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New twist on a tax strategy a painless swap

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Savvy real estate investors for years have used so-called 1031 exchanges. The transactions allow investors to indefinitely delay paying capital- gains taxes on the sale of an investment property if they quickly use the proceeds to buy a like-kind property.

But for investors such as Robin Hayes, the prospect of swapping one piece of real estate for another was not very attractive. With concerns about a softening real estate market, Hayes in 2006 sold a handful of real estate holdings and swapped the proceeds for a stake in oil and natural-gas mineral rights spread across 14 Western states, including fields in Colorado.

"I thought the real estate market had reached the top," said Hayes, 42, a California resident who worked as a biologist before moving into the real estate business almost a decade ago. "And I don't think that oil is going down in the future."

Hayes is among a growing group of investors taking advantage of the latest twist on 1031 exchanges: selling real estate and executing a tax-free swap into oil and natural-gas mineral rights.

Investors traditionally used 1031 exchanges to make a tax- free move from one asset class to a similar asset class.

While experts say the oil- related deals are becoming increasingly common as investors seek to generate headier returns compared with what is currently available in real estate, financial advisers say the swaps carry a variety of risks.

For instance, investors involved in the oil deals are selling a tangible piece of real estate for mineral rights in an oil or natural-gas field that could eventually be depleted, said Jeff Hawks, principal at Apartment Realty Advisors in Denver.

"Everything you can get into has a downside," Hawks said. "The operator could stop pumping. Or the price of oil could go down."

In addition, companies that temporarily hold the proceeds used for the exchanges are unregulated, and some don't carry insurance. A Virginia company that owns a Denver-based investment-exchange firm recently filed for bankruptcy protection, a move that means investors in Colorado and elsewhere stand to lose tens of millions of dollars.

Nonetheless, the oil-related deals underscore the larger trend of tenant-in-common investments. The investments, also called TICs, allow high-net- worth investors to pool their equity with other investors to purchase office buildings or other pieces of property.

Since 2002, when the Internal Revenue Service outlined rules for TICs, the amount of equity invested in TIC deals has increased from $356.6 million to $3.7 billion in 2006, according to Omni Consulting & Research. The number of companies, also called sponsors, conducting such deals has surged from 15 in 2002 to more than 70 today, according to Omni, which is based in Salt Lake City.

The oil-related exchanges, which experts said mostly began popping up within the past two years, provide investors with a tax-free way to move from a cooling real estate market into the white-hot energy industry.

"It's an opportunity to diversify your portfolio," said Gregory Anderson, founder and chief executive of GRAnderson Wealth Management Group in Denver. "Compared to real estate, it provides more cash flow and less liabilities."

Anderson said he advised Hayes on his oil deal, which included money provided by dozens of investors. Hayes said he has been pleased with the 6.5 percent return, although he said he had hoped for something closer to 10 percent.

Noble Royalties, based in Dallas, was among the first companies in the U.S. to begin using 1031 exchanges to move investors from traditional real estate into oil and natural-gas mineral rights, said Wolf Hanschen, an executive with Noble.

Hanschen said the company spent several years researching whether there was legal precedent for investors to make such swaps. He said a U.S. Supreme Court ruling from the 1940s gave the company confidence that the oil-related exchanges would hold up under legal scrutiny.

"We are bullish on oil and natural gas," said Hanschen, who said the investments can turn sour if oil and natural-gas prices decline. "This is ideal for someone who is too much (invested) into real estate and wants to diversify into the energy sector without taking on the risk associated with drilling."

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