What's News in Tax

Analysis that matters from Washington National Tax

Is Mineral Interest Income Eligible for the Section 199A Deduction? It Depends

June 4, 2018

by Megan J. Whitlock, Robert A. Swiech, and Jeanne Sullivan, Washington National Tax*

Tax reform added a new section 199A[1] that creates a potential deduction of 20 percent of qualified business income from partnerships, S corporations, and sole proprietorships. Availability of the deduction is predicated on the trade or business and income being "qualified," but in many situations application of the new law is unclear. Taxpayers have questioned whether income from mineral interests, such as royalties and working interests, is classified as qualified business income for purposes of the new section 199A deduction. Based on a review of the relevant authorities, this article explains why mineral royalties held for investment are not likely to qualify for the 20 percent deduction and why working interest income may be eligible for the deduction.[2]

Income Eligible for the Section 199A Deduction

To qualify for the new section 199A deduction, a taxpayer other than a C corporation generally must have qualified business income ("QBI") from a qualified trade or business ("QTB"), qualified REIT

---

* Megan J. Whitlock is a senior manager and Jeanne Sullivan is a director in the Passthroughs group of Washington National Tax ("WNT") (Dallas). Robert A. Swiech is a director in the Tax Credits and Energy Advisory Services group of WNT (Houston).

1 Pub. L. No. 115-97, § 11011. Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (the "Code") or the applicable regulations promulgated pursuant to the Code (the "regulations").

2 We do not address in this article oil and gas royalties held by a taxpayer as a dealer or trader primarily for sale to customers in the ordinary course of its trade or business, these royalties are not a capital assets by reason of section 1221(1) and any gain or loss on the sale or exchange of the royalties are ordinary gain or loss.

© 2018 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved.

The KPMG name and logo are registered trademarks or trademarks of KPMG International.

dividends, or qualified publicly traded partnership income from a trade or business. Thus, we must consider whether mineral royalties and working interests are derived from a QTB and treated as QBI.

The definition of QBI for purposes of section 199A includes the net amount of "qualified items of income, gain, deduction, and loss" with respect to any qualified trade or business of the taxpayer for the tax year. Section 199A(c)(3)(A) defines qualified items of income, gain, deduction, and loss as effectively connected with the conduct of a trade or business within the United States within the meaning of 864(c) and provides that the income must be included or allowed in determining taxable income. Section 199A(c)(3)(B) lists exceptions to QBI, including investment type income such as items of short-term or long-term capital gain or loss, any dividend or dividend equivalent, interest income other than interest properly allocable to a trade or business, items of gain or loss under 954(c)(1)(C) and (D),[3] items of income or gain taken into account under section 954(c)(1)(F),[4] any amount received from an annuity that is not received in connection with a trade or business, and any item of deduction or loss allocable to the previously described exclusions.

Section 199A does not specifically include or exclude mineral royalties or working interests, so taxpayers must look to other areas of the Code for guidance. Understanding the nature of the income is the first step.

Working Interest Versus Royalty Interest

To classify income from a mineral interest it is imperative to examine how the income is derived. There are many ways to derive income from natural resources. There are income streams from both surface and subsurface activities as well as from varying types of minerals.

A mineral estate for federal tax purposes, also known as a bundle of legal rights, may be severed from the surface estate. It is possible for the owner of the minerals not to own the surface land. When a mineral estate is separated from the surface land there are generally two types of rights: rights to receive lease benefits and rights to develop the mineral estate.[5] Rights to receive lease benefits include the right to receive bonus payments, delay rentals, and royalty payments. Rights to develop include the right to develop and right to produce the minerals. When the mineral estate owner grants a lease, the right to develop is relinquished and then vests with the lessee operator. This distinction is critical in classification of royalty[6] interest (right to receive lease benefits) versus working or operating interest[7] (right to develop the lease).

---

[3] Section 954(c)(1)(C) & (D) include commodities transactions and foreign currency gains.

[4] Section 954(c)(1)(F) includes net income from notional principal contracts.

[5] Altman v. Blake, 712 S.W.2d 117, 118 (Tex. 1986) (quoting R. Hemmingway, Law of Oil and Gas §2.1-2.5 (1971)).

[6] KPMG, Income Taxation of Natural Resources ¶ 2.12 (2014 ed.), Westlaw (updated May 12, 2017). Defines royalty interest for federal income tax purposes as the right to oil and gas or minerals in place that entitles its owner to a specified fractions, in kind or in value, of the total production from the property, free of the expenses of development and operation. Therefore, it is a mineral interest stripped of the burdens and rights of developing the property.

[7] KPMG, Income Taxation of Natural Resources ¶ 2.13 (2014 ed.), Westlaw (updated May 12, 2017). Defines working or operating interest for federal tax purposes as the mineral interest minus any nonoperating interest or the interest in the minerals in place that is burdened with the cost of development and operation of the property.

© 2018 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved.

The KPMG name and logo are registered trademarks or trademarks of KPMG International.

Do Royalty Interests or Working Interests Generate QBI?

Recall that only QBI may be eligible for the new 20 percent deduction. As noted above, section 199A does not refer to royalties or working interest income or loss as either included in or excluded from QBI. However, based on the exceptions to QBI listed in section 199A and the definition of QBI, it appears that portfolio items are generally excluded from QBI. This is relevant because royalties from mineral interests (royalty interests income) are generally treated as investment-type (or portfolio) assets, while working interests (working interests income) are generally treated as trade or business activities.

