

# FUELING YOUR MISSION: CAPITALIZING ON GIFTS OF OIL AND GAS

PLANNED GIVING ROUND TABLE OF ARIZONA  
May 20, 2021

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## MINERAL INTERESTS

Ownership of the right to exploit, mine, or produce minerals lying beneath the surface of a property

- Includes:
  - Oil
  - Gas
  - Coal
  - Iron Ore
  - Sulfur
  - Precious Metals



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## MINERAL INTERESTS

- Mineral estate is dominate over surface estate
  - May use surface in a reasonable manner to extract minerals
- Executive Rights
  - Allows the owner of the interest to lease the interest to others

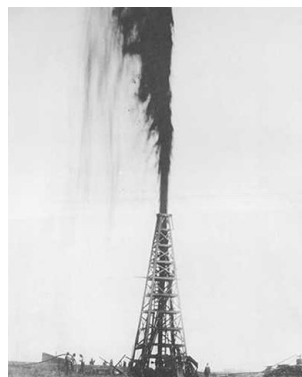
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## HISTORY

- First oil well drilled in Pennsylvania in 1859 – produced 20 barrels a day
- East Texas oil boom (“Spindletop”) occurred in 1901 – produced 100,000 barrels per day. Led to formation of:
  - Gulf Oil
  - Amoco
  - Exxon
- Today, oil and gas are produced in 33 states



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## TERMINOLOGY

- **BONUS:** one-time payment to lessor to acquire a lease
- **ROYALTY PAYMENT:** regular payments, usually based on the volume or price of oil, gas or minerals extracted
- **SHUT-IN:** a non-producing well
- **DELAY RENTAL:** annual payments to delay drilling
- **DIVISION ORDER:** schedule of owners and their respective share of revenues

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## TERMINOLOGY

- **LANDMAN:** negotiates leases, ensures proper title, monitors ongoing well production and payments
- **OPERATOR:** conducts drilling operations for a well

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## TYPES OF OWNERSHIP INTERESTS

- **ROYALTY INTEREST:** shares in production but is not liable for expenses – a 25% royalty is common
- **WORKING INTEREST:** allowed to use surface for exploration and production and is liable for expenses – retains profits

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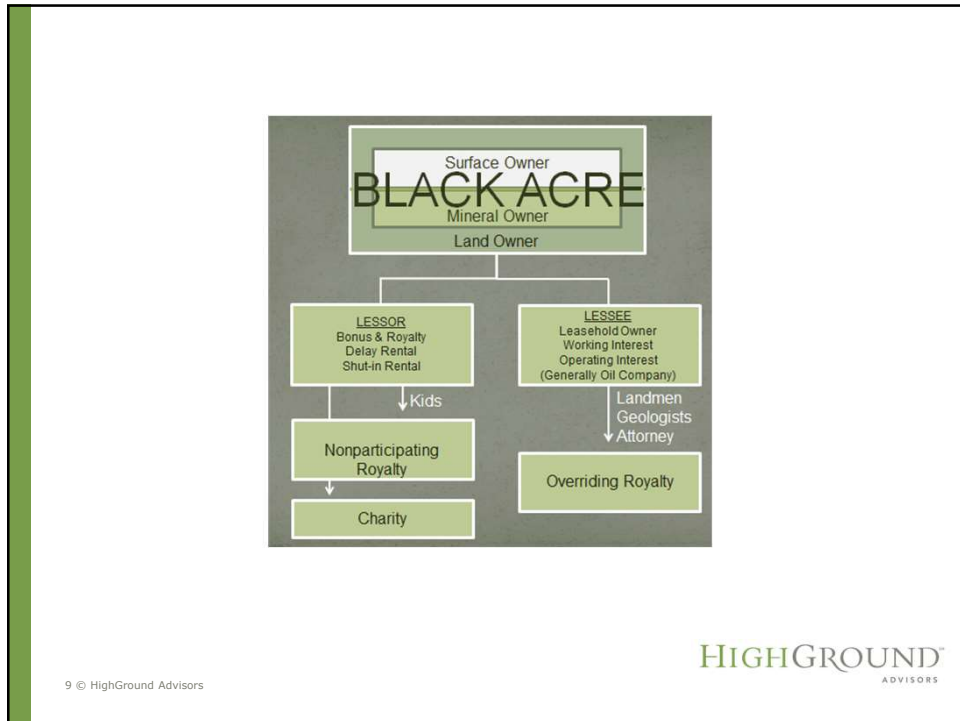
## TYPES OF OWNERSHIP INTERESTS

- **NON-PARTICIPATING ROYALTY:** “carved out” of a prior interest without regard to the terms of the lease
- **OVERRIDING ROYALTY:** “carved out” of working interest to compensate landmen, geologists, attorneys, etc.

