INTERNAL REVENUE SERVICE

IRS Fact Sheet

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Tips on Reporting Natural Resource Income

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Taxpayers who own land that contains valuable natural resources should be aware that arranging for the development of the resources by means of a lease creates tax consequences.

Landowners may make complex financial agreements to receive royalty, bonus or other income in exchange for access to the resources on their land, such as natural gas and oil from shale deposits. Here are some important facts from the Internal Revenue Service about these transactions.

Lease Agreements

Natural resource extraction agreements involve payments for extracting resources such as oil and gas. Payments can include delay rental, royalty and lease bonus payments.

Taxpayers who receive these payments are royalty owners who do not have a working interest in extraction operations. Taxpayers should normally report these payments as income on Part I of Schedule E (Form 1040), Supplemental Income and Loss. Income reported on Schedule E is usually not subject to self-employment tax.

Taxpayers who do have a working interest in the extraction operations are subject to self-employment tax, and must file Schedule C (Form 1040), Profit or Loss from Business.

Leases and Lease Bonuses

Taxpayers/lessors typically receive a lease bonus from a lessee — the party that extracts the natural resource — in consideration for granting the lease. A lease bonus may be paid in a lump-sum or multi-year payments. The lessee should provide the taxpayer with a Form 1099-MISC, Miscellaneous Income, listing the amount of bonus payments as “Rents” in Box 1. Taxpayers usually report their lease bonus income as rent on Schedule E.

Royalty Payments

Taxpayers/lessors may receive periodic payments for their share of the natural resource. These payments are commonly known as royalty payments. They must be based on natural resource production on a recurring or intermittent basis, per the terms of the lease.

The lessee should provide the taxpayer with a Form 1099-MISC reporting the payments as “Royalties” in Box 2. Most taxpayers report royalty payments received as royalty income on Schedule E.

Depletion Deduction

Depletion is the using up of natural resources by mining, drilling, quarrying stone, or cutting timber. The depletion deduction allows a taxpayer who owns an economic interest in a mineral deposit or standing timber to reduce their taxable income and account for the reduction of reserves.

There are two ways of figuring the depletion deduction: cost depletion and percentage depletion. A taxpayer who owns an interest in a mineral deposit must use the method that yields the greater deduction. The percentage depletion rate for federal tax purposes varies depending on the mineral being produced.

A taxpayer must be an independent producer or royalty owner to use percentage depletion for oil and gas. A taxpayer who owns an interest in standing timber can only use cost depletion.

Taxpayers claim depletion and other allowable deductions in the “Expenses” section in Part I of Schedule E. See IRS Publication 535, Business Expenses, for more information.

Additional Expenses

Taxpayers who own working interests may be able to deduct expenses to reduce their natural resource income. This applies to taxpayers who have working interests in extraction operations. Expenses may include overhead, dry holes, certain legal and administrative fees and county health department water testing fees. Severance tax and operation expenses should be detailed on an Authorization for Expenditures (AFE) statement provided by the exploration company.

Only taxpayers who have a working interest in the extraction operations may deduct business expenses such as depreciation, tangible or intangible costs, utilities, car and truck and travel from their natural resource extraction income.

Free Natural Gas

Taxpayers may receive natural gas from a lessee oil and gas company. The receipt of gas may be taxable income if the gas is not from the taxpayer/lessor’s retained ownership interest. In general, the ownership of raw gas extracted by a lessee is based on the lease terms and state law.

Reporting Rental and Royalty Income

Rental and royalty income or loss is calculated on Schedule E. That amount is then transferred to Line 17 on Form 1040 to be combined with income received from other sources such as wages, dividends and interest to determine total income. Net income from royalty and lease payments is not considered passive income.

Estimated Tax

Since federal income tax is not typically withheld from these payments, taxpayers may want to consider making estimated tax payments on their natural resource income. See Publication 505, Tax Withholding and Estimated Tax, for more information.

Income from leasing mineral property and royalty payments for the extraction of natural resources can be significant. Taxpayers who receive this type of income should familiarize themselves with the tax rules to avoid an unexpected bill at tax time. More information is available in Publication 525, Taxable and Nontaxable Income, and the Instructions for Form 1040, Schedule E and Form 1040, Schedule C.