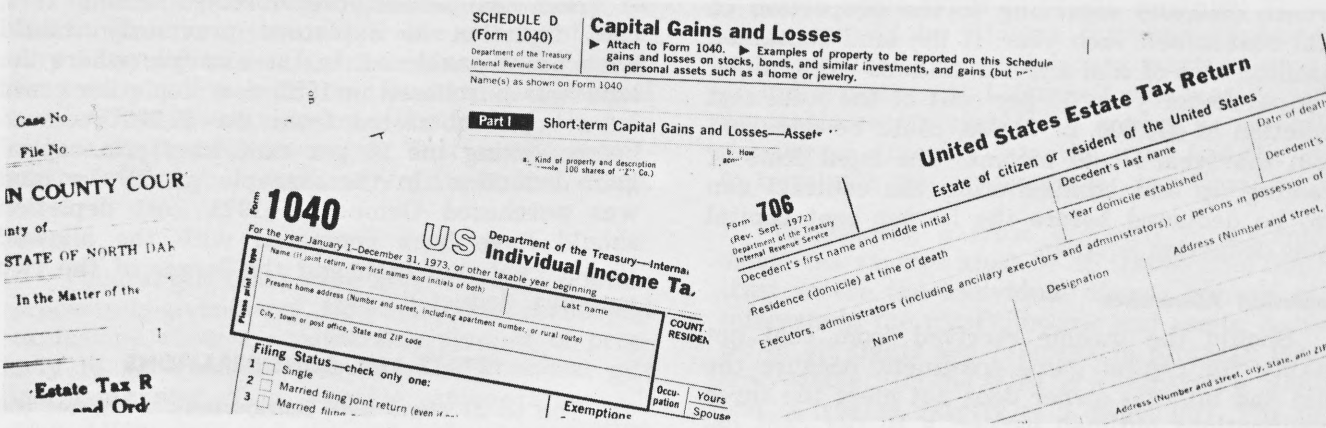

Tax Considerations in Coal and Oil Development Areas

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Discovery of oil and coal in North Dakota and the related importance in surface rights and values have emphasized the necessity for prudent management of mineral rights by landowners. Additional problems are arising in the areas of income and estate tax management. The information presented here is not intended as a substitute for legal counsel, but only to briefly explain a number of alternatives which will allow you to become more knowledgeable in discussing your individual situation with your attorney or tax person. It is strongly recommended that the services of a knowledgeable attorney or tax practitioner be obtained when dealing with tax considerations related to coal and oil development.

INCOME TAX CONSIDERATIONS[1]

Many individuals in coal development areas are now receiving payments for both mined and unmined coal. Problems arise in reporting these payments in determining what deductions are allowed.

Long-Time Capital Gains

The most advantageous deduction available is 50 per cent if the income received qualifies for long-term capital gain treatment. Internal Revenue Service (IRS) regulations concerning capital gains or losses as they pertain to coal state that the difference between the amount of income received from coal and the costs of developing the coal mining process can be considered a capital gain with only one-half of the income being taxable if:

1. The owner has held the property for more than six months.
2. The owner retains an economic interest in the coal.
3. The owner is not a partner or principle in the mining of the coal.

Amounts received by a holder of an economic interest include: (1) amounts realized from the sale of coal, (2) advance royalty payments or minimum royalty payments if the contract of disposal gives the coal owner the right to apply such royalty in payment of coal mined at a later date, and (3) bonuses received with the grant of a contract of disposal.

In general, if a capital gain or profit is realized, only half (50 per cent) of the profit will be taxed as ordinary income. Should the right to mine coal under the contract terminate or the lease expire before the coal is mined, **all** payments attributable to the unmined coal will be taxed as ordinary income.

Allowable Deductions

Before the 50 per cent deduction is taken, two additional deductions can be taken. First, the cost depletion basis can be deducted. This deduction is the cost of coal development attributable to the mineral in place. Suppose 10 years ago a landowner purchased both the surface and mineral rights of a parcel of land with coal for $15,000. His first step in computing the cost depletion basis would be to estimate what that parcel of land will be worth **after** the coal had been mined and the land reclaimed. If the estimate was $20,000 because of increased land values and effective reclamation practices, there would be no cost depletion since the residual value of the land would be greater than the original cost.

