

PBI Hot Topics in Oil and Gas Law
July 21, 2011
Taxation and Estate Issues

Les Greevy, Esq. les@greevy.com

Member National Association of Elder Law Attorneys
Certified Mineral Manager
Member of Society of Petroleum Engineers
Member of Energy & Mineral Law Foundation
Director of National Association of Royalty Owners PA
Certified Elder Law Attorney

John Shoemaker, Esq. john@greevy.com

Member National Association of Royalty Owners PA
Member of Energy & Mineral Law Foundation
Member of National Association of Division Order Analysts
Member National Ass'n of Lease and Title Analysts

Greevy & Associates

5741 State Route 87
P.O. Box 328
Montoursville, PA 17754
(570) 435-2233
(800) 326-9203

What Are We Going to Do?

- Talk about income tax
- Ownership Entities
- Talk about Pa Inheritance Tax & Federal Estate and Gift Taxes
- Talk about hunting clubs & other non-profits
- Will talk about where the problems are

Income Tax

- Income received from gas leases will generally be taxed as ordinary income including
 - Lease bonus payments – Rev Rule 68-606
 - Royalty income
 - Option payment
 - Crop damage
- Other payments
 - Timber sales, surface damages and easements

Easements

- Pipelines and Roads
- Short Term
 - Treated as Rental Income – ordinary income
- Long Term (permanent)
 - Treated as Sale (must prorate basis)

Easement Example

- Fred bought 100 acres for \$1,000 per acre (\$100,000 total basis) years ago
- Fred signed an easement with Gas Pipeline Company to allow them to place a single pipeline directly across his property for 500 feet at \$25 per linear foot (total \$12,500)
- The easement took up exactly one total acre
- Fred's basis in the one acre is \$1,000
- His gain is \$11,500 (\$12,500 less \$1,000)

Actual Story

- \$2,500/acre x 200 acres = \$500,000
- Spent \$100,000 on "toys" (pickup truck, bass boat, snowmobiles, etc.)
- Invested remaining \$400,00 in late summer 2008
- Lost 50% in the stock market
- \$200,000 remaining
- Tax on the \$500,000 was \$200,000

Easement

- Surface damages
 - Permanent – Sale – Capital Gains
 - Temporary – Rent – Ordinary Income
- Timber Sales
 - In business ordinary income
 - Casual sale – Capital gain

Revenue Ruling 68-606

- Suppose that:
 - Cash bonus payment to be made over several years;
 - Lessee obligated to make payment; and
 - Lessor's rights are freely transferable
- Must pay tax on FMV in 1st year. Rev. Rule 68-606, 1968-2 C.B. 42

IRS Revenue Ruling 68-606

If the lessee is unable to avoid such payments by production or by terminating the lease, then the annual payments are regarded as an installment lease bonus. Payments received from an obligation that is not saleable or freely transferable are income in the years the payments are received. However, if the rights to the bonus payments are freely transferable and readily saleable, the total amount of the lease bonus is includible in income at the time the lease is executed even though the bonus is payable in installments

Percentage Depletion I.R.C. 613

- Deduction amount is equal to 15 percent of the of the royalties received – resulting in only 85 percent of royalty income being included in the landowner's income for Federal tax purposes
- Limited to the lessor of:
 - 100 percent of taxable income of the property
 - 65 percent of landowners adjust gross income (AIG)
 - May carry forward amount limited under taxable income limitation
 - For most landowners applies only to royalty
 - Does not apply to Pa Income Tax
- May carry forward amount limited under taxable income limitation
- For most landowners applies only to royalty
- Does not apply to Pa Income Tax

Lease Income from Pass-Through Entities

- Many Landowners will receive lease income from pass-through entities – partnerships, limited liability companies (LLC) and S corporation
- The amount of lease income included on a landowner's return will be based on his or her ownership interest in the pass-through entity
- The landowner's share of pass-through entity lease income is reported on Schedule K-1 (Federal) and Schedule RK-1 (State)

1099 Forms

- Gross vs Net Proceeds – how reported?? (affects depletion calculations)
- Remittance statements – verify 1099s and itemize any deductions
- Deductions may appear only on monthly check stubs
- IBM / India / "generalized processing"
- In lease, require an annual payment regardless of amount – in case of an error or shorting, who is the lessee??

