

Slide 1

Good afternoon.

My name is Jeff Yourkovich, I am a CPA, Certified Mineral Manager, and the owner of Yourkovich & Associates

My accounting and tax practice is located in Wheeling, WV

I am the Treasurer of the NARO Appalachia Board of Directors and I welcome everyone to my session on Understanding Gas & Oil Tax Reporting.

I hope you find my presentation informative and that you learn a few new things. I have been involved with NARO for 7 years attending conferences and town halls – speaking and attending other gas and oil seminars and conferences across the country.

One of the biggest takeaways I learned was that we are not as smart as the gas and oil companies who have been operating for the last 50 years or more and you are only as powerful in a negotiation as you are knowledgeable and educated on the subject matter.

One of our greatest assets is networking with other mineral owners. Another great asset is Education.

NARO provides that forum and we are glad you have attended to do both.

Do we have any other states besides Ohio in the crowd?

Welcome to all.

Slide 2

My Presentation is called Understanding Gas & Oil Tax Reporting including IRS 1099 Forms

I am not sure the title is entirely accurate because the Gas & Oil Industry may be one of the worst industries for tax reporting, although they seem to have gotten a little better lately.

It seems all of the different companies working in the gas-related fields such as drillers, producers, pipeline companies, and their subcontractors all have different positions on whether payments should be reported, how they should be reported, and on what tax form should the information be reported on.

There can be a lot of confusion and tax reporting chaos that can happen with land and mineral owners' taxes.

My job will be to help you navigate the proper tax reporting of gas & oil payments you are receiving, educate you so that you know if your taxes are being prepared correctly and give some important pointers on how to save money and pay fewer taxes.

In fact – I think you should go home after the presentation and look at your old returns and documents while this info is fresh and determine if some potential problems should be fixed.

This information should also help you become a better negotiator next time your need to sign an agreement with a gas & oil company.

I hope we will have time at the end of the presentation for questions – I have 30 slides to present – so for better management of our time – I will ask that you save those questions until the end. If we run out of time, I will be around this afternoon, feel free to ask me questions or contact me via my website www.yourkovichcpa.com. I also have my business card available.

Slide 3

What is IRS Form 1099?

Form 1099 is a tax reporting document that is filed with the IRS and issued to the Recipient.

IRS requires Form 1099-Misc to be filed when in the course of your trade or business, you have paid the following during the year:

- **\$10 in Royalties (Box 2)**
- **At least \$600 in**
 - **Rents (Box 1)**
 - **Services performed by someone who is not your employee (Form 1099-NEC) – a Subcontractor for example**
 - **Other income payments (Box 3)**
 - **Payments to an Attorney (Box 10)**

1099 forms are Due to the IRS and the Recipient by January 31st each year

Slide 4

Let's take a look at Form 1099-Misc – this is the pre-2020 version blank form where non-employee compensation was included on the 1099-Misc.

Slide 5

Starting in 2020, the IRS changed Form 1099-Misc and added Form 1099-NEC so that the reporting of Non-employee Compensation is reported separately on its own form.

You should not receive this form for any gas & oil payments unless you are actually working for the Payer in a Subcontractor capacity.

If you do receive this Form-NEC, you should immediately contact your CPA and you will need to contact the payer to get this form corrected. This form can cause a future IRS notice if not addressed properly.

Slide 6

This is the current 1099-Misc form.

You will see information boxes for

Payer – who paid you

Recipient Name and SS# - should be you and your correct SS# and your address

Box 1 – Rents

Box 2 – Royalties

Box 3 – Other Income

Box 4 – Federal Income Tax Withheld – amounts there would indicate that you probably didn't complete a W-9 when requested and federal taxes were withheld from your payments – this is referred to as Backup Withholding and required by the IRS when there is no SS# on file.

Note that this is not related to taxes deducted from gross royalty on your royalty statement – those tax deductions relate to severance taxes, not federal income taxes withheld. More on that later.

Also, if your SS# is blank - that is going to be a problem. This means the payer sent FIT to the IRS with your name but no SS# to identify the payments. When you put the withholding on your return, the IRS will issue a letter holding your return, denying your refund, and requesting additional information to process the return.

I had several clients with this issue over the last couple of years and it took multiple months to resolve and I even had to get a Taxpayer Advocate involved on a couple of them.

Please be aware when you start receiving royalty payments and reviewing the royalty statement to determine if backup withholding is taking place and federal income taxes are being withheld. Get corrected immediately if this is the case.

