TMS Wealth Management Conference

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Southwest Mississippi Community College

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Potential Taxes for Mineral Owners

I. Income Taxes

II. Net Investment Income Tax

III. Alternative Minimum Tax

IV. Severance Tax

V. Gift Tax

VI. Estate Tax

- **Income Taxes on Mineral Lease (Lease Bonus)**
  - **Taxed as Rental Income (Unearned Income)**
  - **Reported to IRS and Mineral Owner on Form 1099-MISC as Rental Income**
  - **Subject to Net Investment Income Tax, if Applicable**
  - **Subject to Passive Activity Loss Rules**

- **Passive Activity Loss Rules**
  - **Includes rental activities and trade or business activities in which you do not materially participate (including partnerships and “S” corporations)**
  - **Losses from passive activities may only be taken to the extent of passive income**
  - **Income from mineral leases can be used against other passive losses, including passive activity loss carry-forwards from prior years**
  - **Any passive activity loss not allowed in the current tax year may be carried-forward to off-set passive activity income in future years**

- **Income Taxes on Royalty Payments**
  - **Reported to IRS and Mineral Owner on Form 1099-MISC as Royalty Income**
  - **Owner's share of Gross Production Reported**
  - **Severance Taxes and Other Charges, Including Legal and Tax Preparation Fees Associated with Royalty Payments, are Deductible by the Mineral Owner**
  - **Percentage or Cost Depletion May be Allowed**

- **Depletion Deduction Against Royalty Income**
  - **What is Depletion?**
  - **Depletion is similar to depreciation in that it allows the taxpayer to recover the cost of an asset over the resources useful life**
  - **Percentage Depletion**
  - **Cost Depletion**

- Percentage Depletion
  - Most commonly used by mineral owners
  - Generally 15% of gross production
  - Limited to (1) 100% of taxable income from Well, and (2) 65% Percent of taxable income before depletion
  - Any depletion not allowed due to limitations may be carried-forward to future years
  - Not available against Mississippi taxable income

- **Cost Depletion**
  - **Based on cost basis of minerals and units of production**
  - **Limited to taxpayer's basis in minerals**
  - **The taxpayer may use the higher of percentage depletion or cost depletion against federal taxable income**
  - **Available as a deduction against Mississippi taxable income**

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- **Net Investment Income Tax**
  - **Imposed by the Health Care and Education Reconciliation Act**
  - **2013 and later years**
  - **3.8% additional tax imposed on net investment income**
  - **Includes interest, dividends, annuities, royalties, rents, capital gains, and other passive investment income**
  - **Applies to single taxpayers with modified adjusted gross income of $200,000 or more**
  - **Applies to married taxpayers with modified adjusted gross income of $250,000 or more ($125,000 if filing separately)**

- **Potential Ways to Reduce the Net Investment Income Tax:**
  - **Obtaining leases over two or more years (as opposed to all in one year)**
  - **Contributing to tax deductible retirement plans (401(k), etc…)**
  - **Installment sales**
  - **Timing of dividends from closely held corporations**

- Damage Payments:
  - Damage payments representing reimbursement for lost profits (i.e., crop damages and interruption of surface operations) are generally taxes as ordinary income.
  - Payments for damage to land or property rights are generally characterized as a return of capital and gain to the extent the payments exceed adjusted basis.
  - Payments for anticipated surface damages (as opposed to payments for loss of surface use) are taxable as ordinary income.

- Easement/Right-of-Way Payments:
  - The tax treatment of these payments can vary depending on the nature of the easement.
  - Proceeds from easements that are perpetual or with only a contingent right to reversion are generally treated as a nontaxable return of capital to the extent of the owner's basis in the affected land, and any excess payments over basis is reported a capital gain.
  - When an easement is limited in time and subject to reversion, the grant will typically be treated as a lease and taxable as ordinary income.

