

Oil and gas tax and wealth planning considerations for landowners

Recent advances in new drilling technology are driving unprecedented growth in U.S. oil and natural gas exploration and production and a re-domestication of the oil and gas industry. As the result of recent activity in new plays in shale gas, many landowners have found themselves with property and mineral rights that have increased significantly in value and have become a significant source of income.

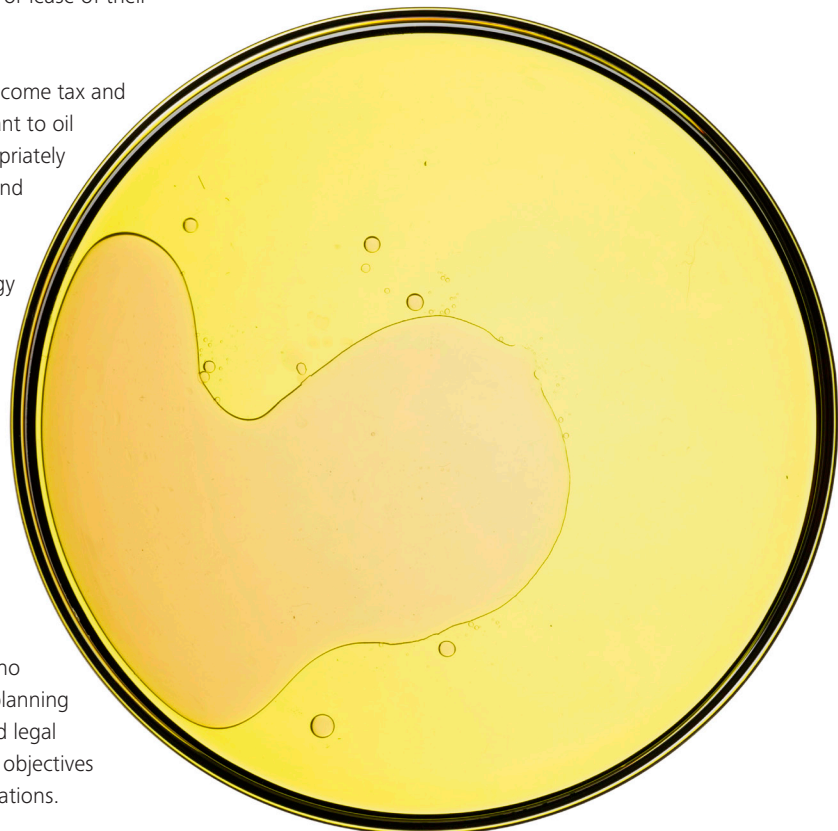
Landowners who have come into wealth as a result of the shale boom face significant income tax and wealth planning considerations. These range from income-tax planning considerations applicable to high-income taxpayers with significant investment income to more distinct, industry-specific taxation matters that apply to certain mineral interest holders and the payments they may receive in conjunction with the sale or lease of their mineral rights.

Most of this article pertains to specific income tax and estate tax planning considerations relevant to oil and gas mineral rights holders. To appropriately understand the complexity of this area and some of the leading tax considerations, however, a basic background understanding of the integral terminology and industry practices surrounding the ownership, transfer, and development of oil and gas properties is necessary. As such, this article provides a high-level overview of some of these particular concepts as well.

Generally speaking, mineral interests are complex arrangements — with terminology, rules, and planning considerations that are specific to the oil and gas industry. Furthermore, because no two situations are exactly alike, careful planning and close coordination with your tax and legal advisors are critical to pursuing personal objectives while considering the relevant tax implications.

What are my rights to the minerals that exist on my property?

Many of the income tax rules surrounding oil and gas properties revolve around an understanding of the types of ownership interest in the underlying property. An individual's rights typically are defined in terms of an "economic interest" in the minerals to be extracted from the property, produced, and sold. The concept of economic interest is important in the oil and gas industry. The basic attribute of an economic interest is the contractual right to receive income that depends on the production of the minerals. The economic interest owned determines how costs of acquiring, developing, and operating the property and production revenue are shared.



There are various types of mineral ownership interests. The most common types of economic interests for landowners that have recently found themselves in possession of property with oil and gas production potential are “royalty interests” and, to a lesser extent, “working interests.”

What is the difference between royalty and working interests?

In most areas of the United States, land and mineral rights may be owned together (termed a fee interest) or separately. That is, the surface landowners may or may not own the minerals underlying the surface area. As such, an oil company may have to deal with multiple owners on an individual tract to obtain the rights to drill. Most oil companies do not purchase surface and mineral rights outright. The typical method of acquiring rights is to enter into a mineral lease with the owner of the mineral rights.

