

Evaluating Direct Working Interest Participation

How an IRC Section 263(c) Intangible Drilling Cost Election Shaped a Statutory Approach to a **\$150,000 Active Income Spike** in Year One

CASE STUDY

TAX MECHANICS

OIL & GAS

This case study examines an illustrative, anonymized composite scenario built from publicly documented statutory mechanics under the Internal Revenue Code. It is not a record of an actual Summit Ventures participant, and no specific financial outcome is guaranteed or implied for any future business participant. It is intended for educational use by physicians, surgeons, dentists, attorneys, and CPAs evaluating how direct working interest participation in oil and gas development interacts with high active income.

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Case Classification & At-a-Glance Summary

Case Type

Illustrative composite, tax mechanics focused

Participant Profile

Orthopedic surgeon, Dallas, Texas — W-2 and 1099 active income exceeding \$150,000 in a single tax year from a surgical center distribution

Mechanism Evaluated

Direct working interest capital contribution under IRC Section 263(c), structured to preserve the IRC Section 469(c)(3) working interest exception

Entity Structure

Direct holding, not through a liability limiting entity — the statutory condition for the 469(c)(3) exception

Primary Statutes Referenced

- 26 U.S.C. 263(c) — Intangible Drilling Cost Election
- Treas. Reg. 1.612-4 — IDC Election Mechanics
- 26 U.S.C. 469(c)(3)(A) — Working Interest Exception to Passive Activity Rules
- 26 U.S.C. 465 — At-Risk Limitation Rules
- 26 U.S.C. 57(a)(2)(A) and (E) — AMT Preference Treatment
- 26 U.S.C. 611 and 613A — Percentage Depletion Allowance

Participant Profile, Trigger & Situation

The Participant

A 44-year-old orthopedic surgeon practicing in the Dallas–Fort Worth area. His compensation combines a hospital W-2 base salary with 1099 income from a surgical center partnership.

In the tax year reviewed, a one-time surgical center distribution pushed his active income above **\$150,000 beyond his typical baseline**, placing a meaningful share inside the top federal bracket — which under IRS Revenue Procedure 2025-32 begins above \$640,600 of taxable income for a single filer and \$768,600 for a married couple filing jointly.

Texas imposes no state individual income tax, so his exposure was purely federal.

What He Had Already Done

He had already maximized his 401(k) deferral and completed a backdoor Roth contribution for the year, both capped regardless of income and neither scaled to offset a six-figure active income event. His CPA confirmed no further room existed inside conventional retirement vehicles.

He had previously declined syndicated shelter products relying on aggressive valuation assumptions rather than a documented statutory mechanism.

The Gap

Conventional retirement vehicles were never built to solve a six-figure active income spike. A new, code-based approach was needed.

Challenge & Decision Criteria

The challenge was structural, not purely financial. He needed a mechanism offsetting **active income specifically**, since most tax-advantaged vehicles available to physicians shelter passive income only or cap out well below a six-figure spike.

Explicit Code Section Required

An explicit Code section rather than a promoter's interpretation — the mechanism had to be independently verifiable against the statute.

Independently Verifiable Structure

An entity structure independently verifiable against the statute, not reliant on a third-party's characterization of the law.

Genuine Business Exposure

Genuine business exposure rather than a passive paper claim — real capital at risk in a real development program.

CPA Relationship Fit

A fit inside his existing CPA relationship rather than a replacement for it — his advisor needed to be able to independently confirm the structure.

Options Evaluated & Approach Selected

Working with his CPA, the surgeon compared two approaches.