- **Potential Ways to Minimize Income Taxes:**
  - **Obtaining leases in two or more years to reduce the overall effective tax rate**
  - **Installment sales of minerals and other assets**
  - **Like-kind exchanges**
  - **Capital Gains v. Ordinary Income**
  - **Utilizing retirement plans to defer income**
  - **Timely payment of taxes to eliminate interest and penalty charges**
  - **Bunch itemized deduction (watch-out for AMT)**

- Like-Kind Exchanges
  - Minerals are considered real property (real estate) for income tax purposes and qualify to be swapped to like-kind property
  - Property like-kind to minerals includes other minerals, real estate such as land, and standing timber
  - Any amount of gross proceeds not used to acquire like-kind property (including cash) will be taxable to the extent of the gain
  - If more is paid for the newly acquired asset, the additional amount paid adds to tax basis

- **Capital Gains v. Ordinary Income**
  - **Selling of minerals may be taxed at the capital gains rate while mineral leases and royalty payments are taxed as ordinary income**
  - **Maximum Federal Long-Term Capital Gains Rate: 23.8% (20% Capital Gains Income and 3.8% Net Investment Income Tax)**
  - **Maximum Federal Ordinary Income Rate: 43.4% (39.6% Ordinary Income and 3.8% Net Investment Income Tax)**
  - **For a sale to qualify for the capital gains rate, the asset must be held for at least one year and one day prior to the sale**
  - **Inherited assets are automatically considered held for more than one year**
  - **Mississippi Maximum Rate: 5%**
  - **Louisiana Maximum Rate: 6% (Louisiana allows a deduction for Federal Taxes)**

- **Retirement Plans**
  - **Utilize retirement plans to defer income out of high income years into future years**
  - **Types of retirement plans:**
    - **Employer and Solo 401(k) plans**
    - **SEP IRA**
    - **SIMPLE IRA**
    - **Traditional IRA**
    - **Roth IRA**

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- **Payment of Income Taxes**
- **Income taxes should be timely remitted to the IRS and state(s) to avoid interest and penalty charges**
- **In general, quarterly estimated tax payments are due if:**
  - **You expect to owe at least $1,000 in tax, and**
  - **You expect your withholding and refundable credits to be the less than the smaller of:**
    - **90% of the current year tax, or**
    - **100% of your prior year tax (110% if prior year AGI was more than $150,000)**

- **The Taxpayer May Also Use the <u>Annualized Income Installment Method</u>**
  - **This method allows the taxpayer to calculate their income tax liability on a quarterly basis and remit the actual tax owed**
  - **This method may be used in lieu of paying estimated taxes**
  - **This method may be more advantageous when:**
    - **Income declined from the prior year**
    - **Income varies during the year or is concentrated later in the year**

- **Ways to Remit Federal Income Taxes**:
  - **Form 1040-ES, Quarterly Estimated Tax**
  - **Electronic Federal Tax Payment System, www.eftps.gov**

    Due April 15, June 15, September 15, and January 15
  - **Form 1040-V, Return Payment Voucher**
  - **Withholding from Wages, Form W-2**
  - **Withholding from Other Income, Form 1099**

Penalties for Underpayment of Estimated Income Taxes

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- Federal Underpayment Penalty
  - For tax year 2013, the underpayment penalty was 3% of the quarterly average underpayment
  - Exception: Farmers and Fisherman who expect to receive at least two-thirds (66.67%) of his or her gross income from the tax year from farming or fishing, or who received at least two-thirds (66.67%) of gross income for the previous year from farming or fishing, may pay one annual estimated payment on January 15th of the following year
  - Farmers and Fisherman who file and pay on or before March 1 of the following year are not required to pay any estimated tax payments
  - After April 15th of the following year, additional interest and penalties may apply

