Oil & Gas Drilling Funds

What Are Oil and Gas Drilling Funds?

Oil and Gas Drilling Funds are investment vehicles that allow individuals to invest in the operational side of drilling for oil and gas resources. The funds involve participation in drilling activities and offer potential returns based on the success of extracting these resources.

How They Work

Unlike ongoing mineral rights, these funds involve direct participation in drilling operations. Investors contribute capital to the fund, which is then used for drilling activities. The funds aim to yield returns through the successful extraction of oil and gas.

Tax Benefits

<u>Intangible Drilling Cost (IDC) Deductions:</u>

- Investors can benefit from Intangible Drilling Costs, deducting a significant portion of their initial investment against their taxable income in the first year of ownership in a Drilling Fund.

- IDCs encompass a range of expenses associated with drilling operations, excluding the physical equipment costs. These expenses can include expenses for labor, services, supplies, and other costs essential to the drilling process.

- By deducting against one's taxable income, investors can potentially substantially reduce their tax liability. By offsetting a significant portion of their initial investment through IDC deductions, investors can effectively lower their tax liability for that year, resulting in tax savings as well as enhancing the overall return on their investment.

- For example, if an investor has a gross annual income of $200,000 and invests $100,000 in a Drilling Fund, it's possible that they can deduct up to 60% of their investment against their earned income. In this case, the investor can deduct $60,000 from their gross income so that they are only paying taxes on an income of $140,000.

<u>Depletion Allowances</u>

- Depletion is another tax benefit available to investors in drilling funds. It allows investors to deduct a portion of the revenue generated from the sale of oil and gas as a way to account for the reduction in the value of the natural resource reserves.

- This deduction recognizes the finite nature of these resources and can provide additional tax savings for investors.

Summary

Step 1: Deduct – Investor invests and writes-off IDCs that will occur in the first year of the investment.

Step 2: Drill – The operator begins drilling for oil and/or gas resources.

Step 3: Distribute – After deducting IDCs and other expenses, any remaining revenue from the well(s) are distributed to investors.

Step 4: Deploy – After a certain amount of time in the fund, the sponsor will create liquidity for investors in the fund. This timeline will vary from sponsor to sponsor. Some hold periods may be as long as 10 or 15 years while some may be as short as 3 to 5 years.

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Important Disclosures

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Real Estate Risk Disclosure:

●There is no guarantee that any strategy will be successful or achieve investment objectives including, among other things, profits, distributions, tax benefits, exit strategy, etc.;

●Potential for property value loss – All real estate investments have the potential to lose value during the life of the investments;

●Change of tax status – The income stream and depreciation schedule for any investment property may affect the property owner's income bracket and/or tax status. An unfavorable tax ruling may cancel deferral of capital gains and result in immediate tax liabilities;

●Potential for foreclosure – All financed real estate investments have potential for foreclosure;

●Illiquidity – These assets are commonly offered through private placement offerings and are illiquid securities. There is no secondary market for these investments.

●Reduction or Elimination of Monthly Cash Flow Distributions – Like any investment in real estate, if a property unexpectedly loses tenants or sustains substantial damage, there is potential for suspension of cash flow distributions;

●Impact of fees/expenses – Costs associated with the transaction may impact investors' returns and may outweigh the tax benefits

●Stated tax benefits – Any stated tax benefits are not guaranteed and are subject to changes in the tax code. Speak to your tax professional prior to investing.

Oil and Gas Investment Risks

Private investments in oil and gas are high risk, including, but not limited to the following considerations:

Political Risk – Federal or local governments could enact regulations/legislation that could adversely affect the oil and gas industry, thereby negatively affecting your investment.

·**Geological Risk** – Oil and gas production can be negatively affected by the difficulty of extraction and the possibility that the accessible reserves in any deposit will be smaller than estimated. There is no guarantee that any drilling operation will be successful.

Supply, Demand, and Price Risk – A reduction in oil and gas prices, a decrease in demand, or a surplus of available supply can reduce or even eliminate investment returns.

Cost Risk – Unexpected or increased operating expenses can reduce or even eliminate investment returns.

Dividend Cuts – Any dividend payments can be reduced or eliminated if the company is unable to earn enough revenue to fund the payments to investors.

Oil Spill Risk – In addition to the cost of repairs, clean up, potential fines, and potential litigation, oil spills can negatively affect the reputation of the company, all of which can reduce or eliminate investment returns.