Estate Planning and Oil and Gas Leasing

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Topics to be Covered

- Succession Planning
- Estate Taxes and Estate Tax Planning
- Lifetime Management of Assets
- Liability Protection
- Income Taxation and Valuation of Mineral Rights

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Importance of Will

- Distribution of property
- Restrictions through a trust
- Avoid intestacy
- Appointment of Executor, Trustee, Guardian
- Estate tax planning

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The Will: Distribution of Property

- Any person or organization
  - Spousal elective share
  - No requirement to include children
- Any percentage or share
- Trust – restrictions and control
- Absent a valid will, intestacy applies

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The Will: Appointment of Fiduciaries

- Executor of Estate
- Trustee of Testamentary Trusts
- Guardian of Minor Children
- The Above Fiduciaries Have the Obligation to Carry Out Your Wishes

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Requirements of a Valid Will

- Use a lawyer
- Capacity and other legal requirements
- Make sure you read and understand terms of will and ask questions

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Estate Tax Planning

- What is the estate tax?
  - One-time separate, non-income tax based on the fair market value of assets owned at the time of death in excess of the exemption amount
- Estate tax planning options that are designed to:
  - Reduce the tax
  - Provide a source of funds to pay the tax

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Assets Included in Gross Estate

- Real Estate
- Investments
- Retirement benefits (including 401(k) and IRA)
- Life insurance if policy owned by the decedent
- Closely held businesses – LLC created for oil and gas purposes

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How is the Estate Tax Calculated?

- No estate tax if the value of assets are less than the current exemption amount.
- Take an inventory of all property interests owned by the decedent.
- Fair market value as of date of death – not what the decedent paid for it.
- There is both a Federal Estate Tax and State Estate Tax

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The size of the Federal Estate Tax Exemption Amount depends upon the decedent's year of death.

Year of Death	Federal Exemption Amount
2001	$675,000
2002-2003	$1,000,000
2004-2005	$1,500,000
2006-2008	$2,000,000
2009	$3,500,000
2010	TAX REPEALED
2011	$1,000,000

The size of the New York Estate Tax Exemption amount is $1,000,000.
Pennsylvania ranges from 0 to 15% but typically 4.5% after deductions.
Waiting for Congress to Act?

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Federal Estate Tax Rate Schedule

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Column A Taxable Amount Over	Column B Taxable Amount not Over	Column C Tax on Amount in Column A	Column D Rate of tax on Excess over amount in Column A
1,000,000	1,250,000	345,800	**41%**
1,250,000	1,500,000	448,300	**43%**
1,500,000	------------	555,800	**45%**

The New York estate tax computation is more complicated, but the rates are much less (6% to 16%) - our main concern is addressing the Federal Estate Tax.

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Estate Tax Planning Options

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There are numerous estate tax planning options designed to:

- Reduce the estate tax; or
- Provide a source of funds to pay the tax

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Estate Tax Planning Options

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- $13,000 annual gift tax exclusion
- Credit shelter trust/QTIP trust
- There is no estate tax when the first spouse dies – it is taxes upon the death of the second spouse.
- Life insurance
- Charitable giving
- Estate Freeze / Discounting Techniques

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How Does the Annual Gift Tax Exclusion Work?

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- A person (the donor) can make gifts of up to **$13,000 gift per donee** (the person receiving a gift) per year with no gift or estate tax implications. If the donor is married, the donor could make gifts up to **$26,000 per donee** per year.
- Applies to anyone: children, grand-children, their spouses, friends.

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How Does the Annual Gift Tax Exclusion Work?

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- Can use a trust – restrict use of qualified funds for specific purpose, such as college education.
- Estate Tax Benefit: Reduces size of estate by removing gifted asset and future growth on asset; therefore reduces estate tax.
- Donee does not pay income tax on gift.
- Donor may have to file Federal gift tax return (IRS Form 709).

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Estate Tax Planning Options

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Credit Shelter Trust

- Unlimited marital deduction allowed for all property passing to surviving spouse upon death of decedent.
- Why not simply leave everything to spouse to avoid estate tax?

