

Oil & Gas Investments: A Viable Alternative For 1031 Investors

In today's active real estate market, real estate investors are frequently turning to alternative investments such as oil and gas.

(PRWEB) April 6, 2005 -- Introduction: As real estate prices continue to increase and investors are seeking different replacement property options for 1031 like-kind exchanges, Oil & Gas alternatives are beginning to emerge as viable alternatives for 1031 investors, and should strongly be considered to complement a real estate dominated portfolio. Section 1031 of the Internal Revenue Code classifies an investment in an Oil & Gas working interest or royalty interest (Oil & Gas production) as "like-kind" real estate for 1031 exchanges. An investor can exchange raw land, an apartment complex, an office building and all other types of investment real estate for an interest in Oil & Gas production.

Portfolio Diversification: While real estate prices have continued to increase, it has become difficult to accurately predict a profitable exit strategy for many passive real estate investments saddled with balloon financing and interest only loans. However, Oil & Gas production can provide a long-term investment with secure cash flow without the headaches of additional 1031 exchanges for the investor. Also, Oil & Gas production is not management intensive, and the investment is wholly owned by the investor who will control the exit strategy.

Unlike Tenant-In-Common investments, there is an active secondary market for Oil & Gas production. At anytime, an investor can sell directly to another investor or liquidate the investment at various auction houses that specialize in auctioning Oil & Gas production.

Diversification in Oil & Gas: Unlike traditional real estate investments where it is difficult to diversify across different asset types in different geographical locations, it is much easier to diversify with an Oil & Gas investment. Oil & Gas production is sold on a fractional basis, typically with a smaller minimum investment. Large producing fields can be sold to hundreds of investors where each individual investor owns a fractional interest in all of the producing wells.

Revenue Procedure 2002-22: Unlike Tenant-In-Common investments, Oil & Gas investments do not have to comply with the strict requirements of Revenue Procedure 2002-22. There is not a maximum investor requirement and Sponsors can earn carried and back-end interests as compensation to align their interests with investors.

Global Currency: Unlike United States based real estate, Oil & Gas is a global commodity that is not solely dependent on the United States economy. As the economies of China, India and other countries continue to emerge, many analysts agree that demand for Oil & Gas will continue to rise. If future supply can't meet this increased demand, the price of Oil & Gas will continue to rise.

Experienced Operator: Similar to Tenant-In-Common ownership, it is important to invest with an experienced Sponsor. A good Oil & Gas investment depends on good engineering and a thorough understanding of the production life of the wells. An experienced operator will have the professionals in place to properly analyze these investments.

Types of Oil & Gas Investments That Qualify as "Like-Kind" Real Estate: Section 1031 of the Internal Revenue Code classifies an investment in an Oil & Gas working interest or royalty interest as "like-kind" real estate for 1031 exchanges. A working interest is a leasehold interest that allows the

lessee the right to search for and produce Oil & Gas on a parcel of land. The Working Interest bears the expense of operating the Oil & Gas wells on the land (Royalty Interests do not), and receives a portion of the proceeds of the Oil & Gas produced.

Not all Oil & Gas investments qualify as "like-kind" for 1031 exchanges. While there are other tax benefits, drilling for Oil & Gas is not "like-kind" to real estate. Also, when selling Oil & Gas production, part of the sales price will be allocated to equipment and machinery. If this amount is 15% or less of the total sales price, it will be treated as de minimis to the sale and the entire sales amount can be exchanged into "like-kind" real estate. However, if the amount allocated to machinery is greater than 15% of the total sales price, it will be treated as personal property and not qualify.

Downsides & Risks: Like any investment, there are some downsides to Oil & Gas investing. Oil & Gas distributions will include a monthly income and principal return. For 1031 investors, it is difficult to continue exchanging the principal into other replacement property. Unlike real estate, Oil & Gas is very difficult to leverage. 1031 investors needing to replace debt in their exchange will have a difficult time acquiring Oil & Gas production.

Oil & Gas investments are valued based on the amount of potential production and the price of Oil & Gas as a commodity. As Oil & Gas commodity prices increase or decrease, values of Oil & Gas production fluctuate. If new areas of exploration are discovered, alternative energy sources are developed or supply begins to exceed demand, an Oil & Gas investment will likely decrease in value. While there are no drilling risks, Oil & Gas wells do require maintenance, and an Owner of a Working Interest will pay a pro rata share of the expenses associated with maintaining the wells.

Tax Treatment: Investors in Oil & Gas production can deduct against income the greater of "cost" depletion or "percentage" depletion. 1031 Investors often transfer a low basis into Oil & Gas production and will typically use "percentage" depletion. "Percentage" depletion is calculated as a percentage of the revenue generated by the wells. The cost or adjusted basis has no bearing on the amount of "percentage" depletion allowed. As a result, depletion deductions can exceed the cost or adjusted basis. Unlike depreciation of real estate, if the investor sells Oil & Gas production, there is no recapture of depletion taken.

Before making an investment in Oil & Gas production, please consult your Advisor to learn more about this viable alternative for 1031 Investors.

This information is intended merely to be a general discussion, not deemed to be investment or legal advice. Real estate and TIC investments are not suitable for all investors. Individual investors should consult their tax advisor, CPA, and financial advisors prior to making any investment decisions.

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