THE TAX ADVANTAGES OF OIL & GAS EXPLORATION

PRESENTED BY ROYALE ENERGY, INC.

CORPORATE OFFICES

7676 Hazard Center Drive
Suite 1500
San Diego, CA 92108
Phone: (800) 447-8505
Fax: (619) 881-2899
www.royl.com

NASDAQ Listed Symbol (ROYL)
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This guide provides examples of the tax advantages of oil and gas exploration. Each individual has a unique tax situation.
Explanations of the Tax Advantages
(This page has been intentionally left blank.)
REDUCING FEDERAL AND STATE INCOME TAXES

The U.S. government has provided tax incentives to stimulate domestic oil and natural gas production financed by private investors. Oil and natural gas projects offer many tax advantages. These tax benefits enhance the economics of oil and natural gas projects.

ACTIVE VS. PASSIVE INCOME

The Tax Reform Act of 1986 introduced into the Tax Code the concepts of “Passive” income and “Active” income. The Act prohibits the offsetting of losses from Passive activities against income from Active businesses. The new Tax Code specifically states that a Working Interest in an oil and gas well is not a “Passive” activity; therefore, deductions can be offset against income from active stock trades, business income, salaries, etc.

Use money you would otherwise pay out to federal and state income taxes to build a portfolio in energy.

INTANGIBLE DRILLING COSTS (IDC’s)

Intangible Drilling Costs are the labor and supplies incidental that are necessary for the drilling and preparation of the well for production of oil and gas. This is approximately 80% of the total cost of the investment and 100% deductible in the year of investment.

IDC’s are placed on Schedule C/Form 1040 (Profit or Loss from Business) in Part V (Other Expenses) on line 48.

See page 35 for additional information on the US Tax Code, Section 263.

TANGIBLE DRILLING COSTS (TDC’s)

Tangible drilling costs include hard assets such as the wellhead and production equipment. TDC’s are approximately 20% of the total cost of the investment and are typically depreciated over a seven year period. In some cases, TDC’s may be accelerated under Section 179 of the Tax Code. If Section 179 is elected, 100% of the TDC’s can be deducted in the year of investment.

TDC’s are placed on Form 4562 (Depreciation and Amortization) in Part III, Section B.

See page 36 for additional information on the US Tax Code, Section 179.

ALTERNATIVE MINIMUM TAX (AMT)

Prior to the 1992 Tax Act, working interest participants in oil and gas joint ventures were subject to the Alternative Minimum Tax to the extent that this tax exceeded their regular tax. The recent Tax Act exempted Intangible Drilling Costs as a tax preference item.
“Alternative Minimum Taxable Income” generally consists of adjusted gross income, minus allowable Alternative Minimum Tax itemized deduction, plus the sum of tax preference items and adjustments.

“Tax preference items” are preferences existing in the Code to greatly reduce or eliminate regular income taxation. Included within this group are deductions for excess Intangible Drilling and Development Costs and the deduction for depletion allowable for a taxable year over the adjusted basis in the Drilling Acreage and the wells thereon.

This is a special exception for independent producers who produce less than 50,000 barrels per day.

**DEPLETION**

Depletion applies when production begins, and it allows the owner of a producing oil and/or gas well to recover their investment through tax deductions over the period in which oil and/or gas is produced. The depletion deduction is 15% of gross income for the life of the well. The deduction is placed on line 12 of Schedule C/Form 1040.

For example, $11,000 in gross income depleted at 15% is $1650 and is placed on line 12 of the Schedule C/Form 1040.
Sample Tax Letters from Royale Energy, Inc.
January 30, 2010

John & Jane Oil
1234 Royale Street
San Diego, CA  92108

Owner ID: ######

RE: Schedule C Information

Dear Mr. & Mrs. Oil:

The amount listed below should be used in reporting your oil and natural gas activities associated with Royale Energy, Inc. in your respective tax returns for 2009. These amounts should be included in Schedule “C” profit or (loss) from business or profession on Form 1040. These amounts are **NOT** reported as a partnership income or (loss) on Schedule “E” of Form 1040.

Intangible Drilling and Development Costs are all expenditures made by an operator for wages, fuel, supplies, etc., inclusive to and necessary for the drilling and preparation of wells for the production of oil and natural gas, including costs incurred to purchase and install well equipment during the development of the well.

Intangible Drilling Costs:  $40,000

Tangible Well Equipment:  $10,000

There are various tax treatments and elections that are accorded to oil and natural gas activities. We are not licensed to advise you regarding your taxes and we strongly recommend that you consult with your tax preparer/accountant as to your individual tax needs.

If you have any questions or need additional assistance, please contact our Investor Relations Department at 619-881-2800.

Sincerely yours,

Ronald Lipnick

Ronald Lipnick
Controller
January 30, 2010

John & Jane Oil
1234 Royale Street
San Diego, CA 92108

Owner ID: ######

Dear Mr. & Mrs. Oil:

The amount listed below should be used in reporting your oil and gas activities associated with Royale Energy, Inc. in your respective tax returns for 2009. These amounts should be included in Schedule “C” profit or (loss) from business or profession on Form 1040. These amounts are NOT reported as a partnership income or (loss) on Schedule “E” of Form 1040.

Oil and Gas Revenue $11,000
Less Operating Expenses $1,500
Less Production Tax $0

FORM 1099

The 1099 you received shows the Gross Revenue you received during 2009. This will not match the amounts of your revenue checks. Lease operation costs and production taxes were deducted from the gross revenue, so the checks show all revenues, taxes and expenses associated with your interest in production.

We hope this will be helpful regarding the information that you may desire to give to your tax preparer/accountant.

If you have any questions or need additional assistance, please contact our Investor Relations Department at 619-881-2800.

Sincerely yours,

Ronald Lipnick
Controller
January 30, 2010

RECIPIENT TAX ID: ###-##-####
OWNER ID: ######

John & Jane Oil
1234 Royale Street
San Diego, CA  92108

2007 STATEMENT FOR RECIPIENTS OF MISCELLANEOUS INCOME
FORM 1099 - MISC OMB No. 1545-0115

The following is important Tax Information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction will be imposed on you if taxable income results from this transaction and the IRS determines that it has not been reported.

Federal regulations require that we report Gross Earnings to the IRS. For your information the following includes the net amount paid to you.

<table>
<thead>
<tr>
<th></th>
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<th></th>
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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>$0</td>
<td>$11,000</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
<td>$11,000</td>
</tr>
</tbody>
</table>

INSTRUCTIONS FOR RECIPIENTS OF MISCELLANEOUS INCOME:

The amounts shown on this form may be subject to self-employment tax. If your net earnings from self-employment income are $400.00 or more, you are required to file a return and compute your self-employment tax on Schedule SE (Form 1040). See Pub. 533, Self-Employment Tax. If no income or social security and Medicare taxes were withheld by the payer, you may have to make estimated tax payments if you are still receiving these payments. See Form 1040ES Estimated Tax for Individuals. If you are an individual, report the taxable amounts on your tax return as shown below. Others, such as corporations or partnerships, report the amounts on the proper line of your tax return.

Item 1 & 2: Report rents from real estate On Schedule E (1040), if you sold real estate as a business, or rented personal property as a business, report on Schedule C or C-EZ (Form 1040). For royalties on timber, coal, and iron ore, see Pub. 544, 'Sales and Other Dispositions of Assets'.

Item 4: Shows backup withholding. For example, persons not furnishing their taxpayer identification number to the payer become subject to backup withholding at 31% rate on certain payments. See Form W-9, Request for Tax-payer Identification Number and Certification, for information on backup withholding. INCLUDE THIS AMOUNT ON YOUR INCOME TAX RETURN AS TAX WITHHELD.

Item 7: Generally, these amounts are considered income from self-employment. Since you received this form, rather than Form W-2, the payer may have considered you self-employed and did not withhold social security or Medicare taxes. Report self-employment income on Schedule C, C-EZ, or F (Form 1040), and compute the self-employment tax on Schedule SE (Form 1040). If you are not self-employed, report this amount on the 'Wages, salaries, tips, etc.' line of Form 1040. Call the IRS for information about how to report any social security and Medicare Taxes.
Three Tax Return Examples
Example #1 (New Investor)

The following tax return example is for a new investor with Royale Energy, Inc. At this point they have no established income and will deduct 80% of their investment as intangible drilling costs. In addition they will begin to depreciate the tangible drilling costs using the seven-year MACRS depreciation schedule, which will amount to approximately 3% of invested dollars giving a first year deduction of approximately 83% of invested dollars.

Please see page 13 for the first year of the seven-year MACRS depreciation schedule.

Example #1 tax return forms follow on pages 9-12.

ASSUMPTIONS USED IN ALL THREE TAX RETURN EXAMPLES

- Based on Using ½ Unit Example of a $50,000 Investment
- Schedule C Letter
  1. Total Invested Dollars: $50,000
  2. Intangible Drilling Costs: $40,000 (80% of Invested Dollars)
  3. Tangible Well Equipment: $10,000 (20% of Invested Dollars)
- 1099 Income Statement
  1. Gross Oil and Gas Revenue: $11,000
  2. Well Operating Expenses: $1,500

EXPLANATION OF THE STEPS USED

Schedule C (Form 1040): pages 9-10

1. Line 13 – Depreciation deduction: $10,000 x 14.29% = $1,429
2. Line 48 – Intangible drilling costs: $50,000 x 80% = $40,000
   \(\text{Intangible Drilling Costs} = \text{Investment} \times 80\%\)
3. Line 27 – Amount calculated in line 48: $40,000
4. Line 28 – Add Lines 8 through 27: $1,429 + $40,000 = $41,429
5. Line 29 – Subtract line 28 from line 7: $0 - $41,429 = ($41,429)
   \(\text{Note: ( ) are used to denote a negative number.}\)
6. Line 31 – Subtract line 30 from line 29: ($41,429) - $0 = ($41,429)
Form 4562: pages 11-12

1. Line 19c – Year 1 of 7 on the MACRS Depreciation Schedule: $10,000 x 14.29% = $1429
2. Line 22 – Add lines 12, 14-17, 19-21: $1429
### SCHEDULE C (Form 1040)

