

**PRACTICAL ESTATE PLANNING FOR
OIL AND GAS ROYALTY OWNERS**

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San Antonio Estate Planners Council
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KRISTI FRANKLIN HYATT

Areas of Practice:

Estates Planning, Family Wealth Transfers, Asset Protection, Incapacity Planning, Probate and Estate Administration and Guardianships

Bar Admissions

Texas, 1989
U.S. District Court Northern District of Texas
U.S. District Court Western District of Texas
U.S. District Court Southern District of Texas
U.S. District Court of Appeals, Fifth Circuit
United States Supreme Court

Education

Baylor University
Waco, Texas, 1989
J.D.

Howard Payne University
Brownwood, Texas, 1986
B.A. - Douglas MacArthur Academy of Freedom Honors Program
Free Enterprise Curriculum

Professional Associations and Memberships:

State Bar of Texas *Member*
Midland County Bar Association *Member*
Midland County Young Lawyers Association *Member*
Midland Odessa Business and Estate Council, *President*
College of the State Bar of Texas *Member*
Texas Bar Foundation *Fellow*

Birth Information:

1963
Big Spring, Texas

Karen S. Schmidt

Certified Public Accountant
Certified Specialist in Estate Planning
Certified Forensic Financial Analyst

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-Curriculum Vitae-

Certificate to Practice Public Accountancy:

Granted after examination by the Texas State Board of Public Accountancy, October 1982

Certified Specialist in Estate Planning:

Granted after examination by the National Institution for Excellence in Professional Education, LLC, September 2007

Certified Forensic Financial Analyst:

Granted after examination by the National Association of Certified Valuation Analysts, November 2009

Education:

University of Texas of the Permian Basin, 1980
B.B.A in Accounting and Information Systems

Authored Memorandums and Tax Opinions:

Springboard Center Newsletter, IRA Rollover Deadline Nears, 2009
On Your MARC, Charity as IRA Beneficiary, 2005
Leave A Legacy Supplement, Charity as IRA Beneficiary, 2003

Lectures and Authored Topics:

The CPA's Guide to Common Problems and Practical Solutions In Estate Planning and Probate, Permian Basin Chapter, Texas Society of CPAs, November, 2011
Making Sense of the 2010 Estate Tax Landscape – Reporting Issues Related to Filing Form 706 or Form 8939, Weaver & Tidwell, LLP Offices throughout Texas, January, 2011

The Legal Assistant's Role in Helping Your Clients Navigate the Estate Planning Maze, National Association of Legal Professionals, April, 2011
 Helping Your Clients Navigate the Estate Planning Maze, Permian Basin Chapter, Texas Society of CPAs, November, 2009
 Generation-Skipping Transfer Tax, Midland College Foundation/Midland Memorial Foundation Estate Planning Update, May, 2006
 IRA Distributions, Midland College Foundation/Midland Memorial Foundation Estate Planning Update, Midland, Texas, May 2003

Professional Activities (Past and Present):

AICPA Member	1983-Present
TSCPA and member of its Advanced Estate Planning Committee	2004-Present
Midland Odessa Business & Estate Council Member/Past President, Secretary & Treasurer	2005-Present
Permian Basin Chapter TSCPA	2006-Present
NACVA Member	2008-Present

Civic Activities (Past and Present):

SHARE Board Member /Past President & Treasurer	2008-Present
Springboard Center Treasurer	2009-Present
MARC (Midland Association of Retarded Citizens) Development Committee Member	2007
Community Children's Clinic Board Member/Past President	1998-2002

Experience and Qualifications:

Karen Schmidt is an independent CPA whose practice focuses on estate, gift and generation-skipping transfer tax, estate planning and probate, wealth transfer and succession planning, family limited partnership formation and operation, trust administration, and litigation support.