Penalties for Underpayment of Estimated Income Taxes

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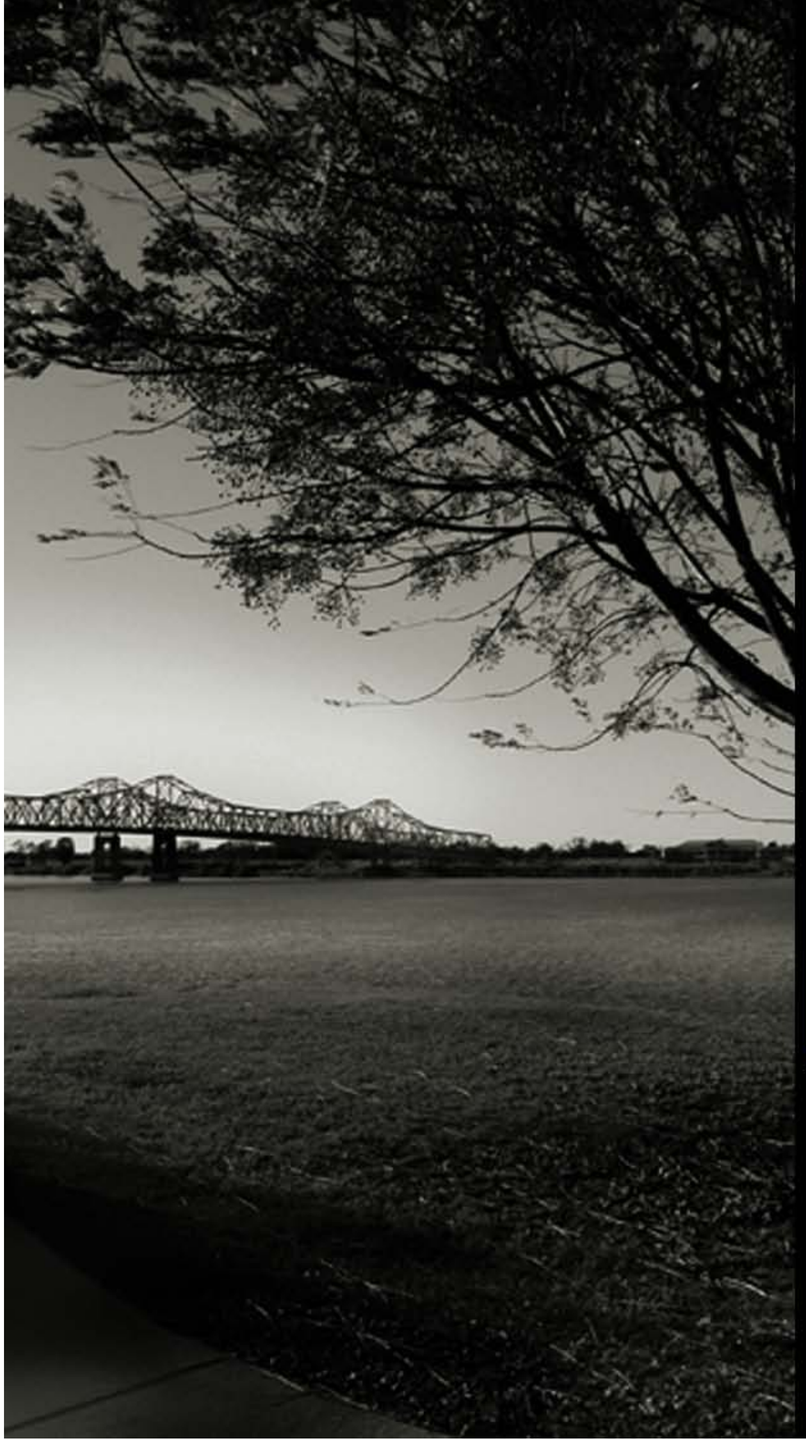
- **Mississippi Underpayment Penalty**
  - **Required to pay the lesser of 80% of current year tax or 100% of prior year tax**
  - **Interest computed as 1% per month**
  - **Exception for Farmers and Fishermen applies**
  - **Annualized Income Installment Method Allowed**
  - **After April 15th of the following year, additional interest and penalties may apply.**

- **Gift Taxes**
  - **Mineral interests gifted to others may be subject to the federal gift tax**
  - **2014 Annual gift exclusion: $14,000**
  - **Spouses who consent to splitting gifts may gift up to $28,000 per donee free of gift and generation skipping transfer tax**
  - **An unlimited amount may be transferred between spouses**
  - **Gift taxes, if any, are filed and paid by the donor**

- **Gift Taxes (continued)**
  - **The donor is allowed a unified credit against gift tax, equal to the estate tax applicable credit amount in effect for the year of the gift, less the sum of all gift tax credits used in prior years**
  - **For 2014, the total unified credit allows for total gifts of $5,340,000 per donor (lifetime exclusion)**
  - **The current maximum tax rate on gifts is 40%**
  - **Valuation Issues and Costs**

- **Estate Taxes**
  - **Federal Estate taxes can be imposed on the transfer of property at the time of a person's death. The estate includes the value of all assets owned by the decedent minus all liabilities and allowable deductions.**
  - **For 2014, the total unified credit allows for a total taxable estate of $5,340,000 per decedent. The unified credit is also used for gift taxes so any prior taxable gifts reduces this credit.**
  - **An unlimited deduction is allowed for property that is transferred to a surviving spouse.**

- **Estate Taxes (continued)**
  - **An unlimited deduction is allowed for transfers to federal, state, and local governments and charitable organizations**
  - **An estate may elect to transfer any unused portion of the deceased spousal unused exclusion to the surviving spouse**
  - **The portability election allows a married couple a combined estate tax exemption of $10,680,000, regardless of ownership of assets**
  - **An estate tax return must be filed to make a portability election**
  - **Valuation Issues and Costs**



? Questions ?

