

The background of the entire page is a dark, atmospheric photograph of an oil drilling rig in a desert. The rig is a complex of metal structures, including a tall derrick and a large platform. The desert floor is sandy and sparsely vegetated. The sky is a deep, hazy blue. The overall tone is professional and industrial.

IRC Section 263(c) Intangible Drilling Costs: Sheltering Active W-2 Income for Surgeons

An Analytical White Paper Examining Statutory Tax Mechanics, Working Interest Ownership, and Active-Income Offset Planning for High-Income Medical, Dental, Legal, and Financial Professionals

WHITE PAPER

TAX STRATEGY

OIL & GAS

Executive Summary

A surgeon earning \$500,000 to \$1,000,000 or more in annual W-2 or 1099 compensation faces a structural problem that standard retirement planning was never built to solve: every deferral vehicle available to a high-income professional is capped by statute, while the tax liability on active compensation is not.

2026 Contribution Limits

For 2026, the IRS caps total 401(k) contributions, employee and employer combined, at **\$72,000**, with an employee deferral limit of \$24,500 and a catch-up allowance of \$8,000 for participants age 50 and older. A Backdoor Roth IRA is capped at **\$7,500** and phases out entirely once modified adjusted gross income exceeds \$168,000 for a single filer or \$252,000 for a married couple filing jointly.

For a surgeon in the top marginal bracket, these vehicles shelter a rounding error relative to total compensation.

A Different Statutory Mechanism

This white paper examines a mechanism that has existed in the Internal Revenue Code since 1916 and was codified as **Section 263(c)** in the Internal Revenue Code of 1954: the election to currently expense Intangible Drilling Costs (IDCs) incurred in the development of a domestic oil and gas well.

When this election is combined with the working interest exception to the passive activity rules under **Section 469(c)(3)(A)**, a licensed professional who holds a working interest directly — or through an entity that does not limit personal liability — can apply IDC deductions against active compensation, the same W-2 wages, 1099 income, and K-1 distributions that otherwise sit fully exposed at the top marginal rate.

- ❏ Nothing in this paper constitutes tax or legal advice. The applicability of any provision discussed depends entirely on an individual's facts, the structure of the specific joint venture, and confirmation by qualified professional advisors.

Introduction: Why This Matters Now

Surgeons occupy a unique position in the tax code. Training consumes a decade or more of a career, income arrives late and concentrated, and by the time earning years begin in earnest, most of the conventional accumulation runway has already closed. The result is a compensation profile that scales quickly past every phase-out threshold in the code: the Roth IRA, the deductible traditional IRA, and, for many hospital-employed and partnership-track physicians, the Section 199A qualified business income deduction itself.

Standard advice from a general financial planning practice tends to stop at "max out your retirement accounts." For a surgeon paying \$150,000 to \$400,000 or more in combined federal and state income tax annually, that advice is directionally correct and numerically insufficient. The retirement system was built around a worker accumulating steadily over a 40-year career. It was not built around a professional who begins earning \$500,000 a year at age 34 and needs a tax mechanism that scales with income rather than capping against it.

Section 263(c) is one of a small number of provisions in the Internal Revenue Code that was deliberately designed to do exactly that. Congress has preserved the IDC election through every major tax reform since 1954, including the Tax Reform Act of 1986 and the Tax Cuts and Jobs Act of 2017, specifically because it is tied to a declared federal energy policy objective: incentivizing domestic exploration and development of oil and natural gas.

The Problem: When Active Income Outgrows Passive-Loss Tools

Most tax-advantaged structures marketed to high-income professionals are passive-activity structures. Under Section 469, losses generated by a passive activity — a rental real estate position, a limited partnership interest, a syndicated structure in which the professional has no material participation — can generally only offset passive income. A surgeon with no other passive income has no immediate use for a passive loss.

Real Estate Professional Status

The primary workaround requires more than **750 hours** of personal service in real property trades annually, and more than half of the taxpayer's total personal service time for the year. A surgeon working a full clinical schedule cannot realistically clear that bar.