Box 17 – State – which indicates what state the income was derived from – more on this a little later.

Let's take a little closer look at these boxes and what should be reported in each box.

Slide 7

Box 1 – Rents

What type of payments should appear in Box 1 Rent?

Paid-up Lease Bonus Payments – this is our initial money for signing a lease – typically a 5-year paid-up lease

Temporary Workspace and Access Payments – receiving money for companies working on or accessing your property for a short period

Short-term ROWs and Easements – “R” “O” “W” stands for Right of Way – temporary roads, temporary waterline – ROWs and easements lasting a year to a couple of years but not permanent

Delay Rentals – which is the consideration paid to the lessor by a lessee to extend the terms of an oil and gas lease in the absence of operations and/or production that is contractually required to hold the lease.

Shut-In Payment - A shut-in payment allows a lessee to temporarily cease production (i.e., shut-in a well) and pay a shut-in payment to the lessor in place of the royalty on production that is not occurring during the shut-in period.

All of these types of payments are taxed as Ordinary Income

I will talk about Ordinary Income and Capital Gain Income throughout the presentation – these indicate different tax rate schedules – which we will discuss in detail as we go on

Slide 8

Box 2 - Royalties

Hopefully, most of you are receiving production royalties and if not, you most likely will at some point in your future.

Royalties are reported in Box 2 of the 1099-Misc as a GROSS Royalty amount

Gross means before deductions

Box 2 will not equal the total of all your royalty checks received if you have a Lease that allows deductions

Or if the producer is taking deductions anyway

It WILL equal your royalty checks if you are fortunate enough to have a No Deductions Lease

This is where you need to read your lease. If you don't know what type of lease you have - let a competent professional landman or attorney look over your lease and see if it allows for deductions or not

Typically, your lease will allow deductions unless it specifically states in an Addendum it is a "No Deductions Lease" or something like "All royalties due shall be based upon gross proceeds without any deductions"

Compare your 1099 with your royalty check statements

Some producer royalty 1099s will have the deduction information on or with the 1099 – I will show you a producer list explaining this in more detail later in the presentation.

Knowing if you have deductions from your gross royalty is important

Producer deductions are tax deductible expenses – let me repeat that – producer deductions are tax-deductible

Slide 9 Royalty Owner Statement

Here is an example of a royalty check statement from Southwestern Energy (SWN) – which is a dominant producer in the northern panhandle of WV.

Thanks to the support of NARO and WV Legislature passing 2018 House Bill 4270 The Check Stub Bill requires that all royalty checks from horizontal wells contain certain basic information such as API number, amount of oil, gas, and NGLs produced, price those products are sold for, owner's share of the unit and any deductions from the gross income. OHIO does not have that law requirement yet but I believe it is something NARO Ohio is working on.

Hopefully, you are receiving a royalty statement similar to this one because it has a lot of good information on it. Others may not be so specific or detailed.

So, we would look to the Owner columns to see what our owner gross is (these total amounts would match our 1099 Box 2 figure) and the owner share of taxes deducted and expenses deducted to arrive at the net check that is issued to the mineral owner.

The royalty statement also tells you the

Production Month

What product was produced – Gas – Natural Gas Liquids – Oil

The Volume that was produced and Price it was sold at to arrive @ Gross Value

Deductions from the Gross Value

Severance taxes associated with the property

Various deductions such as

Gathering Fees

Cost of treating the product

Cost for marketing the product for sale

Transportation costs

Etc., - as mineral owners we probably never really know why or what they are deducting – because the amounts do not seem consistent or verifiable. We are not getting into that discussion today. What is important today is – if it is getting deducted from your gross – that you deduct it on your tax return.

And then the Last column shows your Net Check amount

Slide 10

Now on to Box 3 of the 1099-Misc – Other Income

This is like the catch-all for all other payments that you might receive related to your gas and oil activity.

And sometimes you will have amounts in Box 3 that should have been reported on a different form or different box

But common items that will be reported in Box 3 are

- Well Pad or Spud Fee
- Payments for Crops – most likely hay
- Timber payments – the cutting down of your trees
- Income received to allow for Seismic Testing on your property
- Payments for Roads
- Temporary use payments – usually related to building and activity along your easement or moving equipment along a right of way path
- Easement and ROW payments
- And payment for Damages – probably the most misunderstood payment in the gas and oil industry
 - We have a lot of misinformation out there on Damages
 - Landowners may have negotiated damage payments such as a 60/40 split and been told that damages are not taxable or damages are not reportable.
 - Damages can be amounts not specifically allocated to the ROW cost
- So the real question is “In place of what were the damages awarded?”
 - Payment for damage to property = recovery of capital
 - Payment for use of property = ordinary income
 - Payment for lost profits = ordinary income
- Prepaid damages where actual damage has not been incurred is Ordinary Income
- The truth is Damages are reportable and taxable.
 - There is an ability to offset damages if actual damage is incurred and you have Basis in your property
 - We will discuss this a little further in a minute

All of these payment types can be reported in Box 3 – Other Income

Where should they be reported on the tax return?

