Dealing with Unique Assets – Mineral Interests

Heart of America Fellows Institute of the American College of Trust and Estates Counsel
St. Louis, Missouri
February 28, 2019

Jeffrey N. Myers
Bourland, Wall & Wenzel, P.C.
Attorneys and Counselors
301 Commerce Street, Suite 1500
Fort Worth, Texas 76102
(817) 877-1088
(817) 877-1636 (facsimile)
Website: www.bwwlaw.com
E-mail: jmyers@bwwlaw.com

©Bourland, Wall & Wenzel, P.C.

BW&W
Bourland, Wall & Wenzel, P.C.

Types of Economic Interests

- Lease Bonus
- Royalty Interest
- Working Interest
- Overriding Royalty Interest
- Carried Interest Arrangements
- Production Payments
- Net Profit Arrangements

Federal Tax Consequences Tax Treatment of Payments under a Oil and Gas Lease

Tax Treatment of Payments under a Oil & Gas Lease

(Based on similar table in Baer, 605-2nd T.M., Oil and Gas Transactions)

Payment Name*	Payor or Lessee	Payee or Lessor
Bonus-Payment for executing lease	Capitalize Treas. Reg. section 1.612-3(a)(3)	Ordinary Income (Portfolio) Percentage depletion allowed to August 17, 1986. Only cost depletion after August 17, 1986. Treas. Reg. 1.612-3(a)(1)
Installment Bonus Also consideration for granting a lease, advance payment for oil & gas; each installment is usually larger than normal delay rental	Capitalize	Ordinary Income Rev. Rul. 68-606, total amount includible at time of signing lease if right to income is transferable. Generally, this treatment is the same as for lease bonus
Delay Rental Rent; a payment to defer development rather than a payment for oil & gas	Capitalize (per IRS position under section 263A)	Ordinary Income No depletion. Treas. Reg. section 1.612-3(C)(2)

Federal Tax Consequences
Tax Treatment of Payments under a Oil and Gas Lease (cont.)

Tax Treatment of Payments under a Oil & Gas Lease

(Based on similar table in Baer, 605-2nd T.M., Oil and Gas Transactions)

Royalty Payment for oil or gas.	Deducible Under Rev. Rul. 72-165, when ad valorem taxes are paid by lessee to the extent paid from production income.	Ordinary Income (Portfolio) Subject to depletion (percentage or cost); percentage depletion is allowed if payee qualifies under IRC section 613A
Advance Royalty Royalty payment made before production	Deducible Under Rev. Rul. 72-165, when ad valorem taxes are paid by lessee to the extent paid from production income.	Ordinary Income Subject to cost depletion in year payments are made. Percentage depletion allowed until August 17, 1986.
Advance Minimum Royalty Minimum royalty required by oil & gas lease.	Deductible At option of payor: (1) In year paid or accrued or (2) When oil or gas is sold or recovered. Treas. Reg. section 1.612-3(b)(3)	Ordinary Income Subject to cost depletion in year payments are made. Percentage depletion allowed until August 17, 1986.

Federal Tax Consequences
Tax Treatment of Payments under a Oil and Gas Lease (cont.)

Production Payments

Payment Name*	Payor or Lessee	Payee or Lessor
Retained (Sales Transaction) Not an economic interest. Is treated as a mortgage.	Repayment of principal and interest expense.	Repayment of principal and Interest expense
Retained (Leasing Transaction) Treated as an economic interest.	Capitalize, bonus paid in installment. Treas. Reg. section 1.636-2(a).	Ordinary Income Subject to depletion (percentage or cost). Treas. Reg. section 1.636-2(b).
Carved Out and Sold: Not an Economic Interest A loan.	Repayment of principal and interest expense.	Repayment of principal and interest expense.
Carved Out and Sold: An Economic Interest Applies to carved-out production payments advanced for the exploration or development of the property.	Deducible Capitalize as installment lease bonus.	Ordinary Income Subject to depletion (percentage or cost); percentage depletion is allowed if payee qualifies under IRS section 613A.

Federal Tax Consequences
Tax Treatment of Payments under a Oil and Gas Lease (cont.)

Damages

Payment Name*	Payor or Lessee	Payee or Lessor
Business and Goodwill (Land) Payments made to the landowner by the oil and gas operator for damages to the surface, to growing crops, to streams, or other assets of the landowner.	If acquired or leased, capitalize as geological and geophysical (G&G) costs. If not acquired or leased, expense.	Return of capital to the extent of basis of the property. Amounts in excess of basis are IRC section 1231 gain (generally LTCG).
Loss of Profit Crop damage.	If acquired or leased, capitalize as G&G costs. If not acquired or leased, expense.	Ordinary Income
Anticipated Damages But None was Done Damages based on the anticipation that damages would be done	If acquired or leased, capitalize as G&G costs. If not acquired or leased, expense.	Ordinary Income

*(Caution: The name given to a payment is not determinative of its tax treatment.

