Black Gold:
Gifts of Oil and Gas Interests Made Simple

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As drilling technologies have made significant breakthroughs, oil and gas production has increased dramatically over the past decade, allowing production in states where none existed previously. Approximately thirty two states now realize substantial mineral production each year, creating opportunities for philanthropy that were not formerly available. This presentation will provide an overview of the basic types of mineral interests and equip gift planners to effectively cultivate and close gifts of oil and gas interests. Specific topics will include:

Summary Outline

I. Overview of Mineral Interests

   A. History and State Law
   B. Terminology
   C. Types of mineral ownership interests

II. Gift Acceptance Policies

   A. Identifying types of mineral interests that may be received
   B. Clarification of policies related to environmental assessment and ongoing management

III. Working with Donors

   A. Identifying the donor's ownership interest, objectives and options
   B. Facilitating the gift transaction

IV. Valuation of Mineral Interests

   A. General guidelines
   B. IRS requirements for the qualified appraisal
   C. Factors affecting the valuation of mineral interests
   D. Obtaining a qualified appraisal for mineral interests

V. Substantiation Rules

   A. IRS Forms 8283 and 8282

VI. Special Considerations

   A. Environmental issues
   B. Options for minerals management going forward
   C. Compatibility with specific planned giving vehicles

VII. Taxation Issues

   A. Applicability of the partial interest rules
   B. Potential for unrelated business income

I. Overview of Mineral Interests

A mineral interest is defined as the ownership of the right to exploit, mine, or produce minerals lying beneath the surface of a property.

In the U.S., a majority of the minerals are privately owned which is particularly good for charitable institutions. Other than oil and gas, coal, iron ore, sulphur, and precious metals are considered minerals. Water, sand and gravel, salt, building stone, limestone, and surface shale are not considered minerals and belong to the surface owner.

In Texas and many other states, the mineral estate is the dominant estate and allows the owner to use the surface estate in a reasonable manner to exploit, mine, or produce minerals. The mineral owner has the right to lease the interest to others. This right is known as executive rights. The various interests that can be created using this right are the basis for gift possibilities.

A. History and State Law

The first successful oil well in the United States drilled for the sole purpose of finding oil was located in Titusville, Pennsylvania. The year was 1859. It was named the "Drake Well" after the man responsible for the well, "Colonel" Edwin Drake. The well was drilled to a depth of 69.5 feet and produced approximately 20 barrels of oil per day.

The existence of oil in the Titusville area had been known for hundreds of years. It was used for medicinal purposes by Native Americans and the European settlers used it for lamp fuel and machinery lubrication. Wells had been drilled in the area for some time looking for drinking water or salt water, but not oil. The wells that produced oil were considered nuisances and abandoned.

The Drake well could be considered the start of the oil and gas industry. The Pennsylvania area was responsible for 1/2 of the world's production of oil until the East Texas oil boom of 1901.

From 1859 to the East Texas boom, drilling activity and crude oil production expanded gradually to supply mostly lubricants and kerosene to use in lamps to replace whale oil. Production began to expand in the late 1800s as refineries began producing new petroleum based products to meet demands of U.S. industrialization and the growing number of internal combustion engines.

In 1859, the U.S. produced about 2,000 barrels of oil; in 1879, the number rose to approximately 19 million barrels and by 1899 increased to approximately 57 million barrels. The increase in demand led to the search for new sources.

On January 10, 1901, a well in Beaumont, Texas, known as the "Lucas Gusher," erupted. It was the beginning of an area known as "Spindletop." The initial flow rate for this well was nearly 100,000 barrels per day which was more than all of the other producing wells in the United States combined. It is estimated that over 850,000 barrels of oil were lost before the flow of oil was controlled. Spindletop was responsible for producing many companies that were to become giants in the oil industry, including Gulf Oil, Amoco and Humble Oil Company, which would become Exxon.

Today, oil and gas are produced in Alabama, Alaska, Arizona, Arkansas, California, Colorado, Florida, Illinois, Indiana, Kansas, Kentucky, Louisiana, Maryland, Michigan, Mississippi, Missouri, Montana, Nebraska, Nevada, New Mexico, New York, North Dakota, Ohio, Oklahoma, Oregon, Pennsylvania, South Dakota, Tennessee, Texas, Utah, Virginia, West Virginia, and Wyoming.

Four states produce the bulk of the total United States production – Texas, Alaska, California, and Louisiana. Energy Information Administration, *Petroleum Supply Annual 2007.*

During the early years of the industry, great progress was made in understanding oil and gas; however, laws regarding oil and gas property rights were formulated with little understanding of the nature of the asset.
There are two theories related to the ownership of minerals. The "ownership-in-place" theory says that the surface owner owns all substances under the land. Texas, New Mexico, West Virginia, Mississippi, Montana and about half of the other states follow this theory. The "non-ownership/exclusive right-to-take" theory says that the surface owner does not own the oil and gas, but merely owns the right to capture oil and gas using the land. After the mineral has been captured, the landowner owns the mineral. This is the Oklahoma doctrine.

Minerals are considered real property until extracted. Once extracted, minerals become personal property and personal property laws then control. The mineral owner bears all costs of producing the mineral and gets all profits, but also bears all risk of loss. Once the minerals are leased, the lessee controls the mineral estate subject to the rights retained by the lessor under the lease agreement.

B. Oil and Gas Terminology

In order to understand the asset, it is helpful to have a working knowledge of certain terminology associated with the oil and gas industry. Terms used to describe the potential donor include:

1. LAND OWNER
The person who owns all or part of the minerals under his land and is entitled to lease it. This is known as fee simple ownership. The land owner has the right to the surface, the minerals, the leasing rights, lease bonus payments and the royalty.

2. MINERAL OWNER
Generally, one who owns only minerals under a tract of land but not the surface. The mineral owner has the right to remove the minerals along with the right to execute a lease allowing someone else the opportunity to remove them. This right is superior to the surface owner's rights because, in Texas and many other states, the mineral estate is the dominant estate.