If the residual value were $5,000, then the landowner would be allowed to recover this dif-

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[1] *Summarized from information contained in IRS Practitioners' Newsletter, Number 74-4, January, 1974.*

ference ($10,000) according to the proportion of total coal mined each year. If the land contained a million tons of coal and 100,000 tons were mined in a particular year, 10 per cent of the total cost depletion of $10,000, or $1,000, could be deducted from that year's coal income. The legal costs of drawing up and administering the contract can also be deducted **before** the 50 per cent capital gains deduction is taken.

Depletion Allowance

Should the income received from coal not qualify for capital gains treatment because the land and mineral owner does not meet the three qualifications outlined earlier, a 10 per cent depletion deduction is allowed. However, this figure should always be compared to the "cost depletion" allowance and the larger of the two amounts deducted.

An Example

As an example to further clarify income tax reporting procedures, on May 15, 1973, a landowner entered into a coal lease agreement with a coal company. The owner had purchased the land 20 years previously. The lease provided for an advanced royalty of $2,500 and gave the coal company the right to explore, mine and extract coal. The lease was for 25 years and provided for a 10 cents per ton royalty on coal mined. The advance royalty was deductible by the coal company from the amount it would be required to pay for coal it would eventually mine. The owner paid $150 in legal fees in 1973 which pertained to the coal lease agreement. What was the correct reporting procedure?

The income received qualified for the 50 per cent long-term capital gain deduction, since the owner held the property for more than six months, and he kept an economic interest in the coal as he will look to the mining of coal for future royalty payments. Since mining operations had not yet begun, the last day of the taxable year would be considered the "date sold" for tax reporting purposes.

From the gross sale price of $2,500, the taxpayer also deducted the $150 in legal fees. The remaining $2,350 was then subject to the 50 per cent long-term capital gain deduction.

Had the taxpayer acquired the land on October 1, 1973, and entered into the lease on October 15, 1973, the transaction would not qualify for capital gains treatment. This is because as of January 31, 1973, the six-month holding period requirement would not have been met. However, the taxpayer would have been entitled to the 10 per cent depletion deduction allowed for coal. Any additional royalties received in future years would qualify for capital gains treatment.

Had coal actually been mined during 1973, cost depletion as explained previously should have been considered. In the example where the land was purchased in 1953, cost depletion could have been subtracted from the $2,500 received before taking the 50 per cent long-term capital gain deduction. In the example where the land was purchased October 1, 1973, cost depletion should have been compared with the allowed 10 per cent depletion and the larger of the two amounts deducted.

ESTATE TAX CONSIDERATIONS

Ten to 20 years ago, landowners were not too concerned about estate taxes due on their estates. Most estates were small and deductions and exemptions allowed a tax-free transfer. However, in the past few years, production assets per farm have more than doubled in some cases due both to increased farm size and increased value per acre. To add to the problem, estate tax exemptions have remained virtually unchanged since the early 1940's. Thus, the addition of valuable coal and oil resources to the increased value of other property could create serious family estate settlement problems for land and mineral owners.

These settlement problems can arise first through the actual amount of death taxes paid. Estate taxes are progressive in nature; they are figured on a graduated scale and take an ever-increasing share of the estate as the estate increases in value.

Possibly more serious than the actual amount of estate taxes paid is the fact that most farms, especially those with undeveloped but valuable coal or oil resources, cannot quickly convert available assets to cash to pay necessary estate taxes. Most of the assets are fixed in land, buildings and/or undeveloped mineral resources, and a large estate tax could actually require selling part of the property to pay settlement costs. These costs must be met before the property can be transferred.

