

ESTATE PLANNING
CONSIDERATIONS FOR
OIL AND GAS INTERESTS

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“The Secret of success is to get up early, work late and strike oil.”¹

- AND -

“Anyone may arrange his affairs so that his taxes shall be as low as possible; he is not bound to choose that pattern which best pays the treasury. There is not even a patriotic duty to increase one's taxes. Over and over again the Courts have said that there is nothing sinister in so arranging affairs as to keep taxes as low as possible. Everyone does it, rich and poor alike and all do right, for nobody owes any public duty to pay more than the law demands.”²

I. OVERVIEW OF THE TRANSFER TAX SYSTEM (AKA, “DEATH TAXES”)

A. Size Really Does Matter: The Estate, Gift³ and GST Exemptions

<table>
<thead>
<tr>
<th>Year</th>
<th>Estate Exemption</th>
<th>GST Exemption</th>
<th>Gift Exemption</th>
<th>Top Tax Rate</th>
<th>Step-Up</th>
</tr>
</thead>
<tbody>
<tr>
<td>2001</td>
<td>$ 675,000</td>
<td>$1,060,000</td>
<td>$675,000</td>
<td>55-60%</td>
<td>Full</td>
</tr>
<tr>
<td>2002-03</td>
<td>1,000,000</td>
<td>1,100,000+</td>
<td>1,000,000</td>
<td>50-49%</td>
<td>Full</td>
</tr>
<tr>
<td>2004-05</td>
<td>1,500,000</td>
<td>1,500,000</td>
<td>1,000,000</td>
<td>48-47%</td>
<td>Full</td>
</tr>
<tr>
<td>2006-08</td>
<td>2,000,000</td>
<td>2,000,000</td>
<td>1,000,000</td>
<td>46-45%</td>
<td>Full</td>
</tr>
<tr>
<td>2009</td>
<td>3,500,000</td>
<td>3,500,000</td>
<td>1,000,000</td>
<td>45%</td>
<td>Full</td>
</tr>
<tr>
<td>2010</td>
<td>5,000,000</td>
<td>5,000,000</td>
<td>1,000,000</td>
<td>35%⁺</td>
<td>Limited</td>
</tr>
<tr>
<td></td>
<td>TAX REPEALED</td>
<td>TAX REPEALED</td>
<td>1,000,000</td>
<td>35%</td>
<td>Limited</td>
</tr>
<tr>
<td>2011</td>
<td>5,000,000</td>
<td>5,000,000</td>
<td>5,000,000</td>
<td>35%</td>
<td>Full</td>
</tr>
<tr>
<td>2012</td>
<td>5,120,000⁺</td>
<td>5,120,000⁺</td>
<td>5,120,000⁺</td>
<td>35%</td>
<td>Full</td>
</tr>
<tr>
<td>2013</td>
<td>1,000,000</td>
<td>1,390,000⁺</td>
<td>1,000,000</td>
<td>55-60%⁺</td>
<td>Full</td>
</tr>
</tbody>
</table>

¹ J.D. Rockefeller (1839-1937), Founder, Standard Oil.
² Helvering v. Gregory, 69 F.2d 809, 810-11 (2d Cir. 1934), aff’d 290 U.S. 465 (1935). The author of the opinion was Judge Billings Learned Hand (1872-1961), Judge, U.S. Court of Appeals. Judge Learned Hand is generally considered to be one of the most influential American judges never to have served on the Supreme Court of the United States.
³ Congress enacted the gift tax in 1932 to prevent donors from avoiding the estate tax by transferring their wealth before they die.
⁴ Except 0% GST rate.
⁵ Includes inflation adjustment.
⁶ Estimated.
⁷ 5% surtax imposed on estates between $10,000,000 and $17,184,000.
B. Annual Exclusion Gifts (currently $13,000 per person)
   1. A person (donor) can make gifts up to $13,000 per donee (the person receiving) per year with no gift or estate tax implications
   2. If the donor is married, the donor could make gifts up to $26,000 per donee per year via gift-splitting
   3. Applies to anyone: children; grandchildren; spouses; speakers at the Utica Shale Conference in Cleveland, Ohio
   4. Donee does not pay income tax on the gift received
   5. Donor may have to file Federal gift tax return (Form 709)