3. SURFACE OWNER
Usually a landowner who owns no minerals under his land. The surface owner is not entitled to execute a lease. Yet, the surface owner is affected by leasing activity because the surface is used to access the mineral asset.

Terms used to describe the legal instruments used to convey a mineral interest include:

4. ASSIGNMENT
The legal instrument whereby oil and gas leases or overriding royalty interests are assigned/conveyed.

5. LEASE
The agreement outlining the basic terms of developing lands or minerals. The agreement typically includes the royalty to be paid, length of time or term of the lease, and a

description of the land or interest. Also known as an “oil & gas lease” or an “oil, gas and mineral lease”.

Other terms to be familiar with include:

6. BONUS
An amount paid to acquire an oil and gas lease.

7. DELAY RENTAL
Yearly payments paid during primary term to lessor to delay drilling.

8. DIVISION ORDER
A schedule of owners and their decimal share in revenues of the well derived from the sale of oil or gas.

9. DIVISION ORDER ANALYST
An individual responsible for the proper distribution of revenues obtained from oil and gas production.

10. JOINT OPERATING AGREEMENT
An agreement among working interest owners describing how a well is to be operated.

11. LANDMAN
The person who secures leases and handles damages for oil companies who are drilling new wells or laying pipelines.

12. OPERATING AGREEMENT
Same as Joint Operating Agreement.

13. OPERATING EXPENSES
The costs of operating a well.

14. OPERATOR
The party designated in the Operating Agreement to conduct the operations of the well.

15. PAID-UP LEASE
An oil and gas lease where rental payments are paid along with the bonus.

16. PRIMARY TERM
The initial period in an oil and gas lease to develop the property.

17. PUGH CLAUSE
A clause added to a lease to limit holding non-producing lands or depths beyond the primary term under the lease.

18. RUN STUB
Stub attached to a check disclosing the well name, month of production, price received and total volumes produced.

19. SALT WATER DISPOSAL WELL
A well into which oilfield salt water is disposed.

20. SEVERANCE TAX
A tax due the state on oil or gas produced or "severed" from the earth.
21. SEVERED MINERALS
Minerals whose title has been severed from the surface title.

22. SHUT-IN
An oil or gas well which is inactive.

23. UNLEASED MINERAL INTEREST
A mineral interest not subject to a lease.

C. Types of Oil & Gas Ownership Interests

If an individual owns all of the private rights in land including both surface and subsurface rights, he or she is said to own a fee interest. If only the surface interest is owned, then the individual owns a surface interest, and conversely, if the individual only owns the mineral interest, a mineral interest/mineral estate/mineral right is owned. An individual may own all of the mineral interest or may own a percentage. Additionally, an individual may own a certain mineral type.

When the owner of a mineral interest leases the interest to an individual or company, the individual receiving the lease, the lessee, has a leasehold interest. Leasehold interests are typically called **working interests** or **operating interests**. In exchange for granting the lease, the lessor typically receives a **royalty interest**, an **initial bonus**, **delay rental** and **shut-in royalty**. The lessee has the rights to use the surface of the property to obtain the minerals, the right to incur costs of exploration and production of the minerals and to retain profits subject to the lessor's retained rights, typically the royalty interest. The lessor also holds a reverter in the mineral interest. Upon expiration of the mineral lease, ownership of the minerals revert to the lessor.

A **royalty interest** is a share in the production of the mineral free of the costs of producing it when and if there is production on the property. Oil and gas royalties are typically expressed as fractions or percentages and can be created in different ways. There are landowner's royalty interests, nonparticipating royalty interests, and overriding royalty interests.

The landowner's royalty interest is generally retained by the owner at the time the oil and gas lease is negotiated. It is the landowner's compensation for granting the lease. A 1/8th royalty was standard from the 1920s through the mid 1980s. Today, many consider a standard royalty to be 3/16th, but prevailing royalty amounts will vary somewhat depending on the level of production in a given area.

A **nonparticipating royalty interest** is carved out of the mineral interest and entitles the holder to a stated share of production without regard to the terms of the lease. This can be seen in a situation where a parent conveys a percentage of his or her royalty to children.

An **overriding royalty interest** is carved out of the lessee's working interest and can be used to compensate landmen, lawyers and geologists who helped structure the drilling operation.

A **net profits interest** is similar to a royalty interest but is payable only if there is a net profit. It is important to negotiate what costs are included in the definition.

II. Gift Acceptance Policies

A. Identifying Types of Mineral Interests That may be Received

The management and administration of oil and gas assets requires knowledge and expertise. Charities located in states with mineral production have historically received gifts of minerals. These interests may be received in the conveyance of surface ownership which also includes a mineral interest or the conveyance of the mineral interest alone. Institutions should have acceptance policies addressing mineral gifts. The gift acceptance policies should serve to educate staff and board about the critical issues that can be triggered by gifts of these assets. There can be valuation issues, environmental issues, unrelated business income issues and management issues with the acceptance of this asset type.

Many oil and gas acceptance policies across the country include provisions that:

1. Set-out a minimum value for gifts of surface rights
2. Set-out a minimum per year royalty
3. Provide for review of liability issues
4. Prohibit acceptance of working interests
5. Provide for environmental review in order to prevent current or future exposure to environmental liability

Some charities will sell mineral interests as soon as practical, while others will hold and manage them. The question of whether or not to maintain the asset depends upon the organization's ability to effectively manage this asset type. Is the asset of a size that would allow the charity to obtain third party administration/management? Will the charity accept producing and/or non-producing assets? Holding non-producing mineral assets does not cost the institution anything. There are no carrying costs (ad valorem taxes, severance taxes, etc) associated with an oil and gas asset that is not in production.

