The Marcellus Shale:

Natural Gas Leasing

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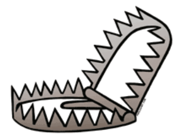
The Net Present Value Trap

By: Gary Schuster



Many landowners look longingly to a natural gas lease as a source of much-needed and long-term income. They see this income as the means to preserve and enhance their property and their way of life, for themselves and for future generations. That vision can be achieved, but there are some traps for the unwary along the way. The most subtle and potentially dangerous may be the one that goes by the mysterious name "Net Present Value."

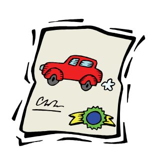
Assume you have entered into a gas lease and gas is being sold to market. Assume you are being paid royalties of $20,000 a month. Now (hold your breath) assume you die. Sorry. ☹ That's how these examples work.

If you have a Last Will and Testament (strongly urged for everyone regardless of wealth or family situation) your executor will gather your assets and carry out your last instructions. If you have no Will (an inconsiderate thing to do to your loved ones) the county Surrogate's Court will appoint an administrator. That person will gather your assets and then distribute them according to the state's laws of intestacy (very likely not as you would have wished).

At this difficult time, your executor or administrator will have to prepare your final tax return and determine if any federal or state estate taxes are due. That will be determined by the net value of the assets you owned at the time of your death. The "net value" is used, meaning you deduct any debt owed on an item of property. So for example, if your home has a fair market value of $300,000 but your mortgage is $200,000, its net value is $100,000.

For illustration purposes, let's assume you are a “typical” dairy farmer in Sullivan County with 200 acres, a home, several out-buildings, equipment, vehicles and some savings and investments. Your "estate" would look like this:

ASSETS		NET VALUE
Farmland & Farm Buildings	$	600,000
Home	$	100,000
Equipment	$	150,000
Vehicles	$	30,000
Savings	$	30,000
Investments (stocks, bonds, etc.)	$	50,000
Total	$	960,000



In 2010 there is no estate tax for anyone. However, the estate tax will return for people who die in 2011 and beyond. Unless Congress changes it, the estate tax will apply to net estates of $1 million or more. For our “typical' list of assets above, no estate tax would be due because the net estate has a value less than $1 million.

However, that does not include the gas lease. The gas lease is an asset, and it generates money. The IRS will require that the date of death value of the gas lease be included in the estate. The calculation is tricky because the money will flow in over time, in the future. However, clever mathematicians have figured out the formula for determining the net present value of the future flow of income that will be generated by the gas lease. Assuming the gas lease will generate $20,000 a month over 20 years, the net present value of that future income flow is $1,985,174.

Now add this to the "typical" list of assets above:

ASSETS		NET VALUE
Farmland & Farm Buildings	$	600,000
Home	$	100,000
Equipment	$	150,000
Vehicles	$	30,000
Savings	$	30,000
Investments (stocks, bonds, etc.)	$	50,000
Gas Lease	$	1,985,174
Total	$	2,945,174

Now the net value of the estate exceeds $1 million, by quite a bit. The estate tax due is calculated as follows:

Tax on first $2.5 million	$	1,025,800
53% marginal tax on excess over $2.5 million or 53% of $445,174	$	235,942
Total estate tax	$	1,261,742

More than $1 million in estate tax! Isn't that a rude surprise!

Actually it's worse than that, because the royalties are still off in the future, while the federal estate tax is normally required to be paid within just 9 months of the date of death. In the example above, there is nowhere near enough cash available to pay the tax. Circumstances like this force heirs to take on a crushing amount of debt, sell valuable or important assets, or in the worst cases, sell the whole farm or family business. It can be a financial, as well as a personal, disaster.

Fortunately, financial and tax planning can reduce and even avoid this kind of problem. Many different strategies can be implemented to manage estate tax. Whatever the solution, it is most important to recognize the problem and start to plan as soon as possible, preferably before a gas lease is signed.

Why is it so vital to plan and take action early? Because making lifetime gifts is very likely to be one of the planning strategies, and the greatest savings can be achieved by making gifts when the asset values are low. An example will show how. First, let's examine how a gas lease would be assigned a value.

Financial evaluation of a gas well depends on the circumstances. If the gas well is already producing gas and royalties are being earned, a calculation can be made based on the actual past and projected future earnings. If gas is not yet being recovered from your property, the appraiser will do what real estate appraisers usually do - look at "comparables" in the same neighborhood. If your neighbors have productive wells, the assumption will be that your well will produce about the same amount and quality of gas. A calculation may be made based on that assumption. If there is no production going on in the area, the appraiser will look at the closest production there is and use his or her professional experience, skill and judgment to come up with the necessary figures. The figure will never be zero. The IRS simply will not allow that. Its position is that virtually everything is worth something. A professional evaluation must be done by a qualified appraiser who will prepare a written appraisal that will withstand scrutiny and possible challenge by the IRS.