C. Unlimited Marital Deduction
   1. Lifetime
   2. Death

D. Charitable Giving
   1. Not subject to gift tax, no matter the size of the gift (not limited to $13,000)
   2. Deduction for income tax purposes
   3. Deduction for estate tax purposes

E. Neither inheritances nor gifts received count as taxable income to the recipient

F. Portability
   1. When the first spouse dies, the executor may elect to transfer any unused portion of the decedent’s $5.12 million estate tax exemption to the surviving spouse
   2. Allows second step-up in basis
   3. Expires in 2012
   4. Obama’s 2013 Revenue Proposals would make it permanent
   5. Must file federal estate tax return (Form 706)
   6. Does not shelter appreciation or income
   7. No portability of the GST exemption; unused GST Exemption of first spouse would be lost
   8. Can only use exemption of most recently deceased spouse

II. WAYS TO REDUCE DEATH TAXES

A. Spend it

B. Gift it away (family or charity)

C. Wealth Transfer Planning (aka, “Estate Planning”)

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8 IRC Section 102(a).
III. **Oil and Gas Perspective to Estate Planning: Why It Is Important**

A. Oil and gas interests may constitute a substantial portion of an estate
   1. Landowners (*i.e.*, existing landowner royalties or mineral interests)
   2. Oil and gas producers (*e.g.*, existing production or sale/assignment of existing leases)

B. Oil and gas interests may require expertise and ability to supervise production

C. Succession planning: members of the family may be in the business; other family members may not be in the business.

D. Liability protection
   1. Are you protected from personal liability
   2. Consider separating the operating interests (*e.g.*, the working interests) from the non-operating interests (*e.g.*, the overriding royalty interests)
   3. Review the indemnification clause in the oil and gas lease
   4. Review homeowner policy and speak with insurance agent

E. Types of interests
   1. Surface
   2. Subsurface (“bundle of sticks”)
      a. Operating interests: 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 essentially the mineral interest minus the royalty interest. Often referred to as a “working interest.”
      b. Non-operating interests: may be in the form of a royalty interest, 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 interests.

   3. Surface and subsurface interests can be dealt with separately
      a. Seller can retain mineral interests when land is sold
      b. Mineral deeds
      c. Lease assignment
      d. **Example**: Surface interest can be owned by mom and dad; subsurface interest can be owned by an LLC.

F. How are the interests owned?
   1. **Individual name**: individual can transfer directly to another person by gift or sale, either outright or to a trust

   2. **Limited partnership (“LP”) or limited liability company (“LLC”)**: oil and gas interests are often owned in a LP or LLC. In this situation, the ownership interest in the LP or LLC (often referred to as “units”) could be transferred (subject to possible transfer restrictions in the operating agreement) to another person by gift or sale, either outright or to a trust
3. **S-corporation or C-corporation**: it is generally undesirable to own oil and gas interests in a corporation.
   a. Create problems at death
   b. Not as flexible as an LLC or LP
   c. C-corporation may be subject to double-taxation
   d. May want to transfer the “deep rights” out to the shareholders/LLC; this could be done via a dividend or sale *(NOTE: see Section VI on valuation of oil and gas interests)*

4. **Trusts**

**IV. TAX EVASION VS. TAX AVOIDANCE**

A. Tax evasion IS a CRIME

B. Tax avoidance is **LEGAL**

C. **Example**: Suppose there is a toll road that takes you directly to this seminar. However, you decide to drive the “back-roads” instead of taking the toll road, you have **avoided** the toll . . . which is legal. If, on the other hand, you take the toll road and do not stop at the toll both to pay, you have **evaded** the toll . . . which is not legal.