Charities typically do not accept working interests because of the liability and tax consequences associated with these interests. As mentioned above in the definition section, the working interest holder has the right to use the surface of the property to obtain the minerals, the right to incur costs of exploration and production of the minerals and to retain profits subject to the lessor's retained rights. All liability issues flow to the holder of the working interest. This includes all environmental issues caused by exploration and production of the asset. Income derived from working interests is considered unrelated business income and therefore subject to unrelated business income tax, as discussed in the last section of this paper.

B. Clarification of Policies Related to Environmental Assessment and Ongoing Management

It is important to have an environmental assessment policy for all gifts of real property. Most policy statements will be broad enough to cover gifts of mineral interests. The following is an example of an environmental policy statement:

> "It is the policy of [Charity] to minimize and, when possible, avoid environmental liability arising from the ownership or control of property or property interests by taking such action reasonably appropriate to determine the extent of any environmental contamination before taking ownership of the property. This action

will include inspections and assessments of the property that will be tailored to meet the specific characteristics of the property. The parameters of the inspection and environmental assessment will be set in each instance by the General Counsel of [Charity]."

III. Working with Donors

A. Identifying the Donor's Ownership Interest, Objectives and Options

Who owns the mineral interest? Is the donor single or are the donors married? When you are dealing with husband and wife donors, the questions are: In what state do the donors reside, and how was the mineral interest obtained? In nine states (Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington and Wisconsin), community property statutes presume that each spouse owns a ½ interest in property acquired during marriage except by gift, devise or bequeath. If the mineral interest was owned before the marriage or obtained during the marriage by gift, devise or bequeath, it is the separate property of the spouse receiving the gift or inheritance and can be conveyed by that spouse individually. If not, both spouses need to make the conveyance in a community property state.

Most states in the U.S. follow the common law property concept – property acquired by any spouse in his or her name is owned individually by that spouse and can be conveyed as such. In states that have homestead protection from creditors, an oil and gas conveyance should be signed by both spouses.

Does the donor own executive rights or a non-executive interest? An executive right gives the holder the power to lease. What does the donor own and what does the owner want to give? These questions must be answered in order to fully understand the consequences of a charitable gift of a mineral interest as described below. Knowing the basic questions to ask when approached about a mineral interest gift will provide the charity information to make an informed decision on whether or not to accept the gift.

The gift planning officer should ask the potential donor the following questions and for copies of any of the following documents that are available:

1. Is the mineral leased
2. How was the mineral acquired
3. What is your understanding of what is owned
4. What do you want to gift
5. Prior or existing leases
6. Prior division orders
7. Prior transfer orders
8. Check stubs from royalty payments

B. Facilitating the Gift Transaction

Oil and gas interests are created and transferred by conveyance, inheritance, judicial action and adverse possession. A conveyance is a transfer of ownership by an instrument intended to pass ownership of the land interest to a third party. The instrument must be in writing, contain words of grant, include an adequate description of the property, designate the grantor and grantee (lessor and lessee), and be properly executed. Oil and gas interests are generally transferred by deed or lease. These documents are formal, legal and recordable.

The execution requirements include delivery and acceptance. In an oil and gas context, it is always best to get the deed or lease in hand. Once received, it is a good idea to have it recorded. Most states do not require the document to be recorded for it to be legally binding, but practically speaking, it is a good idea. Recording protects the charity against claims of subsequent purchasers or creditors. Some states do require the deed to be recorded. For example, Kansas requires recording or registration for taxation within a specified time to validate a mineral deed. Additionally, several states have marketability title acts or dormant mineral acts which require special recordings or use to preserve the interest beyond the statutory limitation.

Oil and gas interests may also be acquired by inheritance. When a charity receives a mineral interest by devise under a last will and testament, the requirements of probate laws must be met. Transfer of the interest occurs when the last will and testament is offered for probate. The executor may or may not prepare an executor's deed transferring the interest. In many cases, if the interest is non-producing it may or may not be included in the estate inventory because the executor is often not aware of the existence of the interest. The question of ownership will not surface until such time as someone is interested in leasing the mineral interest. Typically, a landman will contact the charity offering to lease the interest having examined deed records for ownership.

IV. Valuation of Mineral Interests

A. General Guidelines

For any type of asset, including minerals, the fair market value of the contribution is defined as the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having a reasonable knowledge of relevant facts. Reg. § 1.170A-1(c)(2), Rev. Rul. 68-69, 1968-1 CB 80. The IRS has further asserted that the most probative evidence of fair market value is the price at which similar quantities of property are sold in arm's length transactions. Rev. Rul. 80-69, 1980-1 CB 55. Therefore, fair market value is to be determined in the market in which the item is most commonly sold to the public. *id*.

B. IRS Requirements for the Qualified Appraisal

In order to receive an income tax charitable deduction for their gift, donors must comply with certain appraisal requirements. The fair market value of the mineral interest on the date of the gift must be determined by a "qualified appraisal" that follows all the rules set by the IRS. Treas. Reg. § 1.170A-13(c). Specifically, the qualified appraisal rules apply to gifts of property (other than money and publicly traded securities) if the value claimed or reported for the property is in excess of $5,000. Treas. Reg. § 1.170A-13(c)(1)(i).

The sole purpose of the appraisal is to allow donors to obtain their income tax charitable deduction, and the IRS will not allow a deduction without this appraisal. Accordingly, donors and their advisors bear the responsibility to obtain the qualified appraisal and to ensure that the appraisal is properly completed in a timely fashion and meets all of the requirements for qualification. The appraisal must be prepared no sooner than 60 days prior to the date of gift; however, donors are not required to have the appraisal in hand until they actually file the income tax return on which they will first claim the deduction. Treas. Reg. § 1.170A-13(c)(3)(iv)(B). While the charity may be able to provide helpful information about the qualified appraisal rules, the final determination of the sufficiency of the appraisal rests with the donors and their advisors.

C. Factors Affecting the Valuation of Mineral Interests

Donors who contribute a royalty interest or a net profits interest may claim a charitable deduction for the fair market value of the interest, if they have held the interest for more than one year. IRC § 170(e). And, any such contribution that exceeds $5,000 in value must be substantiated by a qualified appraisal. So, the initial question that will be faced by all donors and gift planners is whether or not the mineral interest would be properly valued in an amount that will necessitate obtaining a qualified appraisal.