Should I report the income on Schedule 1, Line 8 – Other Income on my federal tax return?

I received a 1099-Misc with an amount in Box 3 Other Income and Schedule 1, Line 8 of the Federal tax return Form 1040 says Other Income – sounds like a match, so it should just go there – Right?

Great Question and one I hope you ask your tax preparer and more importantly, did your tax preparer ask you about the facts and documentation surrounding the payments received?

I would say the high majority of the time, the payment SHOULD NOT be reported as Other Income.

If we review a return that a taxpayer has an amount on Line 8, schedule 1 of the 1040 and they received a 1099 with an amount in Other Income Box 3, we will generally find that you have misreported the info on your tax return and worse yet, you have also overpaid on your tax return.

As long as you are within the 3-year window to amend your returns, I will fix the return and get you a refund.

Slide 12 Client Example

Let me give you an example of an actual client scenario.

Client received a 1099-Misc with an amount in Box 3 Other Income for \$100,000.

We obtained all the documentation and discussed with the client about the property basis.

After reviewing the documentation and understanding what activity took place we were able to determine that \$97,000 of the \$100,000 was for

- Timber Sales
- Permanent Pipeline ROW
- Permanent Road ROW

Sale of Timber and permanent Right of Ways and Roads all Qualify for Long-Term Capital Gains

We also learned the facts about how the property was obtained through a purchase so we have Basis in the property we could use to offset some of the \$97,000

The other \$3,000 was determined to be for Temporary Workspace and taxed as Ordinary Income.

Our Conclusion: The difference in reporting as Other Income and Reporting based on the facts and documentation was almost \$25,000.

Slide 13

This is where we talk about the difference between Ordinary Income and Capital Gain

You have heard me mention “taxed as Ordinary Income” and “taxed as capital gains”

What is the difference and why do we care?

Taxed as Ordinary Income

Means taxed at your marginal tax rate – which is the rate at which the additional income would be taxed – we have a tiered income tax bracket system – income is taxed at different rates at different levels of income – rates go up as income goes up

- 2022 federal tax rates are
 - 10, 12, 22, 24, 32, 35 and 37 percent

Taxed as Capital Gain Income

- Means Taxed at capital gain tax rates – these are different tax rates for income that qualifies as long-term capital gains
- 2022 capital gain rates are
 - For tax brackets 10% and 12% pay 0% Yes -0- %
 - For tax brackets 22% and above you pay 15%
 - And then for high earners of \$459,7500 single and \$517,200 MFJ the capital gain rate is 20%

So you can see a difference in paying -0-% and 10 or 12%

And also a difference in paying 15% versus paying 22, 24, 32, or 35% taxes

There can be a pretty big difference if payments are eligible for capital gain treatment versus being taxed at ordinary income tax rates. So we want to take advantage of all payments that are eligible for capital gain treatment.

I want you to pay the least amount possible.

I also need to mention there is an additional tax called the *Net Investment Income Tax* which came out under President Obama and the passage of the Obamacare tax laws

Slide 13 – Continued

Income from Interest, Dividends, Capital Gains, Rental, and Royalty Income are subject to a Net Investment Income Tax of 3.8% if your Federal Adjusted Gross Income is

- **Single > \$200,000 MFJ > \$250,000**

I will say that preparers and people that include amounts on the Other Income line when they should not are also avoiding the NII tax, which is incorrect.

We recently amended tax returns for a couple in Adena, Ohio who was using a part-time tax preparer (who worked as an auto parts clerk during the day) and reported their royalties as other income.

They did save on the NII tax, they only paid \$150 for tax prep, but the 2019 and 2020 tax returns were \$33,000 wrong that will now get refunded after I amended the returns.

We had to almost beg the client to look at their tax returns (their nephew worked in my office) because they trusted and worked with this preparer for a long time.

These returns were so badly prepared that I called the preparer to tell her all the things she did wrong and to send any other gas clients our way and quit doing tax returns for these types of clients.

