MICHIGAN GEOSEARCH, INC.

Oil and Gas Exploration & Production Professionals

Oil and Gas Tax Considerations

In an attempt to reduce our dependency on foreign supplies, the United States Government set out to encourage domestic oil and gas exploration. When Congress passed the Tax Reform Act of 1986 (the "Act"), investors in oil and gas drilling projects received exceptional incentives. Oil and gas drilling projects have become one of the most tax-advantaged investment opportunities, allowing our Joint Venture partners to benefit from many tax deductions. These include intangible drilling costs, depreciation, operating costs and percentage depletion. On the income side, the Act specifically exempts oil and gas working interests from becoming "passive income." This is very attractive as all deductions are generally allowed to be used to offset "active" or "ordinary" income earned elsewhere.

Direct participation oil and gas can generate several tax benefits. These benefits range from large up front deductions for intangible drilling costs (IDC), to tax credits for the development of certain types of tight formations. Deductions are generated mainly from the cost of non salvageable equipment or services conducted during the drilling phase, testing, and/or completion of the well. The following is a synopsis of the tax benefits generated by direct participation in oil and gas investments.

1. **Intangible Drilling Costs (IDC)**: When an oil or gas well is drilled, several expenses may be deducted immediately. These expenses are deductible because they offer no salvage value whether or not the well is subsequently declared to be dry. Examples of these types of expenses would be labor, drilling rig time, drilling fluids etc. IDCs usually represent 0ver 80% of the well cost. Investors usually put up the drilling portion of their investment before drilling operations commence, and the investor's portion of the intangible drilling costs is generally taken as a deduction in the tax year in which the intangible costs occurred. The accounting method adopted however could affect the deduction period.

2. **Intangible Completion Costs**: As with IDCs these costs are generally related to non salvageable completion costs, such as labor, completion materials, completion rig time, fluids etc. Intangible completion costs are also generally deductible in the year they occur, and usually amount to about 15% of the total.

3. **Depreciation**: As opposed to services and materials that offer no salvage value, equipment used in the completion and production of a well is generally salvageable. Items such as these are usually depreciated over a seven year period, utilizing the Modified Accelerated Cost Recovery system or MACRS. Equipment in this category would include casing, tanks, well head and tree,

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pumping units etc. Equipment and tangible completion expenses generally account for 25 to 40% of the total well cost.

4. **Depletion Allowance**: Once a well is in production, the participants in the well are allowed to shelter some of the gross income derived from the sale of the oil and/or gas through a depletion deduction. Two types of depletion are available, cost and statutory (also referred to as percentage depletion). Cost depletion is calculated based upon the relationship between current production as a percentage of total recoverable reserves. Statutory or percentage depletion is subject to several qualifications and limitations. This deduction will generally shelter 15 per cent of the well's annual production from income tax. For "stripper production" (wells producing 15 barrels/day or less), the depletion percentage can be up to 20%.

5. **Tax Credits**: Congress has enacted several tax credits in relation to oil or natural gas production. The enhanced oil recovery credit is applied to certain project costs incurred to enhance a well's oil or natural gas production. This credit is up to 15% of the costs incurred to enhance production. The non conventional source fuel credit provides for a $3 per barrel of oil equivalent credit for production from the so called qualified fuels. Qualified fuels include oil shale, tight formation gas, and certain synthetic fuels produced from coal.

The Alternative Minimum Tax

Historically the tax benefits from oil and natural gas production could potentially present the possibility for taxation under the Alternative Minimum Tax (AMT). In the early 1990's however, Congress provided some tax relief for "independent producers". An independent producer was defined as an individual or company with production of 1,000 barrels per day or less. Although there is still the potential for AMT taxation for excess IDCs, percentage or statutory depletion is no longer considered a preference item.

Lease Operating Expense

This expense covers the day to day costs involved with the operation of a well. The expense also covers the costs of re-entry or re-work of an existing producing well. Lease operating expenses are generally deductible in the year incurred, without any AMT consequences.

Conclusion

As is evident from this discussion, the tax benefits generated by a direct participation in oil and/or natural gas are substantial. The immediate deduction of the intangible drilling costs or IDCs is very significant, and by taking this up front deduction, the risk capital is effectively subsidized by the government by reducing the participant's federal, and possibly state income tax. Each individual participant of course, should consult with their tax advisor.

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