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## Is Mineral Interest Income Eligible for the Section 199A Deduction under the Final Regulations? It Still Depends.

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Section 199A regulations do not directly address whether mineral interest income is eligible for the 20 percent deduction. This article explains why mineral royalties held for investment do not qualify for the 20 percent deduction and why mineral working interest income may be eligible for the deduction.

### Overview

The law commonly referred to as the Tax Cuts and Jobs Act ("TCJA") added section 199A,[1] which creates a potential deduction of 20 percent of qualified business income ("QBI") from partnerships, S corporations, sole proprietorships, and cooperatives, as well as 20 percent of the aggregate amount of qualified REIT dividends and qualified publicly traded partnership ("PTP") income.[2] The deduction is applicable to tax years beginning after 2017 and ending before 2026. The U.S. Treasury and IRS issued proposed regulations for section 199A on August 16, 2018,[3] and final regulations on February 8, 2019.[4] Taxpayers may rely on either the proposed regulations or the final regulations in their entirety for tax years ending in calendar year 2018.

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1 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 Pub. L. No. 115-97, § 11011.

3 REG-107892-18, 83 Fed. Reg. 40884 (Aug. 16, 2018).

4 T.D. 9847, 84 Fed. Reg. 2952 (Feb. 8, 2019).

Availability of the deduction is predicated on the trade or business and income being "qualified," and taxpayers hoped that regulations under the new provision would provide clarity as to whether income from mineral interests, such as royalties and working interests, is classified as qualified business income for purposes of the section 199A deduction. However, the final regulations' guidance surrounding royalties is limited to situations in which the taxpayer is receiving mechanical royalties as a singer or songwriter and provides that the income is derived from a specified service trade or business ("SSTB").[5] This example is of little use in the context of mineral royalties, so taxpayers are forced to look at other resources for guidance.

Based on a review of the relevant authorities, including the final section 199A regulations, this article explains why we conclude that mineral royalties held for investment do not qualify for the 20 percent deduction and why mineral working interest income may be eligible for the deduction.

## Income Eligible for the Section 199A Deduction

To qualify for the section 199A deduction, a taxpayer other than a C corporation generally must have QBI from a qualifying trade or business ("TB") held directly or indirectly through a partnership or S corporation, qualified REIT dividends, or qualified PTP income.

The definition of QBI for purposes of sections 199A and 1.199A-3 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. Sections 199A(c)(3) and 1.199A-3(b)(2)(i) define qualified items of income, gain, deduction, and loss as items that are 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. This definition of qualified items of income, gain, deduction, and loss also applies to the definition of qualified PTP income.[6] Thus, the question of whether mineral royalties are qualified for the section 199A deduction is relevant to determining qualified PTP income as well as determining QBI of a taxpayer other than a corporation that is earned directly or indirectly through partnerships and S corporations. In both cases, the items must be derived from a domestic trade or business activity.

Section 1.199A-3(b)(2)(ii) 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 sections 954(c)(1)(C) and (D);[7] items of income or gain taken into account under section 954(c)(1)(F);[8] any amount received

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5 *See* section 1.199A-5(b)(3)(v). Example 5 is the only mention of royalty income in the final regulations and is limited to discussion surrounding SSTB. Further discussion surrounding SSTB limitations and phase-in for individuals is not addressed in this article.

6 Section 199A(e)(4)(A).

7 Sections 954(c)(1)(C) and (D) include commodities transactions and foreign currency gains.

8 Section 954(c)(1)(F) includes net income from notional principal contracts.

from an annuity that is not received in connection with a trade or business; any qualified REIT dividends or qualified PTP income;[9] reasonable compensation received by a shareholder from a S corporation;[10] any guaranteed payment described in section 707(a) or 707(c) received by a partner for services rendered with respect to the trade or business (regardless of whether the partner is an individual or an RPE);[11] 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 important to understand how the income is derived and classified. 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: This means that the owner of the minerals may not own the surface above the minerals. When a mineral estate is separated from the surface land, there are generally two types of rights associated with the mineral estate: the right to receive lease benefits and the right to develop the mineral estate.[12] Rights to receive lease benefits include the right to receive bonus payments, delay rentals, and royalty payments (collectively "Royalty Interests").[13] Rights to develop the mineral estate 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 vests with the lessee operator, and the lessor (original mineral estate owner) retains the right to receive the lease benefits. This distinction is critical in

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9 As defined in section 1.199A-3(c)(2)-(3). In this connection, we note that while the definition of qualified items is the same for QBI and qualified PTP income, the potential deduction for qualified PTP income is calculated separately from the deduction for QBI and so qualified PTP income is excluded from QBI

10 However, per section 1.199A-3(b)(2)(ii)(H), the S corporation's deduction for reasonable compensation will reduce QBI if the deduction is properly allocable to the trade or business and is otherwise deductible for federal income tax purposes.