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Two Major Problems With Giving Everything to Spouse

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- Estate tax payable on combined estates when surviving spouse dies. Only able to use one unified credit exemption amount upon death of surviving spouse.
- Testator may want to leave assets to someone other than spouse.

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Better Approach

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- Try to utilize unified credit exemption amount available **to both spouses.**
- Not $3,500,000 per couple – it is $7,000,000 per couple [2009 Rules]
- One way to fully utilize both exemption amounts is through the use of credit shelter trusts in both spouse's wills.

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Credit Shelter Trust Example

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Spouse A - $4,000,000 in assets
Spouse B - $ 500,000 in assets

NO ESTATE PLANNING

(Everything being left to surviving spouse, upon death of surviving spouse, then to children)

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No Estate Tax Planning

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<u>**"A" Dies First**</u>		<u>**"B" Dies Next**</u>	
$4,000,000	$4,000,000 To Spouse B → (no estate tax marital deduction)	"A" $4,000,000	
		"B" <u>$ 500,000</u>	
		$4,500,000	Gross Estate
		Federal tax of	$460,000
		N.Y. tax of	$<u>335,000</u>
		Total tax of	$795,000

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Compare to

ESTATE PLANNING
WITH CREDIT SHELTER TRUST

($3,500,000 credit shelter trust, remainder to spouse B; upon death of surviving spouse, then to children [2009 Rules])

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WITH ESTATE TAX PLANNING

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"A" Dies First

$4,000,000

$500,000
To Spouse B
(No tax-Marital Deduction)

$3,500,000
to credit shelter trust

No federal estate tax because of $3,500,000 exemption amount. There is a $229,200 NY estate tax because the NY Exemption is $1M, not $3.5 M.

Trust income to Spouse B; remainder to children upon death of Spouse B

Trust principal to Spouse B in discretion of Co-Trustee

Does not generate estate tax upon death of Spouse B if structured properly

"B" Dies Next

"A" $500,000
"B" $500,000
$1,000,000 gross estate
(assume no deductions)

Federal tax of	$	0
N.Y. tax of	$	0
Total tax of	$	0

***TAX SAVINGS OF $565,800 ($795,000 - $229,200)**

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For Credit Shelter Trust to Work, Two Steps Must Be Followed:

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- Each spouse's will must be drafted with credit shelter trust provisions in it.
- Each spouse should have a certain amount of assets in **his or her name alone.** Joint assets don't help. Assets with designated beneficiaries (life insurance, IRAs) don't help, unless beneficiary designation is changed to the trust.

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Life Insurance and Estate Tax Planning

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- Life insurance **is subject to estate tax** if the policy was owned by the decedent. However, if the policy is owned by someone other than decedent, then the insurance is not subject to estate tax.
- Have life insurance policy owned by an irrevocable life insurance trust or someone other than the insured (such as insured's children)
- Make sure you have an adequate level of insurance
  - Liquidity for need of beneficiaries
  - Liquidity for payment of taxes, both estate and income
  - Liquidity to fund buy-sell agreements

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Charitable Giving

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- Triple tax benefit for qualified charitable contributions
  - Deduction for income tax purposes
  - Not subject to gift tax, no matter what the size of the gift (not limited to $13,000 a year)
  - Deduction for estate tax purposes

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Oil and Gas Perspective to Estate Planning

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- Liability Protection
- Lifetime Management of Assets
- Succession Planning
- Estate Tax Planning
- Income Taxation and Valuation of Mineral Rights

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Liability Protection

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- Are you Protected from personal liability if something goes very wrong?
- Who is going to be named in a lawsuit?
- Look at the indemnification clause in your lease.
- Look at your homeowner insurance policy and talk to you agent.

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The Limited Liability Company "LLC"

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- Separate Legal Entity
  - Also corporations family limited partnership
  - (PA) Capital Stock Tax (for now)
- Starting a Business to Manage this Asset
- No double taxation, income flows to the members of the LLC
- Asset must be transferred to LLC

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The Limited Liability Company "LLC"

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- Generally, managed by the members (similar to shareholders in a corporation)
- Operating Agreement to provide for orderly management of business and rules between members
- If done correctly LLC will limit your personal liability.

