MINERAL ROYALTIES AS TRUST INCOME

By Jennifer M. Spitz

Some individuals own valuable mineral interests, such as oil and gas interests, that generate large royalty payments. These mineral interests may find their way into an irrevocable trust such as a marital trust, bypass trust, or trust for descendants, in which case it is important to consider the implications of holding these income producing assets in trust. For purposes of this article, grantor trusts are not considered.

A mineral royalty payment received by a trust is taxed as ordinary income for federal tax purposes. A non-grantor trust is taxed at the highest income tax rate once it has $12,150 of taxable income (as of 2014). The trust beneficiaries may be in lower tax brackets, making it advantageous, from a tax perspective, for the trust to make distributions that carry out income to the beneficiaries. In this context, it is important to keep in mind that taxable income may not be the same as "income" for state law purposes.

When a trust references "income," such as to direct that all income be distributed to a certain beneficiary at least annually, "income" is generally determined under the Uniform Principal and Income Act (UPIA).[1] UPIA permits the governing instrument to deviate from the UPIA.[2] However, provisions that depart fundamentally from traditional principles of income and principal will generally not be recognized for federal tax purposes.[3] One context where determining "income" is essential is for purposes of the gift and estate tax marital deduction, such as with a power of appointment trust under IRC §2056(b)(5) or a qualified terminable interest property (QTIP) trust under IRC §2056(b)(7) which require that the spouse be entitled to all income from the trust.

Clients may anticipate that a trust requiring all "income" to be distributed will distribute 100% of every mineral royalty payment received because the payment is entirely taxable as ordinary income. However that is not the case under UPIA, absent special drafting in the trust instrument, or an exercise of the trustee's power to adjust.[4] In fact, there can be a considerable discrepancy between "income" under UPIA and taxable income.

Colorado's UPIA has three rules to determine the amount allocated to income from each mineral royalty payment depending upon when the trust was created:

1. **15/85 Rule.** C.R.S. § 15-1-421.5 was enacted in 2009. The general rule under C.R.S. § 15-1-421.5 is that receipts from interests in mineral or other natural resources, if received as a royalty, overriding or limited royalty, or bonus, or from a working net profit, are allocated 15% to principal and 85% to income. C.R.S. § 15-1-435 contains

[1] C.R.S. § 15-1-401 *et. seq.*
[2] C.R.S. § 15-1-403(1)(a)
[3] Treas. Reg. § 1.643(b)-1
[4] C.R.S. § 15-1-404 gives a trustee the power to adjust between principal and income, such as to allocate additional amounts to income. However, this power is not always available, such as if the trustee is a beneficiary of the trust. C.R.S. § 15-1-404(3)(g).

an effective date provision for this section. It states that C.R.S. § 15-1-421.5 applies "to all trusts and estates executed on or after July 1, 2009, unless the qualified beneficiaries elect not to apply said section." Furthermore, "[t]he provisions of section 15-1-421.5 shall not apply to the determination of income from the disposition of natural resources in a trust or estate created before July 1, 2009, unless the qualified beneficiaries elect to apply section 15-1-412.5."

2. **90/10 Rule.** C.R.S. § 15-1-421 applies to receipts from an interest in mineral or other natural resources when C.R.S. § 15-1-421.5 does not apply (*i.e.* trusts and estates "created" before July 1, 2009, absent an election by the qualified beneficiaries).[5] In some limited cases, C.R.S. § 15-1-421 allocates these payments entirely to income, but in general 10% is allocated to income and 90% to principal when C.R.S. § 15-1-421 applies. Note that the 90/10 rule (where 90% is allocated to principal) is almost the opposite result as the 15/85 rule (where 15% is allocated to principal). Accordingly, a trust that requires distributions of all income will distribute a greater amount under the 15/85 rule of C.R.S. § 15-1-421.5 than under the 90/10 rule of C.R.S. § 15-1-421.

3. **Pre-2001 Rule.** For trusts that were existing on July 1, 2001, C.R.S. § 15-1-434 allows the trustee to allocate receipts from the interest in the manner used by the trustee before July 1, 2001.