#### Profit or Loss From Business

(See Instructions for Schedule C (Form 1040))

**John & Jane Oil (1/2 Unit Investment of $50,000- No Established Income)**

<table>
<thead>
<tr>
<th>A Principal business or profession, including product or service (see page C-2 of the instructions)</th>
<th>B Enter code from pages C-9, 10, &amp; 11</th>
</tr>
</thead>
<tbody>
<tr>
<td>Royale Energy, Inc.</td>
<td>2 1 1 1 1 0</td>
</tr>
</tbody>
</table>

**Business address (including suite or room no.)**

7676 Hazard Center Drive, Suite 1500

San Diego, CA 92108

**Social security number (SSN)**

000-00-0000

**Name of proprietor**

John & Jane Oil (1/2 Unit Investment of $50,000- No Established Income)

**Accounting method:**

Cash

**Net profit or (loss).** Subtract line 27 from line 28.

- **Part I Income**
  - Gross receipts or sales. Caution. See page C-4 and check the box if:
    - You are a member of a qualified joint venture reporting only rental real estate income not subject to self-employment tax. Also see page C-3 for limit on losses.
  - Returns and allowances
  - Subtract line 2 from line 1
  - Cost of goods sold (from line 42 on page 2)
  - Gross profit. Subtract line 4 from line 3
  - Other income, including federal and state gasoline or fuel tax credit or refund
  - Gross income. Add lines 5 and 6

<table>
<thead>
<tr>
<th>1 Gross receipts or sales. Caution. See page C-4 and check the box if:</th>
<th>2 Returns and allowances</th>
<th>3 Subtract line 2 from line 1</th>
<th>4 Cost of goods sold (from line 42 on page 2)</th>
<th>5 Gross profit. Subtract line 4 from line 3</th>
<th>6 Other income, including federal and state gasoline or fuel tax credit or refund (see page C-4)</th>
<th>7 Gross income. Add lines 5 and 6</th>
</tr>
</thead>
<tbody>
<tr>
<td>- You are a member of a qualified joint venture reporting only rental real estate income not subject to self-employment tax. Also see page C-3 for limit on losses.</td>
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</tr>
</tbody>
</table>

- **Part II Expenses.** Enter expenses for business use of your home only on line 30.

<table>
<thead>
<tr>
<th>8 Advertising</th>
<th>9 Car and truck expenses (see page C-4)</th>
<th>10 Commissions and fees</th>
<th>11 Contract labor (see page C-4)</th>
<th>12 Depletion</th>
<th>13 Depreciation and section 179 expense deduction (not included in Part III) (see page C-5)</th>
<th>14 Employee benefit programs (other than on line 19)</th>
<th>15 Insurance (other than health)</th>
<th>16 Interest:</th>
<th>17 Legal and professional services</th>
</tr>
</thead>
<tbody>
<tr>
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<td></td>
</tr>
</tbody>
</table>

- **Tentative profit or (loss).** Subtract line 28 from line 7.

- **Expenses for business use of your home.** Attach Form 8829

- **Net profit or (loss).** Subtract line 30 from line 29.

<table>
<thead>
<tr>
<th>28 Total expenses before expenses for business use of home. Add lines 8 through 27</th>
<th>29 Tentative profit or (loss). Subtract line 28 from line 7</th>
<th>30 Expenses for business use of your home. Attach Form 8829</th>
<th>31 Net profit or (loss). Subtract line 30 from line 29.</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
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</tr>
</tbody>
</table>

- **If a profit, enter on both Form 1040, line 12, and Schedule SE, line 2, or on Form 1040NR, line 13 (if you checked the box on line 1, see page C-7). Estates and trusts, enter on Form 1041, line 3.**

  - **If a loss, you must go to line 32.**

  - **If you have a loss, check the box that describes your investment in this activity (see page C-7).**

  - **If you checked 32a, enter the loss on both Form 1040, line 12, and Schedule SE, line 2, or on Form 1040NR, line 13 (if you checked the box on line 1, see the line 31 instructions on page C-7). Estates and trusts, enter on Form 1041, line 3.**

  - **If you checked 32b, you must attach Form 6198. Your loss may be limited.**

For Paperwork Reduction Act Notice, see page C-9 of the instructions.

Cat. No. 11334/P

Schedule C (Form 1040) 2009

OMB No. 1545-0074
Part III  Cost of Goods Sold (see page C-8)

33 Method(s) used to value closing inventory:  
   a  □ Cost  
   b  □ Lower of cost or market  
   c  □ Other (attach explanation)

34 Was there any change in determining quantities, costs, or valuations between opening and closing inventory?  
   □ Yes  □ No

35 Inventory at beginning of year. If different from last year’s closing inventory, attach explanation.

36 Purchases less cost of items withdrawn for personal use.

37 Cost of labor. Do not include any amounts paid to yourself.

38 Materials and supplies.

39 Other costs.

40 Add lines 35 through 39.

41 Inventory at end of year.

42 Cost of goods sold. Subtract line 41 from line 40. Enter the result here and on page 1, line 4.

Part IV  Information on Your Vehicle. Complete this part only if you are claiming car or truck expenses on line 9 and are not required to file Form 4562 for this business. See the instructions for line 13 on page C-5 to find out if you must file Form 4562.

43 When did you place your vehicle in service for business purposes? (month, day, year)

44 Of the total number of miles you drove your vehicle during 2009, enter the number of miles you used your vehicle for:

   a  Business
   b  Commuting (see instructions)
   c  Other

45 Was your vehicle available for personal use during off-duty hours?  
   □ Yes  □ No

46 Do you (or your spouse) have another vehicle available for personal use?  
   □ Yes  □ No

47a Do you have evidence to support your deduction?  
   □ Yes  □ No

   b  If “Yes,” is the evidence written?  
      □ Yes  □ No

Part V  Other Expenses. List below business expenses not included on lines 8–26 or line 30.

   Intangible Drilling Cost (80% of $50,000 Investment)  
      $40,000

48 Total other expenses. Enter here and on page 1, line 27.

   $40,000
**Depreciation and Amortization**

**(Including Information on Listed Property)**

- **Part I** Election To Expense Certain Property Under Section 179
  - **Note:** If you have any listed property, complete Part V before you complete Part I.

<p>| | | |</p>
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<thead>
<tr>
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<tbody>
<tr>
<td>1</td>
<td>Maximum amount. See the instructions for a higher limit for certain businesses</td>
<td>$250,000</td>
</tr>
<tr>
<td>2</td>
<td>Total cost of section 179 property placed in service (see instructions)</td>
<td>$800,000</td>
</tr>
<tr>
<td>3</td>
<td>Threshold cost of section 179 property before reduction in limitation (see instructions)</td>
<td></td>
</tr>
<tr>
<td>4</td>
<td>Reduction in limitation. Subtract line 3 from line 2. If zero or less, enter -0-</td>
<td></td>
</tr>
<tr>
<td>5</td>
<td>Dollar limitation for tax year. Subtract line 4 from line 1. If zero or less, enter -0-. If married filing separately, see instructions</td>
<td></td>
</tr>
</tbody>
</table>

- **Part II** Special Depreciation Allowance and Other Depreciation (Do not include listed property.)
  - **See instructions.**

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<tr>
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<tbody>
<tr>
<td>14</td>
<td>Special depreciation allowance for qualified property (other than listed property) placed in service during the tax year (see instructions)</td>
<td></td>
</tr>
<tr>
<td>15</td>
<td>Property subject to section 168(f)(1) election</td>
<td></td>
</tr>
<tr>
<td>16</td>
<td>Other depreciation (including ACRS)</td>
<td></td>
</tr>
</tbody>
</table>

- **Part III** MACRS Depreciation (Do not include listed property.)
  - **See instructions.**

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</thead>
<tbody>
<tr>
<td>17a</td>
<td>Classification of property</td>
<td>3-year property</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>17b</td>
<td>Class life</td>
<td>3 yrs.</td>
<td></td>
<td>S/L</td>
<td></td>
</tr>
<tr>
<td>17c</td>
<td>Recovery period</td>
<td>200%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>17d</td>
<td>Convention</td>
<td>Half Year</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>17e</td>
<td>Method</td>
<td>S/L</td>
<td></td>
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</table>

- **Part IV** Summary
  - **See instructions.**

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<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>20a</td>
<td>Class life</td>
<td>12-year</td>
<td></td>
<td>S/L</td>
<td></td>
</tr>
<tr>
<td>20b</td>
<td>40-year</td>
<td></td>
<td>S/L</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

- **Note:** Do not use Part II or Part III below for listed property. Instead, use Part V.

**For Paperwork Reduction Act Notice, see separate instructions.**
**Part V Listed Property** (Include automobiles, certain other vehicles, cellular telephones, certain computers, and property used for entertainment, recreation, or amusement.)

**Note:** For any vehicle for which you are using the standard mileage rate or deducting lease expense, complete only 24a, 24b, columns (a) through (c) of Section A, all of Section B, and Section C if applicable.

### Section A—Depreciation and Other Information (Caution: See the instructions for limits for passenger automobiles.)

<table>
<thead>
<tr>
<th>(a) Type of property (list vehicles first)</th>
<th>(b) Date placed in service</th>
<th>(c) Business/ investment use percentage</th>
<th>(d) Cost or other basis</th>
<th>(e) Basis for depreciation (business/investment use only)</th>
<th>(f) Recovery period</th>
<th>(g) Method/ Convention</th>
<th>(h) Depreciation deduction</th>
<th>(i) Elected section 179 cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>25 Special depreciation allowance for qualified listed property placed in service during the tax year and used more than 50% in a qualified business use (see instructions)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

### Section B—Information on Use of Vehicles

Complete this section for vehicles used by a sole proprietor, partner, or other "more than 5% owner," or related person. If you provided vehicles to your employees, first answer the questions in Section C to see if you meet an exception to completing this section for those vehicles.

