

OIL & GAS ROYALTIES QUALIFY FOR REAL ESTATE EXCHANGE

By Gregory Anderson, CFP®

Real estate investors looking for opportunities to exchange property under Internal Revenue Code section 1031 should consider a little known option beginning to gain in popularity. Investors can use the “1031 exchange” to swap real estate for the royalties on land associated with energy exploration.

It’s time for four-plex owners, for example, to quit thinking that the rules of a 1031 exchange limit them to the purchase of another four-plex. The options are virtually endless, as evidenced by the ability to turn a four-plex into a percentage of ownership on energy and mineral lease-hold rights -- meaning royalites.

Another common misconception is that only developed, or “sticks-and-bricks” properties, qualify as real estate. Vacant land, or anything else defined by the state of Colorado as real estate, also qualifies as a “like-kind” 1031 exchange.

Properties dedicated to energy operations qualify as real estate and therefore qualify for a 1031 exchange, with all the associated tax benefits.

Like-kind properties aren’t defined by their physical description but by their intended use or purpose. All 1031 exchange properties are real properties held for investment purposes, trade or business. For example, the exchange of rental property for a retail center qualifies under the tax code. But all such properties must be in the United States. In Colorado, the state’s definition of real estate includes not only improved and vacant land, but also water rights, mineral rights and air rights.

Keep in mind that the list of properties that don’t qualify includes stock in trade or other property held primarily for sale; stocks, bonds or notes; other securities or evidence of indebtedness; interests in a partnership and certificates of trust or beneficial interest. Another 1031 exchange option is the tenant-in-common, or TIC. This is an increasingly popular and an appropriate choice for real estate owners who rent their property but are no longer interested in dealing with maintenance and other issues that can become a nuisance. Tenants-in-common are fractional shares in large real estate projects that can be sold to individuals who want to continue to reap the benefits of tax deferrals without the hassle of everyday maintenance and administration, including tenant-related problems. In addition to offsetting administrative hassles, TICs offer the potential for future appreciation if, for example, you exchange your duplex for a share in an office complex worth, say, millions of dollars. You get a slice of the cash-flow pie without having to manage the property.

Another aspect of this investment makes it particularly attractive to people seeking portfolio diversity. These investments are considered “non-correlated,” which means they do not move in conjunction with the stock or bond market. A stock market move in one direction, for instance, will not necessarily move your TIC in any specific direction.

TICs do have some rules and risks. For instance, the number of owners in a single project is limited to 35. There are conditions regarding decision-making that will have an impact on the property; and there are conditions for management agreements.

Also, Tenant-In-Common interests are available only to accredited investors; TICs are subject to the usual risks of real estate; cash flows and returns are not guaranteed; they involve fees that may offset tax savings; they are generally illiquid (without a secondary market); and they require a high level of due diligence. Investors also face the risk of failure to meet completion deadlines, with a potential lack of cash flow.

Whether you invest in vacant land being used for energy exploration or are interested in a fractional share in a real estate project, definitions of real estate can vary from state to state. Be sure an asset is eligible as real estate before making an exchange.

If you're considering a 1031 exchange, consult with your tax attorney, accountant or financial planner. Make sure the Exchange Addendum is added to the Contract to Buy, and that the Qualified Intermediary is built into the process from the beginning. It's also important that the Exchangor attend the closing and monitor that the proceeds go directly to a Qualified Intermediary -- also called an accommodator. A bank, financial institution, an attorney or a CPA can serve as a QI, but the QI cannot have served as an agent of the Exchangor. In other words, relatives, employees, attorneys, accountants or brokers who have had a recent working relationship with the Exchangor do not qualify. There may come a time when the government regulates 1031 exchanges, but until then, it's imperative that investors safeguard themselves against misappropriation. A Qualified Intermediary can help.

DISCLAIMER: All investments have risks. Past performance is never an assurance of future results. No guarantees are given, nor implied. Risks and suitability should be reviewed by one's tax and/or legal advisor(s). Some programs may require an accredited investor status.

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