

# Trust & Estate *Insights*

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### Key Takeaways:

- Owners of oil, gas and other mineral rights may benefit by unbundling those rights and utilizing these assets for estate planning purposes.
- There are various tools with which owners of oil and gas interests can transfer these interests to children and other descendants. Family entities, such as limited partnerships and limited liability companies may be good options.
- Determining the correct value of the interest for gift and sale purposes is key. There are various valuation methods, and a qualified appraiser should be used to value the interest.
- Master limited partnerships may be good candidates for investment opportunities in the energy sector and for estate planning opportunities.

## Planning with a Bundle of Sticks: Wealth Transfer Considerations for Owners of Oil and Gas Interests

Oil and gas holdings represent an increasing percentage of wealth for some families due to the rising price of oil and continued exploration and development. With active exploration in many states and regions such as Texas, California and Pennsylvania, people who did not anticipate owning substantial interests in oil and gas are finding these interests among their most valuable assets. This creates a unique opportunity for families to transfer oil and gas interests to children and grandchildren in a timely and tax efficient manner.

There are many things to consider when transferring oil and gas interests. Often, mineral interests are passed down from generation to generation through wills, trusts and other estate planning vehicles so that the assets are currently in the hands of descendants who are somewhat removed from the initial acquisition of the interest. It is the current owners who have an opportunity to transfer wealth through gifts or other transfers, and it is often that same generation who knows the least about this type of asset.

It is important to be mindful when planning with oil and gas interests because of the difficulty of valuing some interests for transfer purposes. Further, since one family may hold oil and gas interests across the United States or in foreign countries, the interests may be subject to laws in those various states or countries. It is imperative to know which laws are applicable to an interest prior to employing any estate planning strategies with that interest.

### A good place to begin is to address the following:

- What do you own?
- How is the asset owned?
- What is the value?
- How can the interest be transferred?

## Types of interests: What do you own?

Ownership of a mineral interest has been referred to as a "bundle of sticks" because it is made up of various components, each of which may be independently held and conveyed from the others. In Texas, for example, the components of a mineral estate are:

- 1) the right to develop (right of ingress and egress)
- 2) the right to lease
- 3) the right to receive bonus payments
- 4) the right to receive delay rentals
- 5) the right to receive royalty payments<sup>1</sup>

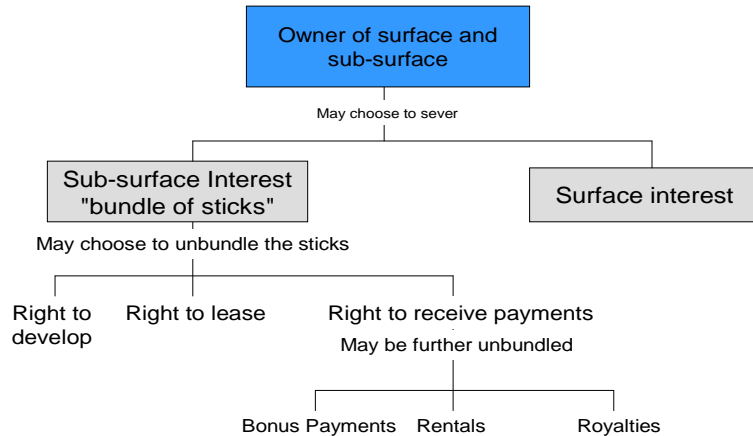
This bundle of rights can be divided and given to various recipients through a number of transfer methods. Therefore, when making initial decisions regarding wealth transfer using mineral interests, a threshold question is: What do you own: surface rights, mineral rights or a combination of both? And, do you want to sever the interests so that you can transfer some interests while retaining others?

If you own a tract of land that is being explored and considered for drilling, you must determine whether you indeed own the mineral rights. There may be surface owners and sub-surface owners of a particular tract of land. The general rule in many states is that the mineral rights pass with the surface rights unless they are specifically "carved out" in the document transferring the property (typically, a deed of conveyance). For example, a deed transferring "all right, title and interest in and to the following described land:" would likely include both the surface and sub-surface rights. If the surface and sub-surface owners are different, however, the sub-surface owner (the owner of the mineral rights) typically has a dominant interest because the surface owner has no claim to any oil, gas or other minerals that may ultimately be produced from the land. The owner of the mineral rights often holds the more valuable cards.

