“PASS IT ON”

ESTATE PLANNING FOR MINERAL/ROYALTY OWNERS

STEPHEN KUNKEL, CPA, CFP, CMM
NARO-CALIFORNIA 2016 CONVENTION
SHERATON GRAND HOTEL
SACRAMENTO, CALIFORNIA

WHY ESTATE PLANNING FOR OIL & GAS/ MINERAL INTERESTS IS ESPECIALLY IMPORTANT:

- Reduce Estate & Gift Taxes
- Avoid Probate and Ancillary Probate
- Avoid Unnecessary Multiple Deed Transfers
- Avoid Having your Interests in Pay Status Being Placed in Suspense
- Create Structure to Facilitate Efficient Transfer of Oil & Gas/Mineral Interests
- Create Succession Plan for Management of Oil & Gas/Mineral Interests
- Utilize Structure to Allow for Centralized Management for Multiple Family Owners
- Oil & Gas Requires Specific Expertise to Manage, Lease and Monitor Production
- Avoid Fractionalization of Oil & Gas/Mineral Interests
- Simplify Income Tax Reporting Especially when Oil & Gas Interests are Located in Multiple States.

"Actually, you can take it all with you –
but it's taxed quite heavily."

Estate & Gift Tax Rates & Exemptions

Highest Rate and Exemption Levels for Gift and Estate taxes in 2016:

Estate tax		Gift tax	
Top rate	Exemption	Top rate	Exemption
40%	$5,450,000 per person	40%	$5,450,000 per person

Source: IRS.gov

Estate and gift tax exemptions and exclusions are adjusted annually for inflation.

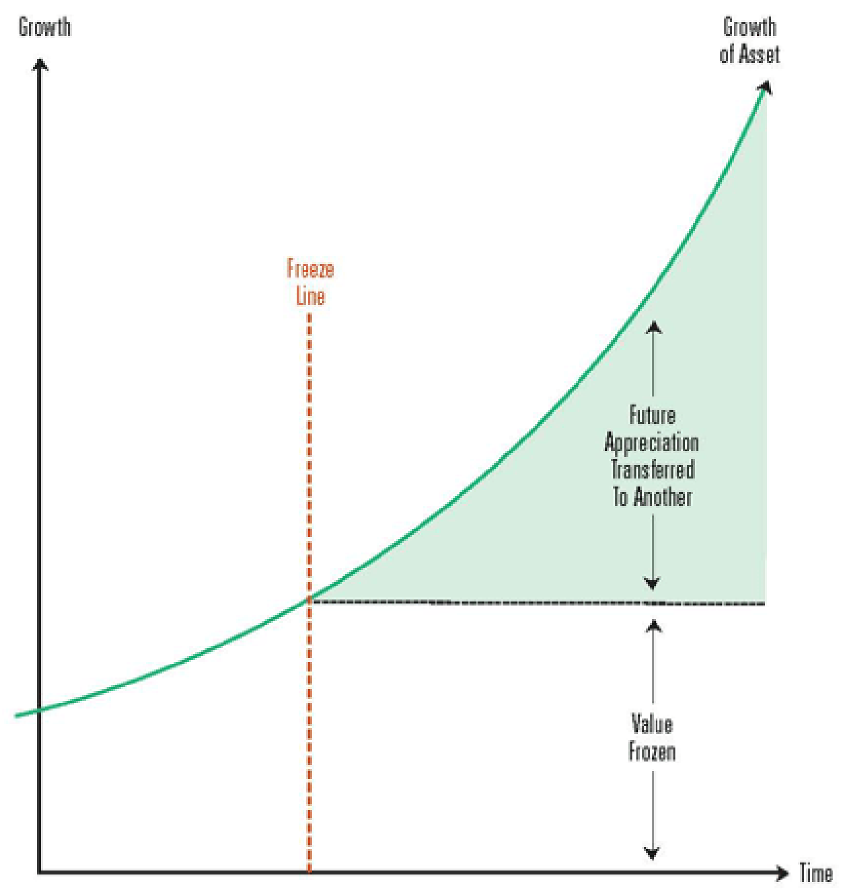
What is Estate Planning?

