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Gifts of Oil and Gas and Other Mineral Interests



Date: June 30, 2016
Time: 1:00 – 2:30 Eastern Time
Presenter: Joe Hancock
 Vice President and General Counsel
 HighGround Advisors


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

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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

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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


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Terminology

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

Operator: conducts drilling operations for a well

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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

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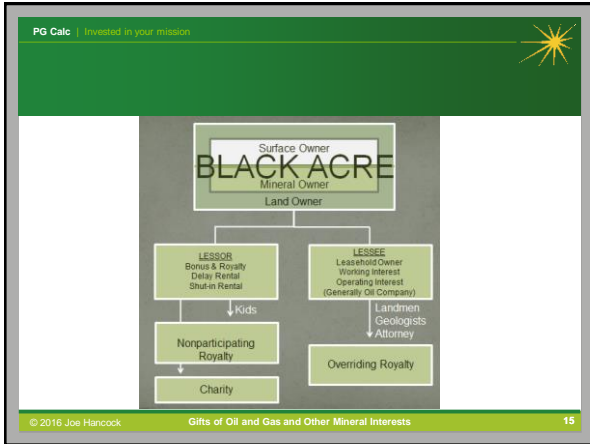
Types of Ownership Interests

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

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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

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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?


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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

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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

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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)


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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

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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

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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

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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

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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

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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?

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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	Annually 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


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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

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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

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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

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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

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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

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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

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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

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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

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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

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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

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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

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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

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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

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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

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Partial Interest Rule

Example:

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

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Partial Interest Rule

Example:

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

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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

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Unrelated Business Taxable Income

Passive income includes:

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

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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

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Unrelated Business Taxable Income


Bonus payments are passive

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

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Questions and Answers



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Still Have a Question?

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