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SEPTEMBER 2014

Gas Leasing & Development update

Recent Tax Law Changes Make Income Tax Planning More Important Than Ever

By Jonathan Samel, Esquire

One universal and challenging objective in wealth preservation planning is reducing taxes. Recent tax law changes, in many cases, shifted the focus of such planning from estate and gift tax reduction to income tax reduction.

On January 1, 2013, Congress passed the American Taxpayer Relief Act of 2012 (ATRA) which, among other things, increased certain income tax rates. ATRA established a new top rate for ordinary income of 39.6% (up from 35%) for taxpayers with annual taxable income in excess of $400,000 for single individuals, $450,000 for married couples filing jointly, and only $12,150 for estates and trusts in 2014. In addition, the top long term capital gain and dividend tax rate was increased from 15% to 20% for taxpayers in the above mentioned highest ordinary income tax bracket.

The Patient Protection and Affordable Care Act ("PPACA") which was originally enacted in 2010 and which first became effective in 2013 established a new 3.8% surtax on investment income. For purposes of this tax, investment income includes interest, dividends, rent, royalties, capital gain and passive activity income. This additional tax applies to taxpayers with an adjusted gross income in excess of $200,000 for single individuals, and $250,000 for married couples filing jointly. For estates and trusts, this tax applies to the lesser of (i) undistributed net investment income or (ii) the excess of adjusted gross income over the amount at which the top income tax bracket for trusts and estates begins (only $12,150 in 2014). Considering this additional 3.8% tax, for taxpayers in the highest bracket, their effective ordinary federal income tax rate (not considering state income tax rates) can be as high as 43.4%, and the top long term capital gain and dividend tax rate is now effectively almost 24%.

Owners of shale property who are receiving significant gas and oil royalty payments, lease bonus payments or delay rental payments may be affected by these new tax laws because all such payments are subject to ordinary income tax rates, and are also

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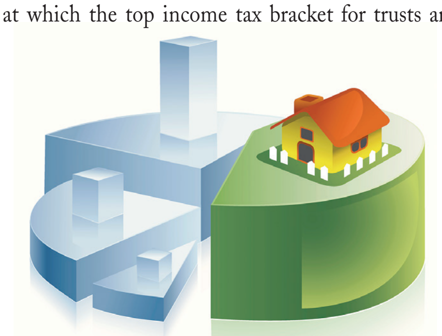

ROYALTIES – *Drilling Down On Post-Production Deductions*

By Mark F. Himsworth, Esquire

Pennsylvania has, for many years, allowed oil and gas drillers to deduct certain post-production costs from royalties. Typically, these are costs of gathering and transporting oil or gas to market. Ordinarily, costs are deducted in proportion to the royalty percentage. Thus, if the lease provides a 1/8th royalty, the statutory minimum, the lessor bears 1/8th of allowable post-production costs. For lessors, the Pennsylvania Supreme Court's holding in ***Kilmer v. Elexco Land Services*** confirmed this even more firmly. While this sounds simple, it may not be. The devil is indeed in the details.

In ***Demchak Partners Limited Partnership v. Chesapeake Appalachia LLC***, the plaintiff brought suit seeking class certification based upon allegations that certain post-production deductions taken by Chesapeake violated the leases signed by the parties. Procedurally, and somewhat unusually, the parties simultaneously filed a motion to approve a settlement. The leases at issue contained a clause which precludes deductions for the transformation of oil or gas into marketable form. Commonly referred to as a "market enhancement" or "ready for sale" clause, which precludes such deductions, the clause appeared in an addendum to the Chesapeake leases as follows:

> *It is agreed between the lessor and lessee that, notwithstanding any language herein to the contrary, all oil, gas or other proceeds accruing to the lessor under this lease or by state law shall be without deduction directly or indirectly, for costs of producing, gathering, storing, separating, treating, dehydrating, compressing, processing, transporting, and marketing, the oil, gas and other products produced hereunder to transform the product into marketable form; however, any such costs which result in enhancing the value of the marketable oil, gas or other products to receive a better price may be deducted from the lessor's share of production so long as they are based on lessor's actual cost of such enhancements. However, in no event shall lessor receive a price that is less than, or more than, the price received by lessee.*

According to the proposed settlement, Chesapeake would continue to deduct post-production costs, but would absorb 27.5% of what it considers to be the landowner's share. Landowners would continue to bear 100% of what Chesapeake considers to be the landowner's share of the cost to transport gas in an interstate pipeline. In addition, Chesapeake would refund 55% of costs already deducted. Whether the proposed settlement will be approved by the Court is an altogether different question.

The bottom line is that the royalty checks require close attention to assure that no deductions are taken which are not explicitly authorized by the lease. If we can help in the analysis, don't hesitate to call.

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investment income for purposes of the additional 3.8% surtax. In addition, landowners who sell substantial gas rights may be affected by the increase in capital gain tax rates.

