



Gifts of Oil and Gas and Other Mineral Interests



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Time: 1:00 – 2:30 Eastern Time

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Mineral Interests

Ownership of the right to exploit, mine, or produce minerals lying beneath the surface of a property

Includes:

- Oil
- Gas
- Coal
- Iron Ore
- Sulfur
- Precious Metals



Mineral Interests

- Mineral estate is dominate over surface estate
 - May use surface in a reasonable manner to extract minerals
- Executive Rights
 - Allows the owner of the interest to lease the interest to others

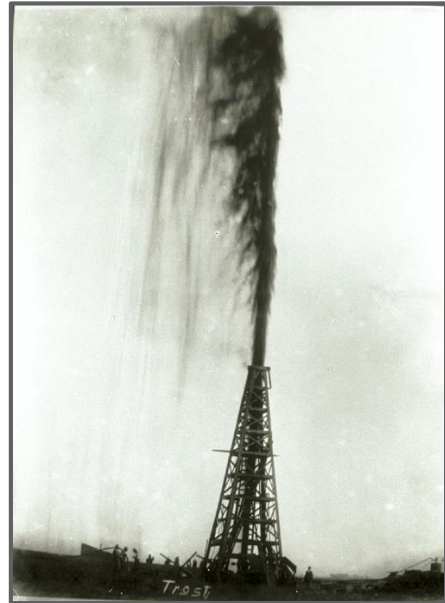
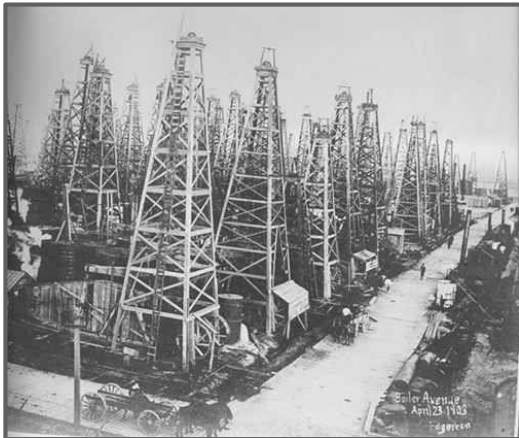


History

- First oil well drilled in Pennsylvania in 1859 – produced 20 barrels a day
- East Texas oil boom (“Spindletop”) occurred in 1901 – produced 100,000 barrels per day. Led to formation of:
 - Gulf Oil
 - Amoco
 - Exxon
- Today, oil and gas are produced in 32 states



Spindletop





Terminology

Bonus: one-time payment to lessor to acquire a lease

Delay Rental: annual payments to delay drilling

Division Order: schedule of owners and their respective share of revenues

Shut-In: a well that is not producing



Terminology

Landman: negotiates leases, ensures proper title, monitors ongoing well production and payments

Operator: conducts drilling operations for a well



Types of Ownership Interests

Working Interest – allowed to use surface for exploration and production and is liable for expenses – retains profits

Royalty Interest – shares in production but is not liable for expenses – a 3/16th royalty is common

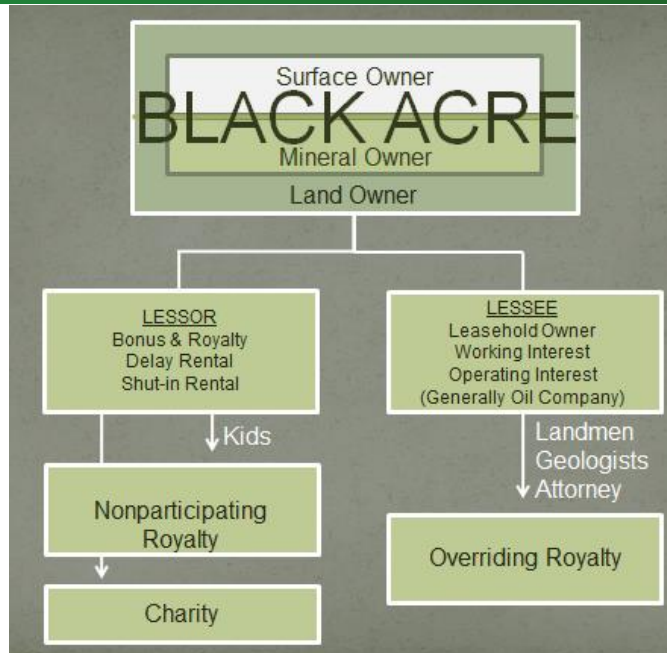


Types of Ownership Interests

Non Participating Royalty – “carved out” of a prior interest without regard to the terms of the lease

Overriding Royalty – “carved out” of working interest to compensate landmen, geologists, attorneys, etc.

