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## Tax Issues for Pennsylvania Gas Leases and Royalties

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By Guest Blogger, Nancy Montanye, CPA

If you are a Pennsylvania landowner with mineral rights who is offered a lease from a gas company, congratulations! This windfall, however, may raise many questions for you. In this blog post I hope to address some basic issues related to natural gas leases and royalties in Pennsylvania.

Natural gas in the Marcellus Shale only recently became accessible through fracking technology. Though Pennsylvania has the oldest oil well in the country and established legislation and case law related to mineral rights years ago, with the development of gas wells the state continues to update its rules and regulations for the industry and landowners.

When negotiating a lease, have an attorney review it before signing. The standard industry gas lease can be revised; typically protections are added by the landowner's attorney. In addition, the attorney will discuss the need, if any, for the creation of a separate legal entity for the gas lease and royalties. It is advisable to also consult a CPA with knowledge of taxation issues. The tax implications may play a factor into any decision regarding the best entity choice, such as a family limited partnership or a limited liability company.

When the lease payment is received, it is time to make estimated tax payments to federal and state tax authorities. Visit your tax accountant and have a tax projection prepared based on the amount of the lease received and other anticipated income. The lease income is reported on Schedule E as rent, with the typical deduction being attorney fees for reviewing the lease. The entire lease bonus is taxable in the year received. Related income received may include rights of way, damages, timber, and crop proceeds. Certain types are tax-advantaged. For example, permanent easements and timber are taxed at lower long-term capital gains tax rates. Most others are normally taxed as ordinary income. In my experience, gas companies are willing to negotiate the proportion allocable to each category, which can result in significant tax savings.



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Once monthly royalty checks are received, it is important to pay quarterly tax estimates to federal and state tax authorities to avoid underpayment penalties. Since the amount of royalties paid varies, it is recommended that the amount due be calculated each quarter by your CPA. It is important that you choose someone knowledgeable in this specialty area, since there are unique rules related to royalty taxation, including deductions and depletion. For example, federal rules allow deducting the higher of cost or percentage (15 percent) depletion, but Pennsylvania does not permit percentage depletion. In most situations, the cost basis for mineral rights is zero; therefore, there would be no Pennsylvania depletion deduction. It is essential that you keep the check stubs from each royalty payment since they contain important deduction details. Provide your tax preparer with the 1099-Misc from the gas company, along with the check stubs at tax time. By definition, royalty income is portfolio income (not passive income) and cannot be used to offset passive losses. Rents and royalties are investment income, and the Net Investment Income Tax will be due, if applicable. However, since royalty income is generally not a trade or business, it is not subject to self-employment tax.

For long-term peace of mind, you need to consider estate planning. At a minimum, be sure to have a current will, durable power of attorney, and health care power of attorney. In addition, you may establish trusts as part of your estate plan. You will need legal documents prepared by an attorney for all of these. Most individuals are not subject to federal estate tax, since the exemption amount is so high (\$5.43 million for 2015, indexed for inflation). In Pennsylvania, the value of royalties for Inheritance Tax purposes is twice the gross amount received in the year prior to death.

Managing your windfall may require the assistance of a reputable financial advisor to handle your investments. There are many companies and brokers available, so select one that is a good fit for you. Communication is key. Your portfolio should be individualized based upon your age and risk tolerance. Annual 1099 Tax Forms will be issued showing the amounts of interest, dividends, and sales.

Being a landowner with a gas lease and royalties is exciting, and at times overwhelming. You can get an idea of the complexity of the issues, [Penn State Extension](#) has some great resources and you can dive a little deeper by participating in the OnDemand [federal tax course](#). A [team of experts](#), however, may be need to help you make the numerous decisions involved. Hopefully, this overview helps guide you in the right direction. Smart choices can lead to significant rewards!

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