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<sup>1</sup> *Altman v. Blake*, 712 S.W.2d 117, 118 (Tex. 1986).

## Severance of Interests and the Bundle of Sticks



### *Operating and Non-operating Interests*

An oil and gas interest may be operating or non-operating. An operating interest is an interest in the minerals that includes the exploration, development and operation of any production on the property. An operating interest is basically the mineral interest minus the royalty interest.

Non-operating interests may be in the form of a royalty interest, or the right to a percentage of the total oil and gas production from the land, or an overriding royalty interest that is tied to the operating interest and is typically between 1% - 5% of total production. It is important when structuring an entity to consider holding operating and non-operating interests separately. Generally, operating interests should not be held in an entity that also holds non-operating interests because the operating interests typically carry more liability risk, and you do not want to subject the non-operating interest to risks associated with the operating interest.

### **How are the interests owned?**

How an interest is titled may impact the transfer of the interest. You may choose to alter your current ownership prior to transfer in one of the following ways:

#### Individual Name

If the interests are directly owned in the individual name of the investor, then the interests can be transferred from the owner's name directly to another person by gift or sale, either outright or to a trust for another's benefit.

### Limited Partnership or Limited Liability Company

Often, oil and gas interests are owned through an entity, such as a limited partnership (LP) or a limited liability company (LLC). In this case, the LP or LLC units would be transferred but the underlying oil and gas interests would remain with the LP or LLC.

It is important to determine any transfer restrictions in the operating agreement of a partnership or LLC prior to attempting to give or otherwise transfer any interest.

### **Valuation**

*What is the value of the interest?*

When transferring assets in the context of estate planning, it is imperative to determine the value of the asset for transfer-tax purposes. Typically, the appropriate value to use is the "fair market value." The fair market value of an asset is the price at which property would change hands between a willing buyer and a willing seller, with both having knowledge of the relevant facts and neither being under a compulsion to buy or sell. Gifts or transfers of oil and gas interests require a thorough appraisal of the underlying mineral interests and, if applicable, also of the entity in which the mineral interests are held.

IRS Regulation §1.611-2 provides guidance in determining the fair market value of interests in oil, gas and other natural deposits. The Regulation provides that the comparative value method should be used to determine the fair market value of an oil and gas interest, if at all possible. The use of other methods, such as the "present value method" should only be used when the comparative method cannot be used.

### *Comparative Value Method*

The "comparative value method" values the interests of similar properties that have been transferred or sold recently. According to Regulation §1.611-2, the due weight and consideration will be given to factors such as:

- cost
- actual sales and transfer of similar properties and improvements
- bona fide offers
- market value of stock or shares
- royalties and rentals
- valuation for local or State taxation
- accounting records of litigation in which the property and improvements may have been inventoried or appraised in probate or similar proceedings
- disinterested appraisals by approved methods<sup>2</sup>

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<sup>2</sup> IRS Regulation §1.611-2(d)(1)

Often, this type of data is not available. In that case, other methods, such as the present value method, may be used.

#### *Present Value Method*

The "present value method" may be used when the value cannot be determined upon the basis of cost or comparative values or any other method. Factors considered when using the present value method are: the future price of produced goods and the estimated total future production from the property; the average quality or grade of the mineral reserves; a present value discount and the risks associated with the property (costs of shutting down, dry holes, decrease in production, etc.).

#### *Other Methods*

Some have used other, simpler valuation methods such a multiple of production over a specified time period. This is likely not a thorough indicator of fair market value of an interest and may not withstand IRS scrutiny.

### **Transfer of oil and gas interests**

Oil and gas interests can be transferred using various wealth transfer techniques.

#### *Direct Gift*

If the assets are held in an individual name, the owner may make a direct gift of the assets. The transfer would likely be made by deed. The person making the transfer, or "grantor," would execute a deed granting his interest in the property to the recipient, or "grantee," either as an outright gift or in a trust. The deed would be recorded in the real property records of the county or parish in which the land is located.

