a 1031 exchange, he's in the role of a qualified intermediary (QI), which means emails are not privileged.

"We are not an escrow company. We are not a fiduciary of the taxpayer. We are actually a principal in the transaction," Brown clarified. "If you're going to be on the margins, we have an obligation to protect our enterprises. We'll say, 'Listen, this is what we've seen. This is information that we have. You need to take this and go back to your tax advisor and work through these issues.' Just be careful what you ask a party with whom you don't have privilege."

"... from active to more passive ..."

The bulk of the discussion was spent on DSTs, which provides an investment vehicle by which private investors can join a diversified, institutional fund with other investors to buy and manage real property. The IRS considers a DST "like-kind" in a 1031 exchange, a popular option for property owners who want a more passive role after being a landlord for years. The DST sponsor, not the individual investor, is responsible for managing the assets in a particular fund, including dealing with the tenants, making repairs, processing rent and paying taxes.

"These are funds that are professionally managed by multi-billion dollar real estate sponsors. An investor can protect his gain, live off a really competitive income stream and not have the management headaches anymore," said Brown. "For anyone who is looking to go from active to more passive real estate ownership, this is a great way to do that."

Unlike an UPREIT, an investment in a DST is not an end-of-the-road tax-deferred investment. Investors are able to exchange in and out of DSTs as long as the investments are like-kind, a new property is identified within 45 days and the deal closes within 180 days.

Digging into that timeline, specifically the 45-day limit for identifying a new property, Lehrmann offered some explanation of the three ways an investor can do that. The first is known as the "three-property rule"; if an investor only lists three properties, there is no limit on the value. If you want more than three choices, the "200 percent rule" allows you to identify an unlimited number of replacement properties as long as their total value doesn't exceed 200 percent of the value of the sold. The third rule is less practical, he said.

"The '95 percent rule" says if you don't follow either one of the first two rules, you'll still have a valid exchange if you are lucky enough to close on 95 percent of what you listed," said Lehrmann. "That's why that's generally not considered our rule to rely on."

All of this becomes an issue when exchanging into a DST because of the number of properties in a given DST.

"Some of the DST sponsors offer multiple properties inside of one DST. With each property, you're deemed to acquire an undivided fractional interest in each one of those assets, so each one of those distinct properties takes up an identification slot on your ID list," Brown explained. "If you have a DST that has multiple sites, you're burning up multiple positions on your ID list, which creates a problem if you're not paying attention to your 200 percent rule."

While DSTs have a long list of benefits, Lehrmann suggested the biggest disadvantage of investing in one is the lack of control.

"It's not your call to say, 'I want to sell this property.' You own a fractional interest with other investors and you're allowing the fund's sponsor to make the call," he said.

Because the management is centralized, there are also fees associated with DSTs, typically an asset management fee and a property management fee. Lehrmann said his research revealed that in 2019, those averaged out to 5.59 percent. His company reviewed 35 different DST sponsors in the past year, factoring in those fees, growth and a number of other factors.

"We currently have approved 10 sponsors out of the 35. We're probably about to go to 13 or so," revealed Lehrmann.

In the next breath he shared which assets have his attention at the moment: "We absolutely love oil and gas."

"... a natural fit ..."

There are really two types of real estate, explained Dirk Todd, president of Oak Tree Minerals. Surface owners manage everything that happens above ground, such as buildings. Mineral owners control everything below the surface, such as oil.

"What we do at Oak Tree Minerals is go out and buy the mineral interests that already have mature, more predictable production on it. Then we fashion that into portfolios that we sell off as 1031 exchanges," he said. "It's a very good niche product because we like to buy assets, aggregate them, recapitalize and sell off pieces of what we already own. 1031 investors are a natural fit."

It's important to clarify that mineral interest is different than royalty interest. The mineral owner is an active role, acting as the executor with the right to enter a lease or develop the underlying resources. A royalty owner is entitled to a share of production, but isn't a factor in executive decisions, making it much more passive.

"My family has had royalties for years. It's a great asset. It's a great way to make money. It's a great cash flow. You don't do anything for it. You go to the mailbox," said Jay Young, CEO of King Operating Corporation and author of *The Upside of Oil & Gas Investing*.
His company is now assembling royalty-based DSTs, focused on the Permian Basin.

"The DST allows us to take that product and build up value in a relatively short time, then I can sell it," Young said.

He pointed to one such project, for which King Operating aims to purchase an oil field with 10 million to 20 million barrels left. The goal is to raise $100 million, then sell the project for up to $250 million in a matter of 12 to 18 months.

"We like to get rigs and increase value," he said in summary.

For professionals like Lehrmann, oil and gas can be an option to help clients diversify their portfolios.

"You're getting in at a much more attractive price when you're looking at oil and gas right now and I think it should be a part of what clients are doing with their exchange money," he said.

Along with the benefit of diversification comes the ease in exit strategy. There's already a secondary market established for royalties.

"Whether it's traditional real estate or these mineral interests that we buy, you want to know what your potential for gain or loss is." Todd said. "Obviously, if you're buying an asset, when the commodity prices are at an all-time high, and they're going to come back down to the bottom, it's not going to look good for you. But you could have the opposite effect as well."

Any investment comes with a level of risk, as any investor is well aware. Knowledge of these trends and new options when it comes to 1031 exchanges is sure to help investors of all levels make more educated decisions about where to put their money going forward. ■