A mineral lease usually provides for a lump-sum payment called a bonus to be paid to the mineral owner upon signing the lease agreement (usually paid on a per-acre basis) and a promise to pay the mineral owner an annual rental to continue a lease for successive years of its term (often referred to as delay rentals). Delay rentals are generally discontinued upon evaluation of drilling results as either productive or nonproductive.

In addition, the mineral owner usually is entitled to receive a royalty from any oil or gas produced from the leased acreage. The amount of the royalty is a negotiated amount. Specifically, a royalty interest is a type of economic interest under which the property owner leases operating rights to another party to develop the property and produce the minerals in return for a fixed portion of the production income. The royalty owner participates in the production revenue from the property leased without incurring an obligation to pay the costs of developing and operating the lease.

The remaining interest typically obtained by the oil company is the working interest. A working interest is considered to be an asset used in a trade or business for purposes of determining section 1231 and capital gain treatment. Working interests may be further classified as limited (where duration of ownership is less than the productive life of the lease) or participating (where the share of expenses incurred for development is limited). The working interest owner generally bears all costs of developing and operating the property and receives revenue subject to the royalty interest. In some situations, a landowner may retain a working interest in the underlying minerals depending on the nature of the drilling arrangement.

Landowners may receive payments for the loss of crops or timber or other consequential impacts to the property associated with the oil company's physical presence and activities. A landowner may also receive payments for items such as pipeline right-of-ways or easements, water rights, or seismograph payments (e.g., “shooting rights”).

How are landowner payments from mineral interests taxed?

Lease bonus and delay rental payments: Lease bonus payments are considered ordinary income for tax reporting purposes and are subject to ordinary income taxes. They are typically reported to landowners on Form 1099 MISC, Box 1, Rents. An individual landowner will generally report this income on his personal tax return on page 1 of Schedule E, Supplemental Income and Loss. This amount flows through to line 17 of Form 1040 and is not subject to self-employment tax.

Royalty payments: Royalty payments are also considered ordinary income reported on an individual landowner's Schedule E of Form 1040. The oil company will generally report the royalty payments to the landowner in Box 2 of Form 1099 MISC. Royalty income may be offset by allowable depletion and other related expenses, such as legal fees (discussed more below).

Damage payments: The tax treatment of various types of damage payments can vary depending on the type and reason for the payment. Damage payments representing reimbursement for lost profits (i.e., crop damages and interruption of surface operations) are generally taxed as ordinary income. Payments for damage to land or property rights are generally characterized as a return of capital and gain to the extent the payments exceed the adjusted basis. Payments for anticipated surface damages (as opposed to payments for loss of surface use) are taxable as ordinary rental income.

Easement/right-of-way payments: The tax treatment of these payments can vary depending on the nature of the easement. Proceeds from easements that are perpetual or with only a contingent right to reversion are generally treated as a nontaxable return of capital to the extent of the owner's basis in the affected land, and any excess is reported as a capital gain. When the easement is limited in time and subject to reversion, the grant will typically be treated as a lease or license and generate ordinary income.

Other: In addition to depletion, landowners that have an operating (e.g., working) interest in the production of oil and gas can deduct other expenditures such as intangible drilling and development costs, operating expenses,

geophysical and geological expenses, production taxes, and other similar expenditures.

What are the income tax planning considerations?

The magnitude of royalty interest income can boost landowners into the highest income tax brackets. Accordingly, if you own a royalty interest(s), you will have income tax planning considerations similar to any higher-income taxpayer with substantial ordinary investment income — including several changes that are the result of recent legislation.

One change is the new net investment income (NII) tax levied on certain unearned income of individuals with adjusted gross income of more than \$200,000 (\$250,000 for joint filers). Introduced as part of the Patient Protection and Affordable Care Act (PPACA), this 3.8 percent tax applies to unearned income such as interest, dividends, capital gains, annuities, royalties, and rents beginning in 2013. The NII tax does not apply to income that is derived from the ordinary course of a trade or business in which the taxpayer materially participates. Most oil and gas income will be subject to the NII tax. However, in some instances, working interest income will be excluded from the tax. As a result, consideration should be given the structure and character of the oil and gas income in light of the NII tax.

Some of the same considerations that apply to royalty interests, discussed above, also apply here. The primary difference is that there is an active business. As discussed above, in certain instances the NII tax may be avoided if the interest retained is a working interest rather than royalty interest.

Otherwise, many of your income and estate planning considerations for a working interest will be similar to those of any closely held business owner, including planning for succession and wealth transfer of the business in addition to investment assets.

The American Taxpayer Relief Act of 2012 (the “Act”), which took effect on January 1, 2013, increased top tax rates on earned income, investment income, and estates and gifts from 2012 levels for more affluent taxpayers. It also permanently reinstated the personal exemption phase-out (PEP) and limitation on itemized deductions (Pease) for single taxpayers with Adjusted Gross Income (AGI) above \$250,000 and joint filers with AGI over \$300,000, with the thresholds indexed annually for inflation. The Act provides permanent alternative minimum tax (AMT) relief for many individual taxpayers; however, high-income taxpayers with certain types of income and

deductions should continue to examine their tax positions every year to understand the possible effects of the AMT and how to address them.

