

LAW WEEK

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Estate Planning For Mineral Rights

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MOYE WHITE

MINERAL RIGHTS require special attention in estate planning. There are a multitude of facets to ownership, management and transfer. Using a family holding company provides for sound management and flexibility. A company may be a partnership, limited liability company or a trust, but generally a company should have pass-through taxation.

The goal of estate planning is a smooth estate administration, preserving asset value and transferring them to beneficiaries without unnecessary complications. At a basic level, transferring mineral rights into a company prevents mistakes in multiple transfers, provides for consolidated management and promotes economies of scale. On a more technical level, company ownership provides valuation and tax efficiencies as well as liability protection from an owner's creditors. A company also helps owners realize more intangible goals such as providing for successive managers, promoting consistency of operations, defining permitted successor owners and creating mechanisms for resolving disputes.

As an example, David received a call from Big Oil Co. offering a lease to explore production on land where his great-grandmother, Anna, held mineral interests. He knew nothing about any family mineral interests, but it turns out that Anna owned quite a few. When she died, no one transferred the mineral interests to her heirs. Anna is still the record owner. Anna had one child, Bertram, who had one child, Charlotte, who had one child, David. David is the oldest living descendant of Anna, but he has five children.

David doesn't become the automatic owner of the mineral interests; he has to work through the legal processes and open probate for Anna, Bertram and Charlotte. David has to track down old probate, ownership and tax records for each ancestor, spend the time and money to go through three probate processes



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and then transfer the properties to his name.

There is no production now, but when David dies, there very well may be production. If ownership is in David's name, his children will have to transfer not only the ownership but also the leases or other agreements or division orders into each of their names. Fortunately David realized that he could prevent this problem for his five children and transferred the mineral interests to a company.

David consulted Uncle Charlie, who is trustee of a trust holding the mineral interests owned by another side of the family. Through the years, that trustee has had the authority and the responsibility to manage the assets in the best interests of the beneficiaries. Because of many children, grandchildren and great-grandchildren, Uncle Charlie manages the mineral interests within the trust and distributes income to 25 beneficiaries.

Managing mineral rights is not intuitive. If held by several individuals, each individual must manage their own interests, pay taxes, evaluate offers for exploration and production, track terms of agreements and track well production figures with income received. Uncle

Charlie is not an expert in the industry, but he learned from the previous trustee, and he uses experts to advise him. He has been able to negotiate advantageous lease provisions because he leveraged the block of holdings. An individual owner has less bargaining power with a smaller interest, and it is cost prohibitive to access the necessary expertise.

All types of family holding companies are created by state law, but most of the decisions about the entity are governed by an agreement of the owners. The owners can agree that only family members (not spouses) can be owners or that there must be one manager from each line of the family or establish buy-out procedures if an owner wants to sell.

Once the mineral interests are owned by the company, the asset is no longer owned by the individual. An owner's creditor cannot reach the property or become a legal owner. A creditor could only hold an economic interest in the company with a right to income.

It is important for the company to be a flow-through tax entity. All tax items are recognized by the owners at their individual tax rates. Contributions of property to the company retain the basis they had outside of the entity. If an ownership interest in the company must be appraised for gift or estate tax purposes, valuation techniques of applying discounts for lack of control and lack of marketability may apply.

David is lucky. Not only does he have a newfound asset, he has Uncle Charlie to guide him through the history of the property and management of similar interests. He has had a glimpse of the problems created by not paying attention to mineral rights in estate planning and administration. He now has the opportunity to create a structure to manage his mineral interests for the benefit of future generations. •

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