- The process of accumulating and disposing of your estate to maximize your goals which often include:
- making sure the largest amount of your estate passes to your intended beneficiaries (paying the least amount of tax);
- planning for estate liquidity (life insurance, installment payments of estate tax for qualified business interests);
- succession planning for management of business interests;
- avoiding unnecessary probate court involvement;
- providing for and designating guardians for minor children; and
- planning for incapacity.

Benefit of Lifetime Gifting

- Lifetime gifting can have a powerful effect on reducing the size of your estate or limiting growth of your estate.
- This is especially true when the estate consists of assets (such as oil & gas interests) that are subject to significant price swings over time.
- The estate and gift tax savings is calculated on the value of the assets transferred and <u>the post gift appreciation</u>.
- You may be hesitant to make major gifts (especially since your oil & gas values have decreased) however, this may be a good opportunity to freeze the value of your estate at the current value.
- Under current rules there are a variety of techniques that can be used to transfer assets at a discount and effectively freeze the value so future appreciation is excluded from your estate.

Transferring Appreciation



Estate Planning Process

Effective estate planning is a continuing process undertaken over an extended period of time.

Techniques used in estate/gift planning transfers include:

- Annual exclusion gifts of $14,000 per beneficiary
- Lifetime exemption gifts
- Unlimited marital gifts between spouses (U.S. Citizens)
- Direct payment of tuition and medical expenses
- Charitable gifts
- Intra-Family Sales
- Probate avoidance (revocable living trusts)
- Family Business Entities (family partnerships, LLCs, etc.)

Family Business Entity Selection

C Corporation – has a number of undesirable income tax attributes: not a pass through entity; double tax structure; inflexible regarding distributions of appreciated property; and no step-up in basis for assets held in the corporation at death.

S Corporation -has a few undesirable income tax attributes: inflexible regarding distributions of appreciated property; and no step-up in basis for assets held in the corporation at death.

Family Limited Partnership (FLP)-is very flexible and is a long standing entity of choice for real estate and oil & gas/mineral interests.

Limited Liability Company (LLC)-is very flexible (unless corporate treatment is elected). California LLC subject to Limited Liability Company Fee (gross receipts tax that can range from $0 to $11,790 per year depending on the amount of California gross receipts).

Irrevocable Trust-undistributed income subject to punitively high Federal income tax rates (39.6% for taxable income in excess of $12,400) compared to individual income tax rates (39.6% for taxable income in excess of $466,950).

Revocable Living Trust-treated as a disregarded entity for income tax purposes. This type of trust is typically used to avoid probate.

Family Limited Partnership (FLP)

- Rental real estate, oil & gas/mineral interests and other business assets can be transferred at reduced valuations while maintaining effective control.

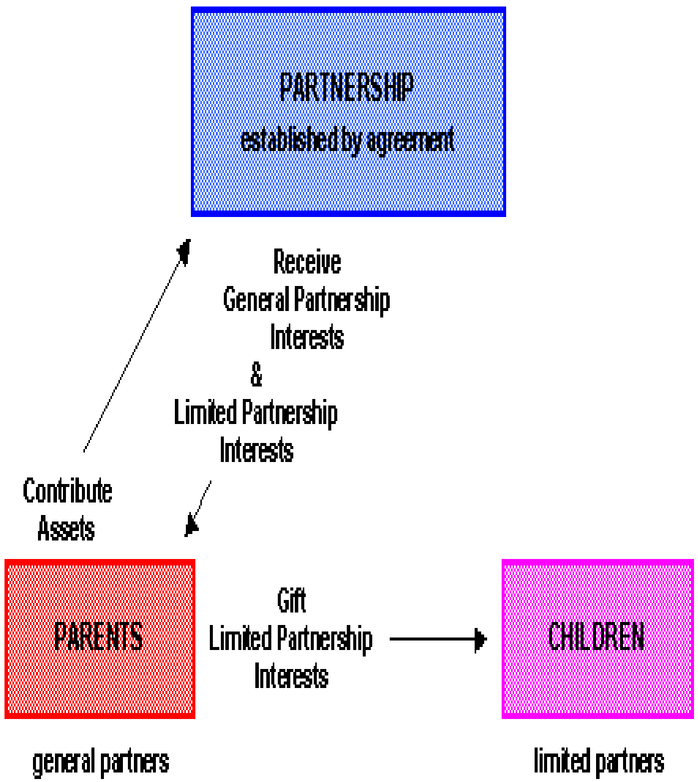
- FLP agreement places restrictions and limitations on ownership and transfer of partnership interests. General Partner manages business operations and administers partnership in accordance with the partnership agreement.