The allocation rules in other states vary, so it is important to determine whether the UPIA of Colorado or a different state applies.[6] The trust could specify that the UPIA of a particular state will apply regardless of where the trust is administered. Specifying which UPIA applies could be a good planning choice if the client wants to ensure that a certain allocation rule, such as the 85/15 rule will apply, rather than an allocation rule that would reach a very different result.

One way "income" will vary from the above rules is if mineral interests are held by a business entity. If the trust holds an interest in an entity, such as a partnership or LLC, rather than the trust holding the direct ownership of the mineral interests, then C.R.S. § 15-1-411 will apply. Under C.R.S. § 15-1-411(2) the general rule is that money received from an entity is allocated to income. The balance of C.R.S. § 15-1-411 provides several exceptions.

To understand the implications of a trust holding an LLC interest compared with direct ownership of a mineral interest, consider the following example: client creates an irrevocable trust for his children in 2014 and transfers mineral interests in Colorado to the trust. The trust requires the trustee to distribute all income to the children annually. The trust receives $100,000 in royalty payments each year. Pursuant to C.R.S. § 15-1-421.5, (the 15/85 rule), the trustee is required to distribute $85,000 annually as income.[7] If the trust instead holds an interest in an LLC that holds the mineral interests, for purposes of determining trust distributions "income" would be determined under C.R.S. § 15-1-411, which generally means that "income" is the

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[5] C.R.S. § 15-1-435(2)

[6] The 90/10 rule is uniform law. Therefore, states that have adopted the UPIA without amending this portion of the UPIA have a 90/10 rule

[7] Expenses are ignored in this example

amount the LLC manager decides to distribute from the LLC. For example, if the LLC manager does not make any distributions, the trust's "income" will be zero (if the trust does not hold other income producing assets), even though the LLC may have received substantial income from mineral interests.

Since an LLC is typically taxed as a pass-through entity for income tax purposes, the trust in the above example would nevertheless be taxed on the trust's share of the LLC's taxable income, even if it receives no distribution to pass on to the income beneficiary. One tool available to the trustee to mitigate this result is the ability to make adjustments between principal and income when the ownership of an interest in an entity whose taxable income, whether or not distributed, is includable in the trust's income.[8]

To summarize: 1) there can be significant taxable income associated with mineral interests; and 2) taxable income may be quite different from the definition of "income" when determining mandatory income distributions from trusts. Consequently, if a trust holds mineral interests it is important to understand what portion of royalties and other payments will be treated as "income" for distribution purposes and plan accordingly.

A trust that requires all "income" to be distributed may require much larger distributions than the client intends. The beneficiaries may receive larger amounts than they need, and the trust assets could be depleted very quickly. Therefore, if a trust will hold mineral interests, rather than drafting the trust with a mandatory income interest, a better option may be to just allow discretionary distributions of income and principal, or to replace the mandatory income interest with a unitrust provision.[9] However, a unitrust will require annual valuations of the mineral interests and other trust assets, so consideration should be given to the cost of revaluations.

On the other hand, a trust that does not distribute all taxable income will have the retained ("trapped") income taxed to the trust, which could result in taxation of the income at a higher income tax rate than if the income were distributed to the beneficiaries and taxed at their rates. Therefore, a better income tax result in such a case may be achieved by requiring all "income" to be distributed so that, if the 85/15 rule applies, most of the taxable income attributable to the mineral interests will be distributed from the trust and taxed to the beneficiaries.

As is the case with most aspects of estate planning, there is no single solution to handling mineral interests held in trust. In light of the significant revenue that may be associated with mineral interests they deserve special attention in the planning process, with consideration given to tax and non-tax objectives.

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[8] C.R.S. § 15-1-431(1)(c)

[9] In the case of a marital trust, eliminating the mandatory income distributions may disqualify the trust for the marital deduction, but a unitrust can qualify for the marital deduction. Treas. Reg § 1.643(b)-1

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