One strategy that might avoid the recent income tax increases is shifting income to family members who are in lower tax brackets by gifting property rights to such individuals. For example, if you and your spouse earn $500,000 in gas royalties in 2014, you will fall in the 39.6% highest income tax bracket applicable to couples earning more than $450,000. However, if you gift 20% of your royalty rights to your children at the beginning of 2014, then you and your spouse will have income of $400,000 and will thereby avoid the highest income tax bracket. In addition, $150,000 of your royalty income (the amount of income over $250,000)

will be subject to the 3.8% surtax instead of $250,000 of such income, which would otherwise have been the case without the income shifting gift to the children. There are other income tax planning strategies that owners of shale property should consider, including the effective use of the depletion deduction and other available tax deductions.

While income taxes have increased, the imposition of federal estate and gift taxes on individuals has been significantly reduced. ATRA made permanent the $5 million estate and gift tax exemption that was first introduced in 2011. The exemption is indexed for inflation, and in 2014, an individual can shield up to a total amount of $5.34 million of assets either transferred during lifetime or at death from federal estate and gift taxes. ATRA also made permanent the portability feature, which now allows a surviving spouse to use his or her deceased spouse's unused exemption. This gives a married couple the ability to protect up to $10.68 million in 2014 from estate and gift taxes. The use of all or a portion of the exemption for gifts made during each person's lifetime will correspondingly reduce the amount that is available to shelter assets from estate tax after that person's death. ATRA increased the top marginal estate and gift tax rate from 35% to 40% to the extent the total value of assets gifted and passed upon death exceeds the available estate and gift tax exemption.

As a result of these recent changes to the estate and gift tax law, planning for these taxes will no be longer relevant for most people. Less than one percent of estates are now subject to these taxes. However, this does not alleviate the need to develop a well-designed wealth preservation plan that (i) will allow you to keep your assets in your family line, (ii) will protect your assets from future liabilities and creditor claims, and (iii) will minimize taxes, including income taxes and state inheritance taxes.

Proper planning is particularly significant if you own shale property. Without such planning, an unexpected illness, death, lawsuit or a divorce in the family can greatly complicate your situation. Lack of well thought provisions in place for managing your property, for resolving disputes among family members and for eventually transferring interests in the property will likely lead to the unplanned separation or sale of the property. If you don't begin planning as soon as possible, you will likely have fewer options available to you later.

We can work with you to review and update your current estate plan and to assure that proper provisions are in place to meet your needs and goals. Wealth preservation planning can involve a number of areas of law, including, estate planning, taxation, business law, litigation, asset protection planning, real estate law and divorce law. HRMM&L takes a multi-disciplinary approach to wealth preservation planning involving attorneys with expertise in a number of different areas of law. Please contact our office if you have any questions or want to learn more about our capabilities in this area.

Redeeming Your Interest in a Hunting Club Can Be Harder than it Seems

By Mark F. Himsworth, Esquire

It has not been unusual in Pennsylvania for many years for groups of individuals to acquire land as trustees for the benefit of hunting clubs. After the land is acquired, the hunting club has typically developed bylaws, rules and regulations relating to the use of land by the club and its members. But what happens after many years when a member wants out? With the prevalence of oil and natural gas leases, many clubs are presented with this precise question. Does a club member have a personal interest in the land? Are interests in the hunting club and the land transferrable? What in fact is owned?

A recent case illustrates that the answer sometimes is "it all depends." How the land is owned is key to the inquiry. In ***Bargo v. Kuhns***, there was an argument among the members in a long-standing hunting

club. In 1958, the hunting club took title to real estate "in trust" for all members of the club. Without alleging any specific act, members claimed certain oppressive acts had been committed by other members and rights under the bylaws of the club had been infringed upon. The plaintiffs alleged that while attempts were made to resolve their differences, efforts were unsuccessful. Intending to exit and redeem their interest for money, the plaintiffs brought suit "in partition" seeking the sale of the property and the subsequent division of the money generated by the sale among members. A partition proceeding affords those individuals who no longer wish to be owners the opportunity to divest themselves for a fair consideration.

Affirming the trial court on appeal, the Pennsylvania's Superior Court found that because the property was held "in trust," it was incapable of being "partitioned." Reiterating long-standing Pennsylvania case law, the Court held that since an unincorporated association cannot hold legal title in property, individuals of an unincorporated association, such as the hunting club at issue, could not partition the property for sale. Consequently, the case was dismissed.

Unfortunately, the case did not propose any way to resolve the dispute, or suggest what to do next. There was no further discussion about the hunting club's bylaws. Nor was there any discussion about bringing an action to terminate the trust which ordinarily must be brought in orphan's court. Nor was there any further discussion about the organizational structure, or about reorganizing. Before a dispute arises, and while everyone is getting along, now may be a good time to review the legal structure of an existing hunting club, including the current title to the club property and the bylaws, rules and regulations governing the operation of the club, and to give some thought to the inevitable question, "What happens if I want out?" well before being forced to do so on the proverbial courthouse steps. Let us know what we can do to help.

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