Unlike donors who gift other assets which also require an appraisal, such as real property and closely-held securities, many donors who wish to gift a mineral interest do not have a general idea or close approximation of the value of the mineral interest. Fortunately, there is a general rule of thumb that is widely accepted in the oil and gas industry to provide a quick estimate of the value of a specific mineral interest. This rule of thumb provides that the value of a mineral interest will closely approximate the annual income produced by the interest multiplied by a factor of four (annual income x 4).

This helpful guideline provides donors with a reliable estimate of the overall value of the interest before incurring the expense of obtaining a qualified appraisal. Based upon this rule of thumb, donors can then proceed to obtain the appraisal if the $5,000 threshold is exceeded. The formal appraisal will be based upon a more sophisticated estimate of the expected future cash flows which will utilize factors such as production history and the number of producing wells, discounted to present value. Mineral interests which are not yielding any production are deemed to be without any current value within the oil and gas industry and with the IRS, and contributions of such interests result in no deduction for the donor.

Another important distinction that must be made among donors is between those that are merely holding a mineral interest as an estate asset or personal investment and those that are actively engaged in the business of drilling wells for oil and gas production (i.e., “operators”). Donors who are not operators may contribute a mineral interest and claim a charitable deduction for the full fair market value of the interest, if they have held the interest for more than one year. IRC § 170(e). However, the deduction for operators who contribute a mineral interest will be limited to the operator’s cost basis. IRC § 170(e)(1)(A). Notwithstanding this limitation, operators who contribute oil and gas interests may deduct any long-term capital gains, if the interest can be treated as real estate used in a trade or business.
Reg. § 1.162-1.

Finally, the quid pro quo rules may also apply in certain situations. For example, a donor who has previously taken deductions for intangible drilling costs will be required to reduce the amount of their deduction by any amount that would have been treated as ordinary income property if it had been sold. IRC § 170(e)(1)(A). And, a gift of an oil and gas lease from which production payments had been previously “carved out” (explained more fully in the section of this outline detailing with partial interests) will be treated as a gift subject to indebtedness, resulting in the lowering of the deduction amount under the bargain sale rules and the realization of some amount of gain by the donor. IRC § 1011(b); Reg. § 1.1011-2.

D. Obtaining a Qualified Appraisal for Mineral Interests

Beyond the familiar requirements for qualified appraisers outlined in Reg. § 1.170A-13(c)(5)(i), the Pension Protection Act of 2006 heightened the requirements necessary to meet the statutory definition of a "qualified appraiser." Under the new law, an individual must hold an appraisal designation from a recognized professional appraiser organization or must otherwise meet minimum education and experience requirements set forth in regulations prescribed by the Secretary of the Treasury. IRC § 170A-13(c)(3)(ii). The individual must also regularly perform appraisals for which he or she receives compensation. *id.* In addition, the individual must demonstrate verifiable education and experience in valuing the type of property subject to the appraisal and must not be prohibited from practicing before the IRS at any time during the 3-year period ending on the date of the appraisal. IRC § 170A-13(c)(3)(iii).

Donors who are seeking to gift a mineral interest with a value in excess of $5,000 will need to find a capable appraiser that is qualified under these new rules to issue a valuation for mineral interests. Specifically, the donor will need to find an appraiser that holds the proper certification and can demonstrate the necessary education and experience needed for this specialized type of appraisal.

Under transitional guidance issued by the IRS after the enactment of the Pension Protection Act, the Service provides insight into the types of certification and education that the Service will require. For valuations of real property, the appraiser must be licensed or certified for the type of property being appraised (residential, commercial, etc.) in the state in which the appraised real property is located. Notice 2006-96, 2006-46 IRB 1, § 3.03(3)(a)(ii). For valuations of property other than real property, the appraiser must (1) successfully complete college or professional-level coursework that is relevant to the property being valued, (2) obtain at least two years of experience in the trade or business of buying, selling, or valuing the type of property being valued, and (3) fully describe in the appraisal the appraiser's education and experience that qualifies the appraiser to value the type of property being valued. Notice 2006-96, 2006-46 IRB 1, § 3.03(3)(b)(ii).

While mineral interests are real property interests which are conveyed by mineral deed and whose ownership is evidenced and recorded in the real property records of a given county within a state, the valuation of mineral interests is a more highly specialized task than the valuation of surface interests generally. State licensing and certification requirements for real estate appraisers generally do not extend to the valuation of sub-surface estates/interests. Therefore, for gift substantiation purposes, donors are advised to use a qualified appraiser that can meet the more thorough requirements established by the Service for the valuation of property other than real property.

Specifically, donors should seek out a geologist or a professional petroleum engineer (or engineering firm) that has at least a bachelor's level degree in their discipline and that is able to perform an engineering and economic evaluation of the mineral interest to determine a fair market value. This value should reflect an analysis of historical production data, a calculation of production decline rates, and a review of historical cash flows. This information will be used to forecast future well performance, calculate remaining oil and gas reserves, and predict future revenues. An estimate of the cost to obtain this type of mineral appraisal is between $1,000 and $2,000 and will vary according to the number of wells to be evaluated, the production history that must be assessed, etc. To find a capable appraiser in a specific region of the country, a donor or gift planner may wish to consult a professional association such as the American Institute of Mineral Appraisers or the American Institute of Professional Geologists.