<table>
<thead>
<tr>
<th>(a) Vehicle 1</th>
<th>(b) Vehicle 2</th>
<th>(c) Vehicle 3</th>
<th>(d) Vehicle 4</th>
<th>(e) Vehicle 5</th>
<th>(f) Vehicle 6</th>
</tr>
</thead>
</table>

**30 Total business/investment miles driven during the year (do not include commuting miles).**

**31 Total commuting miles driven during the year.**

**32 Total other personal (noncommuting) miles driven.**

**33 Total miles driven during the year. Add lines 30 through 32.**

**34 Was the vehicle available for personal use during off-duty hours?**

**35 Was the vehicle used primarily by a more than 5% owner or related person?**

**36 Is another vehicle available for personal use?**

### Section C—Questions for Employers Who Provide Vehicles for Use by Their Employees

Answer these questions to determine if you meet an exception to completing Section B for vehicles used by employees who are not more than 5% owners or related persons (see instructions).

<table>
<thead>
<tr>
<th>Yes</th>
<th>No</th>
</tr>
</thead>
</table>

**37 Do you maintain a written policy statement that prohibits all personal use of vehicles, including commuting, by your employees?**

**38 Do you maintain a written policy statement that prohibits personal use of vehicles, except commuting, by your employees? See the instructions for vehicles used by corporate officers, directors, or 1% or more owners.**

**39 Do you treat all use of vehicles by employees as personal use?**

**40 Do you provide more than five vehicles to your employees, obtain information from your employees about the use of the vehicles, and retain the information received?**

**41 Do you meet the requirements concerning qualified automobile demonstration use? (See instructions.)**

**Note:** If your answer to 37, 38, 39, 40, or 41 is “Yes,” do not complete Section B for the covered vehicles.

### Part VI Amortization

<table>
<thead>
<tr>
<th>(a) Description of costs</th>
<th>(b) Date amortization begins</th>
<th>(c) Amortizable amount</th>
<th>(d) Code section</th>
<th>(e) Amortization period or percentage</th>
<th>(f) Amortization for this year</th>
</tr>
</thead>
</table>

**42 Amortization of costs that begins during your 2009 tax year (see instructions):**

**43 Amortization of costs that began before your 2009 tax year.**

**44 Total. Add amounts in column (f). See the instructions for where to report.**
Example #1 (New Investor)

Sample 7-Year MACRS Depreciation Schedule

The depreciation schedule below is the method used to depreciate the well operating equipment, which is the tangible part of the investment. Some investors may qualify for section 179, which accelerates depreciation as noted in Example #2.

For example #1 the investor is in the first year of the seven depreciation schedule. The Tangible Drilling Costs of $10,000 depreciated at 14.29% would yield $1429.

Please note that each individual has a unique tax situation.

Method: 200% declining balance switching to straight line

Convention: Half-Year

Investment:
½ Unit Investment = $50,000

Intangible Drilling Costs (80% of investment) = $40,000
Deducted during the first year of investment

Tangible Drilling Costs (20% of investment) = $10,000
Depreciated over 7 year period (see table below)

<table>
<thead>
<tr>
<th>Year</th>
<th>Starting Amount Being Depreciated</th>
<th>Percent of Depreciation</th>
<th>Amount of Depreciation Each Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$10,000</td>
<td>14.29%</td>
<td>$1429</td>
</tr>
<tr>
<td>2</td>
<td>$10,000</td>
<td>24.49%</td>
<td>$2449</td>
</tr>
<tr>
<td>3</td>
<td>$10,000</td>
<td>17.49%</td>
<td>$1749</td>
</tr>
<tr>
<td>4</td>
<td>$10,000</td>
<td>12.49%</td>
<td>$1249</td>
</tr>
<tr>
<td>5</td>
<td>$10,000</td>
<td>8.93%</td>
<td>$893</td>
</tr>
<tr>
<td>6</td>
<td>$10,000</td>
<td>8.93%</td>
<td>$893</td>
</tr>
<tr>
<td>7</td>
<td>$10,000</td>
<td>8.93%</td>
<td>$893</td>
</tr>
<tr>
<td>8</td>
<td>$10,000</td>
<td>4.45%</td>
<td>$445</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td>100%</td>
<td>$10,000</td>
</tr>
</tbody>
</table>
Example #2 (New Investor-Section 179 Elected)

The following tax return example is for a new investor with Royale Energy, Inc. At this point they have no established income but because of their unique situation, they are able to qualify for the section 179 election. They will deduct 80% of their investment as intangible drilling costs plus the remaining 20% of their investment as tangible drilling costs. Because of their unique tax situation, this individual is able to deduct the entire investment in the first year.

Please note that you must qualify to elect to use section of 179. See US Tax Code, Section 179 explanation on page 36.

Example #2 tax forms follow on pages 17-20.

**Assumptions Used in All Three Tax Return Examples**

- Based on Using ½ Unit Example of a $50,000 Investment
- Schedule C Letter
  1. Total Invested Dollars: $50,000
  2. Intangible Drilling Costs: $40,000 (80% of Invested Dollars)
  3. Tangible Well Equipment: $10,000 (20% of Invested Dollars)
- 1099 Income Statement
  1. Gross Oil and Gas Revenue: $11,000
  2. Well Operating Expenses: $1,500

**Explanation of the Steps Used**

Schedule C (Form 1040): pages 17-18

1. **Line 13** – Depreciation deduction: $10,000
2. **Line 48** – Intangible drilling costs: $50,000 x 80% = $40,000
   
   *(Intangible Drilling Costs = Investment x 80%)*
3. **Line 27** – Amount calculated in line 48: $40,000
4. **Line 28** – Add lines 8 through 27: $10,000 + $40,000 = $50,000
5. **Line 29** – Subtract line 28 from line 7: $0 - $50,000 = ($50,000)
   
   *Note: ( ) are used to denote a negative number.*
6. **Line 31** – Subtract line 30 from line 29: ($50,000) - $0 = ($50,000)
Form 4562: pages 19-20

1. **Line 2** – Total cost of section 179: **$10,000**

2. **Line 8** – Total elected cost of section 179 property: **$10,000**

3. **Line 9** – Tentative deduction: **$10,000**

4. **Line 10** – Carryover of disallowed deduction: **$0**

5. **Line 12** – Section 179 expense deduction: **$10,000**

6. **Line 22** – Add lines 12, 14-17, and 19-21: **$10,000**
### SCHEDULE C (Form 1040)

**Profit or Loss From Business**

**Sole Proprietorship**

#### Example #2 (New Investor - Section 179)

**Business address (including suite or room no.)**

- **John & Jane Oil**
- **(1/2 Unit Investment of $50,000 - No Established Income)**
- **Royale Energy, Inc.**
- **7676 Hazard Center Drive, Suite 1500**
- **San Diego, CA 92108**

**Accounting method:**
- **(1) Cash**
- **(2) Accrual**
- **(3) Other (specify)**

**Did you “materially participate” in the operation of this business during 2009?**
- **Yes**
- **No**

**If you started or acquired this business during 2009, check here.**

---

#### Part I: Income

1. **Gross receipts or sales. Caution.** See page C-4 and check the box if:
   - This income was reported to you on Form W-2 and the “Statutory employee” box on that form was checked, or
   - You are a member of a qualified joint venture reporting only rental real estate income not subject to self-employment tax. Also see page C-3 for limit on losses.

2. **Returns and allowances**

3. **Subtract line 2 from line 1**

4. **Cost of goods sold (from line 42 on page 2)**

5. **Gross profit.** Subtract line 4 from line 3

6. **Other income, including federal and state gasoline or fuel tax credit or refund**

7. **Gross income.** Add lines 5 and 6

---

#### Part II: Expenses.

Enter expenses for business use of your home only on line 30.

<table>
<thead>
<tr>
<th>Expenses</th>
<th>Line</th>
</tr>
</thead>
<tbody>
<tr>
<td>Advertising</td>
<td>8</td>
</tr>
<tr>
<td>Car and truck expenses (see page C-4)</td>
<td>9</td>
</tr>
<tr>
<td>Commissions and fees</td>
<td>10</td>
</tr>
<tr>
<td>Contract labor (see page C-4)</td>
<td>11</td>
</tr>
<tr>
<td>Depletion</td>
<td>12</td>
</tr>
<tr>
<td>Depreciation and section 179 expense deduction (not included in Part III) (see page C-5)</td>
<td>13</td>
</tr>
<tr>
<td>Employee benefit programs (other than on line 19)</td>
<td>14</td>
</tr>
<tr>
<td>Insurance (other than health)</td>
<td>15</td>
</tr>
<tr>
<td>Interest:</td>
<td>16</td>
</tr>
<tr>
<td>Mortgage (paid to banks, etc.)</td>
<td>16a</td>
</tr>
<tr>
<td>Other</td>
<td>16b</td>
</tr>
<tr>
<td>Legal and professional services</td>
<td>17</td>
</tr>
<tr>
<td>Total expenses</td>
<td>28</td>
</tr>
<tr>
<td>Tentative profit or (loss). Subtract line 28 from line 7</td>
<td>29</td>
</tr>
<tr>
<td>Expenses for business use of your home. Attach Form 8829</td>
<td>30</td>
</tr>
</tbody>
</table>

---

#### Part II: Net profit or (loss).

- **If a profit, enter on both Form 1040, line 12, and Schedule SE, line 2, or on Form 1040NR, line 13 (if you checked the box on line 1, see page C-7). Estates and trusts, enter on Form 1041, line 3.**
- **If a loss, you must go to line 32.**

---

**For Paperwork Reduction Act Notice, see page C-9 of the instructions.**

Cat. No. 11334P

Schedule C (Form 1040) 2009
### Part III: Cost of Goods Sold (see page C-8)

33. Method(s) used to value closing inventory:  
   - [ ] Cost  
   - [ ] Lower of cost or market  
   - [ ] Other (attach explanation)

34. Was there any change in determining quantities, costs, or valuations between opening and closing inventory?  
   - [ ] Yes  
   - [ ] No

35. Inventory at beginning of year. If different from last year’s closing inventory, attach explanation.

36. Purchases less cost of items withdrawn for personal use.

37. Cost of labor. Do not include any amounts paid to yourself.

38. Materials and supplies.

39. Other costs.

40. Add lines 35 through 39.

41. Inventory at end of year.

42. Cost of goods sold. Subtract line 41 from line 40. Enter the result here and on page 1, line 4.

### Part IV: Information on Your Vehicle.
Complete this part only if you are claiming car or truck expenses on line 9 and are not required to file Form 4562 for this business. See the instructions for line 13 on page C-5 to find out if you must file Form 4562.