- Under current law, transfers of limited partnership interests are subject valuation discounts for lack of marketability and minority interest.

- It is very important that FLPs are properly formed and operated to meet IRS requirements.

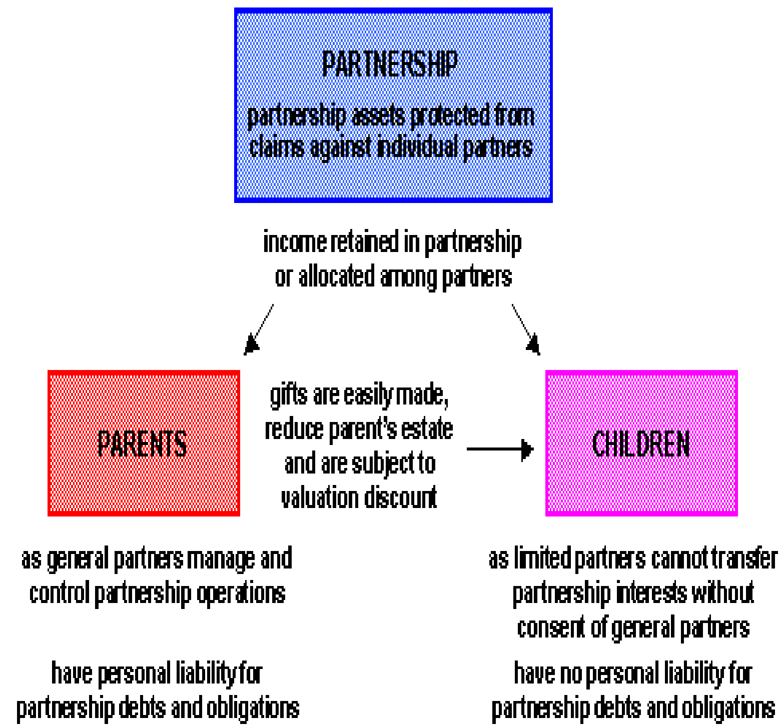
Family Limited Partnership (FLP)

ESTABLISHING PARTNERSHIP



ADVANTAGES OF PARTNERSHIP

Control and Flexibility



Business Purpose for Use of FLPs

Tax partnerships (state law limited partnerships or limited liability companies with pass-through treatment) are frequently used as the business entity of choice for oil & gas/minerals interests. Some of the common business purposes for using FLPs include:

- Establishing a framework for managing mineral interests for multiple generations. The general partner has the operational authority to manage the FLP. The partnership agreement provides the process for changes in management and/or ownership of the FLP.
- Fractionalization of oil & gas/mineral interest is avoided which could otherwise diminish asset values and dilute negotiating power.
- The partnership agreement can restrict transfers to family members and can prohibit limited partners from participating in management.
- A gifted limited partnership interest can provide some level of creditor protection from future creditors and should be treated as separate property in the event of a divorce of the limited partner.

Legal Formalities of FLP must be Observed

The proper formation and operation of an FLP is critical to obtaining the benefits for which it was formed.

- Must be validly formed under state law.
- Must be qualified to do business in all states where it owns oil & gas/mineral interests.
- Must have it own bank account.
- Must have it owns books and records.
- Must hold valid title to all of its assets.
- Must keep required tax records and file tax returns and provide a Schedule K-1 to its partners.
- Must report to its partners and hold meetings as required by state law or the partnership agreement.
- <u>Must be run like a business in all respects</u>.
- Should not own any non-business/personal use assets.

Funding the Family Limited Partnership (FLP)

Common Types of Oil & Gas/Mineral Interests include:

- Mineral interest
- Working Interest
- Overriding Royalty Interest
- Royalty Interest

Oil & Gas/Mineral Interests are transferred to the FLP after formation by mineral deed (warranty or quitclaim).

