

Increase Your Cash Flow Potential and Diversify Your 1031 Exchange with Energy Royalty Interests

By Chris Miller, MBA • Midpoint Financial Services

Would you like to own investment real estate that had-

- Great cash flow potential that is not correlated to the real estate market?
- Deductions that are not limited to basis?
- No expenses?
- No tenants, mold or vacancy concerns?
- Growth potential, and
- No management headaches?

You can; if you “think outside of the box.” Internal Revenue Code Section 1031 allows real properties used in trade or business to be exchanged, tax free, for other real properties used in trade or business.

While the benefits of Section 1031 are best known in connection with rental properties, the IRS also accepts working interests in producing energy wells or royalty interests as “like-kind” real estate.

A working interest is the right to drill or operate a producing oil or gas well on a given property. The working interest holder owns the right to produce oil or gas, but does not necessarily have to own the land. Royalty interests are the mineral ownership rights to what is underground. To drill a well, a working interest owner must lease that right from the royalty owner. The royalty owner will receive a percentage of production from that well.

Just as ownership of a property’s surface rights are “like-kind” real estate, so are the above-the-surface and the below-the-surface leasehold interests. In 1968, the US Treasury Department ruled¹ that “like-kind” real estate included above-ground rights, (like a ground lease), surface rights, and subsurface mineral rights. Available are “will” tax opinions on these matters - the strongest type of tax opinion an attorney can write.

You can get more information regarding the IRS’s position on tax-free, 1031 exchanges to working or royalty interests by going to its website: <http://www.irs.gov/irm/part4/ch37s03.html> and scrolling down to: 4.41.1.4.6 (02-01-2006) Exchanges of Property, paying close attention to 2B and C.

When the IRS issued its Rev. Proc. 2002-22 in 2002, which set forth “Safe Harbor Guidelines” for reviewing tenant in common-type exchanges into fractionalized interest of real property, it specifically excluded “mineral property as defined in section 614” – respecting the Service’s long-established practice of already permitting such exchanges.

Energy Prices Headed Higher

Given today’s high costs of domestic energy, and the forecasts for increasing prices, the opportunity to sell rental properties at a high price today and orchestrate a 1031 exchange, tax free, into royalty interests may be very attractive. The result may be capturing your gains today and receiving great cash flow while waiting, perhaps, to exchange tax-free back into rental properties if prices decline later - for a better value.

Increasing demand worldwide and political tension in Eastern Europe, the Middle East and South America threaten to keep upward pressure on energy prices for years. Various mishaps, (remember the rusty pipeline or the hurricane?), could cause spikes at any time. In 2005, a Goldman Sachs analyst agreed and famously predicted a spike to \$105 per barrel in our future. Goldman more recently (December 21, 2006) forecast worldwide demand growth exceeding worldwide supply growth in 2007 by 15%. Raymond James continues to agree, stating “The Era of Cheap Oil is Over” on December 26, 2006.

¹ Rev. Rul. 68-331, 1968-1 C.B. 352

If the experts agreed that the demand for rental real-estate exceeded the supply and that the shortage was increasing, most of us would rush to purchase more properties. But, this is not the case. It is the case, however, for domestic energy.

It is easy to verify the trend-line of increasing energy prices by researching the prices that real users are paying today for future deliveries. Increasing energy prices are a problem if you are a buyer. But if you are a seller, they are a windfall.

More Benefits

Excellent cash flow potential from investing in royalties is only one of several advantages. Other benefits include:

- 1) No tenants, trash, termites, mold or vacancy concerns.
- 2) No concerns about non-conforming properties.
- 3) No drilling/dry-hole risks. Producing wells may have been operating for many years and may have 35 or more years of remaining life. All of the gathering systems are in place. Sales contracts have been signed. Energy is flowing.
- 4) Appreciation potential. A royalty interest covers a set area of land. When an operator (Exxon or Anadarko, for example) drills another well, *at their own risk and expense*, the royalty owner is paid a percentage of that well's production. The result is *growth potential*.
- 5) No expense risk. A royalty holder receives a percentage payment of a field's production before the operator pays expenses.
- 6) No correlation to the real estate market.
- 7) No management involvement.
- 8) A long-established energy interests auction market for potential liquidity in 60 days at market prices.
- 9) Currently can be 1031-exchanged later for other energy interests or back into rental properties, tax free.
- 10) Depletion deduction - which U.S. Supreme Court Justice Potter Stewart referred to as "the single best business deduction in the entire tax code." Why? Because, unlike depreciation with rental properties, percentage depletion deductions are unlimited to one's cost basis, are not subject to recapture (past a zero basis), and are not an income preference item. (*This deduction does not go away even if you are paying the Alternative Minimum Tax, or AMT.*)

What Are The Risks?