43. When did you place your vehicle in service for business purposes? (month, day, year)

44. Of the total number of miles you drove your vehicle during 2009, enter the number of miles you used your vehicle for:
   - [ ] Business
   - [ ] Commuting (see instructions)
   - [ ] Other

45. Was your vehicle available for personal use during off-duty hours?  
   - [ ] Yes  
   - [ ] No

46. Do you (or your spouse) have another vehicle available for personal use?  
   - [ ] Yes  
   - [ ] No

47a. Do you have evidence to support your deduction?  
   - [ ] Yes  
   - [ ] No
   
   b. If “Yes,” is the evidence written?  
   - [ ] Yes  
   - [ ] No

### Part V: Other Expenses.
List below business expenses not included on lines 8–26 or line 30.

| Intangible Drilling Cost (80% of $50,000 Investment) | $40,000 00

48. Total other expenses. Enter here and on page 1, line 27.
## Part I: Election To Expense Certain Property Under Section 179

**Note:** If you have any listed property, complete Part V before you complete Part I.

<table>
<thead>
<tr>
<th></th>
<th>Maximum amount. See the instructions for a higher limit for certain businesses</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$250,000</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Total cost of section 179 property placed in service (see instructions)</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>2</td>
<td>$10,000</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Threshold cost of section 179 property before reduction in limitation (see instructions)</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>3</td>
<td>$800,000</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Dollar limitation for tax year. Subtract line 3 from line 2. If zero or less, enter 0.</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>4</td>
<td>$0</td>
<td></td>
</tr>
</tbody>
</table>

### Footnotes:
- If you have any listed property, complete Part V before you complete Part I.
- If married filing separately, see instructions.
- Do not use Part II or Part III below for listed property. Instead, use Part V.

## Part II: Special Depreciation Allowance and Other Depreciation (Do not include listed property.)

### (See instructions.)

<table>
<thead>
<tr>
<th></th>
<th>Special depreciation allowance for qualified property (other than listed property) placed in service during the tax year (see instructions)</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>14</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Property subject to section 168(f)(1) election</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>15</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Other depreciation (including ACRS)</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>16</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

## Part III: MACRS Depreciation (Do not include listed property.)

### (See instructions.)

### Section A

<table>
<thead>
<tr>
<th></th>
<th>MACRS deductions for assets placed in service in tax years beginning before 2009</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>17</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>If you are electing to group any assets placed in service during the tax year into one or more general asset accounts, check here</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>18</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

### Section B—Assets Placed in Service During 2009 Tax Year Using the General Depreciation System

<table>
<thead>
<tr>
<th>(a) Classification of property</th>
<th>(b) Month and year placed in service</th>
<th>(c) Basis for depreciation (business/investment use only—see instructions)</th>
<th>(d) Recovery period</th>
<th>(e) Convention</th>
<th>(f) Method</th>
<th>(g) Depreciation deduction</th>
</tr>
</thead>
<tbody>
<tr>
<td>19a</td>
<td>3-year property</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>b</td>
<td>5-year property</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>c</td>
<td>7-year property</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>d</td>
<td>10-year property</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>e</td>
<td>15-year property</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>f</td>
<td>20-year property</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>g</td>
<td>25-year property</td>
<td>25 yrs.</td>
<td>S/L</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>h</td>
<td>Residential rental property</td>
<td>27.5 yrs.</td>
<td>MM</td>
<td>S/L</td>
<td></td>
<td></td>
</tr>
<tr>
<td>i</td>
<td>Nonresidential real property</td>
<td>39 yrs.</td>
<td>MM</td>
<td>S/L</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

### Section C—Assets Placed in Service During 2009 Tax Year Using the Alternative Depreciation System

<table>
<thead>
<tr>
<th>(a) Class life</th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>20a</td>
<td>12-year</td>
<td></td>
<td></td>
<td>S/L</td>
</tr>
<tr>
<td>20b</td>
<td>40-year</td>
<td></td>
<td></td>
<td>S/L</td>
</tr>
</tbody>
</table>

### Part IV: Summary (See instructions.)

<table>
<thead>
<tr>
<th></th>
<th>Listed property. Enter amount from line 28</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>21</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Add amounts from line 12, lines 14 through 17, lines 19 and 20 in column (g), and line 21. Enter here and on the appropriate lines of your return. Partnerships and S corporations—see instructions</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>22</td>
<td></td>
<td>$10,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>For assets shown above and placed in service during the current year, enter the portion of the basis attributable to section 263A costs</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>23</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
### Part V — Listed Property

(Include automobiles, certain other vehicles, cellular telephones, certain computers, and property used for entertainment, recreation, or amusement.)

**Note:** For any vehicle for which you are using the standard mileage rate or deducting lease expense, complete only 24a, 24b, columns (a) through (c) of Section A, all of Section B, and Section C if applicable.

#### Section A — Depreciation and Other Information

<table>
<thead>
<tr>
<th></th>
<th>Type of property (list vehicles first)</th>
<th>Date placed in service</th>
<th>Business/ investment use percentage</th>
<th>Cost or other basis</th>
<th>Basis for depreciation (business/investment use only)</th>
<th>Recovery period</th>
<th>Method/ Convention</th>
<th>Depreciation deduction</th>
<th>Elected section 179 cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>25</td>
<td>Special depreciation allowance for qualified listed property placed in service during the tax year and used more than 50% in a qualified business use (see instructions)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

#### Section B — Information on Use of Vehicles

Complete this section for vehicles used by a sole proprietor, partner, or other “more than 5% owner,” or related person. If you provided vehicles to your employees, first answer the questions in Section C to see if you meet an exception to completing this section for those vehicles.

<table>
<thead>
<tr>
<th></th>
<th>Total business/investment miles driven during the year (do not include commuting miles)</th>
<th>Vehicle 1</th>
<th>Vehicle 2</th>
<th>Vehicle 3</th>
<th>Vehicle 4</th>
<th>Vehicle 5</th>
<th>Vehicle 6</th>
</tr>
</thead>
<tbody>
<tr>
<td>30</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Total commuting miles driven during the year</th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>31</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Total other personal (noncommuting) miles driven</th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>32</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Total miles driven during the year. Add lines 30 through 32</th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>33</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Was the vehicle available for personal use during off-duty hours?</th>
<th>Yes</th>
<th>No</th>
<th>Yes</th>
<th>No</th>
<th>Yes</th>
<th>No</th>
<th>Yes</th>
<th>No</th>
</tr>
</thead>
<tbody>
<tr>
<td>34</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Was the vehicle used primarily by a more than 5% owner or related person?</th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>35</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Is another vehicle available for personal use?</th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>36</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

### Section C — Questions for Employers Who Provide Vehicles for Use by Their Employees

Answer these questions to determine if you meet an exception to completing Section B for vehicles used by employees who are not more than 5% owners or related persons (see instructions).

<table>
<thead>
<tr>
<th></th>
<th>Do you maintain a written policy statement that prohibits all personal use of vehicles, including commuting, by your employees?</th>
<th>Yes</th>
<th>No</th>
</tr>
</thead>
<tbody>
<tr>
<td>37</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Do you maintain a written policy statement that prohibits personal use of vehicles, except commuting, by your employees? See the instructions for vehicles used by corporate officers, directors, or 1% or more owners.</th>
<th>Yes</th>
<th>No</th>
</tr>
</thead>
<tbody>
<tr>
<td>38</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Do you treat all use of vehicles by employees as personal use?</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>39</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Do you provide more than five vehicles to your employees, obtain information from your employees about the use of the vehicles, and retain the information received?</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>40</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Do you meet the requirements concerning qualified automobile demonstration use? (See instructions.)</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>41</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Note:** If your answer to 37, 38, 39, 40, or 41 is “Yes,” do not complete Section B for the covered vehicles.

### Part VI — Amortization

<table>
<thead>
<tr>
<th></th>
<th>Description of costs</th>
<th>Date amortization begins</th>
<th>Amortizable amount</th>
<th>Code section</th>
<th>Amortization period or percentage</th>
<th>Amortization for this year</th>
</tr>
</thead>
<tbody>
<tr>
<td>42</td>
<td>Amortization of costs that begins during your 2009 tax year (see instructions):</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Amortization of costs that began before your 2009 tax year</th>
<th>43</th>
</tr>
</thead>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Total. Add amounts in column (f). See the instructions for where to report</th>
<th>44</th>
</tr>
</thead>
</table>
Example #3 (Existing Investor)

The following tax return example is for an existing investor in the second year with Royale Energy, Inc. At this point they have established income and are able to take deductions as follows.

1. Depletion: 15% of Gross Income (see line 12 on page 23)
2. Continued depreciation of tangible drilling equipment (see line 13 on page 23)
3. Well operating expenses (see line 48 on page 24)

Please note that for this example, the individual is using year two of the seven-year MACRS depreciation schedule. See page 27 for the seven-year MACRS depreciation schedule.

Example #3 tax forms follow on pages 23-26.