Prior to forming Karen S. Schmidt, CPA, PLLC in 2011, Ms. Schmidt practiced with Weaver & Tidwell, LLP (formerly Elms, Faris & Company, LLP) where she managed the Estate Planning and Probate Practice for the firm's Midland Odessa Joint Operation. She was previously affiliated with several area law firms before joining Elms, Faris in 2002, and has extensive experience as a CPA/legal assistant to an attorney board certified in Estate Planning and Probate by the Texas Board of Legal Specialization.

Ms. Schmidt is a member of the Texas Society of Certified Public Accountants, the American Institute of Certified Public Accountants, Permian Basin Chapter Texas Society of Certified Public Accountants, the Midland Odessa Business and Estate Council, and the National Association of Certified Valuation Analysts.

Karen Schmidt is an independent CPA in Midland, Texas. She has earned the professional designation of certified specialist in estate planning and certified forensic financial analyst.

Karen's practice is concentrated in estate, gift, and generation-skipping tax, wealth transfer & succession planning, trust administration, fiduciary litigation, and resolution of family disputes.

Karen is active in community and professional activities; she is a member of TSCPA's Advanced Estate Planning Seminar Committee and a Past President of the Midland/Odessa Business and Estate Council.

**PRACTICAL ESTATE PLANNING
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March 20, 2012

1. Introduction
2. The Client
 - a. Experienced in oil and gas matters
 - i. Aggregators
 - ii. Risk takers
 - b. Inexperienced in oil and gas matters
3. The Initial Process
 - a. Meet with the players
 - b. Obtain information about asset values
 - i. Difficult to obtain
 - c. Obtain information about asset character
 - d. Beware mineral classified lands
 - e. Evaluate the family dynamics
 - f. Educate the client about the process pros and cons
 - g. Meet with all advisors
 - h. Distill the priorities
 - i. Consider the Estate Planning Continuum
 - i. Measure the client's tolerance for complexity
4. Phase I–Self Determination Planning
 - a. Powers of attorney
 - i. Consider gifting power
 - b. Medical powers
 - c. Various other very important documents
5. Phase II–Testamentary Planning
 - a. Probate and Non-Probate Transfers
 - i. Living Trusts
 - (1) Privacy issues
 - (2) Out of state properties
 - (3) Will contest protection
 - (4) Incapacity issues
 - (5) Easier than split beneficiary designation on life insurance
 - ii. Wills
 - (1) Traditional
 - (2) No need to fund now
 - iii. Other non-probate transfers
 - (1) Beneficiary designations
 - (2) Signature cards
 - b. Standard tax planning
 - i. Use both exemptions

- ii. Defer tax until second death
 - c. More sophisticated tax planning
 - i. Passive asset protection via use of bypass and marital trusts
 - ii. Use both GST exemptions
 - iii. Extend trusts for Rule Against Perpetuities
 - iv. Consider the generation jump
 - v. Include charitable planning
 - (1) At least as a contingency
- 6. Phase III—Use of Inter Vivos Transfers
 - i. Irrevocable Life Insurance Trusts
 - (1) For spouse
 - (2) For descendants
 - (3) Fund with mineral assets generating cash flow to pay premiums
 - ii. Family Limited Partnerships
 - (1) Goals
 - (a) Asset protection
 - (i) Environmental
 - (ii) Other
 - (b) Margin tax issues
 - (2) Design
 - (a) Consider use of prior generations or trusts
 - (b) Consider non-reciprocal inter vivos trusts
 - (c) Separate risk generating assets from investment assets
 - (3) Appraisals
 - (a) Hire a petroleum engineer
 - (b) Gather relevant information
 - (i) Legal descriptions
 - (ii) Cash flow
 - (c) Valuation of reserves
 - (i) Decline curve based on historical data
 - (ii) Historical expenses
 - (iii) Current oil and gas prices
 - (iv) Time value of money
 - (v) Not all reserves are recoverable
 - (vi) Wasting asset
 - (d) Non-producing assets
 - (i) Lease bonuses in area
 - (ii) Delay rentals
 - (iii) Nearby production
 - (4) General Partner
 - (a) Entity with control
 - (b) Split up ownership
 - (5) Limited Partners