V. Substantiation Rules

A. IRS Forms 8283 and 8282

When claiming the deduction for a contribution of a mineral interest, donors must attach an appraisal summary (found on Section B of IRS Form 8283) to the income tax return on which they first claim the deduction. Treas. Reg. § 1.170A-13(c)(2)(i). The appraisal summary must be signed and dated by the donee charity, be signed and dated by the qualified appraiser, and state the appraised fair market value of the property on the date of contribution. Treas. Reg. § 1.170A-13(c)(4). Subsequently, should the charity sell, exchange, or otherwise dispose of any property for which the charity signed an appraisal summary within three years of the date of gift, the charity must then file an information return (IRS Form 8282) to report the amount received on the disposition. IRC § 6050L(a)(1). Should the amount claimed by the donor as a deduction (based upon the value reported on Form 8283) significantly exceed the amount received by the charity to dispose of the property (as reported on Form 8282), the IRS could have grounds to question the validity of the donor's claimed deduction.

VI. Special Considerations

A. Compatibility with Specific Planned Giving Vehicles

When considering the different planned giving vehicles that may achieve the objectives of a prospective mineral donor, two main issues must be considered. First, will the annual income produced from the mineral interest be well suited to allow the payout feature of a specific planned giving vehicle to be fully realized? Because minerals are a depleting asset, the long-term production is not certain, and this decline in realized income over the life of the mineral interest must be taken into consideration. Second, what additional other assets may or may not be used to fund the planned gift? If the depleting mineral interest represents only a minority of the total assets used to fund the planned gift, then the depleting nature of the mineral interest may not have as significant of an impact on the performance of the planned gift instrument going forward. These factors will be considered for each of the planned gift vehicles discussed below.

It should also be noted that a charity or trustee could sell a gifted mineral interest immediately upon receiving it in a planned gift context. Just as a gift of a surface interest will typically be sold, a charity or trustee could also readily sell a producing mineral interest and reinvest the proceeds to achieve greater diversity and more predictable long-term income flows. This could provide a greater ability to achieve the stated payout objective of the planned gift arrangement.

While selling the interest is an option, charities and trustees will find that they will typically realize a greater economic benefit from retaining a mineral interest over the long term. The options for managing versus selling a mineral interest are more fully discussed below in the section entitled "Options for Minerals Management Going Forward." For the duration of this section, we will evaluate each planned gift vehicle based upon the assumption that the mineral interest will be retained and its income utilized to satisfy the payout obligation under the instrument.

Perhaps the most popular and most commonly used planned giving vehicle is the **qualified charitable gift annuity**. While this gift arrangement has the benefit of being relatively straight forward and more familiar to many donors, the gift annuity is not the most compatible planned giving vehicle for gifts of minerals. Because the gift annuity has a fixed annuity obligation that will continue for the duration of the life expectancy of the donor(s), charities should carefully consider the feasibility of retaining a gifted mineral interest and relying upon the annual production to satisfy the annual annuity obligation over the long term. As mentioned in the prior paragraph, mineral interests are depleting assets whose production will ultimately decline. Should a charity issue a gift annuity based upon existing production, it would be wise to set a payout rate that is significantly lower than current income from production so that a "reserve amount" could be accumulated prior to a decline in production. Should production begin to decline prior to the termination of the gift annuity agreement, then the issuing charity could draw upon this reserve amount to satisfy the annuity obligation going forward. If such a reserve is not sufficient or available, the charity would be forced to draw upon other assets to satisfy the annuity obligation. That having been said, if the mineral interest is only a smaller portion of a larger gift and if the payout amount established under the gift annuity contract is not significantly reliant upon the income from the mineral interest itself, then a retained mineral interest in this context could provide meaningful benefit to the charity going forward without causing concern over the viability of the gift annuity arrangement.

When considering funding a **charitable remainder trust** with a mineral interest, the key issue will be the type of payout provision contained in the trust agreement. For a charitable remainder annuity trust, the very same issues and limitations outlined in the foregoing paragraph dealing with gift annuities will apply. However, the charitable remainder unitrust provides a better option.

Specifically, the annual revaluation of trust assets to determine the payout to the income beneficiaries for the year is the distinctive feature of unitrusts that allows them to accommodate mineral interests so well. In the earlier section of this outline that deals with the valuation of mineral interests, it was explained that the value of a mineral interest will closely approximate the annual income produced by the interest multiplied by a factor of four (annual income x 4). It was also explained that a nonproducing mineral interest is deemed to be without any current value within the oil and gas industry. So, for purposes of determining the amount to be paid to an income beneficiary under a unitrust, the trustee will determine the current value of the mineral interest each year based upon the level of production that is being currently realized by the interest. This same income will be utilized over the coming year to satisfy the resulting payout obligation to the income beneficiary. In later years, should the level of production begin to decline, the value of the mineral interest will also decline, resulting in a lower payout to the income beneficiary. As you can see, the annual revaluation of the trust assets allows the actual level of production and income from the mineral interest to closely match or remain in step with the correlated increase or decrease in the payout obligation over time.

The most typical scenario where a mineral interest is held in a unitrust occurs when a donor funds the trust with both the surface interest and the mineral interest in the property. When this occurs, our organization will typically market and sell the surface interest while retaining the underlying mineral interest in the trust. The unitrust will include a flip provision which will allow the trust to utilize a straight payout provision beginning on January 1 of the year following the sale of the surface interest (the "flip trigger"). The proceeds from the sale of the surface interest will then be reinvested to meet the payout obligation for the income beneficiary(ies). Going forward, the trustee will conduct the annual revaluation of the trust assets, including the value of the investment portfolio (resulting from the proceeds from the surface interest) and the value of the mineral interest (based upon actual production). The combined value will determine the total payout for the income beneficiary for the year, and the return on invested assets taken together with the income realized from mineral production will be used to satisfy the total payout obligation. As explained in the previous paragraph, the mineral interest will "carry its own weight" due to the correlation of the value of the mineral interest each year (and the resulting payout obligation) and the actual income realized from the mineral interest during that time.

The considerations for funding a **charitable lead trust** with a mineral interest are the same as those discussed above for the charitable remainder trust. As with the charitable remainder unitrust, the variable payment provision that is incorporated into the charitable lead unitrust works very well with the fluctuating nature of future mineral production and the corresponding variations in value. And, for the same reasons outlined in the preceding paragraphs which discuss the compatibility of mineral interests with qualified charitable gift annuities and charitable remainder annuity trusts, the annuitized payment provision of the charitable lead annuity trust creates a need for more careful consideration on the part of the donor and/or trustee before funding a lead annuity trust with a mineral interest. For a more complete overview of this issue, please refer to the paragraph above which discusses the qualified charitable gift annuity.

