



Royalties as Earned Income

IRS Publication 525-2007 Taxable & Non-Taxable Income

Royalties

Royalties from copyrights, patents, and oil, gas, and mineral properties are taxable as ordinary income. You generally report royalties in Part I of Schedule E (Form 1040), Supplemental Income and Loss. However, if you hold an operating oil, gas, or mineral interest or are in business as a self-employed writer, inventor, artist, etc., report your income and expenses on **Schedule C or Schedule C-EZ (Form 1040)**.

Copyrights and patents. Royalties from copyrights on literary, musical, or artistic works, and similar property, or from patents on inventions, are amounts paid to you for the right to use your work over a specified period of time. Royalties generally are based on the number of units sold, such as the number of books, tickets to a performance, or machines sold.

Oil, gas, and minerals. Royalty income from oil, gas, and mineral properties is the amount you receive when natural resources are extracted from your property. The royalties are based on units, such as barrels, tons, etc., and are paid to you by a person or company who leases the property from you.

Depletion. If you are the owner of an economic interest in mineral deposits or oil and gas wells, you can recover your investment through the depletion allowance. For information on this subject, see chapter 9 of Publication 535.

Coal and iron ore. Under certain circumstances, you can treat amounts you receive from the disposal of coal and iron ore as payments from the sale of a capital asset, rather than as royalty income. For information about gain or loss from the sale of coal and iron ore, see Publication 544.

Sale of property interest. If you sell your complete interest in oil, gas, or mineral rights, the amount you receive is considered payment for the sale of section 1231 property, not royalty income. Under certain circumstances, the sale is subject to capital gain or loss treatment on Schedule D (Form 1040). For more information on selling section 1231 property, see chapter 3 of Publication 544.

If you retain a royalty, an overriding royalty, or a net profit interest in a mineral property for the life of the property, you have made a lease or a sublease, and any cash you receive for the assignment of other interests in the property is ordinary income subject to a depletion allowance.

Part of future production sold. If you own mineral property but sell part of the future production, you generally treat the money you receive from the buyer at the time of the sale as a loan from the buyer. Do not include it in your income or take depletion based on it. When production begins, you include all the proceeds in your income, deduct all the production expenses, and deduct depletion from that amount to arrive at your taxable income from the property.

Question: I have a professional corporation, which has two sources of income: (1) about \$100K income from my professional services, and (2) about \$20K royalty income from a book I wrote. My accountant has advised to have my publisher pay me separately, as a sole proprietor, for the royalties, so as to avoid Medicare taxes on the royalty income. Because the sole proprietorship will be under common control with my corporation, will this change my compensation for plan purposes?

Answer: Unless you have substantial other income, yes.

The treatment of royalties can be tricky. How you treat them can have significant retirement plan consequences. The central issue is whether the royalty income derives from a trade or business.

Revenue Ruling 68-498 says:

Whether or not an individual is engaged in a trade or business depends upon the facts in the particular case. As a general rule, a person who is regularly engaged in an occupation or profession for profit which constitutes his livelihood, in whole or in part, and who is not regarded as an employee for Federal Insurance Contributions Act (FICA) purposes, is engaged in a trade or business for self-employment tax purposes. If an individual writes only one book as a sideline and never revises it, he would not be considered to be 'regularly engaged' in an occupation or profession and his royalties therefrom would not be considered net earnings from self-employment. However, where an individual prepares new editions of the book from time to time, and writes other books and materials, such activities reflect the conduct of a trade or business, and, if it is not one of the excluded professions of section 1402(c) of the Self-Employment Contributions Act, the income from it is includible in computing net earnings from self-employment, subject to the limitations of section 1402(b) of the Act.

So, if you have a trade or business as a self-employed writer, then the income is reportable on Schedule C and is subject to self-employment tax. If you do not have a trade or business, then the income is reportable on Schedule E and is exempt from self-employment tax.

The only earned royalties are derived from a self-employment business enterprise (FS 503-1)

IRC 512(b)(2) excludes from unrelated business taxable income:

All royalties (including overriding royalties) whether measured by production or by gross or taxable income from the property, and all deductions directly connected with that income.

The term "royalties" is not defined in either the Internal Revenue Code or the regulations. Reg. 1.512(b)-1 provides that whether a particular item of income falls within any of the modifications provided in IRC 512(b) (which includes "royalties") shall be determined by all the facts and circumstances of each case.

What a Royalty is Not

A. Compensation for Services

Royalty treatment will often be precluded where there is an element of personal services performed in return for the "royalty." One of the two license agreements described in **Rev. Rul. 81-178**, supra, required the organization, through its members, to endorse products or services in personal appearances and interviews. The ruling held that royalties do not include payments for personal services.

The Service takes the position that provision of a relatively minimal degree of services by the exempt organization will bar royalty treatment of the resulting income. For example, in PLR 93-06-030 (February 12, 1993), the IRS revoked a prior ruling and held that an organization was "directly and extensively

involved" in an insurance program where it published advertisements for the insurance company in its magazine, granted the company access to its members once, and permitted representatives of the insurance company to attend its board meetings and meet informally with members.

The key is the individual actively involved in or providing substantial services for obtaining the "royalty"

Earned income is income which is currently received as wages, salaries, commissions, or profits from activities in which an individual or family is engaged through either employment or self-employment. There must be an appreciable amount of personal involvement and effort, on the part of the individual or family, for income to be considered "earned."

Royalty Income

"Royalties" can generally be described as payments you receive for the use of your property, that are based in some way on the number of units sold.

The two types of royalties most commonly encountered are royalties for the use of copyrights, trademarks, and patents, and royalties from the extraction of oil, gas, or minerals from your property.

However, other types of royalties are possible, such as those paid for the use of a name, the sale of products using certain proprietary processes, etc. In any case, income and deductions related to your royalties are generally reported on Schedule E, *Supplemental Income and Loss*.

However, if you are in business as a self-employed artist, author, photographer or inventor, and the royalties relate to a self-created copyright, trademark, or patent, you would report the payments as part of your business income on Schedule C.

Similarly, if you hold an operating oil, gas, or mineral interest in land, you would report your gross income and expenses on Schedule C or C-EZ.

In order for royalties to be considered self-employment income, the recipient has to be considered regularly engaged in that business or profession. **Revenue Ruling 68-498** provides the following example, which should help you contrast your situation:

"If an individual writes only one book as a sideline and never revises it, he would not be considered to be 'regularly engaged' in an occupation or profession and his royalties therefrom would not be considered net earnings from self-employment. However, where an individual prepares new editions of the book from time to time, and writes other books and materials, such activities reflect the conduct of a trade or business, the earnings of which would be subject to self-employment tax."

Schedule E instructions say "If you are in business as a self-employed writer, inventor, artist, etc., report your royalty income and expenses on Schedule C or C-EZ". (self-employment income subject to SS)