

NONPROFITS SHOULD TAKE AN INTEREST IN MINERAL INTERESTS

Accepting gifts of mineral rights can provide substantial financial awards for your nonprofit. But these unique assets come with complexity and risk. To begin to manage your non-financial assets – and then maximize the revenue opportunities – it’s important you become familiar with the mineral rights your organization could receive.

MINERAL INTERESTS TYPICALLY RECEIVED BY NONPROFITS

Whether a gift of a mineral interest is a proposed lifetime gift from a donor, or comes to the charity through an estate, your organization should first determine the type of interest:

- **Mineral interest** is the right to extract, modify and sell the minerals that underlie a parcel of property. In the oil and gas industry, the term “minerals” refers narrowly to underground hydrocarbons. In other contexts, “minerals” may refer to any type of valuable materials embedded in the earth’s crust.
- **Royalty interest** is the mineral owner’s share of production. A nonprofit that owns a royalty interest does not bear any of the operational costs needed to produce the resource, yet still owns a portion of revenue produced.
- **Overriding royalty interest** is a fraction of the gross production of oil, gas, or other mineral subject to a lessee’s/operator’s working interest.
- **Non-participating royalty interest** is an interest in the gross production of oil, gas and other minerals carved out of the mineral fee estate as a free royalty. A non-participating royalty interest does not carry with it the right to participate in the execution of, the bonus payable for, or the delay rentals to accrue under oil, gas and mineral leases executed by the mineral estate’s owner.

The specialized nature of mineral interests requires internal and external expertise to manage these unique assets, including:

- Obtaining all property documentation
- Verifying ownership
- Uncovering unidentified mineral interests or unclaimed revenue
- Transferring operations to your manager
- Communicating risks and liabilities to board

WHY ARE OIL, GAS AND MINERAL INTERESTS SO COMPLEX?

- The industry is always evolving.
- Pricing structures are volatile.
- Leases may contain unfamiliar language and have the potential to negatively impact financial returns and legal rights for years.

WHY ARE NONPROFITS RELUCTANT TO ACCEPT A “WORKING INTEREST?”

A charitable organization may also be gifted a working interest, which is defined as the operating interest under an oil and gas lease. The working interest’s owner has the exclusive right to exploit the land’s minerals. Although the term ordinarily refers to an interest acquired by a lease, it may describe a mineral interest in certain contexts.

A gift of a working interest raises difficult questions which require extensive due diligence. Most charities would not accept a working interest because of the need to make additional investment to extract the minerals, and due to the potential liabilities associated with production (in particular the unpredictable liabilities associated with unforeseen environmental effects). Importantly, the income produced from a working interest would be considered unrelated business taxable income (UBTI, see at right) to the charity.

A tax exempt organization must pay tax on its UBTI as if it were a taxable entity, which (arguably) reduces the overall benefit of such investment. Of greater concern is the possibility of the organization losing its exempt status if a “substantial” portion of its income derives from an unrelated business. There is no fixed percentage or mechanical test for determining what constitutes a substantial portion for these purposes. Although the IRS did not revoke an organization’s tax exemption even though 75% of its income was derived from unrelated sources,* this ruling was issued in 1957, and the IRS may be much less forgiving today.

In the absence of definitive guidelines, some practitioners use a 20% threshold. Thus, if and when an organization’s unrelated business income exceeds 20% of gross income, the organization should carefully evaluate and monitor the benefits and downsides to its investments in such unrelated businesses. Once an organization’s unrelated business income exceeds 50%, it may be difficult to continue to demonstrate to the IRS that the organization’s primary purpose is charitable, and divestment may be prudent.

SO...LEASE OR SELL?

Once a gift is accepted, your organization must decide if it will retain the mineral interest or sell it. From an economic standpoint, the charity can often receive greater value from leasing mineral interests rather than selling them. However, due to the specialized nature of lease agreements, and their terms, charities should have internal or external expertise to manage these types of assets.

UNRELATED BUSINESS TAXABLE INCOME

Unrelated Business Taxable Income is defined as income derived from:

1. An active trade or business (not just an investment)
2. Which is regularly carried on, and
3. Which is not substantially related to the performance of tax-exempt functions, i.e., it does not directly further charitable purposes (other than by the production of funds)

FOR MORE INFORMATION

Northern Trust may help you understand or manage your organization’s interests while investigating revenue opportunities. Our experts can manage day-to-day operations for you and navigate volatile pricing structures.

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* Rev Rul. 57-313, 1957-1 C.B. 316