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Lifetime Management of Assets

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- Who owns the Property now?
- Husband and Wife vs. Single Person
  - Determines Control
  - Income Distribution
- Initially the current owners will be Members of LLC
  - Operating Agreement
  - Determine How Decisions are made
  - Member Managed vs. Manager
  - What will happen in the future

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Succession and Estate Tax Planning

- Do you want to include children?
  - Would have an ownership interest
  - Could share in decision making (Manager Managed)
  - Would share in income distribution of royalties based upon percent of ownership
  - Gift Membership interest over time

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Succession and Estate Tax Planning

- Why Transfer Membership Now?
  - Can over time remove an asset with a very high future value from your estate and potentially avoid or lesson estate tax burden.
  - Maximizing use of lifetime Unified Credit / Annual Exclusion Gifting at Lower value of property vs. after bonus / royalties paid.
  - Can annually gift membership interest to each child with a value of up to $13,000/$26,000 spilt without effecting the Unified Credit.

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Estate Freeze/Discounts

- Freeze values of assets at today's values so that all future appreciation occurs outside of a person's estate
- Transfer of assets by Donor to LLC in return for LLC interests
- Transfer of LLC Interests by Donor to Donor's children or trust created for the benefit of Donor's children

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Estate Tax Benefit of Creating LLC

- The first level of discounting occurs when the donor's property is transferred into the LLC. This discount is for equity in a "private illiquid company"
- The LLC interests that are transferred to the donor's children (or a trust) are discounted for "lack of marketability" and "minority interest". Total discount could range from 20% to 40%

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Estate Tax Benefit of Creating LLC

- Value of gifted LLC interest are fixed as of the date of transfer at the discounted value
- All future appreciation of the gifted LLC interest will be attributed to the gifted interest and thus will not be included in the Donor's estate
- Donor still has some control over the LLC as the LLC Manager

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Variation

- Business Partners
  - Determine how business managed / transfer to others
- Single Person
  - Need an Estate Plan
  - Change in Status in future
  - Charitable Gifts

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Sever Mineral Rights

- Can Sever Mineral /Estate from Surface Estate
  - Further Liability Protection LLCs
  - Especially if house involved
- Mineral LLC Indemnify Surface LLC regarding oil and gas activities.

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Things to Consider

- Future Plans for Property
  - Common Ownership for both?
  - Sell Surface Estate?
  - Marketability / Value Issues

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Things to Consider

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- Upfront Costs
  - Appraisal
  - Legal
  - Recording Fees
- Questions on Future of Estate Tax
- Questions on Volume of Gas / Success
- Property Exemption

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Reasons for Valuation

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- Establish a value for lifetime gifting
- Determine the tax effect on your estate
- Gives beneficiaries a basis for tax purposes
- A qualified appraiser can establish a proper value in case of an IRS audit

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Valuation Methods to Determine Fair Market Value

- Cost or Comparable Sales
- Present Value Method
- Analytical Appraisal Methods
- Other Arbitrary Methods

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Valuation of Mineral Rights without a Lease in Place

- Only the Comparable Sales method should be used
- Mineral Rights should be considered
- Entering into a Gas lease, drilling and production is speculative
- Lowest possible valuation of mineral rights

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Valuation of Mineral Rights with a Lease in Place but No Gas Production

- Comparable Sales or Present Value method can be used
- Mineral Rights must be considered
- Discounts due to drilling and production speculation allowed
- Middle of the road valuation of mineral rights

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Valuation of Mineral Rights with Active Wells in Production

- Comparable Sales or Present Value method can be used
- Mineral Rights must be considered
- Only discount is for future production risk
- Highest valuation of mineral rights

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Income Tax Consequences

- Gas Lease Bonus Payments are considered normal income
- Income tax may be due on the entire bonus amount the year the lease is signed even if bonus is paid out in annual installments
- Royalty payments are considered normal income
- Sale of mineral rights will be considered capital gain

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Bottom Line

- Overall Estate Plan
  - Will, Trust, LLCs, Gifting
- Pass on Wealth, Limit Estate, Tax Expense
- Team Approach
- Not One Plan Fits All
- Don’t do it Yourself
- Don’t put it off

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