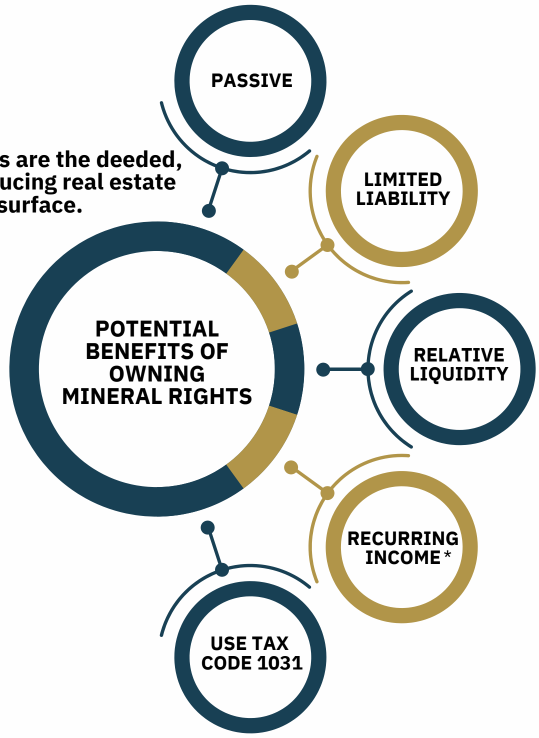
Mineral Rights

Mineral Interest
Under common law, a real property landowner owned the land, including everything to the sky above and down to the depths below. Yet a landowner can sever the surface estate from the mineral estate, also called the "mineral interest," and each estate is considered an interest in real property.

The severance of the mineral interest is achieved with a deed. It can be further divided and severed, as follows:

- Right to develop–enter, occupy and make such use of the surface as is reasonably necessary in the exploring, drilling, mining, removing and marketing of the minerals
- Right to lease–execute oil, gas and mineral leases, thus conveying the right of exploring, mining, removing and marketing to one or more lessees
- Right to receive bonus payments–receive from the working interest owner an initial lease bonus usually computed on a per-acre basis*
- Right to receive delay rentals–receive payment from the lessee to maintain an oil and gas lease during the primary term without drilling
- Right to receive royalty payments–share a percentage of production under the oil, gas and mineral lease, or the proceeds from the sale of such production, without the burden of drilling, operating and production costs*

Mineral rights are the deeded, income-producing real estate beneath the surface.



Royalty Interest
A royalty interest is created when a mineral interest owner signs an oil, gas and mineral lease. Upon the execution of a lease, the lessee gains the exclusive right to drill and develop the minerals. In return for gaining the right to develop the minerals, the lessee agrees to pay the mineral interest owner a royalty on any oil and gas produced during the term of the lease. A non-participating royalty interest owner is entitled to a share of production under the oil, gas and mineral lease, or the proceeds from the sale of such production, without having to bear or participate in any of the costs of drilling, development and operations. The owner of a royalty interest generally is not required to pay any portion of the costs of drilling or operating the wells on the leased acreage.

* Potential cash flows are not guaranteed and could be lower than anticipated.

Working Interest

A working interest owner is the person who owns the oil and gas lease—so called because the working interest owner is entitled to "work" the land by drilling and developing the minerals. The working interest owner is also liable for all of the costs of operations. The term "working interest" is usually used to distinguish that interest from the royalty and other non-cost bearing or non-participating interests. Because a royalty interest is a share of production free of costs, the working interest owners must pay the royalty "off the top," thus reducing the revenue available to recoup their drilling and operating costs and turn a profit. Most investors indirectly hold working interests via a limited partnership offering, either as general or limited partners. General partners have greater liability, but are entitled to increased deduction benefits.

Overriding Royalty Interest (ORRI)

An ORRI is carved out of the lessee's interest (or the working interest) under an oil and gas lease, creating an interest in oil and gas produced at the surface, free of the expense of production, and in addition to the usual landowner's royalty reserved to the lessor in an oil and gas lease. Unlike a royalty interest, an overriding royalty interest owner does not own the minerals. Rather, an ORRI owner owns a right to a portion of the proceeds of produced minerals. The ORRI is carved out of the leasehold interest (or working interest); ORRIs generally conclude when the lease terminates.

TAXATION NUTSHELL—Owners of working interests can deduct both intangible and tangible costs. Intangible drilling costs (IDCs) are costs necessary to prepare wells for production, but have no salvageable value. IDCs include wages, fuel, chemicals, hauling, supplies, ground clearing, survey work and repairs. Approximately 60-85% of total drilling costs are intangible. IRS regulations allow well owners (investors) to deduct 100% of IDCs against their income in the first year.

Tangible drilling costs (TDCs) are the components of a well that have salvageable value. TDCs include certain heavy equipment, casings, pump jacks and wellheads. IRS regulations allow investors to deduct 100% of TDCs against their income over the course of seven years. The extent to which an investor can deduct IDCs or TDCs against income depends in part on whether the investor is a general partner or limited partner.

Royalties are taxed as ordinary income, but may be partially offset by the percentage depletion allowance. Percentage depletion is a modest tax advantage for royalty owners. It is calculated by applying a reduction of 15 percent to the taxable gross income of a productive well's property. The allowance cannot exceed 65 percent of taxable income, and is limited to the first 1,000 barrels of oil (or 6,000 mcf of natural gas) produced per day. Some mineral interest offerings are designed to be eligible as like-kind replacement property in a §1031 exchange.

Taxpayers may acquire fractional, deeded interests in a "basket" of mineral rights across several properties in multiple jurisdictions. The program sponsor then handles the revenue collection, accounting and reporting for all of the royalties in the basket.

Here are the key differences among mineral rights:

	Mineral Interest	Non-Participating Royalty Interest	Overriding Royalty Interest	Working Interest
Generates Revenue from Well Production	Yes	Yes	Yes	Yes
Owns the Underground Minerals	Yes	Yes	No	No
Ownership Continues after Production Stops	Yes	Yes	No	No
Collects Upfront Lease Bonus Payments	Yes	No	No	No
Has Executive Interest-Leasing Rights	Yes	No	No	No
Pays to Operate or Drill the Well	No (unless participating)	No	No	Yes
Participates in the Lease Operating Expenses	No (unless participating)	No	No	Yes
Significant Tax Advantages	No (unless participating)	No	No	Yes

The drilling of oil and natural gas wells involves the risk that the well will not provide enough revenue to return the amount of your investment. The revenues are directly related to the ability to market the oil and gas and their price, which is volatile and cannot be predicted.
If oil and/or gas prices decrease, then your investment return will decrease.
If you choose to invest as an investor general partner, then you will have unlimited liability during the drilling of the wells for partnership obligations until you are converted to a limited partner. However, you will continue to have the responsibilities of a general partner for partnership liabilities and obligations incurred before the effective date of the conversion.
There is a lack of liquidity or a market for the units. Investors have total reliance on the sponsor or managing general partner and its affiliates. Investors may owe taxes in excess of their cash distributions from a partnership. The investor's deduction for intangible drilling costs may be limited for purposes of the alternative minimum tax. Distributions may be a return of capital.
There is a risk that demand for energy, including for oil and gas, and commodity prices will be decrease. There may also be the possibility of increased opportunities due to the impact of these factors on others. The potential impacts should be considered by you in making any investment decision.