If the interest is held in a LP or LLC, then units of the partnership or LLC are given or transferred to the grantee or to a trust for the grantee's benefit.

The value of the LP or LLC must be determined (in addition to the underlying mineral interest previously discussed) through an appraisal prepared by a qualified business appraiser. The appraiser may apply valuation discounts to the partnership or LLC units based on lack of marketability of the interests (or other factors). Valuation discounts must be identified and supported by the appraisal report and justification of the discounts should be detailed in the appraisal report.

A gift tax return (IRS Form 709) may need to be filed to report the gift.

Ideally, the underlying oil and gas interests would be valued by a qualified appraiser using the comparative value method, and the LP or LLC holding the oil and gas interests would be separately valued by a

qualified business appraiser who may determine that valuation discounts are appropriate based on lack of marketability and lack of control (or other factors deemed relevant by the appraiser).

### *Gift to Grantor Trust*

Oil and gas interests, or units of an entity which owns oil and gas interests, may be given or sold directly to a trust for an intended recipient. The trust can be structured as a “grantor trust” for income tax purposes, meaning that all items of income, deduction, credit and loss will flow through to the grantor's personal income tax return. By paying the income tax liability of the trust from the grantor's own assets, the grantor allows the trust assets to grow and compound free from income tax liability. Since significant cash flow (and potentially, taxable income) may be generated from oil and gas production, a grantor trust provides a way to enhance the gift.

Additionally, the trust may provide protection from creditors of the beneficiary if certain provisions and restrictions are included in the trust agreement. This allows owners of significant oil and gas interests to transfer assets to trusts for children while maintaining some protection of the assets for the beneficiary.

### *Sale to Grantor Trust*

Rather than an outright gift to a trust as outlined above, the grantor may sell partnership or LLC units to the grantor trust in exchange for a note.

Unlike a gift, which transfers not only the current value of the transferred property but also the future income and appreciation, in a sale transaction, the grantor will receive back the current value of the transferred property via principal payments on the note. However, the sale still allows the value of future production to accumulate and grow in the trust, rather than in the grantor's taxable estate. Since the grantor is treated as the owner of the trust assets for income tax purposes, the sale to the trust is not a taxable event, and interest payments paid by the trust on the note are not taxable to the grantor for income tax purposes.

## **Examples**

### Example #1 – Gift

Mom and Dad own 100% of *XYZ Interests, L. P.* The LP owns royalties in various oil and gas wells. Prior to drilling, Mom and Dad create grantor trusts for their two children and give a 40% interest in *XYZ Interests* to each child's trust using a portion of their lifetime gift tax exemption. The trusts are structured as grantor trusts.

At the time of the gift, the mineral interests (on which the royalty interests are based) were appraised by a qualified appraiser of mineral interests, and the LP was appraised by a qualified business appraiser.

The value of XYZ was determined to be modest because of the speculative nature of the underlying assets (the royalty interest). Mom and Dad retain 60% ownership of XYZ.

Production begins and the wells produce, resulting in substantial royalty payments. The royalty payments are made to XYZ as the owner of the royalties.

Result: Mom and Dad were able to transfer, through XYZ, 40% of the value of the royalty payments to trusts for their children at a low value prior to production thereby removing the value of those royalty payments from their estates for estate tax purposes. The trust assets continue to grow and compound over time outside of grantors' taxable estates.

*Mom and Dad retained the value of 60% of the royalties through their ownership in XYZ.*

#### Example #2 – Sale to Trust

Mom and Dad are the owners of surface and sub-surface rights of a 3,000 acre tract of land. They sever the surface rights from the sub-surface rights in anticipation of exploration and development of the property. The sub-surface rights are placed in a LP, and they transfer the surface rights to a revocable trust for their personal use and benefit.

Mom and Dad sell a 40% interest in the LP to a trust for their children. The fair market value for purposes of the sale is determined by qualified appraisals of the LP units and the underlying mineral interests.

Production begins and a substantial revenue stream is generated which flows to the LP, 40% of which is owned by the trust for their children.

