



MEMORANDUM

To: Lawrence Buettner
Blue Flame Energy Corporation

From: Douglas P. Harder, Senior Tax Manager

Date: August 19, 2010

Re: *Tax Advantages of Oil and Gas Investments*

As an alternative to real estate, stocks, bonds and mutual funds, a working interest in an oil and natural gas joint venture or partnership can provide portfolio diversification with preferential tax treatment. The acquisition, exploration, and development of properties for the production of oil and natural gas require the investment of significant capital and often involve the assumption of higher levels of risk than many other investments. The government, however, has established favorable tax policies to encourage the development and production of oil and gas properties in an effort to stimulate domestic exploration and production. The tax benefit considerations can materially affect the anticipated return to be realized on the investment and often determine the form and feasibility of the investment.

The major portion of the expenditures paid by a working interest holder in drilling an oil and gas well are classified as intangible drilling and development costs (IDC). These costs include wages, fuel, repairs, hauling, supplies, drilling, shooting, and cleaning of wells, cleaning and draining of ground for the site, construction of an access road, and survey and geological work in preparation for the drilling, and construction of derricks, tanks, pipelines, and other physical structures necessary for drilling and production of oil and gas. These types of expenditures are generally considered nondeductible capital expenditures. However, a working interest holder is granted the option of electing to deduct IDC. The operator exercises the option to expense IDC by deducting such costs on the return for the first taxable year in which the taxpayer pays or incurs such costs. If this election is not made, the taxpayer will be deemed to have elected to capitalize the IDC as leasehold costs (recoverable through depletion) and as equipment costs (recoverable through depreciation). The election is effective for all subsequent taxable years and all oil and gas properties. This benefit makes oil and gas investment more desirable from a tax viewpoint: a significant portion of the investment is written off upon the initial investment contrasted with waiting until disposition of the interest as with other types of investments. An election may also be made to ratably deduct the IDC over a 60-month period allowing an investor the flexibility of timing the deduction to maximize the tax benefits available. This election may be made on a "dollar-for-dollar" basis by the individual investor. The IDC deduction is an ordinary deduction sheltering income at the highest income tax brackets as opposed to a capital loss offsetting largely only capital gains. Note that in certain limited circumstances the IDC deduction may create a preference item for alternative minimum tax purposes. This preference item will not apply to IDC in drilling a non-productive well or if the 60-month election is made, as mentioned above.

Expenditures for tangible property, such as drilling tools, pipe, casing, tubing, tanks, engines, and machines are recoverable through depreciation allowance over a recovery period of five to seven years. In addition to depreciation allowances for the use of physical properties, there is an annual allowance for the depletion of the mineral reserves. The depletion allowance may be the greater of (1) an allocated portion of the adjusted basis (includes the costs incurred in acquiring the working interest and the

capitalized, intangible costs incurred in drilling and developing a mineral deposit) of the depletable property (cost depletion); or (2) a statutory percentage of the gross income from the property (percentage depletion). The statutory percentage depletion allowance for independent gas producers is 15% and is calculated based on the income from each separate property. The percentage depletion allowance cannot exceed 100% of the taxable income from the property. (Based on certain production criteria, the percentage of depletion allowance may be more than 15%.)

As an additional incentive, gross receipts derived from a working interest are includible in domestic production gross receipts (DPGR), which makes an ownership interest in a working interest eligible for the domestic production activities deduction (DPAD). The deduction is 9% of qualified production activity income (QPAI) for taxable years beginning after 2009, further limited to 50% of the wages paid and required to be reported on Form W-2 in the calendar year in which the deduction is claimed.

Another advantage of an oil and gas investment is a special exclusion from the passive activity loss limitations. Generally, deductions exceeding income from an investment in a business activity where the investor does not materially participate in the business are not deductible against other types of income such as salary, interest, dividends, and active business income. The losses are considered passive losses, which are suspended and allowed only against passive income or when the investor disposes of his or her entire interest in the activity. However, a working interest in an oil and gas property, which the investor holds directly or through an entity which does not limit his or her liability with respect to such interest, is not considered a passive activity subject to these rules. Thus, an owner of such a working interest in an oil and gas property is permitted to currently deduct otherwise allowable losses attributable to the working interest, whether or not he or she materially participates in the activity.

In addition to the above tax advantages, deductions for a year-end investment in an oil and gas well may be deductible in the year the expenditure is made, even though the well may be drilled in the subsequent year. The IRS has ruled that an investor may deduct prepayments of IDC in the year in which the payment is made where there exists a binding obligation to pay such costs, irrespective of whether the drilling has commenced in that year or the subsequent year. There is also a special rule for accrual method investors which allows an IDC deduction when the payment is made. In general, economic performance has to have occurred with respect to the prepaid drilling expenses. For certain investors, economic performance is deemed to occur in the year of prepayment if drilling of the well commences within 90 days after the end of the year (commonly referred to as the "90 day spud rule"). Therefore, although an oil and gas program may not begin drilling operations until the following year, an investor may still be able to deduct his or her prepaid investment made in the current year.

Owners of oil and gas working interests have also mitigated some of the costs and risks through the joint development of properties. A Joint Operating Agreement is generally entered into, designating one party as the operator and providing for the development and operation of the property and the proportionate sharing of the costs of production. The investor is entitled to his or her proportionate share of the revenues from production of the well (after royalties) during the life of the well.

The tax benefits and incentives described above increase the return from an investment by reducing its after-tax cost and can be quantified for a particular proposed oil and gas investment. These benefits undeniably enhance the attractiveness of purchasing an investment in a crude oil and/or natural gas field drilling and development project while encouraging domestic oil and gas production.

Please be aware that Congress has debated the tax incentives provided for working interests and as a revenue raiser may eliminate most of the tax benefit previously mentioned. Current and future legislation will be closely monitored to keep an update on any adverse developments.