Use of Tax Partnerships

- Purpose
  - Maintenance of Property
  - Maintaining Ownership
  - Transfer Restrictions (Control)
  - Liability Protection

Use of Tax Partnerships

- Key Provisions of Partnership Agreements
  - Additional Capital Contributions
  - Tax Distributions
  - Management Succession
  - Buy-Sell Restrictions
  - Assignee v. Substitute Member/Partner

Tax Complexities of Oil and Gas Partnerships

- Intangible Drilling Costs and Development Costs
- Basis of Oil & Gas Properties held by Partnership
- Depletion of Oil and Gas Property: Cost vs. Percentage
- Recapture of Intangible Drilling Costs and Depletion (IRC §1254)
- Application of IRC §704(c) to Oil and Gas Partnerships

Estate Planning Strategies

- Intentionally Defective Grantor Trust ("IDGT")
  - Settlor IDGT
  - Beneficiary IDGT
- Defined Value Gift
- Installment Sale to IDGT
- Defined Value Sale

Valuation Issues Related to Ownership Interests

- Underlying Asset Appraisal
- Ownership Interest Appraisal
  - Control
  - Marketability

Case Study 1

- Facts
  - Mr. and Mrs. Smith own 100% of the underlying minerals of 400 acres of farm land that was purchased by Mr. and Mrs. Smith 40 years ago.
  - Mr. and Mrs. Smith have 2 children and five grandchildren
  - Mr. and Mrs. Smith have been approached by Big Time Oil Company ("Big Time") regarding signing a mineral lease that will pay a lease bonus of $2,500/acre and the royalty will be 25%.
  - Mr. and Mrs. Smith want to provide a portion of the value to their children and their kids. They are also concerned about their son's financial responsibility.

Case Study 1 (cont.)

- Plan – Create Limited Partnership with Limited Liability Company GP
  - Mr. and Mrs. Smith created a Limited Partnership ("LP") and contribute only the minerals (not the surface) to the LP in exchange for 49.5% limited partnership interest each.
  - Mr. and Mrs. Smith create and equally own Limited Liability Company ("LLC") as the general partner and contribute cash that the LLC contributes to the LP for a 1% general partnership interest.
  - The LP will be managed through the LLC by Mr. and Mrs. Smith as Co-Managers followed by the survivor. They will have to consider how the succession will flow, taking into account their son's lack of financial responsibility.
  - The limited partners cannot withdraw from the LP.
  - After the Smiths contribute the minerals to the LP, the LP leases the minerals to Big Time and receives a bonus of $1,000,000.

Case Study 1 (cont.)

- Plan – Creation of Settlor IDGT
  - Mr. and Mrs. Smith determine that they will transfer 50% of the LP to their children and grandchildren.
  - Mr. Smith creates an IDGT for the benefit of his daughter. Mr. Smith will be the initial trustee. His daughter will be the successor and will have the ability to appoint her successors. Mr. Smith will be the "grantor" of Daughter Trust.
  - Mrs. Smith creates an IDGT for the benefit of her son. Mrs. Smith will be the initial trustee. Big Trust Company will be the successor trustee, but son will have the power to remove and replace. Mrs. Smith will be the "grantor" of Son Trust.

Case Study 1 (cont.)