The client paid \$150 a year to get a \$33,000 wrong answer. Not a good deal. Have a knowledgeable CPA do the work.

We helped them get a refund of \$150k for 2021 when they had ROWs, producer deductions, and depletion to report.

Slide 14

I have mentioned Basis a few times – I mentioned it in the client example a few slides ago

I get asked a lot - What is Property Basis?

Basis is the amount of your investment in property for tax purposes.

We use basis to figure depreciation, amortization, depletion, and gains or losses from the sale or disposition of the property.

Your basis is usually your Cost – what did you pay for it?

In the stock world, you pay \$50 for Microsoft stock you have a \$50 cost basis in that stock

You sell it for \$75 – you pay on the difference - \$25 is taxable

Same type of premise when we apply it to Property Basis

You can have some adjustments to basis - Improvements to the Property can increase your Basis

Expenses such as depreciation and depletion decrease your Basis

If you inherit property your basis in the property will be determined by the Fair Market Value of the property at the time of the Decedent's Death – you need the property appraised to arrive at that value

When we have permanent ROWS and easements – they are considered sales for tax purposes and we can use the basis against the sales income

Quick example of how you would use basis on a property sale

You inherited 10 acres that was appraised at \$10,000. You have a \$1,000 per acre basis.

You agree with a pipeline company to allow for a 50-foot permanent ROW along 1,000 feet of your property

$50 \times 1,000 = 50,000$ sq ft – divide that by an acre which is 43,560 sq ft and you get a 1.15 acre ROW

$1.15 \times \$1,000 = \$1,150$ basis I can use as an offset against the amount I received for the ROW

And then I will pay capital gain taxes on the difference. So if the pipeline company paid you \$20,000, I would pay taxes on \$18,850 (continued on next page)

Slide 14 – Continued

We also can offset damage payments against basis - If you have actual provable damages you can offset those payments against Basis. The offset reduces your Basis calculation.

So in this example – my original basis is \$10,000 less the \$1,150 I used for the ROW = \$8,850

If I also receive timber damage of \$2,850 - I can now offset the entire \$2,850 against the income and further reduce my basis to \$6,000. This is why establishing your basis is important – it helps save taxes.

Your basis cant be reduced below -0- so once you have used it all - you're done.

It is the responsibility of the taxpayer to keep accurate records of all items that affect basis of property

Let's talk about a different 1099 for a minute – Form 1099-S

1099-S is a form to report the Gross Proceeds from a Real Estate Transaction which would be a sale or exchange of any present or future ownership interest in any improved or unimproved land.

We would rather see Easements and ROW payments be reported on a Form 1099-S

Why do we like to see items reported on 1099-S?

- 1. It gives rise to a capital gain transaction which qualifies us for a lower capital gain tax rate.**

- 2. It is not reported on 1099-Misc Box 3 which can sometimes trigger an IRS notice when we report the information on a different form other than Schedule 1, Line 8 Other Income of the 1040.**

- 3. In negotiations, you can request that any or all payments related to easements and ROWs be reported on Form 1099-S.**

Slide 16

Why does the Reported Tax Form matter?

IRS matching program can create issues when filed tax returns do not match the IRS computers – this is one thing the IRS is good at

- Take your tax return on one side and all the tax documents filed with the IRS on the other side - the IRS computer matches things up to make sure everything is reported
- When Mismatched returns and filed forms do not match – this will create an IRS CP2000 Notice
- When this IRS notice is generated and mailed to you – these notices usually have a large balance due and says it needs to be paid in 30 days.

What happens if you receive this Notice?

- Don't panic

If your return was prepared correctly and you can support the filing you will need to send correspondence to the IRS with supporting documentation to clear up the matter

- Here is where we filed the amounts
- Here is why we filed it that way
- And here is the supporting documentation for the where and why
- We have had 100% success sending the documentation back to the IRS and they accept the return as originally filed

This is why we ask for all documents regarding payments so we have the support if needed and there are no worries about how we reported the information on the tax return.

If you can't support your position or if the documentation suggests the payments should be treated differently – this is where you could get in trouble.

Did your preparer ask for all your documents related to the payments you received?

If not, I would say your return was prepared incorrectly and may have cost you a considerable amount of money. And it could be wrong, where it benefited you to be wrong and cost you less money – if this is the case – you better hope the IRS doesn't find the mistake – and you owe them the correct amount plus penalties and interest.