In addition to federal income taxes, a host of state income tax considerations, including multistate matters, exist. See below.

Because of increased income resulting from the significant oil and gas activity and the significantly higher new rates on oil and gas income, it is prudent to review tax planning, asset allocation, and investment strategies with your advisors. Consideration should be given to the timing of income and deductions, to the extent possible. The tax benefit of items such as charitable deductions should be considered along with potential phase-outs and rate benefits. The true benefit can only be analyzed by using projections to calculate the probable results. Additionally, you should be aware of requirements for estimated taxes, including current “safe harbor” rules, in order to avoid penalties.

What is “depletion” and how is it relevant to me?

Depletion deductions compensate a taxpayer for the natural reduction of an irreplaceable asset that results from drilling for oil and gas in place — similar to depreciation rules for other types of assets. A taxpayer must have an economic interest in the minerals in place to claim depletion deductions. A taxpayer generally computes depletion for each property using two different methods (cost depletion and percentage depletion) and deducts the higher amount from the two alternative computations.

Cost depletion generally involves writing off the capitalized cost of the mineral property over the life of the property on a pro rata basis as the oil and gas is produced. To claim cost depletion, one must have a cost basis in the minerals, which is usually determined upon their acquisition, along with a calculation of the amount of minerals actually depleted during the year. Historically, it has been rare for many landowners to allocate part of the basis to the oil and gas minerals. As such, most landowners will not be able to use the cost depletion method.

Percentage depletion is calculated at a statutory percentage of gross income from the property, but is subject to a number of special limitations. A taxpayer may claim percentage depletion even if there is no cost basis in the underlying property. Most landowners use the percentage depletion method for calculating the depletion deduction since they lack a separate basis in the mineral rights and thus cannot use the cost depletion method. It should be noted that depletion is not allowed against delay rentals and lease bonuses.

What about state taxes?

State and local taxation, in general, is a fluid and evolving area for high-income taxpayers and those with significant investment income — particularly when that income may involve property in multiple states or entities with affairs in multiple states.

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For example, if you live in Texas and have a royalty interest in Louisiana, you may have to file a Louisiana income tax return and pay tax in Louisiana. Those with business or partnership interests, which are common forms of ownership for royalty interests, may have tax filing requirements in a number of locations. It is important to note that every state has different rules on the taxation of mineral interests (i.e., different rates for percentage depletion), and multistate specialists should be consulted to determine any applicable tax.

There are other considerations beyond income taxes; for example, the impact of increased land value on property taxes and increased efforts by states to collect indirect (sales and use) taxes from high-income taxpayers. In addition, some landowners may be subject to nontraditional taxes such as fees or business licenses.

One area of tax specific to this is a state severance tax, imposed by some jurisdictions on the removal of nonrenewable natural resources such as crude oil or natural gas. Landowners with royalty interests generally are responsible for such taxes — one of the few operating risks associated with that type of mineral interest.

How does having an oil and gas property affect my estate planning?

Landowners with property that has increased substantially in value will also have a host of new wealth planning considerations. Families of landowners who were previously not subject to an estate tax at death are now going to potentially be subject to a significant tax at death. This tax may result in the families of landowners being forced to monetize the value of the property prior to the optimal time. As a result, you should work with your advisors to understand the implications of estate, gift, and generation-skipping transfer tax rules currently in place and to discuss your wishes for transferring wealth associated with your mineral interest(s) and any other assets.

If your wealth has increased significantly as a result of mineral interests, you may wish to consider a gifting approach that enables you to take advantage of the annual gift tax exclusion (currently \$14,000 per donee per year) and the lifetime transfer tax exemption (\$5,250,000 for 2013). With passage of the Act, there is now some clarity and certainty in the estate tax area for the foreseeable future. Significantly, the Act preserves a favorable tax environment for making gifts by preserving the \$5 million (indexed for inflation) gift tax exemption for the future; however, a higher top gift-tax rate of 40 percent will apply to taxable transfers starting in 2013. Estate planning is a process, and a frequent examination of your existing estate plan will help determine whether the plan continues to meet your desires along with potentially enhancing the tax benefit.

Consideration should be given to planning with oil and gas property even before income is being generated by the interest. Valuation discounts may be available because of limitations on the rights of the interest transferred along with the economic uncertainties of the interests transferred. Sophisticated planning techniques are available to take advantage of potentially significant future increases in value along with potential benefits of valuation uncertainty. Congress may legislate to remove some of these planning techniques in the future. As a result, it is imperative that this tax planning be entered into as soon as possible in order to maintain the ability to save potential transfer tax savings.

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