Finally, it is also possible for a mineral interest to be included in a **retained interest in a personal residence or farm**. This occurs when the donor conveys the remainder interest in both the surface estate and the mineral estate to charity. Because the donor/life tenant retains the full use and enjoyment of the property during the term of the life estate, certain issues regarding the benefits and management of the mineral estate must be addressed.

The common law rules with regard to mineral interests state that the life estate holder and the remainderman both must execute an oil and gas lease for it to be effective. Bonus monies are considered corpus and therefore should be paid to the remainderman. Delay rentals are considered income and are paid to the life estate holder. Royalties that are paid from production are considered consumption of the corpus and thus belong to the remainderman, but income from payments that are invested belong to the life estate holder.
A contractual life estate that states that the life estate holder shall receive all of the income and that the life estate holder can execute a mineral lease without the joinder of the remainderman will trump the common law. The open mine doctrine is also an exception to the common law rules. It provides that if an oil and gas lease is producing at the time the life estate is created, then there is a legal presumption that the party creating the life estate intended the life estate holder to receive all the income.

B. Options for Minerals Management Going Forward

Once mineral interests have been received by a charity, the charity must then determine how it will effectively manage these interests to ensure that the greatest benefit is realized for the charity over the long term. For many smaller charities that receive mineral interests indirectly through an estate or terminating trust, the initial thought is to immediately sell the mineral interest so that the cash proceeds can be more easily dealt with. And while mineral interests may be readily sold through various brokers, the practical reality is that most buyers will only be willing to pay a purchase price of approximately 1½ to 2 times the amount of annual production being realized from the interest. As a result, it will most often be in the best interest of the charity to retain ownership of the mineral interest.

That having been said, most charitable organizations do not have the resources in-house to effectively manage mineral interests. So, most charitable organizations will need to look outside for a capable minerals management group to assist them with these interests. The most prevalent source for such expertise will be found within a larger banking organization, an investment manager, or a financial services organization that is large enough to support a minerals management group. However, there may be other smaller organizations or consulting groups that provide this same type of minerals management expertise.

Regardless of the group that is selected to manage the mineral interests going forward, the charity needs to be assured that it will receive active management, administration and negotiation for all mineral interest so that it will realize the greatest possible benefit from its mineral interests. Active management should focus on all phases of the oil and gas production process from the initial negotiation of the lease interest through the lifetime of a producing well or field.

For producing mineral interests, the manager should continually review all division orders to ensure that the charity's interest is accurately credited and identified. Going forward, the manager will need to conduct a monthly review of revenues to confirm that the charity is being paid properly and timely and to identify any funds that may be held in suspense and subsequently return the interest to a paying status. The manager will also need to continually review and monitor active leases to determine the producing status of the leasehold and to obtain releases when appropriate.

For non-producing mineral interests, the manager's goal should be to negotiate the maximum bonus and royalty for non-producing acreage should leasing activity begin, taking into consideration existing trends and current demand. In addition, the manager will update and maintain all undeveloped acreage records and all shut-in well requirements, coordinate any easements or permits that affect the rights of the surface owner, and continually monitor all oil and gas lease terms and secure timely releases for expiring leases.

C. Environmental Issues

Charities must always exercise caution before accepting any real property interest to protect the organization from liability for an environmental problem existing on the property that could result in significant (or catastrophic) costs to cure. Fortunately, the majority of prospective mineral interest gifts will not create any liability on the part of the charity donee.

Only the owner of an operating interest or a working interest will bear the liability for environmental problems or liability related to the surface usage. Royalty interest owners that do not participate in the actual production process or maintain any responsibility for the expenses of production are not liable for any environmental conditions which arise or for any other problems associated with the use of the surface interest. As discussed earlier in this paper, many charitable organizations stipulate in their gift acceptance policies that they will not accept any mineral interest that represents an operating interest or a working interest. By adopting a policy that precludes any type of mineral gift other than a royalty interest, charities will be safeguarded from the potential consequence of an expensive environmental clean-up.

While most charitable organizations choose to avoid owning any type of working interest, there may be circumstances where a charity may wish to make an exception to such a policy and receive one or more working interests. Should a charity wish to do so, the organization should consider an appropriate business structure that would provide the greatest possible liability protection for the charity. For example, some charitable organizations have established wholly-owned for-profit subsidiaries solely for the purpose of holding these types of interests. Should the charitable organization you work for or advise wish to consider such an option, the organization should seek competent legal counsel to ensure that the best structure is implemented to provide the necessary liability protection for the charity.

VII. Taxation Issues

A. Applicability of the Partial Interest Rule

As a general rule, income, gift and estate tax law limits a donor's ability to claim a deduction for a contribution of less than the donor's entire interest in the property contributed. IRC § 170(f)(3)(A), Reg. § 1.170A-7(a)(1); IRC § 2522(c)(2), Reg. § 25.2522(c)-3(c)(1)(i); and IRC § 2055(e)(2), Reg. § 20.2055(c)-2(e)(1)(i). Notwithstanding this general rule, certain exceptions to the "partial interest rule" are outlined in tax law, including the deductible contribution of an undivided portion of a taxpayer's entire interest in property. IRC §§ 170(f)(3)(B)(ii), 2522(c)(2), and 2055(e)(2).

Because all donors must comply with the partial interest rule (or fall within one of its exceptions) and recognizing that mineral interests are often owned separately from the surface interest and are often fractional interests of a larger whole, gift planners must familiarize themselves with the applicability of the partial interest rules to gifts of various types of mineral interests to ensure that the donors they are working with will not erroneously make a nondeductible contribution. In general, donors of mineral interests must either contribute their entire interest or an undivided fraction or percentage of their entire interest in order to claim a deduction for their gift.