Option A: Fund or Limited Partnership

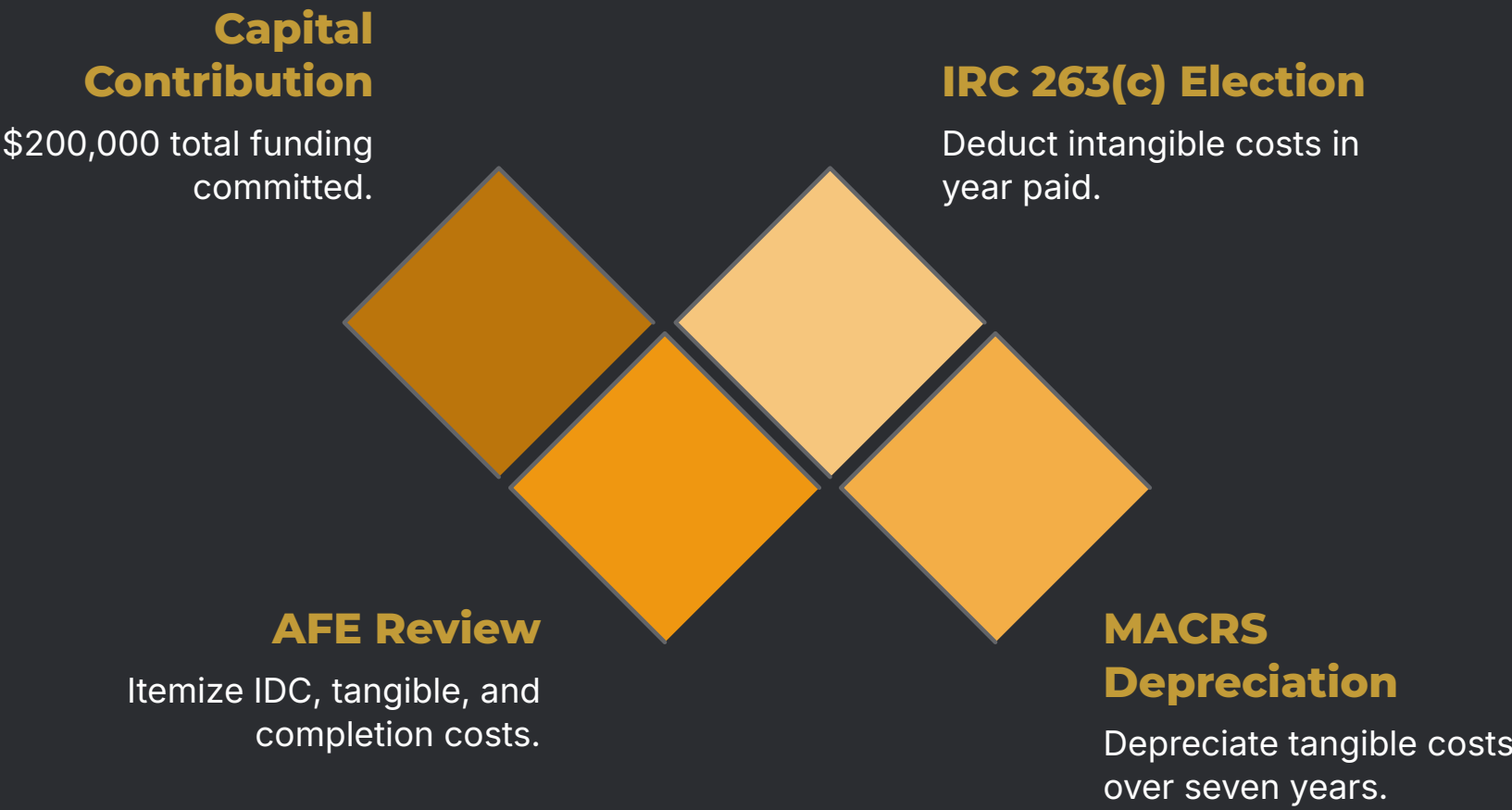
Participation through a fund or limited partnership, pooling capital through a liability-limiting entity. While simpler, this approach forfeits the working interest exception entirely. Losses through a liability-limiting fund or LLC are treated as passive regardless of the underlying asset — and passive losses can only offset passive income, which does little for a surgeon whose earnings are almost entirely active.

Option B: Direct Working Interest (Selected)

A direct working interest capital contribution, held through a structure that does not limit liability — consistent with 26 U.S.C. 469(c)(3)(A), which excludes from the definition of a passive activity "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."

He selected the direct structure, joining as an active JV member and contributing capital into a Summit Ventures entrepreneurial joint venture participating in a producing field development program — specifically to preserve the active income offset.

Implementation: How the Structure Was Built



The AFE Framework

The capital contribution was structured around the authorized financial estimate (AFE) for the wells, which itemizes intangible drilling costs, tangible drilling costs, and completion costs ahead of the capital call. Under 26 U.S.C. 263(c) and Treas. Reg. 1.612-4, a working interest owner may elect to deduct intangible drilling costs — the labor, fuel, chemicals, and site preparation costs with no salvage value — in the year paid rather than capitalizing them.

Industry documentation generally places intangible costs in a **60 to 80 percent range** of total well cost, with the balance made up of tangible, salvageable equipment depreciated separately.

Capital Allocation in This Illustration

In this illustration, the surgeon contributed **\$200,000 in total capital**. The AFE allocated approximately **75 percent to intangible costs**, within the documented range and confirmed against the AFE rather than assumed. The remaining 25 percent — tangible completion equipment — was placed on a 7-year MACRS schedule.

The deduction was further bounded by the at-risk limitation under 26 U.S.C. 465, capping deductible losses at the cash and recourse obligations actually at risk.