Active Participation Exception

Even the narrower "active participation" exception for rental real estate caps the usable loss at **\$25,000 annually** and phases out completely once modified adjusted gross income reaches \$150,000.

The Structural Gap

Every conventional tool scales with the taxpayer's **time**, not their income, and every tool phases out well below the income level where a surgeon actually needs relief.

This is the structural gap surgeons and other high-income professionals consistently encounter. The search for a strategy that is simple enough to sit alongside an existing CPA relationship, documented enough to withstand audit scrutiny, and structurally capable of offsetting active compensation rather than only passive income is what drives interest toward working interest ownership in oil and gas development.

Background: What Section 263(c) Actually Governs

Defining Intangible Drilling Costs

Treasury Regulation 1.612-4 defines Intangible Drilling Costs as expenditures made by an operator for wages, fuel, repairs, hauling, supplies, and other items that are incident to and necessary for the drilling and preparation of wells for production, and that in themselves have **no salvage value**. Labor to drill and complete a well, drilling mud and chemicals, site preparation, and the cost of surveying and location work typically fall into this category.

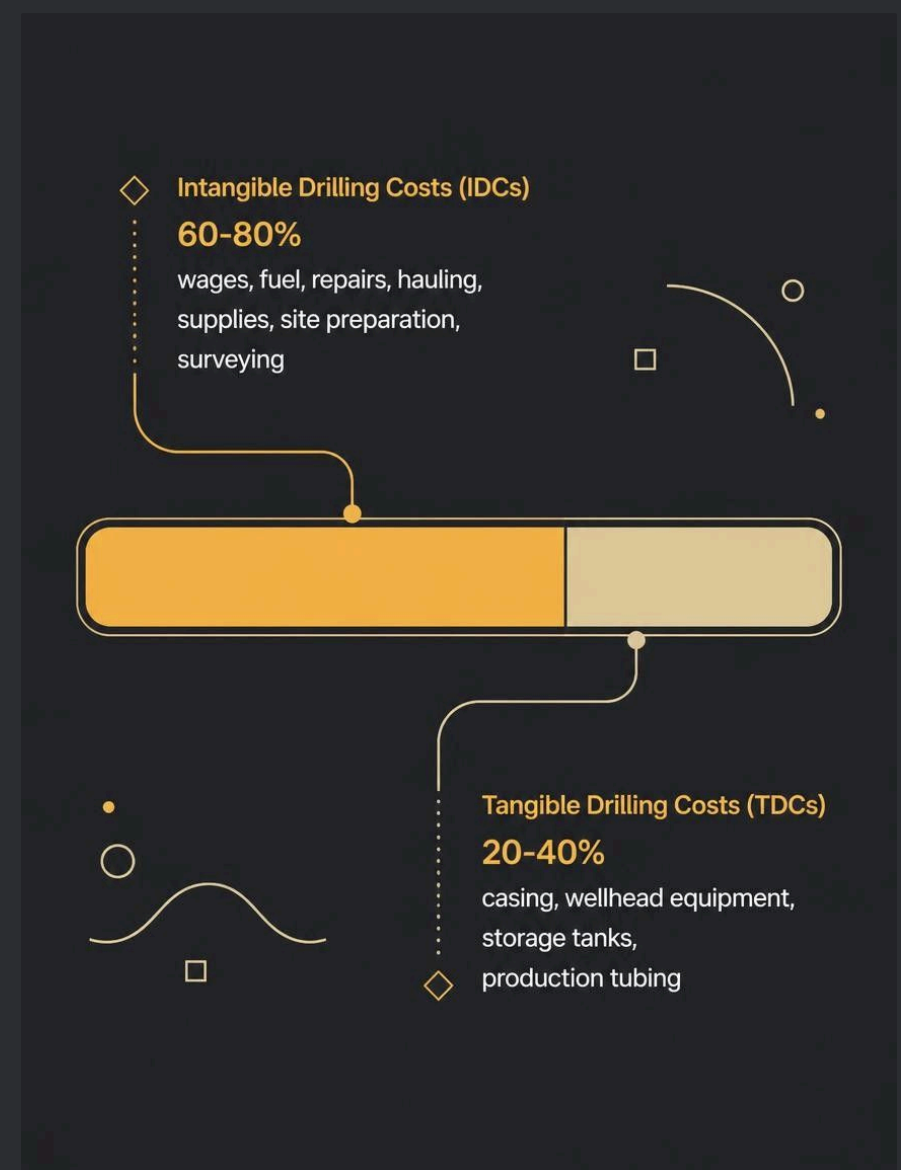
Tangible Drilling Costs, by contrast, cover equipment that retains salvage value — casing, wellhead equipment, storage tanks, and production tubing — and these costs are capitalized and recovered through depreciation under the Modified Accelerated Cost Recovery System rather than expensed immediately.