Slide 17 Pipeline ROW Example

Let's go through a Pipeline ROW example - we did not prepare this return – we just reviewed the return. Probably should have done it because it was done wrong.

Here is a payment receipt from Rice Midstream.

As you see the landowner received \$21,559 for their 25% interest in a Pipeline ROW transaction –

there were 4 joint owners of the property so his portion is 25% or $\frac{1}{4}$

How many types of payments did the landowner receive?

What is taxable as Ordinary Income, Self-employment Income, or Capital Gains?

How many think there is (1) payment and (1) reporting issue?

How many think there is (2)?

Any other guesses?

The landowner receives 5 different types of payments and 5 different reporting scenarios in this transaction. There is a

1. ROW payment
2. Damage payments for the ROW
3. Crop Damage
4. Timber Damage
5. Temporary Workspace

All have some differences in how we report and where we report.

Slide 18

Landowner received one check for \$21,559

Landowner received (2) tax forms at the end of the year.

A 1099-S for \$6,202.50 and a 1099-Misc Box 3 for \$15,356.50.

Wait a minute – I agreed to a 70/30 split on ROW and Damages – landman told me Damages were not taxable. What are these forms?

The forms do total the entire check of \$21,559 – what do I do?

I guess my thoughts of non-reportable and non-taxable income are gone – well you should have never had them in the first place.

Why were these particular forms prepared and issued?

The ROW is a sale of RE so it was reported on the 1099-S. The ROW that was recorded was for \$30/ft – so \$30/ft ROW for 827 feet x 25% Interest = \$6,202.50

But - I got paid and negotiated \$100 a foot, so

The Other \$70/ft negotiated as Damages was reported as Other Income – because all payments are reportable.

The Crop damage, Timber Damage and temporary Workspace were also reported as Other Income in Box 3.

Slide 19

Where do we report these payments on our tax returns?

ROW and Damages are reported on Form 8949 or Form 4797 depending if the property is trade or business property

Use Form 8949 if NOT in a trade or business and

Use Form 4797 if the property is used in a trade or business such as a farm

ROW and Damages can be offset by Basis if applicable

Crop Damage is reported on Schedule F if the property is in a Farming operation and can be subject to Self-employment taxes.

If not operating a farm then the crop income is ordinary income reported as Other Income

A quick story about a client who thought he was getting the best of a pipeline negotiation by negotiating a \$130,000 crop payment. The client a few years beforehand wanted to be in the farming business so he could write off purchases, so he started a farm. By negotiating a \$130,000 crop payment he now created \$130,000 in self-employment income which could be an additional 15.3% SE tax on top of his income tax rates. Be careful what term you negotiate as payment and how it could eventually affect your taxes.

Timber Damage and the amount paid for the Pipeline company cutting down your trees will be reported on Form 8949 or Form 4797 depending if the property is trade or business property

Timber amounts can be offset by Basis if applicable

Temporary Workspace is taxable as Rental Income and reported on Schedule E. This income is taxed as ordinary income.

A lot of possibilities in this transaction – things are not always apparent to what took place – that is why the documents are very important. What was agreed upon? What am I being paid for?

(continued)

Slide 19 continued

There were 4 owners of this land – if they all went 4 different places to have their taxes done – they might get 4 different answers – if you go to a CPA who knows – you should get the same answers. I just explained the correct answer.

Another quick example – two neighbors receive a \$100,000 ROW payment

Neighbor #1 Negotiates a 30/70 split between ROW and damages.

Neighbor #2 Negotiates a 60/40 split between ROW and damages.

Did one neighbor get a better deal than the other?

Nope – they both have \$100,000 in income

Split only matters if they have usable Basis and provable damages

Slide 20

Let's talk about a few basic myths and incorrect reporting problems. Many of the people in this room are probably guilty of some of these over the years.

Landman told me that damages are not taxable. I believe everyone has heard this once or twice before whether it was from a landman, a neighbor, or a friend.

- Landman does not know or care about the IRS rules – they just want your signature. Your neighbors and friends should also not be preparing your taxes unless they are your qualified CPA.

Damages are Not Taxable so I am not reporting it on my return

- If it shows somewhere on a 1099 you will have an IRS Notice in your future if not addressed appropriately

I will deduct the amount of Damages as an Expense

- Damages are not valid expenses and not a proper deduction – you didn't have an actual expenditure or payout
- If you did have a payout to repair the damages and you are getting reimbursed – then they can offset

I will deduct the Damages as Basis against the Total amount received

- You need to have actual determinable Basis and keep that Basis calculation in your records to properly deduct the basis from the proceeds.