- (6) Caveat—do not accidentally convert separate property into community property by putting it in a FLP
 - (a) Royalty is removing principal therefore maintains separate character
 - (b) But, profits from a partnership are community
 - (c) Consider partition
 - (d) See Appendix 1
 - (e) Warning about divorce implications
 - (7) Agreement Provisions
 - (a) Right of first refusal among family members
 - (b) Capture any available discounts
 - (c) Pigs get fat and hogs get slaughtered
 - (d) It takes discipline—it isn't just a bank account
 - (8) Timing the gift
 - (9) Transfers
 - (a) Letters in lieu vs “not” letters in lieu
 - (10) The FLP--Step by step
 - (a) See Appendix 2
 - iii. Estate Freezes
 - (1) GRATs
 - (2) Sale to IDGT
 - (3) Gift of \$5 million
 - (a) Possible clawback issues
7. Phase IV—Post Mortem Planning
- a. Disclaimers
 - b. Graegin loans
 - c. Funding bypass and marital gifts
 - i. Fund marital gift with producing properties
 - ii. Fund bypass trust with assets possessing potential for gain
 - (1) Best place to put limited partnership interests
 - iii. Use of distribution deeds
 - d. Alternate valuation date
 - e. Portability
 - i. New six month extension for 2011 decedents
8. Appendices:
- Appendix 1: General Rules For the Characterization of oil and gas marital properties
 - Appendix 2: The FLP—Step by Step
 - Appendix 3: Helpful websites
 - Appendix 4: Process of Shale Gas Development (Duration)
 - Appendix 5: Riches Below the Surface Chart

Appendix 1

General Rules For the Characterization of oil and gas marital properties are as follows:

- a. Bonus payments for mineral leases on separate property are separate property. These payments are considered to be a return of principal. *Texas Co. v. Parks*, 247 S.W.2d 179, 184 (Tex. Civ. App. - Fort Worth 1952, *writ ref'd n.r.e.*).
- b. Income from the production of minerals from separate property and the sale of a separate property leasehold remains separate property. *Norris v. Vaughan*, 260 S.W.2d 676, 678-679 (Tex. 1953). Royalty payments on separate property also remain separate property. *Norris v. Vaughan* at 678.
- c. Delay rentals on separate property, however, are community property. These payments are considered income and not a return of principal. *McGarragh v. McGarragh*, 177 S.W.2d 296, 300 (Tex. Civ. App. - Amarillo 1943, *writ dismiss'd*).
- d. Since the date of these early cases, many courts have consistently applied these holdings.
- e. In Rev. Rul. 71-32, 1971-1 C.B. 27, the Internal Revenue Service announced that, for federal income tax purposes, it would follow the characterization of marital property established by the Texas courts. Under the facts of Rev. Rul. 71-32, the cash bonus for execution of oil and gas leases on a wife's separate real property was her separate property.

Planning for Owners of Oil and Gas Interests, Craig S. Adams, State Bar of Texas, 30th Annual Advanced Estate Planning and Probate Course, June 7-9, 2006, Houston, Texas.

Appendix 2

The FLP–Step by Step

- Have a legitimate non-tax reason to form the FLP
- Get all players on board
- Reserve entity names
- Design overall structure
- Get legitimate valuations
- Obtain accounting advice
- Create and fund any trusts necessary to participate in entities
- Consider any partitions of community property
- Form and fund General Partner
- Get EIN
- Set up bank account
- Prepare subscription agreements for general partner and limited partners
- Prepare Partnership Agreement
- Convey cash from General Partner to Partnership
- Convey assets from Limited Partners to Partnership
- Partition Limited Partnership interests if necessary
- Create and maintain ownership ledger
- Get EIN
- Set up bank account
- Prepare and file deeds
- Write paying oil companies “letter in lieu of division order”
- Have annual meetings
- Wait to begin gifting
- Value once, gift twice
- Transfers
- Maintain accurate capital accounts
- Only make pro-rata distributions
- Treat it like a business
- Have regular “check ups”

