Gas Rights Owners Need To Begin To Think Like Business

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Landowners who are fortunate enough to have property overlying the Marcellus Shale formation are realizing significant economic transformations. They and their heirs can look forward to a lease bonus payment followed by continued royalty payments. With so much at stake, it is critical that landowners plan now on how this money will be distributed to their families later.

We all know that it is good practice to review your estate plan whenever there are significant changes in the law or in your own life. The goal is to make sure that the estate plan properly provides for the distribution of assets and that the plan minimizes any Federal Estate or State Inheritance Taxes.

“Isn’t it enough to leave it all to my spouse or equally distribute among my children?” Given the size of the estate, this kind of “simple Will” isn’t sufficient at all. Much of the wealth gained may be lost to taxes, divorce or even creditors.

One option is to place portions of your estate into a business structure, rather than holding them as an individual. To do that, one of the first things to determine is whether the ownership of the gas rights is properly structured to most efficiently distribute that asset upon death and take advantage of estate and inheritance tax planning techniques. In Pennsylvania, gas rights are completely severable and can be divided from the rest of the real property. In many situations, it makes sense to form a limited liability company ("LLC") or a limited partnership ("LP") to own these rights with the landowner as the initial member or partner.. By using either an LLC or LP as the owner of the gas rights, the owner can control many facets of that ownership both now and in the future. First, the owner can determine the initial number of partners or members. Generally speaking, it makes sense for the gas right owners to be the sole member(s) or partner(s) in the LLC or LP that holds the gas rights. By utilizing the LLC or LP structure, the gas rights themselves remain fully intact within the LLC or LP rather than being fractured between individuals. Also, the management of the gas rights is centered in the LLC or LP and governed according to the operating agreement (for the LLC) or the partnership agreement (for the LP). The use of an LLC or LP allows the owner to control how members or partners can transfer their membership interest or partnership interest to third parties. By appropriately wording the operating agreement or the partnership agreement, the owner can control whether the membership or partnership interests can be sold to a third party and if so, to the type of third party (e.g. only family members, etc.). The operating or partnership agreements can also limit the extent to which a member or partner can assign or pledge his or her interest in the LLC or LP. Further, the operating or partnership agreements can limit whether or not the interest is devisable pursuant to the member or partner's Last Will and Testament. Finally, with respect to any of these restrictions, the owner can provide language granting the owner (or other members/partners) the right to buy back the membership or partnership interest upon a multitude of events. This last point is very important because it can often be used to restrict the rights of non-family members to acquire interests in the LLC or LP.

In conjunction with the control of ownership and management that an LLC or LP structure provides, membership or partnership interests are excellent assets to use to fund trusts for family members because the trusts can contain provisions controlling how the assets are distributed to family members and at what time. In situations where the owner is survived by minor children or young adult children, the passing of substantial assets outright upon the owner's death may not be suitable given the age and/or maturity of the children. The transfer of membership or partnership interests into trusts for the owner's children is a perfect vehicle to provide limits, not only on the receipt by the beneficiary of both net income and principal generated from the membership or partnership interests, but also at what age or life event, the beneficiary may receive them.

In addition to the above benefits the LLC or LP structure provides in terms of funding trusts, membership and partnership interests are also efficient assets to pass outright or into certain trusts for the purpose of removing them from one's estate and thus avoiding paying Federal estate tax. At the most basic level, the owner can utilize his or her annual gift exclusion and transfer membership interests in the LLC or partnership interests in the LP to family members either outright or in trust via gifts of membership or partnership interests equal to the annual gift tax exclusion (currently $13K per person or $26K with spousal consent). In addition, the owner can make gifts of membership and partnership interests either outright or into trusts using his or her lifetime gift tax exclusion (currently $5M). If an owner does not want to use his or her lifetime gift tax exclusion (or if the owner does not have any of the exclusion remaining), he or she can gift membership or partnership interests into "Crummey Trusts" for the beneficiaries and, provided the trust contains the appropriate withdraw right for the beneficiary, the gift will pass both estate tax and gift tax free. In addition to "Crummey Trusts," an Intentionally Defective Grantor Trust ("IDGT") is also a vehicle that works well for either the gifting or sale of membership or partnership interests. In an IDGT, the grantor is treated as the owner of the trust for income tax purposes, but not for estate or gift tax purposes. In order to qualify as an IDGT, the trust must satisfy one or more grantor trusts rules, so it is important to work with legal counsel on properly establishing the trust. Clearly, these techniques are not exhaustive but merely illustrate that there are numerous estate tax planning techniques that can be utilized in conjunction with LLC or LP ownership structures.

Marcellus Shale has transformed many things in Pennsylvania, including the way gas rights owners need to think about what they own and how they will pass that ownership to future generations.

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