D. **Conclusion**: It is neither “sinister” nor “illegal” to implement legitimate estate planning techniques to minimize taxes

**V. LIFETIME TRANSFER OF OIL AND GAS INTERESTS**

A. **Outright/Direct Gift**
   1. If owned individually, would transfer via a deed
   2. If owned in an LLC or LP, the “units” would be gifted
      a. Subject to the transfer restrictions of the operating agreement
      b. May be subject to valuation discounts

B. **Gift to Defective Grantor Trust (“DGT”)**
   1. Trust is “defective” for income tax purposes *(see IRC Section 671-678)*
      a. Donor pays the income tax attributable to the income of the trust, allowing the trust to grow income tax-free for the beneficiaries
      b. Can design to “flip” the switch and make the trust non-defective

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9 It has been broadly reported Republican presidential candidate Mitt Romney and his wife, Ann, have used sophisticated estate-planning techniques for more than a decade to minimize taxes and amass at least $100 million for their family outside of their taxable estate.
2. Spousal Access Trust (“SPAT”) or Spousal Lifetime Access Trust (“SLAT”)
   a. If properly designed, the spouse can be a beneficiary, the trustee and have a power to appoint the assets at death
   b. Can be eligible for annual exclusion gifts
   c. Greater creditor protection
   d. Gift-splitting should not be used if the spouse is a beneficiary
   e. Be leery of the “reciprocal trust doctrine” if each spouse intends to create a SPAT/SLAT for the other spouse

3. Beneficiary DGT: with careful drafting, a DGT can be drafted so that it is “defective” as to the beneficiary (aka, the beneficiary defective inheritor’s trust or the “BDIT”)

4. Oil and gas interests (or “units” in an LLC or LP) may be transferred to a DGT

5. DGT’s can be drafted to be very flexible

6. Generally, it is best to apply GST Exemption to the gift . . . then, the assets can pass free of estate tax and GST tax for successive generations

7. Can leverage the gift later with a loan or installment sale to the DGT (see V.C. below)

8. President Obama’s Fiscal Year 2013 Revenue Proposal provides that (i) a grantor trust treated as owned by an individual for income tax purposes would be included in that individual’s gross estate for estate tax purposes, (ii) transfers from a grantor trust would be treated as gifts, and, (iii) conversion to non-grantor status would be treated as a gift

C. Installment Sale to Defective Grantor Trust

1. Freezes value of the assets for estate planning purposes
   a. Donor receives back the current value of the transferred property via principal payments on the note
   b. Allows the future value (e.g., future oil and gas production) to accumulate and grow in the trust and not in the donor’s taxable estate

2. Rule of thumb is there should be “seed money” of at least 10% of the purchase price of the property sold to the DGT . . . this helps provide the DGT with economic substance apart from the property you sell to the DGT

3. Could use a “beneficiary guarantee” as an alternative to “seed money” . . . BE VERY CAREFUL using only a beneficiary guarantee

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10 See PLR 95-15039 (IRS held that a beneficiary guarantee would suffice in the context of a private annuity sale, provided the guarantor had sufficient personal assets to make good on the guarantee). Also, it is uncertain whether a gratuitous guarantee is a gift; as such, you should consider paying guarantors a reasonable payment for the guarantor in order to avoid gift tax issues.
4. The DGT is your “alter ego” for income tax purposes
   a. Equivalent of selling the property to yourself
   b. No income or capital gains taxes due on sale
   c. **Rev. Rul. 2004-63**: the payment by the donor of the income taxes on the
      DGT are not taxable gifts to the DGT
   d. **Rev. Rul. 85-13**: the seller and the DGT are treated as the same taxpayer;
      the sale is disregarded since the donor is both the maker and owner of the
      note for federal income tax purposes

