The Tax Benefits

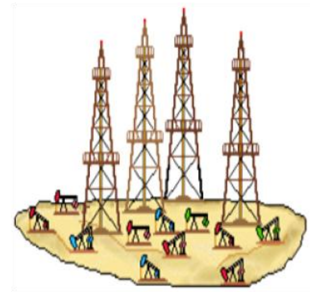
Tax Advantages of Oil & Gas Drilling

Congressional Incentives Encourage Domestic Petroleum Development - Natural gas and oil development from domestic reserves helps to make our country more energy self-sufficient by reducing our dependence on foreign imports. In light of this, Congress has provided tax incentives to stimulate domestic natural gas and oil production financed by private sources. Natural gas and oil drilling projects offer many tax advantages. These tax benefits enhance the economics of natural gas and oil projects.

Intangible Drilling Cost Tax Deductions - Oil and gas projects are labor intensive, so a significant portion of the expenditure is considered Intangible Drilling Cost (IDC), which is 100% deductible during the first year. For example, a participation of $60,000 could result in approximately $48,000 in tax deductions for IDC and other deductible expenses even if the well does not start drilling until March 31st of the year following the contribution of capital. The remaining $12,000 of tangible costs may be deducted as depreciation over a five to seven year period. (See Section 263 of the Tax Code).

Small Producers Tax Exemption - The 1900 Tax Act provided some special tax advantages for the typical participant in oil and gas drilling projects. This tax incentive, known as the "Percentage Depletion Allowance", is specifically intended to encourage participation in oil and gas drilling. The tax benefit is not available to large oil companies or taxpayers who sell oil or natural gas through retail outlets or those who engage in refining crude oil with runs of more than 50,000 barrels per day. It is also not available for entities owning more than 1,000 barrels of oil (or 6,000,000 cubic feet of gas) average daily production. The "Small Producers Exemption" specifically allows 15% of the gross income from an oil and gas producing property to be tax free. (See Section 613A of the Tax Code).

Active vs. Passive Income - The Tax Reform Act of 1986 introduced into the Tax Code the concepts of "Passive" income and "Active" income. The Act prohibits the offsetting of losses from Passive activities against income from Active businesses. The new Tax Code specifically states that a Working Interest in an oil and gas well is not a "Passive" activity, therefore, deductions can be offset against income from active stock trades, business income, salaries, etc. (See Section 469 (c)(3) of the Tax Code).



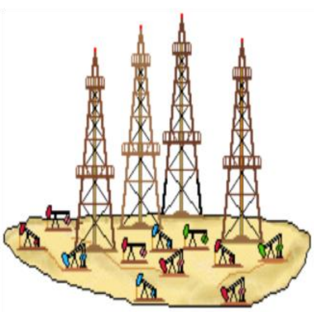
The following general discussions are provided for background information only. This information is not intended to be individual advice. Participants should consult with their personal tax advisor concerning the applicability and effect on their personal tax situation. Tax laws change from time to time and there can be no guarantee of the interpretation of the tax laws.

Alternative Minimum Tax

Prior to the 1992 Tax Act, working interest participants in oil and gas joint ventures were subject to the Alternative Minimum Tax to the extent that this tax exceeded their regular tax. This Tax Act specifically exempted Intangible Drilling Cost as a tax Preference Item. "Alternative Minimum Taxable Income" generally consists of adjusted gross Income, minus allowable Alternative Minimum Tax itemized deduction, plus the sum of tax preference items and adjustments. "Tax preference items" are preferences existing in the Code to greatly reduce or eliminate regular income taxation. Included within this group are deductions for excess Intangible Drilling and Development Costs and the deduction for depletion allowable for a taxable year over the adjusted basis in the Drilling Acreage and the wells thereon.

Section 29 Tax Credits

Recompletions Qualify for Tax Credit in 1979, Congress enacted Section 29 of the tax code in an effort to stimulate the production of domestic oil and gas production from unconventional fuel sources. The Section 29 credit was a major stimulus for drilling natural gas wells from the late 1980s through December 31, 1992, when the tax credit expired. IRS revenue ruling 93-54 provides that well recompletions qualify for the credit as long as the original well qualified for the credit and the recompletion does not involve drilling the well deeper. Historically, operators have abandoned wells when production has become uneconomical. Many of the abandoned wells are now available for recompletions. Typically, Coalbed Methane wells have several potential producing zones that were never completed or produced by prior operators. By completing the zones of existing wells that were not previously completed (but not deepening the wells), the natural gas production will generate valuable Section 29 credits. Tax Credit Calculation Section 29 credits are based on gas production. Approximately one dollar of tax credit is created for every thousand cubic feet of gas produced. A tax credit is not a deduction, it is a direct reduction of tax liability. Because the tax credit is computed based on production, price fluctuations for natural gas will have no effect on the amount of tax credits generated.



2014 Tax Rates

Income (Single)	Income (Married Filing Jointly)	Marginal Federal Income Tax Rate		State Taxes (where applicable)		Marginal Tax Rate
$406,750	$457,600	39.6%	+	0-12%	=	39.6% to 51.6%
$405,100	$405,100	35%	+	0-12%	=	35% to 47%
$186,350	$226,850	33%	+	0-12%	=	33% to 45%

Tax Examples

(1) The Intangible Drilling Cost (IDC) deductions and the depreciation of tangible equipment on a typical oil well allow a large income tax deduction of the investment in the first year (usually 75% to 85%). The tax consequences for a $60,000 participation can be *approximated* as follows:

Intangible Costs (1 Unit)	
Capital Contributions	$60,000
Intangible Drilling Costs/Other Expense	x 80%
IDC Deduction	$48,000
Tangible Costs	
Capital Contribution	$60,000
Tangible Drilling Costs	x 20%
TDC Deduction	$12,000
Depreciate over 5 years	
1st Year Tangible Depreciation	$2400
1st Year Reduction in Taxable Income	$50,400

(2) Example of joint venturer's potential tax benefits. Each joint venturer's tax liabilities are different, consult with your personal tax advisor regarding the potential benefits of oil and gas joint venture investments. The below example *assumes* a self-employed person in a 39.6% Federal Income Tax Bracket and a 10% State Income Tax Bracket (If applicable) = 49.6% marginal tax rate.

Investment (1 Unit)	$60,000
Intangible Drilling Costs/Other Expense (Approx. 80% of Investment)	$48,000
Tangible Drilling Costs (TDC – Capitalized and Depreciated over 5 Years or Approx. 20% of Investment)	$12,000
1st Year Tax Deductions	$50,400
1st Year Tax Savings	$24,998
Net Investment after One Year	$35,002

In addition, joint venturers may receive depletion allowances on revenue from oil and gas wells.