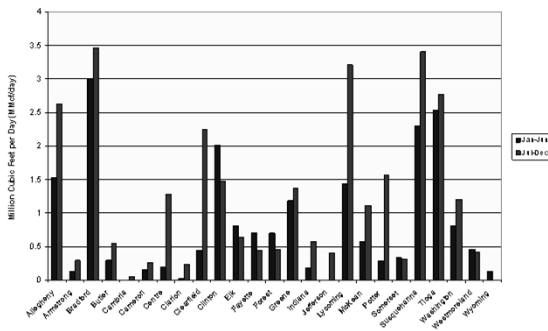
Death Taxes

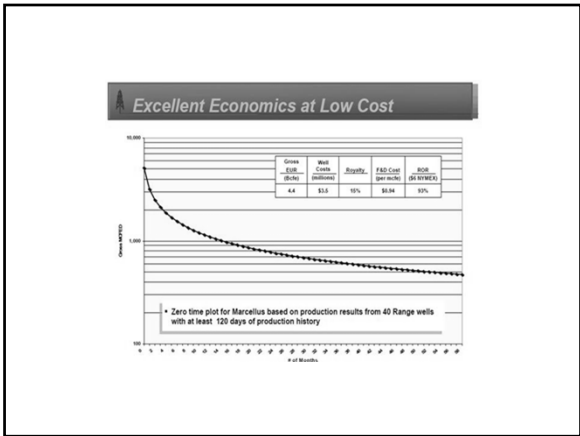
- The threat of catastrophic death taxes for Marcellus royalty owners is grossly overstated
- Other good reasons to own royalties separate from surface

What Is It Really Worth?

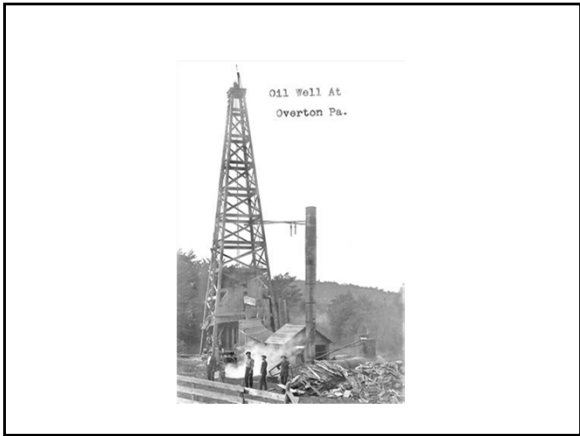
- From review of recorded production units in Northeast and Northcentral PA Marcellus we see
- 85% of landowners have less than all of their acreage in one production unit
- The average number of acres that a royalty owner has in a unit is less than 33
- May be in more than one unit
 - What is the Gas Company's business plan?
 - Proper production appraisal will show for each future year the present FMV of royalty
- May have more than one well
- May be in more than one production unit

Average Production by County, 2010





- In 5 years production will be less than a quarter of what it was in the first year and in 10 years production will be less than a tenth of what it was in the first year
- Each succeeding year will be worth less
 - That is when to make gifts



Two Separate Estates in the Land Created

- Surface = normal use
- Subsurface = cash flow –
 - dominate to surface
- Interest or estates can be dealt with separately

If Selling Land – Sub-surface Rights Can Be:

- Sold with the land
- Retained by the seller
- Sold separately
- Mineral Deed
- Lease assignment
 - No Realty Transfer Tax

Estates Can Be Owned Separately

- Surface by Mom & Dad
- Sub-surface by FLP
 - Family Limited Partnership
 - Mom and Dad general partners and limited partners
 - Gift Limited Partnership Units to children
 - General Partners keep all decision powers
 - Provides governance and keeps parents in control
 - Orderly and easy shift of equity to next generation
 - Favorable Federal Estate Tax consequences
 - Protect cash flow

Protect Cash Flow From

- Death taxes
- Divorce and other creditors
- Nursing home – Medicaid qualification
- Treat children equally or differently
- Liabilities occurring on surface

Passing Subsurface Rights to Next Generation

- Will
- LLC – Limited Liability Company
 - Subject to Pa Capital Stock Tax
- LP – Limited Partnership
- FLP – Family Limited Partnership
- Deed
- Trust
- Life Estate Deed

Principal and Income Act 20 Pa.C.S.A. 8101

- Applies to Life Estates and Trusts
 - 20 Pa.C.S.A. 8102
- Applies to Oil and Gas Rents and Royalties
 - 20 Pa.C.S.A. 8151
 - If more than nominal
 - Requires 1/3 paid to Life Tenant
 - 2/3 Invested with Income to Life Tenant