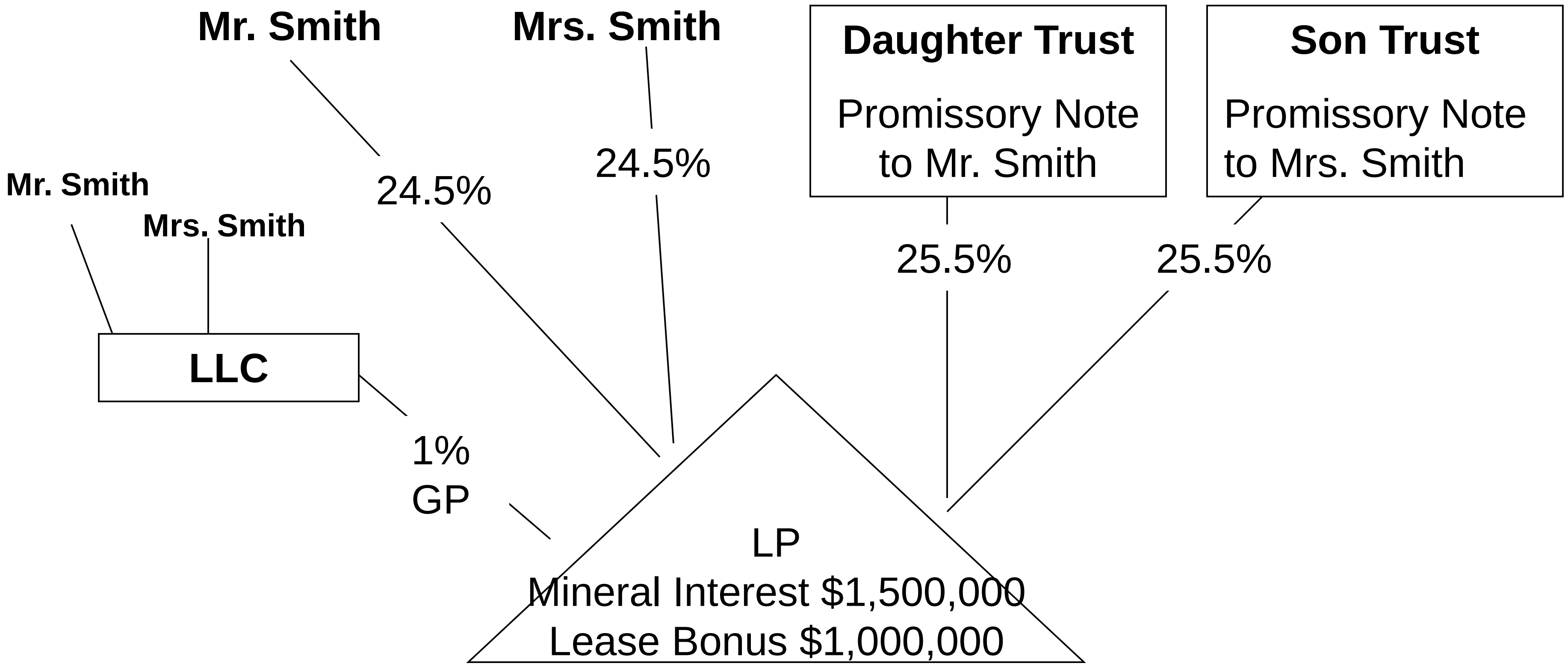
- Plan – Valuation
  - Mr. and Mrs. Smith hire Mineral Appraisers Inc. to prepare an appraisal of the non-producing mineral interests owned by LP. The appraiser settles on a value of $1,500,000 for the mineral interests.
  - Mr. and Mrs. Smith hire Business Valuations R' Us to value the interests to be transferred. Mr. and Mrs. Smith have determined to each transfer half of the limited partnership interests owned by each of them to each trust.
  - The value is determined to be $418,750 for 25% of the limited partnership equity.

Case Study 1 (cont.)

- Plan – Sale
  - Mr. Smith makes a gift of 3% of a limited partnership interest ($50,250) to Daughter Trust and then sells a 22.5% limited partnership interest to Daughter Trust in exchange for a 9 year promissory note, such note paying interest only for years 1-8 and principal and interest due in year 9. The interest on the note is the February mid-term AFR (2.63%).
  - Mrs. Smith makes a similar gift and sale to Son Trust.

Case Study 1 (cont.)

- Schematic of Transaction: Result



Case Study 1 (cont.)

- Wealth Shift
  - LP royalties over the next 7 years are allocated as follows:

	Total Royalties	Mr. Smith 25%	Mrs. Smith 25%	Daughter Trust 25%	Son Trust 25%
Year 1	$ 300,000	$ 75,000	$ 75,000	$ 75,000	$ 75,000
Year 2	$ 500,000	$ 125,000	$ 125,000	$ 125,000	$ 125,000
Year 3	$ 600,000	$ 150,000	$ 150,000	$ 150,000	$ 150,000
Year 4	$ 800,000	$ 200,000	$ 200,000	$ 200,000	$ 200,000
Year 5	$ 1,000,000	$ 250,000	$ 250,000	$ 250,000	$ 250,000
Year 6	$ 1,000,000	$ 250,000	$ 250,000	$ 250,000	$ 250,000
Year 7	$ 950,000	$ 237,500	$ 237,500	$ 237,500	$ 237,500
Total	$ 5,150,000	$1,287,500	$ 1,287,500	$ 1,287,500	$1,287,500

Case Study 2

A. PHASE I – TRUST CREATION AND FUNDING

Mr. Smith's Sister

① Nominal Cash Gift
(up to $5,000) →

Mr. Smith Irrevocable Asset Trust
(B-IDGT)

Creator/Settlor:
Mr. Smith's Sister
Trustee: Mr. Smith

Beneficiaries:

Mr. Smith, Mrs. Smith and their descendants

Case Study 2 (cont.)

B. PHASE II – WEALTH MIGRATION

① Shares of Mr. Smith Limited Partnership (mineral partnership)

Mr. Smith

Mr. Smith Irrevocable Asset Trust (B-IDGT)

Creator/Settlor:
Mr. Smith's Sister
Trustee: Mr. Smith

Beneficiaries:

Mr. Smith, Mrs. Smith and their descendants

① Shares of Mr. Smith LP

② Promissory note payments

③ Annuity

Mr. Smith Grantor Retained Annuity Trust

3 year term
Annuity payable to Mr. Smith each year

Remainder to descendants of Mr. and Mrs. Smith