Appendix 3

Helpful websites:

American Petroleum Institute

www.api.org

American Royalty Council

www.americanroyaltycouncil.com

Baker Hughes - Rig Count

<http://www.bakerhughes.com/rig-count>

Drilling Info

www.drillinginfo.com

Energy Advocates

www.energyadvocates.org

Independent Petroleum Association of America (IPAA)

www.ipaa.org

Interstate Oil & Gas Compact Commission (IOGCC)

www.iogcc.state.ok.us

National Association of Unclaimed Property

www.naupa.org

National Association of Royalty Owners

<http://naro-us.org/>

<http://naro-us.org/texas>

Oil Field Trash

<http://www.oilfieldtrash.com/>

Oil and Gas Journal

<http://ogj.pennnet.com>

Oil Law Records

www.oil-law.com

Plants Need CO2

www.PlantsNeedCO2.org

Railroad Commission of Texas - Oil & Gas Well Records

www.rrc.state.tx.us/data/wells/wellrecords.php

Schlumberger Glossary -

www.slb.com/resources/publications/oilfield_review/oilfield_glossary_app.aspx

Texas Energy Council

www.txenergycouncil.org

Texas File - Oil, Gas & Mineral Reports

www.texasfile.com

Texas Independent Producers & Royalty Owners Association (TIPRO)

www.tipro.org

Texas Oil & Gas Association (TxOGA)

www.txoga.org

Texas Unclaimed Property

www.claimitexas.org

Appendix 4 PROCESS OF SHALE GAS DEVELOPMENT (DURATION)

Mineral Leasing

Companies negotiate a private contract or lease that allows mineral development and compensates the mineral owners. Lease terms vary and can contain stipulations or mitigation measures pertinent to protect various resources. (Several weeks to years)

Permits

The operator must obtain a permit authorizing the drilling of a new well. Surveys, drilling plans, and other technical information are frequently required for a permit application. The approved permit may require site specific environmental protection measures. Other permits such as water withdrawal or injection permits may also be required. (Several weeks to months)

Road and Pad Construction

Once permits are received, roads are constructed to access the wellsite. Well pads are constructed to safely locate the drilling rig and associated equipment during the drilling process. Pits may be excavated to contain drilling fluids. (Several days to weeks)

Drilling and Completion

A drilling rig drills the well and multiple layers of steel pipe (called casing) are put into the hole and cemented in place to protect fresh water formations. (Weeks or months)

Hydraulic Fracturing

A specially designed fracturing fluid is pumped under high pressure into the shale formation. The fluid consists primarily of water along with a proppant (usually sand) and about 2% or less of chemical additives. This process creates fractures in rock deep underground that are "propped" open by the sand, which allows the natural gas to flow into the well. (Days)

Production

Once the well is placed on production, parts of the wellpad that are no longer needed for future operations are reclaimed. The gas is brought up the well, treated to a useable condition, and sent to market. (Interim Reclamation: days; Production: years)

Workovers

Gas production usually declines over the years. Operators may perform a workover which is an operation to clean, repair and maintain the well for the purposes of increasing or restoring production. Multiple workovers may be performed over the life of a well. (Several days to weeks)

Plugging and Abandonment/Reclamation

Once a well reaches its economic limit, it is plugged and abandoned according to State standards. The disturbed areas, including well pads and access roads, are reclaimed back to the native vegetation and contours or to conditions requested by the surface owner. (Reclamation Activity: Days; Full Restoration: Years)

Riches below the surface

Many Crossroads area towns are experiencing an oil boom thanks to horizontal drilling called hydraulic fracturing in the Eagle Ford Shale Play. A look at where the action is taking place.

