Marcellus Shale Update

Issue 2: Natural Gas and Landowners – A Recipe for Tax Revenue

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In the earliest days of the Marcellus Shale natural gas boom, landowners were most concerned with the terms of their leases. With little known about the potential for future income, **bonus payments and royalty rates started low and have increased over time.** With the **increase in rates of payment comes increased tax liabilities.** As noted in our previous article, there are income taxes, transfer taxes, estate taxes, inheritance taxes and gift taxes associated with gas and oil royalties and bonuses. Bringing tax efficiency to the oil and gas exploration relationship is absolutely essential.

There are plenty of reasons to be concerned. Let's look at a fairly simple estate and inheritance tax issue. The Commonwealth of Pennsylvania has an **Inheritance Tax** which is paid on the value of rights to property passed upon death. The **maximum rate of tax is 15%**. There is a **Federal Estate tax**, also due upon death. Prior to the temporary repeal of the Estate Tax, the maximum rate was 45% on transfers of wealth with a value of more than $3.5 million. Using a "royalty calculator" widely available to the general public, a single well which produces at an initial rate of 3.0 MMcfe when natural gas sells at $5.00 per Mcfe at a royalty rate of 20% could yield a value of $2.844 million considering a 20 year life. Now that's the projection for a single well using the calculator without considering a host of risk factors, present value concerns, or the notion of discounted future cash flows. If the parcel upon which this well was drilled consisted of 400 acres, a geologist might suggest that as many as five wells could be drilled on this property. The value of the oil and gas royalty in the aggregate could be worth more than $14.22 million. Imagine what might happen if the landowner died holding this royalty right during the production phase of these wells. You don't have that active an imagination, you say? Let's explore this together.

Within nine months of the date of the landowner's death, an Estate Tax Return must be filed with the Internal Revenue Service and estate taxes must be paid. The Federal Estate Tax on an asset with a value of $14.22 million at the rates in existence on December 31, 2009 was $3,864,150. **Most believe that the Federal Estate Tax will be restored to 2009 levels in the coming months.** The Inheritance Tax due the Commonwealth of Pennsylvania could be as much as $2.13 million on the same valuable right. Total taxes could be as much as $6.0 million. And as if this were not horrible enough, that's not the truly terrible news.

These taxes must be paid within nine months of the date of the landowner's death. While an extension of time to file the returns can be secured, there is no extension of the time to pay the taxes. Fail to pay the taxes on time and interest and penalties will balloon the liabilities to an even larger balance. Where will the landowner's family get nearly $6.0 million to pay these taxes within nine months of the date of death?

If the landowner failed to plan during his or her lifetime, the choices left to family members make the situation even worse. **The first source of funds to pay the estate and inheritance taxes would be the royalty income that the natural gas lease produced over time.** After all, it was the lease that caused all of this trouble in the first place. If we knew when the landowner was going to die, the landowner might be able to save enough money to pay the taxes. If death occurred unexpectedly, though, the savings plan might not work. The family members could try to borrow from a bank to pay taxes. Given the state of the economy and the recovering position of banks around the country, there can be little assurance that loan money would be available for this purpose. The family might consider selling a portion of the valuable royalty rights to pay taxes. Opportunistic investors would likely pay a fraction of what the rights were worth, sensing a chance to cash in on the misfortune of others. **Failing to plan for the untimely death of a landowner could be disastrous.**

In our next installment we will explore some of the opportunities available to manage estate, inheritance and gift taxes. The lesson here is that Marcellus Shale landowners need to plan now.