Consider how royalty interest income is treated for purposes of the net investment income tax. Section 1411 and section 469 distinguish between trade or business income and loss and portfolio income and loss. Section 1411 imposes a tax of 3.8 percent on "net investment income" of the taxpayer above certain thresholds. Net investment income is defined as interest, dividends, royalties,[8] annuities, and rents other than such items derived in a non-passive trade or business, gross income from passive activities and from the business of trading, and net gain from the disposition of property (other than property held in a non-passive trade or business) minus the deductions allowed and properly allocable to included income. Interest, dividends, royalties, annuities, and rents that are not held in a trade or business are investment assets that are treated as portfolio income under sections 1411 and 469. The section 469 regulations explicitly exclude such items of portfolio income from the calculation of the taxpayer's net passive activity income or loss. Under both provisions, royalties from mineral interests are treated as portfolio income unless derived in the ordinary course of a trade or business.[9]

---

[8] Section 1.1411-1(d)(11). The term gross income from royalties includes amounts received from mineral, oil, and gas royalties, and amounts received for the privilege of using patents, copyrights, secret processes and formulas, goodwill, trademarks, tradebrands, franchises, and other like property.

[9] Section 1.1411-1(d) and section 1.469-2T(c)(3)(ii)(G) requires the income to be identified by the Commissioner as income derived in a trade or business. T.D. 8175, 53 Fed. Reg. 5686, 5690-91 (Feb. 25, 1988). *See also* Market Segment Specialization Program Guideline, Oil and Gas Industry (Nov. 2014), available at 2014 WL 12740037, which states:

> Oil and gas royalties, net profits interests and overriding royalties will generally be considered portfolio income. But there are two situations set out in the regulations that exempt royalties as portfolio income.
>
> Treas. Reg. section 1.469-2T(c)(3)(iii)(B) provides active income treatment for royalties derived in the ordinary course of a trade or business. This exception does not apply to a taxpayer who is not a dealer in royalties.
>
> Treas. Reg. section 1.469-2T(c)(3)(ii)(G) requires the income to be identified by the Commissioner as income derived in a trade or business. The taxpayer must request a ruling to have the royalties characterized as trade or business income. Industry publications suggest that taxpayers should request a ruling to treat oil and gas royalties as nonpassive income derived in a trade or business. Until, or if ever, the Commissioner expands the regulations to include certain oil and gas royalties as business income, oil and gas royalties are to be included as portfolio income.
>
> The determination of whether royalties are portfolio income is made at the entity level in the case of pass through entities, such as limited partnerships and S Corporations.

© 2018 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved.

The KPMG name and logo are registered trademarks or trademarks of KPMG International.

In addition, royalties are not burdened with the costs of production and the sale or exchange of a royalty interest is generally treated as sale or exchange of a capital asset.[10] Also in light of this classification, the deduction under section 199A does not apply for purposes of reducing income subject to the 3.8 percent net investment income tax.

In contrast, a working interest generally is treated as a trade or business activity: It is burdened with the costs of development and operation and the income and loss is generally treated as self-employment income under section 1402.[11] Moreover, there is nothing in section 199A that excludes a working interest in oil and gas from the definition of a QTB. Exclusions under section 199A(d)(1) provide that the term QTB does not include a specified service trade or business or the trade or business of performing services as an employee. A working interest does not meet any of the exclusions described in section 199A(d)(1). Therefore, if the working interest is a domestic trade or business, it appears to be a QTB that produces QBI for purposes of the section 199A deduction.

Parting Thoughts

To recap, mineral royalties held for investment are not likely to qualify for the 20 percent deduction; however, working interest income appears to be eligible. Although it is beyond the scope of this article, the 20 percent deduction for QBI from the working interest income is subject to a wage/qualified property limitation. Thus, additional planning may be needed to minimize the impact of any limitation on the potential section 199A deduction. It is important for taxpayers and their advisors to determine the nature of income streams and navigate eligibility for the new deduction. Moreover, taxpayers should consider quantifying the potential section 199A benefit for 2018 to properly estimate any tax distributions or payments.

The information in this article is not intended to be "written advice concerning one or more federal tax matters" subject to the requirements of section 10.37(a)(2) of Treasury Department Circular 230 because the content is issued for general informational purposes only. The information contained in this article is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser. This article represents the views of the author or authors only, and does not necessarily represent the views or professional advice of KPMG LLP.

---

[10] If the oil and gas royalty is held by the taxpayer for investment, such royalty is a capital asset as defined in section 1221, and any gain or loss on the sale or exchange of the royalty is a capital gain or loss. Rev. Rul. 73-428. Prior section 1.199-3(i)(9) prevented oil and gas royalty interests from receiving any section 199 deduction, even if owned by an oil and gas company that also owned working interests that qualified for the section 199 deduction and the royalty burdened an owned working interest. We do not address the issue of whether a taxpayer owning both the working interest and a royalty interest in the same minerals would be treated as having QBI for the royalty interest under section 199A.

[11] Small individual working interest owner who was not the designated operator of an oil and gas property was liable for self-employment tax on trade or business income. Cokes v. Commissioner, 91 T.C. 222 (1988); and, Methvin v. Commissioner, T.C. Memo. 2015-81, *aff'd*, 2016 WL 3457623 (10th Cir. 2016). The payor of a mineral royalty would generally provide the lessor with a Form 1099-MISC listing the payment amounts as "Royalties" in Box 2 and the lessor would generally report the payments received as royalty income on Form 1040 Schedule E. IRS has indicated that revenue and expenses from non-operating interests should be reported on Schedule E, *Supplemental Income and Loss*, of an individual's Form 1040, *U.S. Individual Income Tax Return*, and will generally not be subject to self-employment taxes and that working interest revenue and expenses should be reported on Schedule C, *Profit or Loss From Business*. IRM 4.41.1.5.1.4 (02-01-2006).

© 2018 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved.

The KPMG name and logo are registered trademarks or trademarks of KPMG International.