Fundamentals Driving Today's Energy Markets and Real Estate to Oil and Gas in an IRC § 1031 Exchange

By: Todd Garner, CEO
Pinnacle Royalties

There's been quite a buzz (or hangover) in the TIC industry lately. Real Estate is experiencing tough times and energy is seeing new highs each day. That's the nature of cyclical industries. Five to ten years ago, the situation was reversed as it may yet again be in the future. As most folks in real estate are intimately familiar with the fundamentals hampering there, let's focus on what's happening on the energy side and how energy TICs are still a way for investors to move portfolio gains to the upside in this or any market environment.

It's hard to ignore the recent headlines with oil topping $145 per barrel (bbl). Natural gas was also on a tear at over $13 per thousand cubic feet (Mcf). Both have retreated due to the dollar rebounding strongly. Despite the volatility in energy markets there are long-term indicators of supply and demand fundamentals that point solidly upward.

Many want to know how to participate in the exciting and dynamic energy markets in an IRC § 1031 exchange. Further, investors want to know if it is a good time to get in or if they have missed the boat.

From someone on the inside, here's the scoop.

- High oil prices are here for the medium term….probably longer. However, you don't get to $145/bbl strictly on fundamentals. $85/bbl, maybe…but not $145/bbl. The weakened dollar was largely to blame while oil traders in the pits are also likely to share some of the blame. But, let's talk about the fundamentals.
- If peace broke out all over the world and the dollar and euro reached parity tomorrow, you'd still see $75 to $90 per barrel on pure fundamentals. Those fundamentals are that we consume over 86 million barrels a day worldwide while we only produce a little more than 85 million barrels per day. That means that meeting the demand has to come from existing reserves and inventories around the world. This creates the upward price pressure that's not likely to recede anytime soon, barring worldwide recession or depression. Higher prices are the norm from here on out. Get used to it.

If one is contemplating an IRC § 1031 exchange and looking to move into energy there are options. For some, the concept of migrating from traditional bricks and mortar to oil and gas in an IRC § 1031 exchange is nothing new. For others, the sentiment ranges from keen interest to outright denial of the possibility that oil and gas would be considered as real property by the IRS.

When contemplating an IRC § 1031 there are a few key items that are critical in accomplishing successful exchanges using oil and gas properties. This list is not exhaustive, but should serve as a guideline for the initial questions to ask about any IRC § 1031 exchange offering using oil and gas.

1. The investor cannot purchase an interest in a partnership of any type.
2. The investment must provide a conveyance or direct assignment of the interest (royalty or working interest) to the exchanger. The working interest is really a lease on acreage owned by others. This lease provides the lessee the right to "explore, develop and extract" minerals as provided in the lease. These "minerals in place" are what help define a real property interest in the eyes of the IRS.
3. The tax opinion written for the offering must be from a reputable firm in the IRC § 1031 exchange realm and must be a "Should" level or higher. This means that the attorneys opine that the offering "should" be considered real property, among other items.
4. The co-owner must be able to take his or her share of production "in-kind" at any time.

Hopefully, this will provide food for thought the next time you're embarking upon an IRC § 1031 exchange. Recent commodity price moves and fundamentals show great promise for oil and gas investors. This includes those completing an IRC § 1031 exchange. Perhaps we can help you learn how to evaluate an oil and gas offering as well as demystify oil and gas lingo in a future article.