WHAT A LANDOWNER NEEDS TO KNOW ABOUT SALES OF MINERAL RIGHTS?
Sandusky, MI
Sanilac County
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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
Characteristics of Mineral Sale Continued

• 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
Characteristics of Mineral Sale Continued

• 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
Characteristics of Mineral Sale Continued

• 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 x 200 x $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
Characteristics of Mineral Sale Continued

- Know what “Partnering Together” means in the sales contract
- Example: Sell 50% undivided interest 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 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

• http://news.msue.msu.edu MSU Extension news articles

• Your county MSU extension office
THANK YOU

• QUESTIONS?