Net Profits Interest– similar to a royalty but payable only if there is a net profit





Gift Acceptance Policies

May include:

- Minimum values for surface rights
- Minimum per year royalty amounts
- Liability review procedures
- Provision prohibiting working interests
- Environmental review procedures
- Ongoing management considerations



Working With Donors

Questions to Ask:

1. What is the ownership interest?
 - a. Prior or existing leases
 - b. Prior division orders
 - c. Prior transfer orders
 - d. Check stubs from royalty payments
2. How was the interest acquired?
3. Is the interest under lease?
4. What do you want to gift?



Facilitating the Gift

- Oil and gas interests are created by:
 - Mineral deed
 - Lease
 - Assignment
- Conveyance may or may not be recorded
- May receive interest by testamentary transfer – probate process will evidence conveyance and ownership



Valuation of Interest

Fair Market Value (FMV)

The price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having a reasonable knowledge of relevant facts

Reg. § 1.170A-1(c)(2)
Rev. Rul. 68-69, 1968-1 CB80



Valuation of Interest

The FMV is to be determined in the market which the item is most commonly sold to the public

Rev. Rul. 80-69, 1980-1 CB55

For interests valued in excess of \$5,000, a qualified appraisal is required

Reg. § 1.170A-13(c)(1)(i)



Valuation of Interest

- Gift of royalty interest or net profits interest – may deduct FMV if held more than 1 year
- Operators-deduction limited to basis



Valuation of Interest

General Rule of Thumb

Value = annual income x 4

Formal appraisal will determine expected future cash flows

- Production history
- Number of producing wells
- Discounted to present value



Valuation of Interest

Qualified Appraisers

Pension Protection Act of 2006 requires:

- Appraisal designation or minimum education and experience
- Regularly perform appraisals for pay
- In good standing



Valuation of Interest

Qualified Appraisers

For real property – licensed by the state

For other assets

- College or professional level coursework
- 2 years experience buying, selling, or valuing the type of property



Valuation of Interest

Qualified Appraisers

- Highly specialized
- Geologist or Petroleum Engineer
- Cost will range from \$1,000-\$2,000
- American Institute of Mineral Appraisers
or American Institute of Professional Geologists



Compatibility with Planned Gift Vehicles

Questions to ask:

1. Will annual income support payment provision of the gift arrangement?
2. Will other assets be involved?
3. Sell or retain the mineral interest?



Compatibility with Planned Gift Vehicles

Gift Annuity

- Careful consideration is necessary
- Fixed payment obligation
- Depleting asset



Compatibility with Planned Gift Vehicles

Gift Annuity example:

- Donor, age 67, gifts mineral interest valued at \$60,000 (annual royalty income of \$15,000).
- ACGA rate is 5.4%, resulting in annual annuity obligation of \$3,240
- Donor life expectancy is 18.3 years



Compatibility with Planned Gift Vehicles

Gift Annuity example continued:

Year	Royalty Amount	Annuity Obligation	Annual Reserve Amount	Total Reserve
1	15,000	3,240	11,760	11,760
2	13,500	3,240	10,260	22,020
3	12,000	3,240	8,760	30,780
4	10,500	3,240	7,260	38,040
5	9,000	3,240	5,760	43,800
6	7,500	3,240	4,260	48,060
7	6,000	3,240	2,760	50,820
8	4,500	3,240	1,260	52,080
9	3,000	3,240	0	51,840
10	1,500	3,240	0	50,100
11	0	3,240	0	46,860
12	0	3,240	0	43,620
13	0	3,240	0	40,380
14	0	3,240	0	37,140
15	0	3,240	0	33,900
16	0	3,240	0	30,660
17	0	3,240	0	27,420
18	0	3,240	0	24,180