The gas companies do not understand this and will pay life tenant based on "open mines"

Absolute liability for missing this

Death Taxes

- PA Inheritance Tax
 - 0% between husband and wife
 - 4.5 % to children and grandchildren
 - 12% to siblings
 - 15% to others
- If not drilled gas interest is to be listed as \$0.00 in Pa Inheritance Tax Return
 - Chief Counsel Letter Ruling No. INH-03-008

Death Taxes

- Federal Estate Tax
 - Very few people affected
 - 35% on transfers in excess of applicable exclusion
 - \$5 million per individual
 - With portability, \$10 million per married couple
 - Valuing the taxable estate
 - Discount future income to present value
 - Discount FLP interest for lack of marketability
 - 2032A: special-use valuation for farms
 - 6166: deferral of payments; installment payment

**Reduce to Present Value
Death Taxes Due on Present Fair
Market Value of Future Royalties**

- Example #1
 - \$100 to be paid 20 years in future = \$1.89 present value if discounted at 20%
 - \$20,000 per month for 20 years aggregated = \$4.8 million
 - Reduced to present value at 20% = \$1,177,284.57
 - Discounted Cash Flow

Conclusion

- Not very many royalty owners will need Federal Estate Tax Planning
 - Nursing home is bigger risk
 - Consider long term care insurance
- Understand your client's needs and goals

**What Are the Landowner/Royalty
Owners' Real Goals?**

- Protect the land for future generations – Century Farms
- Protect the royalties for future generations
- Avoid or reduce death taxes. For most that means PA Inheritance Tax
 - If the land has not been drilled the value for PA Inheritance Tax is \$0.00
 - Chief Counsel Letter Ruling No. INH-03-008 PA Inheritance Tax
 - "No Ascertainable Value"
 - Feds – not much guidance – F. M. V. but D. C. F.
- Protect from children's divorce
- Protect from surface liability
- Protect from nursing home cost or Estate Recovery
- Federal Estate Planning

Necessary Documents

- Will
 - With Bypass Clause – protect from nursing home
 - Disclaimer Tax Credit Shelter Trust
 - If Federal Estate Tax issue
- Power of Attorney
 - Adequate gifting powers = unlimited
 - Specifically mention Gas and FLP's
- Living Will – Advance Directive
- Separate Entity for Royalties

Cost Benefit Analysis

- Everything you do to save taxes or protect assets has a cost if not in dollars in inconvenience or lack of flexibility
- Many times, the cost outweighs the benefit

Before You Start You Must Understand Your Client's Needs

- How old is he?
- Will he outlive well?
- What is this asset really worth?
 - Does he need Federal Estate Planning
- Family dynamics

Proper Estate Planning

- Selection of ownership entity for royalty
- Sound investment plan
- Proper Estate Plan
 - 3 Rules
 - Keep principals in control
 - Don't paint self into corner
 - Keep it simple

Not for Profit Organizations

- Most formed under Pa Not-for-Profit Corporation Act
- Two sets of rules
 - Pa Not-for-Profit Corporation Act
 - Federal Internal Revenue Code
 - IRC 501(c)

Two Basic Types

- Both prohibit income inuring to members
- 501(c)(3) charities
 - Church, Cemetery, educational, etc
 - Exempt from taxes on royalties, rents and other income which is not derived from the conduct of an unrelated trade or business

Two Basic Types

- 501(c)(7) – Social and Recreational Club
 - The Pennsylvania hunting club
 - Will pay tax at corporate (35%) rate on unrelated business income

Unrelated Business Income

- IRC 512(a)(3)(A)
 - Social Clubs = all gross income that is not exempt function income
 - Will include cash bonus, royalty, right-of-way, water impound, compression station, etc. income

501(c)(7) – Social Clubs (Hunting Clubs, Country Clubs, etc.)