ASSUMPTIONS USED IN ALL THREE TAX RETURN EXAMPLES

- Based on Using ½ Unit Example of a $50,000 Investment
- Schedule C Letter
  1. Total Invested Dollars: $50,000
  2. Intangible Drilling Costs: $40,000 (80% of Invested Dollars)
  3. Tangible Well Equipment: $10,000 (20% of Invested Dollars)
- 1099 Income Statement
  1. Gross Oil and Gas Revenue: $11,000
  2. Well Operating Expenses: $1,500

Example #3 Tax Return

Schedule C (Form 1040): pages 23-24

1. **Line 7** – Gross oil and gas revenue: $11,000

2. **Line 12** – Depletion deduction: $11,000 x 15% = $1,650
   
   *(Depletion Deduction = Gross Revenue x 15%)*

3. **Line 13** – Depreciation deduction: $10,000 x 24.49% = $2,449
   
   *(Depreciation Deduction = Tangible Well Equipment x 24.49%)*

   *This percentage is based upon year 2 of 7 on the MACRS Depreciation Schedule.*

4. **Line 48** – Well operating expenses: $1,500

5. **Line 27** – Amount calculated in line 48: $1,500
6. **Line 28** – Add Lines 8 through 27: $1,650 + $2,449 + $1,500 = $5,599

7. **Line 29** – Subtract line 28 from line 7: $11,000 - $5,599 = $5,401
   
   *Note: ( ) are used to denote a negative number.*

8. **Line 31** – Subtract line 29 from line 30: $5,401 - $0 = $5,401

**Form 4562**: pages 25-26

1. **Line 17** – MACRS deductions for assets placed in service in tax years beginning before 2006: $10,000 x 24.99% = $2449
   
   *This is the 2nd year of the 7 year MACRS Deprecation Schedule.*

2. **Line 22** – Add lines 12, 14-17, and 19-21: $2449
### Part I: Income

- **1. Gross receipts or sales.**
  - See page C-4 and check the box if:
  - This income was reported to you on Form W-2 and the “Statutory employee” box on that form was checked, or
  - You are a member of a qualified joint venture reporting only rental real estate income not subject to self-employment tax. Also see page C-3 for limit on losses.
  - $11,000

- **2. Returns and allowances.**
  - $11,000

- **3. Subtract line 2 from line 1.**
  - $11,000

- **4. Cost of goods sold (from line 42 on page 2).**
  - $11,000

- **5. Gross profit.**
  - Subtract line 4 from line 3.
  - $11,000

- **6. Other income, including federal and state gasoline or fuel tax credit or refund (see page C-4).**
  - $11,000

- **7. Gross income.**
  - Add lines 5 and 6.
  - $11,000

### Part II: Expenses. Enter expenses for business use of your home only on line 30.

- **8. Advertising.**
  - $11,000

- **9. Car and truck expenses (see page C-4).**
  - $11,000

- **10. Commissions and fees.**
  - $11,000

- **11. Contract labor (see page C-4).**
  - $11,000

- **12. Depletion.**
  - $(1,650)

- **13. Depreciation and section 179 expense deduction (not included in Part III) (see page C-5).**
  - $(2,449)

- **14. Employee benefit programs (other than on line 19).**
  - $11,000

- **15. Insurance (other than health).**
  - $11,000

- **16. Interest: a. Mortgage (paid to banks, etc.).**
  - $11,000

- **17. Legal and professional services.**
  - $11,000

- **18. Office expense.**
  - $11,000

- **19. Pension and profit-sharing plans.**
  - $11,000

- **20. Rent or lease (see page C-6): a. Vehicles, machinery, and equipment.**
  - $11,000

- **21. Repairs and maintenance.**
  - $11,000

- **22. Supplies (not included in Part III).**
  - $11,000

- **23. Taxes and licenses.**
  - $11,000

- **24. Travel, meals, and entertainment: a. Travel.**
  - $11,000

- **25. Utilities.**
  - $11,000

- **26. Wages (less employment credits).**
  - $11,000

- **27. Other expenses (from line 48 on page 2).**
  - $11,000

- **28. Total expenses before expenses for business use of home. Add lines 8 through 27.**
  - $(5,599)

- **29. Tentative profit or (loss). Subtract line 28 from line 7.**
  - $5,401

- **30. Expenses for business use of your home.**
  - $11,000

- **31. Net profit or (loss).**
  - Subtract line 30 from line 29.
  - $11,000

- **32. If you have a loss, check the box that describes your investment in this activity (see page C-7).**
  - $11,000

For Paperwork Reduction Act Notice, see page C-9 of the instructions.
### Part III  Cost of Goods Sold (see page C-8)

33 Method(s) used to value closing inventory:  
   a ☐ Cost  
   b ☐ Lower of cost or market  
   c ☐ Other (attach explanation)  

34 Was there any change in determining quantities, costs, or valuations between opening and closing inventory?  
   If “Yes,” attach explanation  
   ☐ Yes ☐ No  

35 Inventory at beginning of year. If different from last year’s closing inventory, attach explanation  

36 Purchases less cost of items withdrawn for personal use  

37 Cost of labor. Do not include any amounts paid to yourself  

38 Materials and supplies  

39 Other costs  

40 Add lines 35 through 39  

41 Inventory at end of year  

42 **Cost of goods sold.** Subtract line 41 from line 40. Enter the result here and on page 1, line 4  

### Part IV  Information on Your Vehicle.  
Complete this part only if you are claiming car or truck expenses on line 9 and are not required to file Form 4562 for this business. See the instructions for line 13 on page C-5 to find out if you must file Form 4562.  

43 When did you place your vehicle in service for business purposes? (month, day, year)  

44 Of the total number of miles you drove your vehicle during 2009, enter the number of miles you used your vehicle for:  
   a Business  
   b Commuting (see instructions)  
   c Other  

45 Was your vehicle available for personal use during off-duty hours?  
   ☐ Yes ☐ No  

46 Do you (or your spouse) have another vehicle available for personal use?  
   ☐ Yes ☐ No  

47a Do you have evidence to support your deduction?  
   ☐ Yes ☐ No  

   b If “Yes,” is the evidence written?  
   ☐ Yes ☐ No  

### Part V  Other Expenses.  
List below business expenses not included on lines 8–26 or line 30  

<table>
<thead>
<tr>
<th>Well Operating Expenses</th>
<th>$1,500.00</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
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</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
</tbody>
</table>

48 **Total other expenses.** Enter here and on page 1, line 27  

<table>
<thead>
<tr>
<th>48 Total other expenses.</th>
<th>$1,500.00</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
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<tr>
<td></td>
<td></td>
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<td></td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Schedule C (Form 1040) 2009
### Part I - Election To Expense Certain Property Under Section 179

**Note:** If you have any listed property, complete Part V before you complete Part I.

<p>| | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Maximum amount. See the instructions for a higher limit for certain businesses</td>
<td>$250,000</td>
</tr>
<tr>
<td>2</td>
<td>Total cost of section 179 property placed in service (see instructions)</td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>Threshold cost of section 179 property before reduction in limitation (see instructions)</td>
<td>$800,000</td>
</tr>
<tr>
<td>4</td>
<td>Reduction in limitation. Subtract line 3 from line 2. If zero or less, enter -0-</td>
<td></td>
</tr>
<tr>
<td>5</td>
<td>Dollar limitation for tax year. Subtract line 4 from line 1. If zero or less, enter -0-. If married filing separately, see instructions</td>
<td></td>
</tr>
</tbody>
</table>

<p>| | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>6</td>
<td>(a) Description of property</td>
<td>(b) Cost (business use only)</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>7</td>
<td>Listed property. Enter the amount from line 29</td>
<td></td>
</tr>
<tr>
<td>8</td>
<td>Total elected cost of section 179 property. Add amounts in column (c), lines 6 and 7</td>
<td></td>
</tr>
<tr>
<td>9</td>
<td>Tentative deduction. Enter the smaller of line 5 or line 8</td>
<td></td>
</tr>
<tr>
<td>10</td>
<td>Carryover of disallowed deduction from line 13 of your 2008 Form 4562</td>
<td></td>
</tr>
<tr>
<td>11</td>
<td>Business income limitation. Enter the smaller of business income (not less than zero) or line 5 (see instructions)</td>
<td></td>
</tr>
<tr>
<td>12</td>
<td>Section 179 expense deduction. Add lines 9 and 10, but do not enter more than line 11</td>
<td></td>
</tr>
<tr>
<td>13</td>
<td>Carryover of disallowed deduction to 2010. Add lines 9 and 10, less line 12</td>
<td></td>
</tr>
</tbody>
</table>

**Note:** Do not use Part II or Part III below for listed property. Instead, use Part V.

### Part II - Special Depreciation Allowance and Other Depreciation (Do not include listed property.)

(See instructions.)

<p>| | | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>14</td>
<td>Special depreciation allowance for qualified property (other than listed property) placed in service during the tax year (see instructions)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>15</td>
<td>Property subject to section 168(f)(1) election</td>
<td></td>
<td></td>
</tr>
<tr>
<td>16</td>
<td>Other depreciation (including ACRS)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

### Part III - MACRS Depreciation (Do not include listed property.)

(See instructions.)

#### Section A

<p>| | | | | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>17</td>
<td>MACRS deductions for assets placed in service in tax years beginning before 2009</td>
<td></td>
<td></td>
<td></td>
<td>$2,449</td>
</tr>
<tr>
<td>18</td>
<td>If you are electing to group any assets placed in service during the tax year into one or more general asset accounts, check here</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

#### Section B - Assets Placed in Service During 2009 Tax Year Using the General Depreciation System

<p>| | | | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>19</td>
<td>(a) Classification of property</td>
<td>(b) Month and year placed in service</td>
<td>(c) Basis for depreciation (business/investment use only—see instructions)</td>
<td>(d) Recovery period</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>a</td>
<td>3-year property</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>b</td>
<td>5-year property</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>c</td>
<td>7-year property</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>d</td>
<td>10-year property</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>e</td>
<td>15-year property</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>f</td>
<td>20-year property</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>g</td>
<td>25-year property</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>h</td>
<td>Residential rental property</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>i</td>
<td>Nonresidential real property</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

#### Section C - Assets Placed in Service During 2009 Tax Year Using the Alternative Depreciation System

<p>| | | | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>20</td>
<td>(a) Classification of property</td>
<td>(b) Month and year placed in service</td>
<td>(c) Basis for depreciation</td>
<td>(d) Recovery period</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>(business/investment use only—see instructions)</td>
<td></td>
</tr>
<tr>
<td>a</td>
<td>Class life</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>b</td>
<td>12-year</td>
<td></td>
<td></td>
<td>12 yrs.</td>
</tr>
<tr>
<td>c</td>
<td>40-year</td>
<td></td>
<td></td>
<td>40 yrs.</td>
</tr>
</tbody>
</table>

### Part IV - Summary

(See instructions.)