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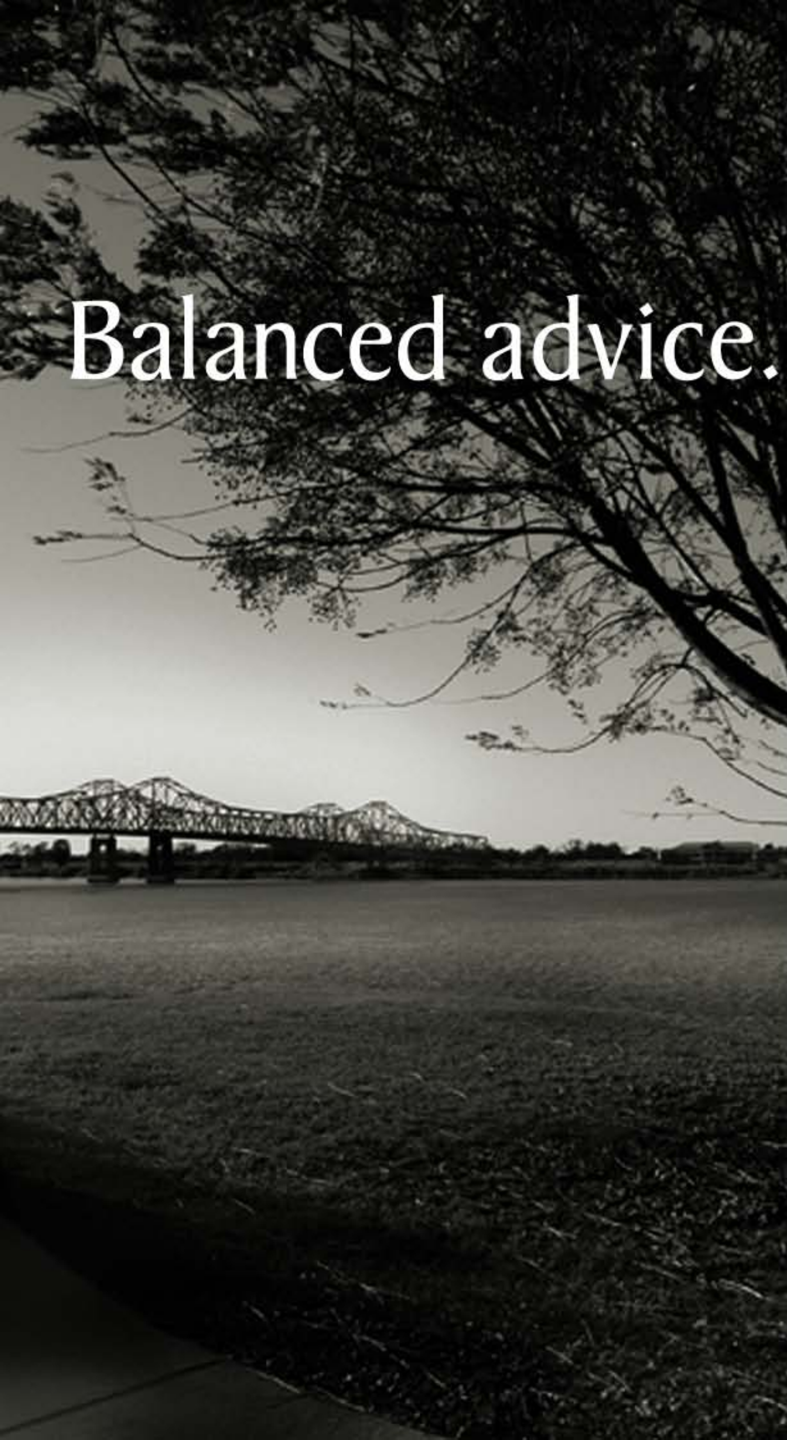

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