- Gas lease income subject to Unrelated Business Income Tax
- Exempt Status Threatened
 - If gross receipts from "other than exempt function sources of income" in excess of 35% of gross receipts, exempt status may be terminated
 - Generally results in C corporation status (tax purposes)
- Rents – lease bonus
 - Generally a one-time event
- Royalties
 - Generally a recurring event
- Personal Inurement (Rev. Rule 58-589)
 - Receipt of cash distributions
 - Income from non-members used to subsidize club operations
 - Failure to increase dues to cover increased services

Unrelated Business Income

- See IRS Pub 598 for details
- Taxed at Corporate Rates
- File Form 990-T
- Watch out for estimated tax rules

Pa Hunting Club

- Unique animal rarely seen outside of Pennsylvania
- 100's in Northern PA
- Most are Pa Not-for-Profit corps
 - Ease of transferability of interests
 - Limited Liability
 - Perks

Perks

- Perpetual existence
- Because of prohibition of inurement, typically low buy out at death or resignation
- Share not included for death taxes
- Share not reachable by outside creditors
- Share not subject to divorce equitable distribution

PA Hunting Clubs

- Some very large
 - Over 5,000 acres and 100 members
- Some very small
 - 5 or fewer acres and 5 or fewer members
- Few have ever made a profit
 - Some have filed no return and not qualified for 501(c)(7)
- Ratio of acres to members is high

Broad Membership Clubs

- Country Clubs
- Sportsmen's Clubs
- Fewer acres and more members
- Ratio of acres to members is low
- Annual membership
- 35% limit is much higher

501(c)(7)

- Can lose tax exempt status
- Unrelated Business Taxable Income exceeds 35% of gross income
- Can become taxed as a 277 organization
 - Deduction apply only to related business income
 - All Unrelated Business Taxable Income taxed fully

Problem Occurs When Cash Bonus and Royalty Are Received

- Prohibition of Inurement means funds cannot go to members
- Tremendous increase in value to club
- How to take in new members
- How to deal with estates
- How to deal with divorce

Solutions

- If broad membership club
 - Just go 277 route and pay taxes
- If hunting club – 3 choices
 - Plans A, B, and C

Plan A

- Form a new LLC
- Transfer the 501(c) Organization's Oil, Gas, and Mineral Rights to the new LLC
 - Retain the surface in the Club
- Need an Appraisal
 - Transfer must be for fair-market-value consideration
- Expensive
- Fed & PA Securities issues

Plan B

- Convert 501(c) Organization to For-Profit Entity
- Purge retained earnings and elect Subchapter S
- Form new Not-for-Profit Entity
- Lease Surface to new Not-for-Profit
 - Long-term lease
- Tax issues to members
- Built-in Gains (Big) Tax – Sec 1374

Plan C

- For Small Clubs
- Fly Under the Radar
- Worst-case scenario is taxation under I.R.C. 277
- Avoid inurement
 - No Taj Mahal club house
 - No reduction of dues

Website Resources

- National Association of Royalty Owners
<http://www.naro-us.org/>
- IRS MSSP – Oil and Gas Industry
<http://www.irs.gov/pub/irs-mssp/oilgas.pgf>
- Council of Petroleum Accountants Societies, inc. (COPAS) <http://www.copas.org>
- Oil and Gas Accountability Project
http://www.earthworksaction.org/oil_and_gas.cfm

Marcellus Specific Resources

- Appalachian Basin Natural Gas Play
<http://geology.com/articles/marcellus-shale.shtml>
- Shaleblog News about Natural Gas from Shale
<http://shaleblog.com/category/marcell-shale/>
- NYS DEC <http://www.dec.ny.gov/energy/46288.html>
- Cornell Cooperative Extension – Natural Gas
<http://blogs.cce.cornell.edu/gasleasing/>
- DRBC <http://www.state.nj.us/drbc/naturalgas.htm>
- SRBC <http://www.srbrc.net/prgrams.projreviewmarcellus.htm>
- Tioga County Landowners Group <http://www.tiogagaslease.org/>
- Windsor Coleville Landowners Group
<http://www.windsornygaslease.com/>

PBI Hot Topics in Oil and Gas Law July 21, 2011 Taxation and Estate Issues

Les Greevy, Esq. les@greevy.com

Member National Association of Elder Law Attorneys
Certified Mineral Manager
Member of Society of Petroleum Engineers
Member of Energy & Mineral Law Foundation
Director of National Association of Royalty Owners PA
Certified Elder Law Attorney

John Shoemaker, Esq. john@greevy.com

Member National Association of Royalty Owners PA
Member of Energy & Mineral Law Foundation
Member of National Association of Division Order Analysts
Member National Ass'n of Lease and Title Analysts

Greevy & Associates

5741 State Route 87
P.O. Box 328
Montourville, PA 17754
(717) 435-2233
(800) 326-9203
