



CLIENT CHECKLIST – ALTERNATIVES

ALT INVESTMENTS – OIL & GAS FUNDS – CHECKLIST

Oil drilling funds, often structured as partnerships or joint ventures like DrillCos, allow investors to fund drilling costs in exchange for working interests in wells, sharing production revenues after recouping capital. When oil prices are high and wells are productive, the financial gains from investing in wells can be substantial. Investing in oil and gas can also diversify your portfolio, as oil prices are only 35% correlated to the stock market.

These investments hinge on high upfront costs offset by oil price-driven returns, with average production costs around \$62 per barrel influencing drilling decisions. Tax incentives significantly enhance economics by accelerating deductions against other income.^{[1][2][3][4]}

Core Mechanics

Investors typically provide capital for exploration, drilling, and completion via structures like working interests, where they bear unlimited liability but gain active participation status. Operators contribute leases and expertise, assigning interests post-drilling; in DrillCos, interests may revert partially after hitting an IRR threshold. Funds generate revenue from oil/gas sales, distributed pro-rata minus operating expenses, aiming for cash flow once wells produce.^{[2][5][6][7]}

Drilling Costs

Intangible drilling costs (IDCs), covering 60-85% of expenses like labor, fuel, surveys, ground cleaning, and supplies, are fully deductible in year one for working interest holders. Generally, expenditures are considered intangible drilling costs if they lack salvage value. Taxpayers deducting intangible drilling costs must declare these expenses for the year they are incurred, regardless of whether the well strikes oil or not, as long as it is operational by March 31 of the following year. IDCs work the same for everyone at the federal level and in most states, with several notable exceptions:

State	Federal Law (IDCs)	State Law (IDCs)	Amortization/Depreciation Schedule (Asset Life)
California	Fully deductible in year 1	TBD – California just passed a bill updating their application	TBD

State	Federal Law (IDCs)	State Law (IDCs)	Amortization/Depreciation Schedule (Asset Life)
Pennsylvania	Fully deductible in year 1	Capitalized and depreciated over asset life	Often 10 to 20 years
New Jersey	Fully deductible in year 1	Capitalized and depreciated over asset life	Often 10 to 20 years
Massachusetts	Fully deductible in year 1	Capitalized and depreciated over asset life	Often 10 to 20 years
North Carolina	Fully deductible in year 1	Capitalized and depreciated over asset life	Often 10 to 20 years

Tangible drilling costs (TDCs), 15-40% for equipment like drill bits, the drilling rig, and casing, are depreciated over seven years or via 100% bonus depreciation. Together, these can make nearly the full investment deductible upfront.^{[8][9][10][11][12][1]}

Depletion Tax Benefits

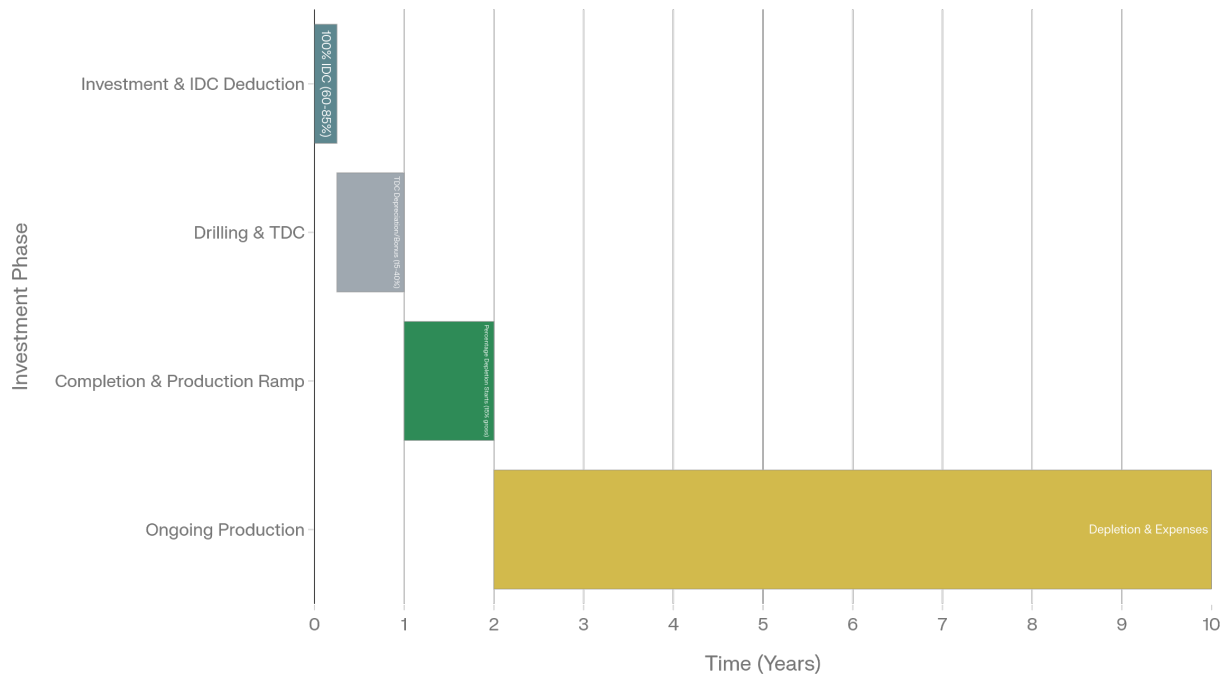
Percentage depletion lets investors deduct 15% of gross production income (e.g., \$1,500 tax-free on \$10,000), exceeding cost recovery in many cases and limited to independents. Working interests bypass passive loss rules, allowing IDC/TDC offsets against W-2 or business income; limited partnerships face restrictions. Master limited partnerships (MLPs) pass through deductions without entity-level tax, if 90% of income qualifies from oil/gas activities.^{[13][3][14][15][7][1]}