Estate Tax Management[2]

Attempts to minimize tax liabilities may be only one of the factors to consider in transferring property from one generation to the next. Certainly, the financial security of the parents, security for the operating heir, fair treatment of other heirs and keeping the business within the family are important considerations. However, if tax reduction is a major objective, estate planning tools are available to aid in reaching this goal.

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[2] *A summary of estate planning principles, methods, and tools can be obtained from Jerome E. Johnson and Robert E. Beck,* Family Estate Planning, *Extension Bulletin 19, Fargo, North Dakota, November, 1972.*

In estate planning, ownership is closely related to taxation. If a considerable amount of property is owned at death, estate taxes will have to be paid possibly both on the state and federal level. Thus, ownership must be relinquished to reduce the tax consequences. This can be accomplished through transfers by gifts before death.

Gifts

Federal gift taxes have to be considered when property is given away. However, exemptions and exclusions allow a considerable amount of property to be transferred without any federal gift tax being paid. **Two** separate options are available. First, there is a lifetime specific exemption of $30,000. Each individual has one $30,000 exemption which can all be given to one individual in one year or divided among a number of individuals over a period of years.

Over and above the lifetime specific exemption of $30,000, each individual has an annual exclusion of $3,000 per year per individual. The $3,000 exemption is in effect for as many individuals the giver wishes to present a $3,000 gift. The individual can also make these gifts each year for as many years as desired. However, the $3,000 annual exclusion is not allowed for gifts of a future interest. For married couples, the $30,000 lifetime exemption and $3,000 yearly exclusion are doubled, even though the husband may be the sole owner of the property given away.

If the value of property given away exceeds these allowable exemptions and exclusions, a federal gift tax must be paid. This tax, for the initial taxable gift, is only 75 per cent of the federal estate tax. However, for additional taxable gifts, an additivity feature built into gift taxing procedures decreases the advantage.

All gifts in amounts of over $3,000 per person per year require the filing of a federal gift tax return. North Dakota does not have a state gift tax.

Trusts

Used in combination with gifts, trusts provide a useful tool in reducing the estate tax consequences when property, including mineral rights and mineral acres, are transferred from one generation to the next. A trust is a legal arrangement made during life or under the terms of a will that allows a property interest to be held and managed by one person or institution for the benefit of another. The entire arrangement is spelled out in a legal contract known as a trust agreement. The agreement outlines the wishes of the person setting up the trust.

Two basic types of trusts exist: (1) "living" trusts created by lifetime transfers of property into trust, and (2) testamentary trusts created by an individual's will. Lifetime trusts may be either revocable or irrevocable. If a trust is revocable, the person entering into the trust has the right to terminate the agreement at any time.

In general, a trust designed to accomplish estate tax savings must be an irrevocable lifetime trust where the individual divests himself of all interests in the trust's income and assets. A transfer of all rights and interests in property into an irrevocable lifetime trust is a completed transfer and is treated exactly as a direct gift. The property will not be taxed in the individual's estate, but like other gifts, it will be subject to the federal gift tax provisions and the lifetime specific exemptions discussed in a preceeding section. Also, if the beneficiaries have the right to any current trust income or assets, the annual exemption is also generally available.

Thus, gifts in trusts usually have the same potential tax advantage as do direct lifetime gifts. By making lifetime gifts into lifetime trusts, property owners can reduce potential estate tax liability. Other advantages of trusts in the transfer of mineral interests is that competent and continuing property management is provided in cases where the beneficiaries may be minor children and further development of the resources may not take place until sometime in the future. Also, by completing an effective present transfer either by direct gifts or gifts placed in an acceptable irrevocable trust, the mineral interests transferred are appraised according to present-day value. Should development be accelerated in the future, the value of the mineral interests could increase substantially with accompanying estate, gift and/or income tax consequences.

SUMMARY

The complexity and importance of tax consequences associated with mineral interests strongly suggest the need for assistance from competent and experienced lawyers and tax planning professionals. The related fields of investments, financial planning, law, taxation and property management indicates the need for additional assistance.

Changes in federal and state tax laws, and changes in personal, family and business situations could outdate many estate plans, thus creating a need for continuous review and updating.