We could probably have a really long discussion on BASIS and DAMAGES and have arguments from everyone in this room, but the IRS code and laws govern the treatment of these payments not your perception or misinformed facts. I would be glad to address some of the arguments or questions later.

Slide 21

Let's switch back to Royalties – Royalty Income and Royalty Expenses and talk about Depletion

What is Depletion?

Depletion, like depreciation, is a form of cost recovery.

Just as the owner of a business asset is allowed to recover the cost of an asset over its useful life, a mineral owner is allowed to recover the cost of mineral property. Even if you didn't pay for the mineral property or have Basis in the mineral property, the IRS still allows for a depletion expense.

Depletion is almost the last FREE thing you will find in the tax code.

Depletion is taken over the period that the mineral is extracted.

Two forms of depletion are allowed:

- **Cost Depletion**
- **Percentage Depletion.**

The taxpayer is required to use the method which will result in the greatest deduction.

Recent proposed legislation has debated removing the Depletion Deduction from the tax code.

NARO as an organization protects Depletion in the tax code through its lobbying efforts – paying your membership dues of \$150 is important just for that reason only – if you received just \$1,000 in royalties you are breaking even on keeping depletion in the tax code.

Percentage Depletion is the most commonly used method for mineral owners and what is used by all of my clients

The Percentage Depletion Rate is 15% - so you will never pay more than 85% of your royalty income. For shoppers, this is like a permanent 15% discount.

The amount of the deduction allowable under percentage depletion is not limited by the basis of the property. Meaning I don't need to establish basis to deduct depletion. And also my basis can be -0- and I can still deduct Depletion.

Depletion is Calculated on the Gross Royalties

There are some limits – but they are related to your taxable income – Depletion is limited to

- **100% of your taxable income from the property figured without the deduction for depletion**
- **65% of your taxable income from all sources, figured without the depletion allowance**

So it is possible to be not eligible for Depletion based on your income. If not eligible in a year, the calculated depletion will carry forward until you have enough income to take the depletion carryover.

Look at Line 18 of your Schedule E – if there is no amount there – you overpaid your taxes because you didn't take an eligible deduction to lower your taxable income. As long as you met the income limits I just talked about, there should be an amount equal to 15% of your Gross on Line 18 of Schedule E. We see a lot of mistakes by uneducated preparers, self-prepared returns and mineral owners who live outside of Appalachia and have their returns prepared by people who don't understand gas & oil taxes.

For PA mineral owners – PA tax laws do not allow for percentage depletion – so you can take the 15% on the federal return – but not on your PA return.

Slide 23

Let's talk about eligible expenses and reporting royalties on our tax returns.

We report Royalty Income on a Schedule E – Rent and Royalty Schedule

What expenses can I use to reduce my royalty income?

Lease negotiation fees – did you pay someone to look over documents

Legal and CPA fees – I deduct the fees you pay me to prepare your taxes correctly

Travel if required to negotiate agreements or attend conferences or town halls like today – or even travel to your CPA's office

Real estate taxes – taxes paid on the mineral property – In WV minerals are assessed separately from your house

- In WV, I tell mineral owners to save for future RE Tax Bills – WV is two years behind on assessment
- 2022 tax assessment is based on 2020 calendar year production
- Ohio does not make a separate assessment for mineral RE taxes, but still needs to be calculated for the tax deduction

NARO Membership and any conference and registration fees are eligible expenses

And the big one

Expenses deducted from royalty payments by the Lessee – the expenses we talked about when I had the SWN royalty statement on the screen

Expenses deducted for

Severance taxes, Gathering Fees, Cost for treating the product, Transportation costs, etc. – anything that was withheld from my gross royalty check

And the of course - Depletion – which we just talked about.

Slide 24

With all of that being said, here is what a completed Schedule E should look like.

You can see what is reported

Gross Royalties

My fee for tax preparation

Taxes paid on the property

15% percentage depletion expense

And the expenses deducted from my gross royalty that appear on my royalty check statement.

Arriving at the Net Income which I will have to pay ordinary income taxes at my marginal tax rate.

Anything missing?

Yep, this taxpayer is not a NARO member – so they are not getting the educational information like today and did not deduct their membership dues.

Slide 25

Here is a sample list of producers (our actual list is more than one slide can hold) that have come through my office from clients.