11 However, per sections 1.199A-3(b)(2)(ii)(I) & (J), the partnership's deduction for such guaranteed payment will reduce QBI if the deduction is properly allocable to the trade or business and is otherwise deductible for federal income tax purposes.

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

13 KPMG, Income Taxation of Natural Resources ¶ 2.11 and 2.12 (2014 ed.), Westlaw (updated July 15, 2019), defines bonus payments as typically paid to a lessor at the time of lease signing as an amount of dollars per acre leased. Delay rentals are defined as amounts paid annually, usually as a dollar amount per acre paid during the primary term for the lease only or until development of the lease commences. The payor of a lease bonus or a delay rental would generally provide the lessor with a Form 1099-MISC listing the payment amounts. A 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. The payor of a royalty would generally provide the lessor with a Form 1099-MISC listing the payment amounts.

classification of Royalty Interests (right to receive lease benefits) versus working or operating interest[14] (right to develop the lease).

## Do Royalty Interests or Working Interests Generate QBI and Qualified PTP Income?

Recall that only qualified items derived from a domestic trade or business are eligible for the new 20 percent deduction and that neither section 199A nor the regulations address Royalty Interests or working interests. However, it is clear that non-trade or business portfolio items are excluded from QBI and from qualified PTP income. As a result, as royalties from mineral interests are generally treated as investment-type (or portfolio) assets, while working interests are generally treated as trade or business activities, income from working interests may qualify for the section 199A deduction, while income from Royalty Interests generally will not.[15]

As an example of the general treatment of Royalty Interests, consider the net investment income tax (section 1411) and the passive activity loss (section 469) rules. Like section 199A(c)(3) and the regulations, sections 1411 and 469 distinguish between trade or business income and loss and portfolio income and loss. Section 469 defines a passive activity as a trade or business activity in which the taxpayer does not materially participate, includes most rental activities, and excludes items of portfolio income.[16] Section 1411 imposes a tax of 3.8 percent on "net investment income" of the taxpayer above certain thresholds and defines net investment income is defined as interest, dividends, royalties,[17] annuities, and rents other than items derived in a non-passive trade or business, gross income from passive activities (as defined in section 469) 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 the included income. The regulations under sections 1411 and 469 address the question of when interest, dividends, royalties, annuities, and rents are held in a trade or business and when such income is treated as portfolio income. Under both provisions, royalties

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[14] KPMG, Income Taxation of Natural Resources ¶ 2.13 (2014 ed.), Westlaw (updated July 15, 2019), 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.

[15] However, it is important to note an exception to this investment-type treatment for a trader of royalties or a dealer that holds the royalties primarily for sale to customers in the ordinary course of its trade or business ("trader or dealer royalty income"). Trader and dealer royalty income is derived from a trade or business of trading or dealing and as a result could meet the criteria for QBI provided the other requirements of section 199A are satisfied. Further discussion and analysis of the dealer or trader exception is outside of the scope of this article.

[16] Sections 469(c)(1), (2), and (e)(1).

[17] 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.

from mineral interests are treated as portfolio income unless derived in the ordinary course of a trade or business of trading or dealing royalties.[18]

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.[19]

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[20] and is subject to special passive activity loss rules.[21] Moreover, there is

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[18] Sections 1.1411-1(d) and 1.469-2T(c)(3)(ii)(G) require 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.
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> 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.
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> 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.

Treas. Reg. section 1.469-2T(c)(3)(iv), Example (4), states: C is a partner in a partnership that is engaged in an activity of trading or dealing in royalty interests in mineral properties. The partnership derives royalty income from royalty interests held in the activity. If the activity is a trade or business activity, C's distributive share of the partnership's royalty income from such royalty interests is treated under paragraph (c)(3)(ii)(D) of this section as derived in the ordinary course of the partnership's trade or business.

[19] 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, 1973-2 C.B. 303. 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. As a result of the treatment under prior section 199, if a taxpayer owned both the working interest and Royalty Interest under section 199A in the same minerals then the portion derived from Royalty Interests would still not be QBI for purposes of section 199A.

[20] 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); Methvin v. Commissioner, T.C. Memo. 2015-81, *aff'd*, 2016 WL 3457623 (10th Cir. June 24, 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).

[21] *See, e.g.,* sections 469(c)(3) and 1.469-1T(e)(4).

nothing in section 199A or the regulations that excludes a working interest in oil and gas from the definition of a trade or business. Therefore, if the working interest is a domestic trade or business, it appears to be a trade or business that produces QBI and qualified PTP income 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, income from a 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 2019 to properly estimate any tax distributions or payments.

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