Charitable Gifts

Summary and Recommendation

Royalty trust investments made in years past that have used up much of their depletion for sheltering current income from tax might be especially suitable for charitable gifts. As with other securities the capital gains tax can be avoided by giving securities. In addition a recapture tax at ordinary income rates that applies to depletion previously claimed can also be avoided when giving royalty trust securities. Gifts to a split interest charitable trust effectively avoid the tax on both the charitable interest and the retained interest. If all that reads as too complicated, placing royalty trusts in a tax-exempt account simplifies tax accounting. Meanwhile seven income stocks have an estimated distribution yield for 2005 of 8.4% using futures prices as of the close of trading for the year 2004.

U.S. Natural Gas and Oil Royalty Trusts
The Account

	Symbol	*Price ($/un) 30-Dec 2004*	*Units*	*Market Value ($)*	*Next Twelve Months Distrib. ($/un)*	*NTM Distrib. Yield (%/yr)*
Cross Timbers Royalty Trust	CRT	39.71	400	15,884	2.91	7.3
Dorchester Minerals, L.P.	DMLP	23.65	700	16,555	1.88	8.0
Hugoton Royalty Trust	HGT	25.97	500	12,985	2.40	9.2
Mesa RoyaltyTrust	MTR	67.80	200	13,560	5.22	7.7
Permian Basin Royalty Trust	PBT	13.76	1,200	16,512	1.08	7.9
Sabine Royalty Trust	SBR	35.50	400	14,200	3.24	9.1
San Juan Basin Royalty Trust	SJT	29.47	500	14,735	2.84	9.6
Total				*104,431*		*8.4*

Futures Strip	
12 Month - Oil ($/bbl)	42.66
12 Month - Natural Gas ($/mmbtu)	6.33
72 Month - Oil ($/bbl)	39.11
72 Month - Natural Gas ($/mmbtu)	5.67

Remember Depletion

The essential fact to understand about taxation of U.S. royalty trusts is cost depletion. Assume recent purchase at $30 a unit. About 10% of cost may be claimed as depletion that offsets taxable income. Thus if the distribution is also 10%, there is no income tax due the first year. The rate of depletion in the following year is applied against original cost minus depletion previously claimed. As a result the tax shield of depletion gradually diminishes. On units held for ten years depletion almost disappears and nearly the whole current distribution would be taxable.

In the old days before the recapture tax there was an incentive to turn over royalty trust interests to reestablish a higher cost basis for depletion. To counter that temptation a new tax was established that the sale of units required the unitholder to pay ordinary income tax on amounts previously depleted. Liability to the recapture tax encourages long-time holders of royalty trusts to continue to hold to postpone further the potential tax.

The charitable donation avoids the recapture tax. If the gift is to a split interest trust, an investor around retirement age might find that he or she can donate to a charity an amount equal to the taxes that would be paid and still retain the after-tax value of the royalty trust. The cash that might otherwise have been given directly to the charity could be reinvested in new royalty trust units that would then have the benefit of depletion that once again shelters most of current income.

Royalty trust taxation is more complicated than straight dividends, but less complicated than master limited partnership taxation. A practical rule is to own enough of a royalty trust to justify additional tax accounting effort. Alternatively, the royalty trust account with seven different holdings that we track every week might best be part of a tax-exempt account like an IRA. That eliminates the need for extra tax accounting. Giving up depletion may not be tax-efficient initially while avoiding the recapture tax becomes advantageous later.

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