The IDC Election

Under Section 263(c), the operator or working interest owner may elect to deduct IDCs in the year incurred rather than capitalize and amortize them over the life of the well. This election was first articulated in a **1916 Treasury regulation** and has been preserved through every subsequent recodification of the federal tax code — a continuity that reflects a deliberate, long-standing congressional policy decision rather than a transient provision subject to annual renewal.

Typical Cost Allocation

Across multiple independently reported industry data points, IDCs typically represent **60 to 80 percent** of the total cost to drill and complete a well, with the remaining balance allocated to tangible, depreciable equipment.



That range is a widely cited industry benchmark, not a guaranteed outcome for any individual position. The specific allocation for any given well is determined by the Authorization for Expenditure (AFE) and the engineering detail of that particular drilling program.

Analysis: Why This Deduction Can Offset Active W-2 and 1099 Income

The IDC deduction by itself does not determine whether a loss can offset active compensation. That determination is governed by Section 469, the passive activity loss rules enacted in 1986.

Section 469(c)(3)(A) contains a specific statutory carve-out: the passive activity definition "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."

This single sentence is the structural hinge of the entire strategy. It means a working interest, properly held, is excluded from passive-activity treatment by category — not by a facts-and-circumstances material participation test. This is a materially different standard than the one real estate professionals face. There is no hours requirement and no material participation test to satisfy. A surgeon working a full operating schedule does not need to document 500 or 750 hours of participation in the venture to preserve active-income treatment, because the working interest exception operates on **how the position is held**, not on how many hours the holder personally contributes to field operations.

⚠ The entity structure requirement is strict and unforgiving. If the working interest is held through a limited partnership, an LLC, or any other liability-limiting entity, the working interest exception is lost and the position reverts to passive treatment — regardless of how the deduction is marketed.

The Five Statutory Layers

Three additional statutory layers govern the ultimate size and durability of the benefit, and a professional evaluating a position should expect each of these to be addressed in the offering's tax documentation and discussed directly with their own CPA:

1	Section 263(c) — Election Determines <i>when</i> a cost is deducted: currently in the year incurred versus capitalized over the life of the well.
2	Section 469(c)(3) — Classification Determines <i>what kind</i> of income the deduction can offset: active compensation versus passive income only.
3	Section 465 — At-Risk Basis Caps <i>how much</i> can be deducted: limited to capital actually at economic risk. Nonrecourse debt generally does not increase at-risk basis in oil and gas.
4	Section 57(a)(2) — AMT Preference Governs AMT exposure on excess IDC. Excess IDC is a preference item only to the extent it exceeds 65% of net income from oil, gas, and geothermal properties. Independent producers may elect to exclude some IDC preference, subject to a 40% AMTI cap.
5	Sections 611/613A — Depletion Once a well reaches production, independent producers may claim a 15% percentage depletion allowance against gross income from the property — continuing annually for the life of the well, independent of remaining cost basis.

Evaluating a working interest position in isolation, without walking through all five layers with a qualified advisor, is the most common source of confusion in this planning area.

