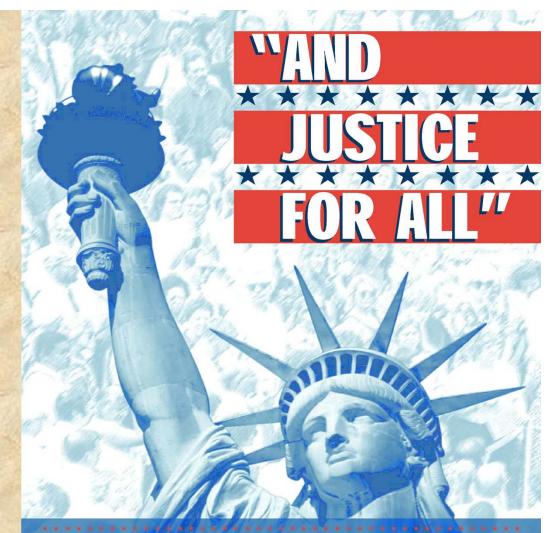
# WHAT A LANDOWNER NEEDS TO KNOW ABOUT SALES OF MINERAL RIGHTS? Sandusky, MI Sanilac County 1-30-14

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### Definition of Mineral Property

- Mineral property is real property can be severed from surface
- "Mineral" no universal definition
- Generally includes: Fossil fuels oil, natural gas, and coal; Metals and metal-bearing ores such as gold, copper, and iron; Non-metallic minerals and mineable rock products such as limestone, gypsum, building stones and salt; May also include sand and gravel, peat, marl, etc.
- Can also include potassium, gases such as helium "mineral" can vary from state to state and even change over time

### Characteristics of Mineral Sale

- Sale is generally forever
- Owner's goals very important
  - Cash now vs. potential future cash from lease bonus or royalty
  - Financial need may be a factor
  - Young vs. Older; goals may differ
  - Older may want to live better now
- Can sell all or a portion
  - Example 50% divided interest (tenant in common) of the hydrocarbons
  - Done by mineral deed

- If no royalties, difficult to establish value
  - What are non-producing minerals worth?
  - Consult oil and gas appraiser
- Seller loses control and leverage with eventual mineral developer
- If cash flows exist several valuation methods
  - One Rule of thumb: Sales price = 4 years of royalties
  - Example: If royalties the past 4 years averaged \$5,000 per year; sale value = \$20,000

- Analysis of previous cash flows to project future cash flows and Net Present Value
  - Allocates very little or no value to non-producing minerals
  - Does not consider future improvements in new technology impact on cash flows

- Current cash flows can sell by mineral auction
  - If there is competition can significantly increase income
- Surface owner loses control of reducing impacts to surface
- New mineral owner no incentive to protect surface
- Get references on potential buyer
- Understand sales contract! qualified legal advice

### Magnitude of the Royalty

- Situation: 40 acres, one oil well @25 barrels/day for 200 days @ \$90/barrel
- $25 \times 200 \times $90 = $450,000/$  year
- 1/8 royalty = \$56,250/yr = \$1,406/acre/yr
- 1/6 royalty = \$75,150/yr = \$1,878/acre/yr
- 3/16 royalty = \$84,375/yr = \$2,109/acre/yr
- .20 royalty = \$90,000/yr = \$2,250/acre/yr

- Know what "Partnering Together" means in the sales contract
- Example: Sell 50 % <u>undivided interest</u> for \$250/acre grants buyer 50% of future mineral income to 100% of property—see Magnitude of Royalty
- Buyer may "flip" the land just as can be done with the sale of an oil and gas lease

### Mineral Retention Considerations

- Oil and gas companies prefer same owner of surface and minerals
  - Less people to please (1 vs.2)
  - Surface owner more clout with company when mineral owner and surface owner the same
- Lease bonus can be immediate cash
  - Bonuses \$15/acre up to \$3,500/acre in MI 2010
- Lease has long term royalty potential
  - Short primary term may mean opportunity to lease again = bonus again

### Mineral Retention Considerations Continued

- Technology constantly changing
  - Hydraulic fracturing and horizontal drilling examples
  - New technology increases production from old wells
- Potential to negotiate favorable lease

## Sales of Mineral Rights "Reducing Risk?"

- Will severing minerals affect future sale of surface?
  - Mineral production present but no royalty to surface owner may reduce potential buyers
- Intact minerals with royalty income attractive to certain buyers – sale now could increase risk later

## Sell Mineral Rights and Reclaim in 20 Years?

- Under Michigan's Dormant Minerals Act, severed oil or gas rights revert to the surface owner after twenty years, unless:
- The severed interest is sold, leased, mortgaged, or transferred by recorded instrument.
- A drilling permit is issued.
- Oil or gas is actually produced or withdrawn from the severed holdings.
- The interest is utilized for underground gas storage operations

# Sell Mineral Rights and Get Them Back in 20 Years?

- Buyer must file record claim of interest with the county Register of Deeds (affidavit to retain) during the 20 years.
- Clock starts ticking day deed filed
- The Dormant Minerals Act applies only to oil or gas rights, and not other mineral rights.

#### I Wish You Tax Problems!

- DO NOT LET INCOME TAX DICTATE A DECISION
- Sale: 2013 MFJ if taxable income <\$72,500</li>
   Cap. gain rate 0%; earned income rate = 15%
   + SE tax
- Sale: 2013 MFJ taxable income >\$72,500 Cap. gain rate 15%; earned income rate 25% + SE tax

#### I Wish You Tax Problems!

- Oil & Gas lease bonus not earned income: tax
   @ ordinary rate; no SE tax
- Oil & gas royalties not earned income; tax @ ordinary rate; no SE tax
- Crop damages ordinary income subject to SE tax
- Surface damages ordinary income not subject to SE tax

#### Resources

- MSU Extension has the Oil and Gas web page at http://msue.anr.msu.edu/program/info/oil and gas
- Oil and gas leasing video on web page
- Lease addendum on webpage
- Quarterly Oil and Gas Newsletter contact talleycu@anr.msu.edu
- <a href="http://news.msue.msu.edu">http://news.msue.msu.edu</a> MSU Extension news articles
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