Now let's go back to the "typical" estate described above. If the net present value of the gas lease is appraised at approximately $2 million, let's now assume a lifetime gift is made of $1,000,000 worth of that lease.

(Continued on Page 3)

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Here's how the estate tax situation will turn out:

Net Estate excluding gas lease	$	960,000
Gas lease after $1 million gift	$	985,174
Taxable estate at death	$	1,945,174

To determine the estate tax:

Tax on first $1.5 million	$	555,800
45% marginal tax on excess over $1.5 million or 45% of $445,174	$	200,328
Total estate tax	$	756,128

This is better. Making the $1 million lifetime gift reduced the estate tax from $1,261,742 to $756,128, a savings of $505,614. However, an estate tax of more than $750,000 is still a disaster. We can do better, and now it will become apparent why it is important to make gifts when valuations are as low as possible.

Let us suppose the gas lease is gifted, not after the gas and the royalties begin to flow, but before a well is even drilled, before a lease is even signed, even before the State of New York starts issuing permits for drilling. At that point in time, there are no nearby comparables, there is much uncertainty, gas royalties are highly speculative, and the net present value of a possible gas lease will be appraised at a much lower value.

We were recently involved in an appraisal of a possible future gas lease covering more than 1,500 acres, and the value came in at about $250,000. Extrapolating those figures for a 200 acre farm, the appraisal value would come in at about $31,250. This is, of course, an approximation, and there are many variables to be considered. We cannot guarantee any appraisal value for any parcel of land. However, it was a thorough appraisal by well qualified appraiser, and the result is obviously a fraction (1.574%) of the 20- year net value of the lease after gas is recovered.

With a gift of the gas lease valued at $31,250, the net value of the remainder of the estate falls below $1 million, so no estate tax will be due and no other gifting is necessary.

With the early gifting of the gas lease, at an extremely low (but plausible and lawful) value, we avoid estate tax entirely! The lessons are clear: lifetime gifting is a powerful strategy, and the most benefit is gained when the asset value is low. For a gas lease, that means gifting before the royalties start flowing, before the gas is recovered, before a well is drilled, before the State starts permitting drilling.

How does one actually make a gift of the right to receive a gas royalty? The donor would sign a very brief document called a Declaration of Gift. Once that is done, the gas company would be informed so future checks are paid in accordance with the gift. Also, the IRS requires that Form 709 Gift Tax Return be filed for the tax year of the gift if the value of the gift during the tax year, as determined by the appraisal, is more than $13,000 per donee.

For the “typical” estate in our example, the early gift of the royalty rights was sufficient to avoid all estate tax. However, many estates will be larger and other strategies will be required. Another common procedure is to form a corporation or limited liability company and then transfer the assets into that new entity. Then, instead of gifting an individual asset, like the lease, a vehicle or a savings accounts, gifts are made of shares of stock in the corporation or, as they are called in limited liability companies, membership interests. Under this scenario, it may be possible to achieve additional discounts in valuation of up to 35%. Even more of the estate could be transferred to the next generation free of the estate tax.

There still other possibilities utilizing trusts, life insurance, charities, self-cancelling promissory notes, bargain sales and more, all of which should be discussed with qualified legal or tax professionals. All of these strategies and procedures are perfectly legal. The key is to act when asset values are low so as to avoid the Net Present Value trap.

NEW YORK PASSES DRILLING MORATORIUM - November 29, 2010

The New York Assembly passed a bill , previously passed by the Senate, imposing a moratorium on issuing any drilling permits until at least May 11, 2011. Governor Paterson will likely sign the bill into law before leaving office on December 31 st . The bill is intended to allow additional study of hydraulic fracturing, the process of "loosening" shale deposits using water, sand and chemicals under high pressure to free up the natural gas. Some say the moratorium is merely political posturing since it is unlikely that the NYDEC will complete it's current environmental study process before early summer.

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MARCELLUS SHALE IN MAJOR MEDIA

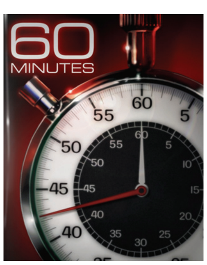
BREAKING NEWS

The Marcellus Shale has now made the big time, recently appearing in major national media. The following reports, from highly respected sources, both attempt to cover both positive and negative aspects:

NATIONAL GEOGRAPHIC

National Geographic recently published a series of articles on natural gas drilling, "Special Report: The Great Shale Gas Rush." The articles can be found online at:

HTTP://NEWS.NATIONALGEOGRAPHIC.COM/NEWS/ENERGY/2010/10/101022-ENERGY-MARCELLUS-SHALE-GAS-RUSH/
There are a variety of articles on science, the environment, job creation, and the effects on homeowners, farmers and local businesses.



On November 13, 2010, "60 Minutes" aired a report on the Marcellus Shale called "Shaleionaires" (as in, shale-made millionaires). The episode can still be found online at CBS.com and on YouTube.com.

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