<p>| | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>21</td>
<td>Listed property. Enter amount from line 28</td>
<td></td>
</tr>
<tr>
<td>22</td>
<td>Total. Add amounts from line 12, lines 14 through 17, lines 19 and 20 in column (g), and line 21. Enter here and on the appropriate lines of your return. Partnerships and S corporations—see instructions</td>
<td></td>
</tr>
<tr>
<td>23</td>
<td>For assets shown above and placed in service during the current year, enter the portion of the basis attributable to section 263A costs</td>
<td></td>
</tr>
</tbody>
</table>

For Paperwork Reduction Act Notice, see separate instructions.
### Part V  Listed Property
(Include automobiles, certain other vehicles, cellular telephones, certain computers, and property used for entertainment, recreation, or amusement.)

**Note:** For any vehicle for which you are using the standard mileage rate or deducting lease expense, complete only 24a, 24b, columns (a) through (c) of Section A, all of Section B, and Section C if applicable.

#### Section A—Depreciation and Other Information (Caution: See the instructions for limits for passenger automobiles.)

<table>
<thead>
<tr>
<th>(a) Type of property (list vehicles first)</th>
<th>(b) Date placed in service</th>
<th>(c) Business/investment use percentage</th>
<th>(d) Cost or other basis</th>
<th>(e) Basis for depreciation (business/investment use only)</th>
<th>(f) Recovery period</th>
<th>(g) Method/Convention</th>
<th>(h) Depreciation deduction</th>
<th>(i) Elected section 179 cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>25 Special depreciation allowance for qualified listed property placed in service during the tax year and used more than 50% in a qualified business use (see instructions)</td>
<td>%</td>
<td>%</td>
<td>%</td>
<td>%</td>
<td>%</td>
<td>%</td>
<td>%</td>
<td>%</td>
</tr>
</tbody>
</table>

#### Section B—Information on Use of Vehicles

Complete this section for vehicles used by a sole proprietor, partner, or other "more than 5% owner," or related person. If you provided vehicles to your employees, first answer the questions in Section C to see if you meet an exception to completing this section for those vehicles.

<table>
<thead>
<tr>
<th>(a) Vehicle 1</th>
<th>(b) Vehicle 2</th>
<th>(c) Vehicle 3</th>
<th>(d) Vehicle 4</th>
<th>(e) Vehicle 5</th>
<th>(f) Vehicle 6</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total business/investment miles driven during the year (do not include commuting miles)</td>
<td>%</td>
<td>%</td>
<td>%</td>
<td>%</td>
<td>%</td>
</tr>
<tr>
<td>Total commuting miles driven during the year</td>
<td>%</td>
<td>%</td>
<td>%</td>
<td>%</td>
<td>%</td>
</tr>
<tr>
<td>Total other personal (noncommuting) miles driven</td>
<td>%</td>
<td>%</td>
<td>%</td>
<td>%</td>
<td>%</td>
</tr>
<tr>
<td>Total miles driven during the year. Add lines 30 through 32</td>
<td>%</td>
<td>%</td>
<td>%</td>
<td>%</td>
<td>%</td>
</tr>
<tr>
<td>Was the vehicle available for personal use during off-duty hours?</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Was the vehicle used primarily by a more than 5% owner or related person?</td>
<td>%</td>
<td>%</td>
<td>%</td>
<td>%</td>
<td>%</td>
</tr>
<tr>
<td>Is another vehicle available for personal use?</td>
<td>%</td>
<td>%</td>
<td>%</td>
<td>%</td>
<td>%</td>
</tr>
</tbody>
</table>

#### Section C—Questions for Employers Who Provide Vehicles for Use by Their Employees

Answer these questions to determine if you meet an exception to completing Section B for vehicles used by employees who are not more than 5% owners or related persons (see instructions).

<table>
<thead>
<tr>
<th>(a)</th>
<th>(b)</th>
<th>(c)</th>
<th>(d)</th>
<th>(e)</th>
<th>(f)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Do you maintain a written policy statement that prohibits all personal use of vehicles, including commuting, by your employees?</td>
<td>%</td>
<td>%</td>
<td>%</td>
<td>%</td>
<td>%</td>
</tr>
<tr>
<td>Do you maintain a written policy statement that prohibits personal use of vehicles, except commuting, by your employees? See the instructions for vehicles used by corporate officers, directors, or 1% or more owners</td>
<td>%</td>
<td>%</td>
<td>%</td>
<td>%</td>
<td>%</td>
</tr>
<tr>
<td>Do you treat all use of vehicles by employees as personal use?</td>
<td>%</td>
<td>%</td>
<td>%</td>
<td>%</td>
<td>%</td>
</tr>
<tr>
<td>Do you provide more than five vehicles to your employees, obtain information from your employees about the use of the vehicles, and retain the information received?</td>
<td>%</td>
<td>%</td>
<td>%</td>
<td>%</td>
<td>%</td>
</tr>
<tr>
<td>Do you meet the requirements concerning qualified automobile demonstration use? (See instructions.)</td>
<td>%</td>
<td>%</td>
<td>%</td>
<td>%</td>
<td>%</td>
</tr>
</tbody>
</table>

**Note:** If your answer to 37, 38, 39, 40, or 41 is “Yes,” do not complete Section B for the covered vehicles.

#### Part VI  Amortization

<table>
<thead>
<tr>
<th>(a) Description of costs</th>
<th>(b) Date amortization begins</th>
<th>(c) Amortizable amount</th>
<th>(d) Code section</th>
<th>(e) Amortization period or percentage</th>
<th>(f) Amortization for this year</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amortization of costs that begins during your 2009 tax year (see instructions):</td>
<td>%</td>
<td>%</td>
<td>%</td>
<td>%</td>
<td>%</td>
</tr>
<tr>
<td>Amortization of costs that began before your 2009 tax year</td>
<td>%</td>
<td>%</td>
<td>%</td>
<td>%</td>
<td>%</td>
</tr>
<tr>
<td><strong>Total.</strong> Add amounts in column (f). See the instructions for where to report</td>
<td>%</td>
<td>%</td>
<td>%</td>
<td>%</td>
<td>%</td>
</tr>
</tbody>
</table>

Form 4562 (2009)
Example #3 (Existing Investor)

Sample 7-Year MACRS Depreciation Schedule

The depreciation schedule below is the method used to depreciate the well operating equipment, which is the tangible part of the investment. Some investors may qualify for section 179, which accelerates depreciation as noted in Example #2.

For example #3 the investor is in the second year of the seven deprecation schedule. The Tangible Drilling Costs of $10,000 depreciated at 24.49% would yield $2449. This example is the basic set-up for current investors who are already receiving income in year 2. Beyond this example it is used for all income years 2-7.

Please note that each individual has a unique tax situation.

Method: 200% declining balance switching to straight line

Convention: Half-Year

Investment:
½ Unit Investment = $50,000

Intangible Drilling Costs (80% of investment) = $40,000
Deducted during the first year of investment

Tangible Drilling Costs (20% of investment) = $10,000
Depreciated over 7 year period (see table below)

<table>
<thead>
<tr>
<th>Year</th>
<th>Starting Amount Being Depreciated</th>
<th>Percent of Depreciation</th>
<th>Amount of Depreciation Each Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$10,000</td>
<td>14.29%</td>
<td>$1,429</td>
</tr>
<tr>
<td>2</td>
<td>$10,000</td>
<td>24.49%</td>
<td>$2,449</td>
</tr>
<tr>
<td>3</td>
<td>$10,000</td>
<td>17.49%</td>
<td>$1,749</td>
</tr>
<tr>
<td>4</td>
<td>$10,000</td>
<td>12.49%</td>
<td>$1,249</td>
</tr>
<tr>
<td>5</td>
<td>$10,000</td>
<td>8.93%</td>
<td>$893</td>
</tr>
<tr>
<td>6</td>
<td>$10,000</td>
<td>8.93%</td>
<td>$893</td>
</tr>
<tr>
<td>7</td>
<td>$10,000</td>
<td>8.93%</td>
<td>$893</td>
</tr>
<tr>
<td>8</td>
<td>$10,000</td>
<td>4.45%</td>
<td>$445</td>
</tr>
<tr>
<td></td>
<td>Total</td>
<td>100%</td>
<td>$10,000</td>
</tr>
</tbody>
</table>
### Calculating Your Sheltered Income From your Royale Energy, Inc. Project

As an existing investor who is in year two of the seven-year MACRS Depreciation Schedule, you could shelter . . .

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross Income (Line 7)</td>
<td>$11,000</td>
</tr>
<tr>
<td>Well Operating Expenses (Line 27)</td>
<td>- $1,500</td>
</tr>
<tr>
<td><strong>Paid Income</strong></td>
<td><strong>$9,500</strong></td>
</tr>
<tr>
<td>Depletion Deduction (Line 12)</td>
<td>$1,650</td>
</tr>
<tr>
<td>Depreciation Deduction (Line 13)</td>
<td>+ $2,449</td>
</tr>
<tr>
<td><strong>Sheltered Income</strong></td>
<td><strong>$4,099</strong></td>
</tr>
<tr>
<td>Paid Income</td>
<td>$9,500</td>
</tr>
<tr>
<td>Sheltered Income</td>
<td>- $4,099</td>
</tr>
<tr>
<td><strong>Net Paid Income</strong></td>
<td><strong>$5,401</strong></td>
</tr>
</tbody>
</table>

\[
\text{Sheltered Income} / \text{Paid Income} = 57\%
\]

The investor may be able to shelter over 57% of their Net Paid Income!
Supplemental Documentation Materials
Introduction
This publication discusses common business expenses and explains what is and is not deductible. The general rules for deducting business expenses are discussed in the opening chapter. The chapters that follow cover specific expenses and list other publications and forms you may need.

Comments and suggestions. We welcome your comments about this publication and your suggestions for future editions. You can write to us at the following address:

Internal Revenue Service
Business Forms and Publications Branch
SE-W-CAR-MP-T-B
1111 Constitution Ave. NW, IR--6406
Washington, DC 20224

We respond to many letters by telephone. Therefore, it would be helpful if you would include your daytime phone number, including the area code, in your correspondence.

You can email us at taxforms@irs.gov. (The asterisk must be included in the address.) Please put “Publications Comment” on the subject line. Although we cannot respond individually to each email, we do appreciate your feedback and will consider your comments as we revise our tax products.

Tax questions. If you have a tax question, visit www.irs.gov or call 1-800-829-4933. We cannot answer tax questions at either of the addresses listed above.