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## GIFT ACCEPTANCE POLICIES

- May include:
  - Minimum values for surface rights
  - Minimum per year royalty amounts
  - Liability review procedures
  - Provision prohibiting working interests
  - Environmental review procedures
  - Ongoing management considerations

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## WORKING WITH DONORS

Questions to ask:

1. What is the ownership interest?
  - a. Prior or existing leases
  - b. Prior division orders
  - c. Prior transfer orders
  - d. Check stubs from royalty payments
2. How was the interest acquired?
3. Is the interest under lease?
4. What do you want to gift?

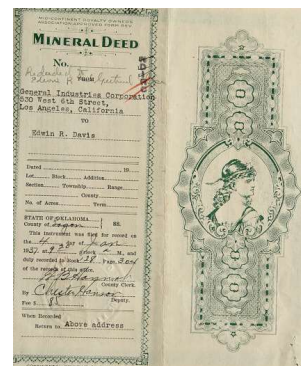
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## FACILITATING THE GIFT

- Oil and gas interests are conveyed by:
  - Mineral deed
  - Lease
  - Assignment
- Conveyance may or may not be recorded
- May receive interest by testamentary transfer – probate process will evidence conveyance and ownership



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## VALUATION OF INTEREST

### FAIR MARKET VALUE (FMV)

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 CB80*

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## VALUATION OF INTEREST

- The FMV is to be determined in the market which the item is most commonly sold to the public

*Rev. Rul. 80-69, 1980-1 CB55*

- For interests valued in excess of \$5,000, a qualified appraisal is required

*Reg. § 1.170A-13(c)(1)(i)*

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## VALUATION OF INTEREST

- Gift of royalty interest or non-participating royalty interest – may deduct FMV if held more than 1 year
- Operators-deduction limited to basis

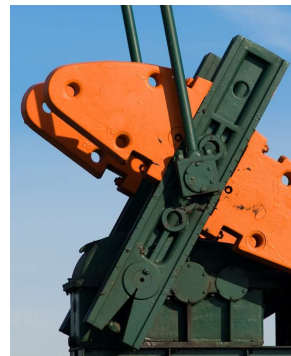
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## VALUATION OF INTEREST

- General Rule of Thumb:  
 $\text{Value} = \text{annual income} \times 5$
- Formal appraisal will determine expected future cash flows
  - Production history
  - Number of producing wells
  - Discounted to present value



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## VALUATION OF INTEREST

### QUALIFIED APPRAISERS

- Pension Protection Act of 2006 requires:
  - Appraisal designation or minimum education and experience
  - Regularly perform appraisals for pay
  - In good standing

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## VALUATION OF INTEREST

### QUALIFIED APPRAISERS

- For real property – licensed by the state
- For other assets
  - College or professional level coursework
  - 2 years experience buying, selling, or valuing the type of property

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## VALUATION OF INTEREST

### QUALIFIED APPRAISERS

- Highly specialized
- Geologist or Petroleum Engineer
- Cost will range from \$1,000-\$10,000
- American Institute of Mineral Appraisers or American Institute of Professional Geologists



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## COMPATIBILITY

With Planned Gift Vehicles

Questions to ask:

1. Will annual income support payment provision of the gift arrangement?
2. Will other assets be involved?
3. Sell or retain the mineral interest?

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## COMPATIBILITY

With Planned Gift Vehicles

### GIFT ANNUITY:

- Careful consideration is necessary
- Fixed payment obligation
- Depleting asset

### EXAMPLE:

- Donor, age 72, gifts mineral interest valued at \$75,000 (annual royalty income of \$15,000).
- ACGA rate is 5.8%, resulting in annual annuity obligation of \$4,350
- Donor life expectancy is 14.5 years

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## COMPATIBILITY

With Planned Gift Vehicles

Year	Royalty Amount	Annuity Obligation	Annual Reserve Amount	Total Reserve
1	15,000	4,350	10,650	10,650
2	13,500	4,350	9,150	19,800
3	12,000	4,350	7,650	27,450
4	10,500	4,350	6,150	33,600
5	9,000	4,350	4,650	38,250
6	7,500	4,350	3,150	41,400
7	6,000	4,350	1,650	43,050
8	4,500	4,350	150	43,200
9	3,000	4,350	0	41,850
10	1,500	4,350	0	39,000
11	0	4,350	0	34,650
12	0	4,350	0	30,300
13	0	4,350	0	25,950
14	0	4,350	0	21,600
15	0	4,350	0	17,250