There is no such thing as an investment with no risks. Royalties are attractive investments because, while they do have some vulnerabilities, they are missing many of the risks that other energy investments have. As mentioned above, royalties have no dry hole risk or expense risk.

Investing in Energy royalties has these risks-

1. The commodity price of oil and gas drops substantially, as does income from the investment.
2. The fields the royalties cover run dry and income from the investment stops.
3. One of the wells has a problem, and income slows while the problem is fixed.

These risks can be mitigated in the following ways:

1. Income from a royalties investment is completely dependent upon the commodity prices of oil and natural gas. If oil and natural gas were free tomorrow, your investment probably would not be worth anything. That example is overly simplistic, but the point is – if prices rise, your income will rise. If

prices fall, so will your income. This is where due diligence is important. When reviewing a potential royalties purchase, much attention should be paid to the price assumptions used in the forecasting model. These questions should be asked-

- a) What do energy prices need to be to achieve this expected return? If commodity prices of \$80/bbl oil and \$11/mcf natural gas are required to meet the expected returns, investors could be in for disappointment. Reasonable prices here make performance benchmarks more easily attainable.
- b) What is the “worst case scenario?” For example, what would the returns be if oil prices dropped to \$40 per barrel?

Looking for conservative projections can help investors find good royalty deals.

2. Royalties will only pay you for as long as the ground is producing petroleum products. To guard against fields that may go dry, look for a sponsor who performs substantial engineering due diligence prior to purchasing a deal, and has a third-party firm check their work. For example, a property where engineering firms estimated a 35+ average remaining life for currently producing wells, and estimated that the field is 50% undeveloped (verified growth potential) is preferred.

3. *Institutional-grade* royalty offerings can address this problem through diversity. If you own royalties on 1000 acres with 20 producing wells, then three of those wells stopping production for an extended period of time could have a large effect on cash flow. Owning royalties on hundreds of thousands of acres with, perhaps, 10,000 wells mitigates this risk. If three wells stopped producing in this field for three months, the investors would likely not even notice.

Give Your Zero-Basis Assets Deductions Again!

The depletion deduction is, again, unlimited to one’s cost basis. Many investors have owned rental properties for 30 or 40 years, and have fully depreciated them. The tax-sheltered income that was once enjoyed is now gone – all income from the property is now fully taxable. If this investor exchanged from that rental property into royalties, the investor would get his deductions back – 15% of his income would be sheltered from tax. This is a free deduction – one that can be taken forever, with no recapture due – Ever! (In this example – where the investor has a zero cost basis.) His result is more after-tax, spend-able income with royalty interests.

Direct Ownership and Control

One’s interest in energy is “on title” as a direct owner. An investor receives assignments (the royalty equivalent of a deed) showing him as a percentage owner of these mineral interests. Owners are free to keep or to sell their interests anytime they want.

A 1031 exchange option does not have to be all or nothing. Instead, a seller might orchestrate a 1031 exchange into a traditional rental property for half of his sales proceeds and orchestrate another exchange into energy interests for the remainder. The result is less risk by allocating investments among different product types.

A minimum cash investment of \$100,000 can purchase a fractionalized interest in royalties covering, for example, 1,500,000 acres, spread over 18 states, with 26,000 currently producing wells. This can reduce one’s overall risk via diversification. The direct assignment process makes it easy to provide an investor with exactly the replacement value he needs down to the penny.

Same 1031 Requirements

Accomplishing a 1031 exchange into energy interests requires the same use of a Qualified Intermediary (QI) as when exchanging into a rental property. The deadline of 45 days to identify replacement properties and 180 days to have concluded the purchase of a replacement property(s) are the same. But, because evaluating and purchasing royalties takes time, identifying such a portfolio needs to begin sooner than later. The time to get serious about considering this option is when a seller is in escrow to sell his relinquished property.

Are Royalties Right for You?

If you are interested in great cash flow and making your life less complicated, then investing (outright or via a 1031 exchange) in royalty interests deserves consideration. If the IRS regards mineral and /or energy interests as “like-kind” real estate then perhaps you should too. But, to delay is to decide.

Chris Miller is a Senior Consultant with Midpoint Financial Services in Tustin, California. Chris earned an MBA with an emphasis in Real Estate Finance from the University of Southern California, and can be reached toll-free at 877-313-1868.