Oil & Gas/Mineral Interests often have curative title issues including:

acreage discrepancies, cessation of production (HBP), unfiled probate proceedings, name discrepancies, etc.

It is best to try to resolve the curative title issues in the deeding process to avoid future title problems. It may be helpful to hire a landman and/or title analyst to assist in identifying and correcting curative title issues.

FLP Valuation Considerations

For estate & gift transfer tax purposes, you will need an appraisal of the underlying assets owned by the FLP (appraisal methodology varies and includes methods described below):

- **Fee Minerals-**market price per net acre for comparable sale/lease bonus multiple;
- **Leased non-producing royalty interests-**discounted cash flow models/lease bonus multiple;

  [non-producing royalties/mineral interests are usually deeply discounted to consider the possibility that the minerals may never be leased or the primary term of the non-producing lease may expire without production].
- **Producing Royalty Interests/ORRI-**discounted cash flow models/reserve report;
- **Working Interest-**discounted cash flow models/reserve report.

Additionally, you will need an appraisal of the ownership interest being transferred (e.g. limited partnership interest). This will reflect a proportionate share of the underlying net asset value <u>discounted for minority interest/lack of control</u> and <u>discounted for a lack of marketability</u>.

Avoid Fractionalization of Mineral Interests

- Transfer of mineral interests into smaller and smaller pieces over several generations through inheritance creates “dilution of interest”.
- Each beneficiary must separately manage the unleased mineral interests, evaluate lease offers, track royalty payments, compute cost & percentage depletion and maintain adequate business and tax records.
- Not all beneficiaries have the knowledge skill set, recordkeeping diligence, available time or interest in managing the mineral interests and often sell their inheritance at fire sale prices.
- The administrative burden can increase dramatically for beneficiaries who hold title to the fractionalized mineral interest individually. This could require probate proceedings in each county that the decedent held mineral interests (with the associated legal fees, court costs and time delays). This can lead to royalties held in suspense or delays in leasing activity.
- Lessees do target prospects with numerous fractionalized unleased mineral interests they will typically make <u>“low ball” purchase or lease offers</u> and/or pursue forced pooling (especially in Oklahoma).
- Owners of larger consolidated interests often have more negotiating power in the leasing process since lessees are more likely to prefer mineral interests with consolidated mineral ownership to reduce their administrative costs.

Benefits of Using Family Business Entity

For significant holdings of oil & gas/mineral interests the use of a family business entity can provide many benefits, including:

- Streamlined estate administration;
- Preserving asset value;
- Centralized management and succession;
- Economies of scale;
- Liability protection;
- Tax efficiency (pass through entity, group non-resident returns);
- Avoidance of extra deeds involved in multiple transfers;
- Estate tax savings through use of valuation discounts; and
- Step up in basis for share of FLP interest held in an estate (special tax election to increase cost basis of oil & gas interests and increase cost depletion).

Perfect Storm for Estate Planning?

- Oil & gas/mineral interest valuation are currently depressed.
- Current law allows for applicable valuation discounts to be taken for gifts of closely held business interests (FLPs & LLCs) however the Obama administration has indicated they may issue tax regulations to reduce or eliminate these discounts.
- The current lifetime gift exemption of $5,450,000 is not guaranteed to stay in place. The Obama administration has proposed reducing this to $1,000,000 (back to the 2009 level) and eliminating the inflation adjustment.
- Presidential Candidate Hillary Clinton has adopted the $1,000,000 gift tax exemption rollback to 2009 as part of her campaign tax proposals.
- Additional advanced techniques are available for estates that exceed the current Lifetime exemption amounts.

QUESTIONS?

THE INFORMATION PROVIDED IN THIS PRESENTATION IS GENERAL IN NATURE AND SHOULD NOT BE CONSIDERED LEGAL OR TAX ADVICE SINCE ALL TAXPAYER SITUATIONS ARE UNIQUE. PLEASE CONSULT YOUR ATTORNEY AND YOUR TAX ADVISER BEFORE TAKING ACTION.

Stephen Kunkel
Managing Director
CBIZ MHM LLC
Los Angeles