Compatibility with Planned Gift Vehicles

Charitable Remainder Trust

CRAT – Some considerations as with the gift annuity, but Trustee may not rely on non-trust assets



Compatibility with Planned Gift Vehicles

Charitable Remainder Trust

- CRUT – Annual revaluation of assets accommodates mineral interest well
- Annual value based on production
 - Production used to satisfy resulting payment
 - Payment obligation and production “rise” and “fall” together



Compatibility with Planned Gift Vehicles

CRUT example:

- Donor, age 67, funds FLIP CRUT with both surface and mineral interests
- Surface appraised at \$250,000 and Minerals appraised at \$60,000
- CRUT flips upon sale of surface interest. Mineral interest is retained
- Annual valuation of invested sale proceeds and retained mineral interest determines payment outcome



Compatibility with Planned Gift Vehicles

Charitable Lead Trusts

- CLAT – Same considerations as with the GA and CRAT
- CLUT – Variable payments work well with fluctuations in mineral production/valuation



Compatibility with Planned Gift Vehicles

Retained Interest in Residence or Farm

- Donor conveys both surface and mineral estates, retaining life interest

Common Law Rules

- Life tenant & remainderman must both execute leases
- Bonus money is considered corpus and paid to remainderman



Compatibility with Planned Gift Vehicles

Common Law Rules Continued:

- Royalties from production treated as consumption of corpus and paid to remainderman
- Income from invested payments are considered income for the life tenant



Compatibility with Planned Gift Vehicles

Retained Interest in Residence or Farm

- Contractual Life Estate trumps Common Law
- Open Mine Doctrine presumes that life tenant will receive all income if production was occurring when life tenancy was established



Options for Minerals Management

Sell the interest

- Typical purchase price is 1.5 to 2 times annual production

Hire minerals management group

- Larger banking organization
- Investment management group
- Financial services firm



Options for Minerals Management

Active management for producing interests

- Review division orders
- Monthly review of revenues and payment status
- Monitor actual production
- Obtain releases when necessary



Options for Minerals Management

Active management for non-producing interests

- Negotiate maximum bonus and royalty for new leases
- Update and maintain undeveloped acreage records and shut-in well requirements
- Coordinate easements or permits for surface owners
- Monitor existing leases and secure timely releases



Environmental Issues

Operating or working interests

- Liable for environmental or surface related problems

Royalty interests

- Do not participate in production
- Not responsible for expenses
- Not liable

Note: Charities holding working interests may want to form a separate legal entity



Partial Interest Rule

General Rule

Contribution of less than a donor's entire interest in property precludes a deduction

Key Exception

Undivided portion of the donor's entire interest:

- Must be a fraction or percentage of every substantial right
- Extend over entire term of donor's interest



Partial Interest Rule

Undivided Interest

Many mineral interests are fractional shares of a larger whole

- Gift of fractional interest may be entire interest
- May gift a “sub-fraction” as an undivided interest



Partial Interest Rule

Example:

- Donor owns surface and minerals
- Wants to gift surface and retain minerals
- No deduction

Note: Charity may want to restrict surface use if minerals are retained



Partial Interest Rule

Example:

- Donor owns surface and minerals
- Donor partitions surface interest from mineral interest
- Donor gifts surface interest
- No deduction



Partial Interest Rule

Example:

- Working interest owner “carves out” a net profits interest or overriding royalty interest for charity
- No deduction



Unrelated Business Taxable Income

UBTI

Gross income from an unrelated trade or business that is regularly carried on

Unrelated trade or business

Not substantially related to charitable purpose



Unrelated Business Taxable Income

Passive income includes:

1. Oil and gas royalties
2. Shut-in royalties
3. Delay rentals



Unrelated Business Taxable Income

Income from working interest is UBI

To avoid UBI, Service requires royalty interest to be free from:

- Development costs
- Operating expenses



Unrelated Business Taxable Income

Bonus payments are passive

- Not “regularly carried on”
- Only a one-time payment



Questions and Answers





Still Have a Question?

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