As mentioned above, many of the mineral interests held by prospective donors are fractional interests which represent a smaller undivided portion of a larger interest that is owned collectively by many owners (example: a 3/8 net royalty interest). While a contribution of such an interest may appear at first glance to pose a partial interest dilemma, the partial interest rule does not preclude a deduction for a contribution of such an interest if the undivided fractional interest represents the donor's entire interest in the property.

One of the most common scenarios where prospective donors run into the partial interest rule involves the situation where a donor that is the current owner of both the surface estate and the mineral estate is contemplating a gift of the surface interest to charity but is planning to retain ownership of the mineral rights. The retention of the mineral interests in the gifted property will cause the gift to be one of a partial interest for which the donor will not be allowed a deduction. Rev. Rul. 76-331, 1976-2 CB 52; Priv. Later. Rul. 8429021. For many donors, the realization of this consequence will motivate them to also contribute the mineral interest along with the surface interest.

The applicable tax regulations also deny a charitable deduction for a contribution of a donor's "entire" interest in property immediately following a division of a larger interest for the purpose of creating the contributed portion. For example, if a prospective donor owns both the surface estate and the mineral estate in a given piece of property and the donor partitions the two estates and subsequently gifts only the mineral interest, the donor will not be allowed a deduction. The tax regulations make clear that no deduction will be allowed where the gifted interest exists by reason of a division or partition in order to create the interest. Reg. § 1.170A-7(a)(2)(i).

While the foregoing rule that donors must convey their entire interest to charity in order to receive a deduction will almost always apply, the IRS has conceded that a donor will not lose his deduction if the retained interest (mineral or otherwise) is deemed to be an "insubstantial interest." Such an insubstantial interest is one that cannot effectively reduce the donee's rights to something less than full ownership of the donor's entire interest in the property. For example, one tax court allowed a donor to claim a deduction after retaining mineral interests where the evidence showed that the existing value of the retained mineral interest was nominal and the potential for future mineral production was negligible. In that case, there were no known mineral deposits underneath the surface, numerous dry holes had been drilled on adjacent properties in the immediate vicinity, the nearest mineral producing property was thirty-five miles away, the terrain of the property was not conducive to either transporting equipment or maintaining an oil rig, and the value of the mineral interest was determined to be between $1 and $2 per acre (as compared to a value of $1,800 per acre for the surface interest). Based upon these facts, the tax court determined that the retained mineral interest was insubstantial, and the donor was allowed to claim a charitable deduction for the value of the surface interest contributed. *Stark v. Commissioner*, 86 TC 243 (1986).

As a cautionary note to charities, should a donor ever elect to retain a substantial mineral interests while contributing the surface ownership to charity (and foregoing a deduction in the process), the charity receiving the surface interest should seek to restrict the donor's surface use rights so that the donor (or a subsequent owner of the mineral interest) could not later begin drilling operations on the property that would interfere with charity's use of the land. As explained earlier in this paper, the mineral estate is the dominant estate and allows the owner to use the surface estate in a reasonable manner to exploit, mine, or produce minerals. Our organization confronted this issue several years ago while working with a church that was receiving a gift of land to be used for the construction of a new church facility. The donor was planning to forego a charitable deduction for the contribution of the surface rights to the property because of the long term benefit that he believed he would realize from retaining the mineral interest for himself. As a result, a restriction was placed in the deed that precluded the donor from accessing the surface estate for drilling purposes. This restriction ensured that the church would not be hindered in its ability to use and enjoy the surface interest for its charitable purposes. Similar restrictions may also be incorporated into a lease agreement or separate contract to limit the number or location of drill sites on a property.

While it is far more typical for a deduction to be denied when an underlying mineral interest is retained by the donor, it is possible for a donor to realize a charitable deduction in this situation when the gift of the surface interest qualifies as a gift of a qualified conservation contribution. In a 1993 letter ruling, the Service allowed a charitable deduction for a contribution of 1,200 acres of unimproved land to a nonprofit that was formed to preserve environmental interests by holding and maintaining land dedicated to be used for outdoor recreation by the general public. The deed which the donor used to convey the property restricted the use of the land for such conservation purposes into perpetuity but also reserved the subsurface mineral rights for the donor and the right of access to those minerals. The deed also specified drill site locations and provided that the method of mining, removal, or extraction of the retained subsurface oil, gas, and other minerals was permitted only if it had a temporary, localized impact on the property and did not frustrate conservation interests. Section 170(h)(1) of the Code defines the term "qualified conservation contribution" for purposes of Section 170(f)(3)(B)(iii) as a contribution of a qualified real property interest to a qualified organization exclusively for conservation purposes. Section 170(h)(2)(A) of the Code provides that the term "qualified real property interest" includes the entire interest of the donor in real property other than a qualified mineral interest. Section 170(h)(6) provides that for the purposes of Section 170(h), the term "qualified mineral interest" means subsurface oil, gas, or other minerals, and the right to access such minerals. Accordingly, the Service ruled that the conveyance of the property was a qualified conservation contribution under Section 170(h) and that the individual would be allowed a charitable deduction for the gifted surface interest. Finally, the Service found that the deed provided sufficient safeguards so that the conservation purposes of the proposed conveyance would be protected in perpetuity. Priv. Ltr. Rul. 9318027.

As mentioned above, one of the stated exceptions to the partial interest rule for a gift of any type of asset allows the donor to realize a deduction for a conveyance of an undivided portion of the taxpayer's entire interest in the property. IRC §§ 170(f)(3)(B)(ii), 2522(c)(2), and 2055(e)(2). The applicable regulations require that the undivided portion of the donor's entire interest in the property must:

- consist of a fraction or percentage of each and every substantial interest or right owned by the donor in the property, and

- extend over the entire term of the donor's interest in the property and in other property into which the property may be converted. Reg. § 1.170A-7(b)(1)(i).