I have identified whether the company reports deductions or the source state on or with the 1099 form

You can see the gas company name and in the Deductions column – a YES means they report deductions on or with the 1099 or

RED NO means that information is not available

When I say On or With the 1099 I mean it is either on the Front of the 1099, on the back of the 1099 or sometimes the info is attached on additional sheets included with the 1099.

Some report the deductions information as a YTD amount on the royalty checks – if there are deductions we need to find the information somewhere so we are calculating our taxes correctly

I also have a column for State - Box 17 of the 1099 shows the state – this is meant to be where the property is located - Should not be the address of the recipient but the state where the property is located

This list shows some problems – the Red NO's

Can you always TRUST the information on the 1099?

That answer is also NO – I do have trust in some companies such as SWN, Ascent, Equinor, and others but you can see examples like Triad Hunter in 2019. They switched software during the year and only deductions from August through December 2019 were included on the 1099.

You can prepare your own spreadsheet by month that shows Gross, Taxes Deducted and Other Deductions and the Net Check and then add it up and total it for the year.

When the deduction information does not appear or is blank it is best to reconcile your checks for the year.

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Slide 25 – Continued

Energy Corporation and Patchwork Energy report the NET Royalties — you will need to get all of the royalty check stub statements to get the gross royalty amounts so you can calculate the higher available depletion amount.

NET vs GROSS - Don't think it makes much of a difference on a Depletion calculation

We consulted with a large gas and oil client and after a review determined the accountant was calculating depletion on the net royalty checks. Because they had leases that allowed deductions, calculating depletion on the net resulted in a significantly lower depletion amount. One producer deducts for the year was \$600,000

$\$600,000 \times 15\% = \$90,000$ which was the lost additional depletion expense they should have taken.

$\$90,000 \times 50\%$ tax rate (approximately) = \$45,000 in overpaid taxes lost by this type of mistake

You can see that this screen has lots of potential for mistakes to be made.

You also see where some do not report the state. Why does the state matter?

Slide 26

Source Income

What is Source Income?

- **Income derived from Property located in a State**
 - **Gas Leases**
 - **Royalty Income**
 - **Pipeline-related Income**
 - **Sales of Property including Mineral Interests**

Where is it taxable?

- **Taxable to the State where the Property is Located**
 - **Regardless of your residency**

Example: Ohio resident receives a gas lease bonus on property located in WV = Taxable to WV and reportable on a WV non-resident tax return. Will receive a tax credit on the Ohio return for the taxes paid to WV.

Important for the tax preparer to know where the property is located to recognize the necessary state filing requirements that will be needed.

Slide 27 Ohio Tax Issues

A couple of tax issues specific to our Ohio land and mineral owners

Ohio has something called an Ohio Business Income Deduction

This deduction has been around since 2013 thanks to Governor Kasich - which allows you to deduct the first \$250,000 of business income from taxation. Business income usually includes income reported on Schedules C, E, and F on your federal tax return. This is a Great tax break in Ohio. No such luck in my home state of WV.

Royalty income alone will not justify the ability to take this deduction.

If there is income-producing property, Such as a farm or rental property, where mineral royalties being paid is located, then you can justify taking the Business Income Deduction.

If you placed your mineral interests in an LLC or Family Limited Partnership and you now receive a K-1 with your share of the income, the fact that you receive a K-1 or that it is in an LLC does not automatically qualify you for the BID.

Royalties are passive income, and thereby not eligible for Ohio BID, and changing the way you receive them to an LLC does not change the fact that they are still passive income.

This comment may come as a surprise to some Ohio mineral owners.

We only use the business deduction on royalty income when the surface property also produces taxable income – such as a farm, business, or rental.

Let your CPA evaluate your eligibility for this deduction.

Slide 27 – Continued

Ohio also has an Ohio Commercial Activity Tax known as CAT Tax

Years ago, when Ohio did away with business personal property taxes they implemented the CAT tax.

You are subject to CAT tax once your taxable gross receipts exceed \$150,000.

Your Paid-up lease bonuses, rent, and royalties are all subject to CAT.

From \$150,000 to \$1 million – the tax is \$150.

<u>Taxable Gross Receipts</u>	<u>Annual Minimum Tax</u>	<u>CAT</u>
\$1 Million or less	\$150	No Additional Tax
More than \$1 Million but less than or equal to \$2 Million	\$800	0.26% x (Taxable Gross Receipts - \$1 Million)
More than \$2 Million but less than or equal to \$4 Million	\$2,100	0.26% x (Taxable Gross Receipts - \$1 Million)
More than \$4 Million	\$2,600	0.26% x (Taxable Gross Receipts - \$1 Million)

Ohio Tax Dept is somewhat contradictory when it comes to royalty income - they say you are not eligible for the Ohio Small Business Deduction but have to pay a Commercial Activity Tax.