Investment Timeline

A typical oil drilling investment unfolds over 3-10 years, starting with heavy capital outlays for drilling followed by production cash flows, with tax breaks accelerating deductions upfront to offset income. Key phases include immediate IDC deductions in year 0, TDC depreciation through year 1, and ongoing percentage depletion once revenue flows.^{[21][22][23][24]}

Oil Drilling Investment Timeline with Tax Benefits (Years 0-10)

IDC & TDC deductions front-loaded, depletion ongoing



Timeline of Typical Oil Drilling Investment Phases and Tax Benefits

Phase Details

- **Year 0 (Investment):** Capital funds leasing and initial drilling; claim 100% IDC deduction (60-85% of total costs) against active income.^{[21][22]}
- **Years 0-1 (Drilling/Completion):** Core operations occur; TDC (15-40%) depreciated over 7 years or via bonus rules for faster write-offs.^{[25][26]}
- **Years 1-2 (First Production):** Wells come online, generating revenue; percentage depletion begins at 15% of gross income annually.^{[24][27]}

Economic Flow

Upfront deductions can shelter 70-100% of investment in year one for working interests, improving IRR amid volatile oil prices. Production peaks early then declines, with cash distributions covering ops and returning capital over 5-10 years. Tax benefits phase out as basis depletes, shifting focus to net income.^{[28][29][30][31]}

Risks and Limitations

- **Dry Wells:** Drilling may not lead to commercially viable quantities of oil or gas. This risk has fallen over time as drilling technology has made it easier to locate minerals and drill into areas that were previously hard to reach. Traditional vertical wells had a 40% chance of success in the early 2000s, meaning that nearly half of all drilled wells might not hit oil in economically viable

quantities. Horizontal wells, combined with better geological mapping and data analytics, now offer an 85% success rate, minimizing the risk of “dry wells.” Moreover, these oil and gas funds drill lots of wells as part of a one project, not just a single well, so the investment’s profitability doesn’t depend on an individual well’s profitability.

- **Unexpectedly Low Revenue:** The revenue is tied to the volume of oil they extract and global oil and gas prices. Those prices can be volatile. However, oil and gas well funds often use hedging strategies to minimize the impact of volatility in the short run.
- **General Partner Liability:** Investors are potentially subject to liability for drilling-related accidents while they are “active” in the business and classified as “general partners.” The drilling funds take out large insurance policies to hedge against this risk, but there is a theoretical liability risk associated with these investments (typically investors only face this risk during their first year, as from year 2 onwards investors become limited partners and aren’t liable for the fund’s accidents).
- **Alternative Minimum Tax Limitations:** AMT can limit the amount that you can deduct from your taxes in any given year.
- **Excess Business Loss Limitations:** The Excess Business Loss Limitation is a tax rule designed to restrict the amount of business losses that non-corporate taxpayers (such as individuals and partnerships) can deduct from their non-business income

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