5. Interest rates based on AFR (historic lows)\(^{11}\)
   a. Short-term (3 years or less) AFR (September): 0.21% annual
   b. Mid-term (in excess of 3 years to 9 years) AFR (September): 0.84% annual
   c. Long-term AFR (in excess of 9 years) (September): 2.18% annual

6. May want to consider using self-cancelling installment note (SCIN) (see V.E. below)

7. Qualified appraisal necessary to determine fair market value

D. **Grantor Retained Annuity Trust – GRATs**

1. A trust into which the donor transfers assets in exchange for an annuity
   payable for a fixed term
2. Transfer (i.e., the remainder interest) results in a taxable gift
   a. Actuarial computation: the fair market value of the property less the
      present value of the donor’s retained interest
   b. Zeroed-out GRATs (aka, Walton GRATs)\(^{12}\)
3. Based primarily on interest rate assumptions
4. Use assets that are likely to earn more than the Section 7520 rate\(^{13}\)
5. Mortality risk: if donor dies during the term, a portion of the GRAT is
   includible in the donor’s taxable estate under IRC Sections 2036 and 2039
   (however, the gift tax exemption is restored if any was used)
6. End of term: assets pass to the beneficiaries designated in the GRAT
   (remainder beneficiary can be a trust)
7. Beneficial for those who do not want to “give it all away”
8. Beneficial for those who have used virtually all of their gift exemption
9. **NOTHING TO LOSE**: If assets do not appreciate, they are returned to the
   donor; if GRAT is zeroed-out, virtually no cost to the donor (other than set-
   up and administration fees for the GRAT)
10. Can not allocate GST Exemption to the GRAT until the Estate Tax Inclusion
    Period (“ETIP”) ends (i.e., the end of the term of the GRAT)
11. President Obama’s Fiscal Year 2013 Revenue Proposals would require a 10-
    year minimum thereby increasing the mortality risk of predeceasing the term
    of the GRAT

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\(^{11}\) **See** www.pmstax.com.

\(^{12}\) The Walton case (Walton v. Com., (2000) 115 T.C. 589), explains how to reduce the gift element of a

\(^{13}\) The Section 7520 rate for September 2012 is 1.0%.
12. Oil and gas interests (including units in LLCs or LPs that own oil and gas interests) can create tremendous results

E. **Private Annuity/Self-Cancelling Installment Notes – SCINs**

1. These techniques are beneficial when donor has a shortened life expectancy
2. Income stream

**VI. Valuation of Oil and Gas Interests**

A. Fair market value: “the price at which the property would change hands between a willing buyer would pay a willing seller, neither under any compulsion to buy or sell and both having reasonable knowledge of relevant facts”

B. Appraisal methodology of minerals

1. **Comparative values (non-analytical appraisals)**
   a. Looks at market information such as comparable sales
   b. IRS considers more probative of fair market value

2. **Present value/discounted cash flow method (analytical appraisals)**
   a. Essentially an engineering study/scientific prediction
   b. Used if comparative values are not available
   c. Factors to consider
      i. Future price of oil and gas
      ii. Estimated future production (decline curve)
      iii. Discount rate (including risk)

3. **Shortcut (or “Rule of Thumb”) method**
   a. Royalty interest: 3 to 5 times annual production
   b. Working interest: 2 to 3 times annual production
   c. Undervalues if the property has a longer life than estimated
   d. Overvalues if the property has a shorter life than estimated

4. **Regulations to IRC Section 611**

5. **Producing vs. Non-producing properties**

6. **Interests in entities**
   a. Value both the underlying oil and gas interests by a qualified appraiser; and
   b. Value the LLC or LP units holding the oil and gas interests who may determine that valuation discounts are appropriate

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14 IRC Section 20.2031-1(b).
BIBLIOGRAPHY

1 S. Joyce Crivellari, *Wealth Transfer Considerations for Oil and Gas Interests*, ESTATE PLANNING, April 2012, at 22.