Framework: How the Entrepreneurial Joint Venture Structure Applies These Mechanics

Summit Ventures operates as a direct oil and gas entrepreneurial joint venture platform. Business participants hold a working interest position as active JV members rather than as holders of a pooled security, and the entity structure used for each venture is built specifically to preserve the direct or general-partnership holding pattern that Section 469(c)(3)(A) requires.

This is a structural distinction worth understanding in its own right: a fund structured as a limited partnership or LLC may still participate in oil and gas wells, but if the participant's own interest in that fund is a liability-limited interest, the active-income offset described above does not pass through to that participant — because the exception attaches to **how the working interest itself is held**, not to the underlying asset class.

Structural Integrity

Every venture is structured to preserve the direct or general-partnership holding pattern required by Section 469(c)(3)(A) — the foundational condition for active-income offset treatment.

Operational Transparency

Every joint venture is administered against a specific Authorization for Expenditure (AFE) that itemizes the intangible and tangible cost allocation for that well before capital is contributed.

Governance Rights

Active JV members hold rights under the joint operating agreement to review operator reporting on drilling progress, cost allocation, and production results.

CPA Integration

Each participant receives a Schedule K-1 reflecting IDC deductions, tangible cost allocation, depletion, and production income — designed to coordinate with existing CPA relationships, not replace them.

The Market Backdrop

The U.S. Energy Information Administration confirms that domestic crude oil production set a new annual record of **13.6 million barrels per day in 2025**, and the American Petroleum Institute reports that the oil and natural gas industry supported **10.6 million American jobs** and contributed **\$2.1 trillion** to the U.S. economy in the most recently measured year. This context does not predict the outcome of any specific well or venture, and no production or return outcome should be inferred from industry-level statistics, but it does establish that domestic development activity — the activity Section 263(c) was written to incentivize — remains an active and ongoing feature of the U.S. economy rather than a historical curiosity.

Recommendations and Implications

For a surgeon, dentist, attorney, or CPA evaluating this structure, four implications follow directly from the mechanics described above.

1 Confirm Entity Structure in Writing

The entity structure of any specific opportunity should be confirmed in writing before capital is contributed, not assumed from marketing language. Ask specifically whether the working interest is held directly or through a liability-limiting vehicle, because that single fact determines whether Section 469(c)(3) applies at all.

2 Verify the IDC-to-TDC Allocation

The IDC-to-TDC allocation should be confirmed against the specific Authorization for Expenditure for the well in question, not against an industry-wide percentage. The 60 to 80 percent range cited in this paper is a benchmark for understanding how well costs are typically structured, not a projection of any individual's deduction.

3 Model All Statutory Limitations

A participant's own CPA should model the at-risk limitation, the AMT preference calculation under Section 57(a)(2), and the interaction with any other excess business loss limitation under Section 461(l) before the size of a capital contribution is finalized, since these provisions jointly determine the usable deduction in the year the cost is incurred.

4 Evaluate as Part of a Broader Plan

This strategy should be evaluated as one component of a broader, CPA-coordinated tax plan rather than as a standalone solution. The same statutory framework that allows an IDC deduction to offset active income in year one also governs percentage depletion income in subsequent years, so the multi-year tax profile of a working interest position should be modeled, not just the first-year deduction.

Questions for Your Advisory Team

Before evaluating any working interest position, a surgeon or high-income professional should bring the following questions directly to their CPA and tax counsel. These questions are designed to walk through each of the five statutory layers described in this paper and confirm how each applies to an individual's specific return and the specific structure of the joint venture under consideration.

1

Entity Structure & Section 469(c)(3)

Is the working interest held directly or through an entity that limits personal liability, and how does that affect Section 469(c)(3) eligibility for my specific position?

2

AFE Cost Breakdown

What is the Authorization for Expenditure breakdown between intangible and tangible costs for the specific well or wells underlying this joint venture?

3

At-Risk Basis Under Section 465

How does my at-risk basis under Section 465 compare to my planned capital contribution, and does any portion of my contribution involve recourse or nonrecourse debt?