I do recommend if you take the BID that you should also be paying and filing the CAT tax returns.

Slide 28

A lot of talk this evening about Form 1099 form that we receive in the mail – but
What happens if you don't receive a 1099?

Maybe the Payor did not issue a tax reporting form for damages, selling your mineral interests, or whatever payment you received – what do you do?

You are responsible to report all forms of income regardless if you receive a tax document

In some cases, the payer sent the tax form to the IRS but you didn't get it in the mail

For a bad address or you moved or it was lost in the mail.

We talked about the matching program, if the IRS has it and you don't – there is going to be an issue.

Tax fraud is a felony and can land you in jail – the IRS can also go back 6 years when you have concealed your income – and Fraud has no statute of limitations.

The penalty for Not Reporting is steep

On top of the taxes and interest you will owe, You can be assessed an additional accuracy-related penalty of 20 or 40% of the tax due.

So, the original taxes + interest + 40% penalty + state tax costs could be an extremely costly tax issue, interest and penalties can add up if you get caught. Save yourself the extra interest and penalties and get it right the first time.

Starting in 2018 – there is a 20% deduction for Qualified Business Income – these rules are complicated. Passive income from Mineral ownership is not eligible for QBI. We are not getting into all the characteristics of what qualifies or not today – but what I want you to know is – if you take this deduction and you are not eligible – you could be subject to the Accuracy Related Penalty.

We only have a couple of clients (out of 300+) receiving royalties that are eligible for QBI.

Slide 29

We discussed receiving 1099s – now a quick discussion on – Do I need to issue a 1099?

If you are in a trade or business, farmer, rental property owner, or business owner you would be required to issue 1099s if you meet the guidelines. The tax return schedules you file all ask –

Did you make any payments that would require you to file Form 1099?

If yes, did you or will you file all required Form 1099?

You may also need to issue a 1099 to other owners of royalties if you are the primary name on the account and your SS# was used to report 100% of the royalty income.

Typically if you are just receiving royalties – you are not in a trade or business and you would not be required to send 1099s.

The Penalty for not filing a 1099 to the IRS and not sending it to the Recipient is

- \$1,080 per 1099 not filed
- No Maximum penalty
- Five (5) 1099s should have been filed equals a \$5,400 penalty

This penalty is why gas and oil companies send 1099s even if they are wrong.

If the IRS was smart – they would audit a pipeline company – look at their check register for landowner pipeline payments – determine if they issued 1099s for all of those payments and then look at the landowner's tax returns to see if they reported the payments.

We covered a lot and you may not remember it all. My powerpoint slides will be made available through NARO.

I hope this was informative and you know a little more than before today, you know to ask better questions and you know that there are complicated and costly aspects of gas and oil tax reporting so please see a knowledgeable and qualified CPA to assist you with your tax preparation.

Do not trust your gas and oil taxes to a “No experience Required” preparer. If you are paying \$100 for tax prep or you are doing it yourself – there is a significant chance that the tax return is wrong. I just looked at a return this week, the preparer charged \$106 which included sales tax and the return was \$44,000 wrong. I also gave you the example of the Adena, OH couple earlier.

Do not file a return just to comply with the requirement to file a return – file to get it right and pay the least amount of taxes. Pay a professional, I will save you a lot more money over the years than I charge you.

Show of hands – how many people had their taxes prepared by a CPA?

Good – for the rest of you I hope you took notice of why a qualified CPA is a good choice.

Since you are here today and hopefully paid attention to what I explained you should be able to review your prior returns and see if you notice if something doesn’t appear right.

Please review your prior years’ tax returns and if you think a gas and oil activity was misclassified or not properly reported – you have 3 years to amend your return. 2019, 2020, and 2021 are eligible to be fixed.

Slide 31

NARO needs your support and NARO can be the association that can help make changes in the law to benefit mineral owners

The gas and oil companies have droves of people advocating for their interests. NARO fights for your interests and we are only as strong as our membership, we need your support and welcome your feedback.

I hope you continue to educate yourself and I hope you take your mineral and property ownership seriously and think of it like a business. The decisions you make are multi-generational.

In the time remaining, I would be glad to take any questions and I thank you for your time.

I will also be around the conference and feel free to ask me any questions after this presentation.