As mentioned above, the entire mineral interest of many donors will be only a fractional share of a larger interest (example: a 3/8 net royalty interest). When this is the case, the donor may still make use of the undivided portion exception to the partial interest rule by conveying a "sub-fraction" of their original fractional interest. For example, a donor who holds a 1/8th net royalty interest may convey half of their 1/8th interest to a charity and receive a deduction for the gift because it falls within the undivided portion exception. After the gift is completed by conveying a mineral deed to the charity, the charity and the donor will each own an individual 1/16th net royalty interest.

By contrast, however, a donor that holds a working interest in minerals cannot receive a deduction for contributing either an overriding royalty interest or a net profits interest that has been "carved out" of the working interest. In this situation, the donor has not contributed the donor's entire interest in the property but instead has carved out and contributed only a portion of that interest. Further, the portion contributed was not an undivided portion of the donor's interest because it did not convey a fraction of each and every substantial interest or right owned by the donor in the property. By transferring an overriding royalty interest or a net profits interest, the donor has retained the right inherent in the ownership of a working interest to control the development and operation of the lease. This right to control is a substantial right, the retention of which prevents the donated interest from being considered an undivided portion. Rev. Rul. 88-37, 1988-1 CB 97.

B. Potential for Unrelated Business Income

Unrelated business taxable income ("UBTI") includes "the gross income derived by any organization from any unrelated trade or business ….regularly carried on by it…." IRC § 512(a)(1). The term "unrelated trade or business" means, in the case of any organization subject to tax imposed by IRC § 511, any trade or business the conduct of which is not substantially related to the exercise or performance by such organization of its charitable, educational or other purpose or function. IRC § 513(a). Tax-exempt organizations are subject to tax on their UBTI at the regular corporate tax rates. IRC § 511. Excessive UBTI for a tax-exempt organization can ultimately jeopardize its tax-exempt status.
However, the Code also identifies certain unrelated business activities that, when conducted by a tax-exempt organization, are excluded from UBTI. Such excluded income is often referred to as "passive income". One such exclusion is provided under the Code for certain types of royalties paid to a tax exempt organization. IRC § 512(b)(2). In the context of oil and gas law, royalties are defined as the right to a share of production reserved to the owner of the property for permitting another to drill for oil or gas or extract other types of minerals from a mine or quarry. *Fraternal Order of Police III. State Troopers Lodge No. 41 v. Commissioner*, 833 F.2d 717, 723 (7th Cir. 1987). It is also possible for a lessor to receive a "shut-in royalty" which is a payment made when a gas well, capable of paying in producing quantities, is shut-in for lack of a market for the gas.

Similarly, a lessor may also receive a “delay rental” which is a sum or money paid by the lessee for the privilege of deferring the commencement of drilling operations or the commencement of production during the primary term of the lease. Fortunately, for tax-exempt organizations, each of these types of income are generally treated as “royalties” which are considered passive income that is not subject to unrelated business income tax. IRC § 512(b)(2).

While most royalty interests that may be conveyed to a charitable organization will constitute passive income that will not generate unrelated business income tax, there are exceptions to this general rule that the gift planner should be aware of. Specifically, if a tax-exempt organization owns a working interest in a mineral property and remains liable for its share of the development costs under the terms of an operating agreement, then the income derived from the working interest will be subject to unrelated business income taxation. Reg. § 1.512(b)-1(b). In one ruling, the Service clarified that a royalty interest holder must not be liable for either development costs or operating expenses to ensure that the income received from the interest would not be subject to unrelated business income tax. Rev. Rul. 69-179, 1969-1 CB 158.

In a 1977 private letter ruling, the Service examined a tax-exempt university's oil and gas interests and focused on the liability for operating expenses as a key factor to determine the applicability of unrelated business income tax. In that case, the university bought interests in oil and gas leases and subsequently assigned 100% of its “working interests” to various oil companies. After the assignments were made, the university was no longer liable for any development or operations expenses that exceeded gross profits. Said differently, the university was entitled to 100% of the net profits from its original pro rata interests in the leases. The Service determined that the university’s mineral interest was a royalty within the Code's definition so long as the holder of the interest isn't liable for development or operations expenses. And, the holder is not liable for such expenses if his interest is a net profits interest not subject to expenses that exceed gross profits. As a result, the income from the university’s net profits interest was excluded from the computation of its unrelated business taxable income. Priv. Ltr. Rul. 7741004.

However, the Service also made it clear in an earlier 1969 ruling that it would not allow charities to “disguise” income derived from a working interest that is held by a controlled entity. The facts cited in that ruling involved a tax-exempt foundation that received 100% of the net profits in certain oil properties that were operated by two corporations that were controlled by the foundation. The Fifth Circuit Court of Appeals had earlier ruled in *United States v. The Robert A. Welch Foundation*, 334 F.2d 774 (1964), affirming per curiam 228 F.Supp. 881 (1963), that the income from this interest was “royalty” income under Section 512(b)(2) of the Code and therefore not included in the computation of the foundation’s unrelated business taxable income. However, in its ruling, the Service made it clear that it would continue to review exempt organizations' transfers of mineral properties to controlled corporations and would characterize the payments according to the substance of the transaction regardless of its form. Therefore, if in substance the income received by an exempt organization is from a working interest, characterization of the income as “royalty” by the exempt organization will not be accepted by the Service. Rev. Rul. 69-162, 1969-1 CB 158.

Finally, having determined the applicability of unrelated business income tax to the various types of royalty interests that a charity could own, charities will also want to know whether or not bonus payments received from a lessee will be subject to unrelated business income tax. In short, bonus payments received from a royalty interest do not meet the definition of unrelated business taxable income found in IRC § 512(a)(1) which requires that the income derived from the unrelated activity be regularly carried on by the charity. Bonus payments represent only a one-time payment received by the royalty interest owner at the time a new mineral lease is executed.

Accordingly, bonus payments are classified as passive income and not subject to the unrelated business income tax.