4

AMT Preference Under Section 57(a) (2)

Based on my current-year income from oil, gas, and geothermal properties, how would the Section 57(a) (2) alternative minimum tax preference calculation apply to any excess IDC I am allocated?

5

Interaction with Existing Tax Position

How does this joint venture interact with my existing retirement contributions, Section 199A qualified business income position, and any excess business loss limitation under Section 461(l)?

6

K-1 Reporting & Section 469 Classification

What K-1 reporting will I receive, and how will the activity's Section 469 classification be documented on that K-1?

Closing Perspective

The Internal Revenue Code rarely offers a high-income professional a mechanism that scales with income rather than capping against it. Section 263(c), read together with Section 469(c)(3)(A), is one of the few provisions that was built that way on purpose — a declared statutory preference for domestic energy development that happens to intersect with the exact structural gap most standard retirement and deduction planning leaves open for a surgeon or other high-earning professional.

None of this changes the fact that every number, every entity determination, and every deduction amount described in this paper depends on the specific facts of an individual's return and the specific structure of a specific joint venture. A business participant evaluating this strategy should expect — and should insist on — documentation detailed enough that their own CPA can independently confirm every statutory layer discussed here before any capital contribution is made.

Understanding the mechanism is the first step. Confirming how it applies to an individual's own return, in direct conversation with qualified tax counsel, is the step that follows.

Section 263(c) Codified 1954. Preserved through every major tax reform. A deliberate, long-standing congressional policy decision tied to domestic energy development.	Section 469(c)(3)(A) The statutory carve-out that excludes a properly held working interest from passive-activity treatment — by category, not by hours or material participation.	Summit Ventures A direct oil and gas entrepreneurial joint venture platform built to preserve the structural conditions these provisions require — with full AFE transparency and CPA-ready K-1 reporting.
--	--	--

Ready to explore whether a working interest position belongs in your tax plan?

- Explore Summit Ventures
- Request a Consultation

Sources and References

[1] Internal Revenue Service, IR-2025-111, "401(k) limit increases to \$24,500 for 2026, IRA limit increases to \$7,500" (Nov. 13, 2025). [2] Employ America, "The Long Game," and Tax Notes summary of Revenue Ruling 71-206. [3] Kleinman Center for Energy Policy, University of Pennsylvania, and U.S. Government Accountability Office report RCED-00-301R. [4] Cornell Law School Legal Information Institute, 26 U.S.C. Section 469(c)(3)(A). [5] BassEXP, "Section 469 Working Interest: Active vs. Passive." [6] Kingdom Exploration, "Intangible Drilling Costs Tax Treatment" FAQ. [7] IRS Publication 925, Passive Activity and At-Risk Rules. [8] Cornell Law School Legal Information Institute, 26 CFR Section 1.612-4. [9] Anchor1031, "Intangible Drilling Costs." [10] AE Tax Advisors, "Oil and Gas Working Interest Tax Deduction." [11] Weaver, "Individual Tax Considerations for Investing in Oil and Gas Properties." [12] Uncle Kam, "Oil and Gas Intangible Drilling Costs." [13] Cornell Law School Legal Information Institute and Bloomberg Tax, 26 U.S.C. Section 57(a)(2)(A). [14] IRS Office of Chief Counsel Memorandum 201235010. [15] AE Tax Advisors, "Oil and Gas Working Interest Tax Deduction." [16] BassEXP, "K-1 Tax Reporting for Oil and Gas Investors." [17] U.S. Energy Information Administration, "U.S. crude oil production rose in 2025, setting new record." [18] American Petroleum Institute, "Industry Explained."

ⓘ This paper is provided for general education regarding statutory tax mechanics and does not constitute tax, legal, or financial advice. Applicability of any provision discussed depends on individual facts and circumstances and should be confirmed with a qualified CPA and tax attorney before any capital contribution is made to an entrepreneurial joint venture.