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## COMPATIBILITY

With Planned Gift Vehicles

### CHARITABLE REMAINDER TRUST:

- CRAT: Some considerations as with the gift annuity, but Trustee may not rely on non-trust assets
  - 5% probability of exhaustion could also be an issue

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## COMPATIBILITY

With Planned Gift Vehicles

### CHARITABLE REMAINDER TRUST:

- CRUT: Annual revaluation of assets accommodates mineral interest well
  - Annual value based on production
  - Production used to satisfy resulting payment
  - Payment obligation and production “rise” and “fall” together

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## COMPATIBILITY

With Planned Gift Vehicles

### CRUT EXAMPLE:

- Donor, age 72, funds FLIP CRUT with both surface and mineral interests
- Surface appraised at \$250,000 and minerals appraised at \$60,000
- CRUT flips upon sale of surface interest. Mineral interest is retained
- Annual valuation of invested sale proceeds and retained mineral interest determines payment outcome

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## COMPATIBILITY

With Planned Gift Vehicles

### CHARITABLE LEAD TRUSTS:

- CLAT: Same considerations as with the GA and CRAT
- CLUT: Variable payments work well with fluctuations in mineral production/valuation

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## COMPATIBILITY

With Planned Gift Vehicles

### RETAINED INTEREST IN RESIDENCE OR FARM:

- Donor conveys both surface and mineral estates, retaining life interest

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## COMPATIBILITY

With Planned Gift Vehicles

- Common Law Rules:
  - Life tenant and remainderman must both execute leases
  - Bonus money is considered corpus and paid to remainderman
  - Royalties from production treated as consumption of corpus and paid to remainderman
  - Income from invested payments are considered income for the life tenant

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## COMPATIBILITY

With Planned Gift Vehicles

### RETAINED INTEREST IN RESIDENCE OR FARM:

- Open Mine Doctrine presumes that life tenant will receive all income if production was occurring when life tenancy was established
- Contractual Life Estate trumps Common Law
  - Could raise partial interest concerns



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## MINERALS MANAGEMENT OPTIONS

- Sell the interest:
  - Typical purchase price is 5 to 7.5 times annual production
- Hire minerals management group
  - Larger banking organization
  - Investment management group
  - Financial services firm

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## MINERALS MANAGEMENT OPTIONS

- Active management for producing interests
  - Review division orders
  - Monthly review of revenues and payment status
  - Monitor actual production
  - Obtain releases when necessary

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## MINERALS MANAGEMENT OPTIONS

- Active management for non-producing interests
  - Negotiate maximum bonus and royalty for new leases
  - Update and maintain undeveloped acreage records and shut-in well requirements
  - Coordinate easements or permits for surface owners
  - Monitor existing leases and secure timely releases

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## ENVIRONMENTAL ISSUES

- Operating or working interests
  - Liable for environmental or surface related problems
- Royalty interests
  - Do not participate in production
  - Not responsible for expenses
  - Not liable



*Charities holding working interests may want to form a separate legal entity*

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## PARTIAL INTEREST RULE

- General Rule:
  - Contribution of less than a donor's entire interest in a property precludes a deduction
- Key Exception: an undivided portion of the donor's entire interest:
  - Must be a fraction or percentage of every substantial right
  - Extend over entire term of donor's interest

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## PARTIAL INTEREST RULE

- Undivided Interest:
  - Many mineral interests are fractional shares of a larger whole
  - Gift of fractional interest may be entire interest
  - May gift a “sub-fraction” as an undivided interest

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## PARTIAL INTEREST RULE

### EXAMPLE:

- Donor owns surface and minerals
- Wants to gift surface and retain minerals
- No deduction

*Charity may want to restrict surface use if minerals are retained*

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## PARTIAL INTEREST RULE

### EXAMPLE:

- Donor owns surface and minerals
- Donor partitions surface interest from mineral interest
- Donor gifts surface interest
- No deduction



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## PARTIAL INTEREST RULE

### EXAMPLE:

- Standard royalty owner "carves out" a non-participating royalty interest for charity
- No deduction

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## UNRELATED BUSINESS TAXABLE INCOME

- UBTI: Gross income from an unrelated trade or business that is regularly carried on
- Unrelated trade or business – not substantially related to charitable purpose

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## UNRELATED BUSINESS TAXABLE INCOME

- Passive income includes:
  - Oil and gas royalties
  - Shut-in royalties
  - Delay rentals



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## UNRELATED BUSINESS TAXABLE INCOME

- Income from working interest is UBI
- To avoid UBI, service requires royalty interest to be free from:
  - Development costs
  - Operating expenses

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## UNRELATED BUSINESS TAXABLE INCOME

- Bonus payments are passive
  - Not “regularly carried on”
  - Only a one-time payment

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