Ordering forms and publications. Visit www.irs.gov/formspubs to download forms and publications, call 1-800-829-3676,
7. Costs You Can Deduct or Capitalize

Introduction
This chapter discusses costs you can elect to in deduct or capitalize.

You generally deduct a cost as a current business expense by subtracting it from your income in either the year you incur it or the year you pay it.

If you capitalize a cost, you may be able to recover it over a period of years through periodic deductions for amortization, depletion, or depreciation. When you capitalize a cost, you add it to the basis of property to which it relates.

A partnership, corporation, estate, or trust makes the election to deduct or capitalize the costs discussed in this chapter except for exploration costs for mineral deposits. Each individual partner, shareholder, or beneficiary elects whether to deduct or capitalize exploration costs.

You may be subject to the alternative minimum tax (AMT) if you deduct research and experimental, intangible drilling, exploration, development, circulation, and business organizational costs. For more information on the alternative minimum tax, see the instructions for Form 3468 for more information.

Intangible Drilling Costs

The costs of developing oil, gas, or geothermal wells are ordinarily capital expenditures. You can usually recover them through depreciation or depletion. However, you can elect to deduct intangible drilling costs (IDCs) as a current business expense. These are certain drilling and development costs for wells in the United States in which you hold an operating or working interest. You can deduct only costs for drilling or preparing a well for the production of oil, gas, or geothermal steam or hot water.

You can elect to deduct only the costs of items with no salvage value. These include wages, fuel, repairs, hauling, and supplies related to drilling wells and preparing them for production. Your cost for any drilling or development work done by contractors under any form of contract is also an IDC. However, see Amounts paid to contractor that must be capitalized, later.

You can also elect to deduct the cost of drilling exploratory bore holes to determine the location and delineation of offshore hydrocarbon deposits if the shaft is capable of conducting hydrocarbons to the surface on completion. It does not matter whether there is any intent to produce hydrocarbons.

If you do not elect to deduct your IDCs as a current business expense, you can elect to deduct them over the 60-month period beginning with the month they were paid or incurred.

Amounts paid to contractor that must be capitalized. Amounts paid to a contractor must be capitalized if they are either:

- Amounts properly allocable to the cost of depreciable property, or
- Amounts paid only out of production or proceeds from production if these amounts are depletiable income to the recipient.

How to make the election. You elect to deduct IDCs as a current business expense by taking the deduction on your income tax return for the first tax year you have eligible costs. No formal statement is required. If you file Schedule C (Form 1040), enter these costs under “Other expenses.”

For oil and gas wells, your election is binding for the year it is made and for all later years. For geothermal wells, your election can be revoked by the filing of an amended return on which you do not take the deduction. You can file the amended return for the year up to the normal time of expiration for filing a claim for credit or refund, generally, within 3 years after the date you filed the original return or within 2 years after the date you paid the tax, whichever is later.

Energy credit for costs of geothermal wells. If you capitalize the drilling and development costs of geothermal wells that you place in service during the tax year, you may be able to claim a business energy credit. See the instructions for Form 3468 for more information.

Nonproductive well. If you capitalize your IDCs, you have another option if the well is nonproductive. You can deduct the IDCs of the nonproductive well as an ordinary loss. You must indicate and clearly state your election on your tax return for the year the well is completed. You can revoke your election for a geothermal well by filing an amended return that does not claim the loss.

Costs incurred outside the United States. You cannot deduct as a current business expense all the IDCs paid or incurred for an oil, gas, or geothermal well located outside the United States. However, you can elect to include the costs in the adjusted basis of the well to figure depletion or depreciation. If you do not make this election, you can deduct the costs over the 10-year period beginning with the tax year in which you paid or incurred them. These rules do not apply to a nonproductive well.

Depletion

Depletion is the using up of natural resources by mining, quarrying, drilling, or felling. The depletion deduction allows an owner or operator to account for the reduction of a product’s reserves.

There are two ways of figuring depletion: cost depletion and percentage depletion. For mineral property, you generally must use the method that gives you the larger deduction. For standing timber, you must use cost depletion.

Topics
This chapter discusses:

- Who can claim depletion
- Mineral property
- Timber

Who Can Claim Depletion?

If you have an economic interest in mineral property or standing timber, you can take a deduction for depletion. More than one person can have an economic interest in the same mineral deposit or timber.

You have an economic interest if both the following apply:

- You have acquired by investment any interest in mineral deposits or standing timber
- You have a legal right to income from the extraction of the mineral or cutting of the timber to which you must look for a return of your capital investment.

A contractual relationship that allows you an economic or monetary advantage from products of the mineral deposit or standing timber is not, in itself, an economic interest. A production payment carved out of, or retained on the sale of, mineral property is not an economic interest. Individuals, corporations, estates, and trusts who claim depletion deductions may be liable for alternative minimum tax.

Mineral Property

Mineral property includes oil and gas wells, mines, and other natural deposits (including geothermal deposits). For this purpose, the term “property” means each separate interest you own in each mineral deposit in each separate tract or parcel of land. You can treat two or more separate interests as one property or as separate properties. See section 614 of the Internal Revenue Code and the related regulations for rules on how to treat separate mineral interests.

There are two ways of figuring depletion on mineral property.

- Cost depletion.
- Percentage depletion.

Generally, you must use the method that gives you the larger deduction. However, unless you are an independent producer or royalty owner, you generally cannot use percentage depletion for oil and gas wells. See Oil and Gas Wells, later.

Percentage Depletion

To figure percentage depletion, you multiply a certain percentage, specified for each mineral,
by your gross income from the property during the tax year.

The rates to be used and other conditions and qualifications for oil and gas wells are discussed later under Independent Producers and Royalty Owners and under Natural Gas Wells. Rates and other rules for percentage depletion of other specific minerals are found later in Mines and Geothermal Deposits.

Gross income. When figuring your percentage depletion, subtract from your gross income from the property the following amounts.

- Any rents or royalties you paid or incurred for the property.
- The part of any bonus you paid for a lease on the property allocable to the product sold (or that otherwise gives rise to gross income) for the tax year.

A bonus payment includes amounts you paid as a lessee to satisfy a production payment retained by the lessor.

Use the following fraction to figure the part of the bonus you must subtract.

\[
\text{No. of units sold in the tax year} \times \text{Bonus Payments}
\]

For oil and gas wells and geothermal deposits, gross income from the property is defined later under Oil and Gas Wells. For property other than a geothermal deposit or an oil and gas well, gross income from the property is defined later under Mines and Geothermal Deposits.

Taxable income limit. The percentage depletion deduction generally cannot be more than 50% (100% for oil and gas property) of your taxable income from the property figured without the depletion deduction and the domestic production activities deduction.

Taxable income from the property means gross income from the property minus all allowable deductions (excluding any deduction for depletion or qualified domestic production activities) attributable to mining processes, including mining transportation. These deductible items include the following.

- Operating expenses.
- Certain selling expenses.
- Administrative and financial overhead.
- Depreciation.
- Intangible drilling and development costs.
- Exploration and development expenditures.

The following rules apply when figuring your taxable income from the property for purposes of the taxable income limit.

1. Do not deduct any net operating loss deduction from the gross income from the property.
2. Corporations do not deduct charitable contributions from the gross income from the property.
3. If, during the year, you dispose of an item of section 1245 property that was used in connection with mineral property, reduce any allowable deduction for mining expenses by the part of any gain you must report as ordinary income that is allocable to the mineral property. See section 1.613-3(b)(1) of the regulations for information on how to figure the ordinary gain allocable to the property.

Oil and Gas Wells

You cannot claim percentage depletion for an oil or gas well unless at least one of the following applies.

- You are either an independent producer or a royalty owner.
- The well produces natural gas that is either sold under a fixed contract or produced from geopressed brine.

If you are an independent producer or royalty owner, see Independent Producers and Royalty Owners, next.

For information on the depletion deduction for wells that produce natural gas that is either sold under a fixed contract or produced from geopressed brine, see Natural Gas Wells, later.

Independent Producers and Royalty Owners

If you are an independent producer or royalty owner, you figure percentage depletion using a rate of 15% of the gross income from the property based on your average daily production of domestic crude oil or domestic natural gas up to your depletable oil or natural gas quantity. However, certain refiners, as explained next, and certain retailers and transferees of proven oil and gas properties, as explained later, cannot proclaim percentage depletion. For information on figuring the deduction, see Figuring Percentage depletion, later.

Refiners who cannot claim percentage depletion. You cannot claim percentage depletion if you or a related person refine crude oil and you and the related person refined more than 75,000 barrels on any day during the tax year based on average (rather than actual) daily refinery runs for the tax year. The average daily refinery run is computed by dividing total refinery runs for the tax year by the total number of days in the tax year.

Retailers who cannot claim percentage depletion. You cannot claim percentage depletion if both the following apply.

1. You sell oil or natural gas or their by-products directly or through a related person in any of the following situations.
   a. Through a retail outlet operated by you or a related person.
   b. To any person who is required under an agreement with you or a related person to use a trademark, trade name, or service mark or name owned by you or a related person in marketing or distributing oil, natural gas, or their by-products.
   c. To any person given authority under an agreement with you or a related person to occupy any retail outlet owned, leased, or controlled by you or a related person.

2. The combined gross receipts from sales (not counting resales) of oil, natural gas, or their by-products by all retail outlets taken into account in (1) are more than $5 million for the tax year.

For the purpose of determining if this rule applies, do not count the following.

- Bulk sales (sales in very large quantities) of oil or natural gas to commercial or industrial users.
- Bulk sales of aviation fuels to the Department of Defense.
- Sales of oil or natural gas or their by-products outside the United States if none of your domestic production or that of a related person is exported during the tax year or the prior tax year.

Related person. To determine if you and another person are related persons, see Related person under Refiners who cannot claim percentage depletion, earlier.

Sales through a related person. You are considered to be selling through a related person if any sale by the related person produces gross income from which you may benefit because of your direct or indirect ownership interest in the person.
Instructions for Form 6251 (2009) 14:57 - 7-DEC-2009

The type and rule above prints on all proofs including departmental reproduction proofs. MUST be removed before printing.

Alternative Minimum Tax—Individuals

Section references are to the Internal Revenue Code unless otherwise noted.