Result: Mom and Dad retain full use and control of the surface. The children's trust can participate and benefit from the future revenue from the production through its 40% ownership in the LP, and 40% of future income is removed from the estates of Mom and Dad. Mom and Dad continue to benefit from the revenue stream generated by their 60% interest in the LP.

#### Example #3 – Extended Family Management

Various oil, gas and other mineral interests have been held by an extended family for decades. Through the years, the interests have splintered through lifetime gifts and testamentary distributions so that the interests are now owned by family members who cover multiple generations. There is increased interest in further exploration and development of the property. Older generation family members are concerned about management of the splintered interests as production increases. The family members decide to consolidate their

interests for ease of management of the assets and to facilitate seamless wealth transfer going forward.

The family members create a member-managed LLC and each transfers his interest to the LLC. Ownership percentages in the LLC are based on the value of the interest contributed by each family member, and voting rights, including the right to vote on the manager of the LLC, track the ownership percentages.

The family continues to own the interests through the LLC. Older generations may transfer LLC units through gifts or sales to grantor trusts as previously discussed. This will allow for centralized management, as well as wealth transfer opportunities.

### **Considerations for executives of publicly held energy companies**

While executives of major oil companies and other energy related companies can utilize the same techniques discussed above, they often have additional factors to consider. They may be subject to certain restrictions on the transfer of stock so that they cannot transfer except upon the expiration of a period of time. Assuming that they are outside any time restrictions, they can utilize LPs and/or LLCs to transfer wealth. However, they may be subject to certain SEC reporting requirements that must be adhered to when transferring their shares.

Additionally, executives of publicly traded oil or energy related companies may own "incentive units" or may have a "carried interest" that would require specific planning considerations.

Planning considerations for insiders, executives and principals in public companies is outside the scope of this article, but they should certainly seek expert counsel prior to engaging in transfer strategies with their interests.

### **Conclusion:**

Owners of oil and gas interests may want to consider transferring those assets and the income stream generated from them to family members. Transfers can be customized to address the owners' specific circumstances through unbundling of the various ownership rights held by sub-surface owners. However, due to the complexity of the issues involved, it is important for the owners to seek counsel prior to transferring any interest in oil and gas properties.

# Investing in the Energy Sector... What's Happening Now and How Does It Affect My Long Term Estate Plan?

## **What is happening with investments in the energy sector?**

Investing in energy related assets is on the rise. Some investors are increasing their exposure to the energy sector in their portfolios by adjusting asset allocations to include more assets in the energy sector.

## **Why would I invest in energy related investments?**

There is a view that there will be a long term trend of increasing energy demand. This demand results from a global shortage of energy supply and an increased need from emerging markets. If accurate, this increased long term demand could make energy investments a solid component of a portfolio.

## **How do I invest in energy related investments?**

There are several ways to invest in energy and energy related assets:

- Investing directly in the commodity (e.g., purchasing a barrel of oil)
- Investing in the equity of companies directly involved in the energy sector (e.g., purchasing stock of a company in the coal, natural gas or oil business)
- Investing in "clean" or "green" energy alternatives (e.g., wind)
- Participating in one or more Master Limited Partnerships, in order to gain exposure to businesses involved in the energy sector and benefit from the favorable tax treatment of a partnership.

## **How does this affect my estate plan?**

Many estate planning techniques are based on a desire to transfer assets that the transferor (or "grantor") believes will appreciate in value. Since there is substantial development in the energy industry and a consistent demand for all types of energy, these assets may be well suited to transfer to trusts for children, with the intent that the trust will have a time horizon that would allow for appreciation prior to the trust assets being utilized for the benefit of the beneficiary.

Since many MLPs are publicly traded and thus publicly valued on a daily basis, MLP units may be good candidates for wealth transfer because the value of the gift or transfer can be readily determined.

Other energy related holdings, such as a private limited partnerships or limited liability companies have to be independently valued each time a transfer or gift is made.

### **Take away**

Keep in mind that a variety of assets may be appropriate for gift and wealth transfer purposes. The energy sector may be one place to look at the moment.\*

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