General Instructions

What’s New

- The exemption amount has increased to $46,700 ($70,950 if married filing jointly or qualifying widow(er)), $35,475 if married filing separately.
- The minimum exemption amount for a child has increased to $6,700.
- Interest on private activity bonds issued in 2010 is not a tax preference item. Do not include it on line 13. See page 4.
- If you claimed a regular tax deduction for any state or local sales or excise tax on the purchase of a new motor vehicle, that tax is also allowed as a deduction for the AMT. See lines 3 and 7.
- The 90% limit on the alternative tax net operating loss deduction (ATNOLD) does not apply to the portion of an ATNOLD attributable to any 2008 or 2009 loss you elected to carry back more than 2 years under section 172(b)(1)(H). See the instructions for line 12 on page 3.

Purpose of Form

Use Form 6251 to figure the amount, if any, of your alternative minimum tax (AMT). The AMT applies to taxpayers who have certain types of income that receive favorable treatment, or who qualify for certain deductions, under the tax law. These tax benefits can significantly reduce the regular tax of some taxpayers with higher economic incomes. The AMT sets a limit on the amount these benefits can be used to reduce total tax.

Also use Form 6251 to figure the tax liability limit on the credits listed under Who Must File next.

Who Must File

Attach Form 6251 to your return if any of the following statements is true.

1. Form 6251, line 32, is greater than line 35.
2. You claim any general business credit in Part I of Form 3800, the empowerment zone and renewal community employment credit, the qualified electric vehicle credit, the alternative fuel vehicle refueling property credit, or the credit for prior year minimum tax.
3. The total of Form 6251, lines 9 through 28, is negative and line 32 would be greater than line 35 if you did not take into account lines 9 through 28.

Recordkeeping

For the AMT, certain items of income, deductions, etc., receive different tax treatments than for the regular tax. Therefore, you need to refigure items for the AMT that you figured for the regular tax. In some cases, you may wish to do this by completing the applicable tax form a second time. If you do complete another form, do not attach it to your tax return, but keep it for your records. However, you may have to attach an AMT Form 1116, Foreign Tax Credit, to your return; see the instructions for line 33 that begin on page 9.

For the regular tax, some deductions and credits may result in carrybacks or carryforwards to other tax years. Examples are investment interest expense, a net operating loss, a capital loss, a passive activity loss, and the foreign tax credit. Because you may have to refigure these items for the AMT, the carryback or carryforward amount may be different for the AMT than for the regular tax. Your at-risk limits and basis amounts also may differ for the AMT. Therefore, you must keep records of these different amounts.

Partners and Shareholders

If you are a partner in a partnership or a shareholder in an S corporation, see Schedule K-1 and its instructions to figure your adjustments or preferences from the partnership or S corporation to include on Form 6251.

Nonresident Aliens

If you are a nonresident alien and you disposed of U.S. real property interests at a gain, you must make a special computation. Fill in Form 6251 through line 31. If your net gain from the disposition of U.S. real property interests and the amount on line 29 are both greater than the tentative amount you figured for line 31, replace the amount on line 31 with the smaller of that net gain or the amount on line 29. Also, enter “RPI” on the dotted line next to line 31. Otherwise, do not change line 31.

Credit for Prior Year Minimum Tax

See Form 8801, Credit for Prior Year Minimum Tax—Individuals, Estates, and Trusts, if you paid AMT for 2008 or you had a minimum tax credit carryforward on your 2008 Form 8801. If you pay AMT for 2009, you may be able to take a credit on Form 8801 for 2010.

Optional Write-Off for Certain Expenditures

There is no AMT adjustment for the following items if you elect for the regular tax to deduct them ratably over the period of time shown.

- Circulation expenditures—3 years (section 173).
- Research and experimental expenditures—10 years (section 174(a)).
- Mining exploration and development costs—10 years (sections 616(a) and 617(a)).
- Intangible drilling costs—60 months (section 263(c)).

For information on making the election, see section 59(e) and Regulations section 1.59-1. Also see Pub. 535.

Specific Instructions

If you owe AMT, you may be able to lower your total tax (regular tax plus AMT) by claiming itemized deductions on Form 1040, even if your total itemized deductions are less than the standard deduction. This is because the standard deduction (except the part due to a net disaster loss or sales or excise tax on the purchase of a new motor vehicle) is not allowed for the AMT and, if you claim the standard deduction on Form 1040, you cannot claim itemized deductions for the AMT.
10 years for the AMT. Enter the difference between the regular tax and AMT deduction. If the AMT deduction is greater, enter the difference as a negative amount.

If you had a loss on property for which research and experimental costs have not been fully amortized for the AMT, your AMT deduction is the smaller of (a) the loss allowable for the costs had they remained capitalized or (b) the remaining costs to be amortized for the AMT.

**Line 26—Installment Sales**
The installment method does not apply for the AMT to any nondealer disposition of property after August 16, 1986, but before January 1, 1987, if an installment obligation to which the proportionate disallowance rule applied arose from the disposition. Enter the amount of installment sale income reported for the regular tax as a negative amount on line 26.

**Line 27—Intangible Drilling Costs (IDCs)**

Do not make this adjustment for costs for which you elected the optional 60-month write-off for the regular tax.

IDCs from oil, gas, and geothermal wells are a preference to the extent that the excess IDCs exceed 65% of the net income from the wells. Figure the preference for all oil and gas properties separately from the preference for all geothermal properties.

**Excess IDCs.** Figure excess IDCs as follows.

**Step 1.** Determine the amount of your IDCs allowed for the regular tax under section 263(c), but do not include any section 263(c) deduction for nonproductive wells.

**Step 2.** Subtract the amount that would have been allowed had you amortized these IDCs over a 120-month period starting with the month the well was placed in production. If you prefer not to use the 120-month period, you can elect to use any method that is permissible in determining cost depletion.

**Net income.** Determine net income by reducing the gross income that you received or accrued during the tax year from all oil, gas, and geothermal wells by the deductions allocable to those wells (reduced by the excess IDCs). When figuring net income, use only income and deductions allowed for the AMT.

**Exception.** The preference for IDCs from oil and gas wells does not apply to taxpayers who are independent producers (that is, not integrated oil companies as defined in section 291(b)(4)). However, this benefit may be limited. First, figure the IDC preference as if this exception did not apply. Then, for purposes of this exception, complete Form 6251 through line 28, including the IDC preference and treating line 12 as if it were zero, and combine lines 1 through 28. If the amount of the IDC preference exceeds 40% of the total of lines 1 through 28 (figured as described in the preceding sentence), enter the excess on line 27 (your benefit from this exception is limited). Otherwise, do not enter an amount on line 27 (your benefit from this exception is not limited).

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**AMT & Intangible Drilling Costs**
US Tax Code, Section 469.c.3

For practical purposes, the entire section 469.c.3 of the US Tax Code has not been included, only relevant highlights.

469. Passive activity losses and credits limited

(3) Working interests in oil and gas property
   (A) In general
   The term “passive activity” shall not include any working interest in any oil or gas property which the taxpayer holds directly or through an entity which does not limit the liability of the taxpayer with respect to such interest.
   (B) Income in subsequent years
   If any taxpayer has any loss for any taxable year from a working interest in any oil or gas property which is treated as a loss which is not from a passive activity, then any net income from such property (or any property the basis of which is determined in whole or in part by reference to the basis of such property) for any succeeding taxable year shall be treated as income of the taxpayer which is not from a passive activity. If the preceding sentence applies to the net income from any property for any taxable year, any credits allowable under subpart B (other than section 27 (a)) or D of part IV of subchapter A for such taxable year which are attributable to such property shall be treated as credits not from a passive activity which are allocable to such net income.
US Tax Code, Section 263

For practical purposes, the entire section 263 of the US Tax Code has not been included, only relevant highlights.

263. Capital expenditures

(c) Intangible drilling and development costs in the case of oil and gas wells and geothermal wells

Notwithstanding subsection (a), and except as provided in subsection (i), regulations shall be prescribed by the Secretary under this subtitle corresponding to the regulations which granted the option to deduct as expenses intangible drilling and development costs in the case of oil and gas wells and which were recognized and approved by the Congress in House Concurrent Resolution 50, Seventy-ninth Congress. Such regulations shall also grant the option to deduct as expenses intangible drilling and development costs in the case of wells drilled for any geothermal deposit (as defined in section 613 (e)(2)) to the same extent and in the same manner as such expenses are deductible in the case of oil and gas wells. This subsection shall not apply with respect to any costs to which any deduction is allowed under section 59 (e) or 291.

(6) Application of this subsection with subsection (g)

(i) Special rules for intangible drilling and development costs incurred outside the United States

In the case of intangible drilling and development costs paid or incurred with respect to an oil, gas, or geothermal well located outside the United States—

(1) subsection (c) shall not apply, and

(2) such costs shall—

(A) at the election of the taxpayer, be included in adjusted basis for purposes of computing the amount of any deduction allowable under section 611 (determined without regard to section 613), or

(B) if subparagraph (A) does not apply, be allowed as a deduction ratably over the 10-taxable year period beginning with the taxable year in which such costs were paid or incurred.

This subsection shall not apply to costs paid or incurred with respect to a nonproductive well.
US Tax Code, Section 179

For practical purposes, the entire section 179 of the US Tax Code has not been included, only relevant highlights.

179. Election to expense certain depreciable business assets

(5) Inflation adjustments
   (A) In general
   In the case of any taxable year beginning in a calendar year after 2003 and before 2008, the $100,000 and $400,000 amounts in paragraphs (1) and (2) shall each be increased by an amount equal to—
   (i) such dollar amount, multiplied by
   (ii) the cost-of-living adjustment determined under section 1 (f)(3) for the calendar year in which the taxable year begins, by substituting “calendar year 2002” for “calendar year 1992” in subparagraph (B) thereof.

(c) Election
   (1) In general
   An election under this section for any taxable year shall—
   (A) specify the items of section 179 property to which the election applies and the portion of the cost of each of such items which is to be taken into account under subsection (a), and
   (B) be made on the taxpayer’s return of the tax imposed by this chapter for the taxable year.

Such election shall be made in such manner as the Secretary may by regulations prescribe.