Results: Year One Tax Mechanics

\$200K

Total Capital Contributed

Total capital contribution into the Summit Ventures entrepreneurial joint venture

75%

IDC Allocation per AFE

Intangible drilling cost allocation, within the documented 60–80% industry range

\$150K

Year One Deduction

Illustrative Year One deduction under IRC 263(c), directly offsetting the surgical center distribution

\$50K

Tangible Cost Basis

Remaining tangible cost basis, depreciated over 7 years under MACRS

K-1 Classification: Nonpassive

Because the working interest was held directly rather than through a liability-limiting entity, it was coded on his Schedule K-1 as **nonpassive**, allowing it to offset W-2 and 1099 income rather than being trapped against passive income only — consistent with 469(c)(3)(A).

AMT Modeling

His CPA also modeled alternative minimum tax exposure before the election was finalized. Under 26 U.S.C. 57(a)(2)(A), excess intangible costs are an AMT preference item only above 65 percent of net income from oil, gas, and geothermal properties for the year. Section 57(a)(2)(E) gives independent producers a further exception limited to 40 percent of alternative minimum taxable income. The contribution did not trigger a material AMT preference once modeled against those thresholds — though this calculation is fact-specific and must be rerun for every participant and tax year.

Metrics Summary & Ongoing Benefits

Metric	Detail
Total capital contribution	\$200,000
Illustrative IDC allocation per AFE	~75% (within documented 60–80% industry range)
Illustrative Year One deduction under IRC 263(c)	~\$150,000
Remaining tangible cost basis	~\$50,000, depreciated over 7 years under MACRS
At-risk basis under IRC 465	Limited to cash capital contributed
K-1 classification	Nonpassive — active income offset under 469(c)(3)(A)
Ongoing benefit once wells produce	Percentage depletion allowance of 15% of gross production income for independent producers under IRC 611 and 613A
State income tax exposure on the distribution	None — Texas imposes no individual income tax

"What mattered to me was not a number someone pitched. It was being able to hand the operating agreement and the AFE to my own CPA and have her independently confirm the structure matched the statute. That is a different conversation than most alternative deductions I had been shown."

— *Illustrative Composite Participant Statement (not an actual participant)*

Assumptions, Key Takeaways & Questions for Advisor Discussion

Assumptions Any Reviewing CPA Should Verify

This case rests on assumptions any reviewing CPA should independently verify for a specific participant and tax year.

- The intangible cost allocation is set by the actual AFE for the specific wells, not a fixed or guaranteed rate, and varies by project.
- The at-risk limitation under IRC 465 and the passive activity rules under IRC 469 depend on how the interest is held — only a direct holding, or participation through an entity that does not limit liability, preserves the active income offset.
- AMT exposure under 57(a)(2) must be modeled individually.
- Percentage depletion under 611/613A is an ongoing mechanism tied to production income once wells are online, not a Year One event.

❏ The central lesson: **entity structure — not the asset class alone** — determines whether a deduction offsets active income or is trapped as a passive loss.

Questions for Advisor Discussion

1 469(c)(3) Eligibility

Does my working interest documentation hold the interest directly, or through an entity that limits my liability, and how does that affect my 469(c)(3) eligibility?

2 AFE Cost Split

What does the AFE show as the intangible versus tangible cost split for the specific wells I am contributing capital toward?

3 At-Risk Basis

How does my at-risk basis under IRC 465 compare to my total capital contribution?

4 AMT Liability

Based on my projected net oil and gas income this year, does 57(a)(2)(A) or 57(a)(2)(E) materially change my AMT liability?

5 Full Tax Position

How does this deduction interact with the rest of my current-year tax position, including any other active income events in the same year?

Closing: A Code-Based Framework, Not a Promotional Shortcut

A six-figure active income event — whether from a surgical center distribution, a partnership bonus, or a practice sale component — creates a tax planning problem conventional retirement vehicles were never built to solve.

The mechanics reviewed here — direct working interest holding under 469(c)(3), the intangible cost election under 263(c), the at-risk boundary under 465, and the AMT exception thresholds under 57(a)(2) — form a **documented, code-based framework** rather than a promotional shortcut.

Any physician, dentist, attorney, or CPA evaluating a similar structure should request the AFE, the operating agreement, and the entity documentation in advance, and review all three with a personal tax advisor before contributing capital. Summit Ventures structures its entrepreneurial joint venture participation to keep direct holding intact, so the active income offset mechanics described here remain available to verify rather than taken on faith.

Request the AFE

Obtain the authorized financial estimate itemizing intangible vs. tangible cost splits for the specific wells

Review the Operating Agreement

Confirm the entity structure does not limit liability — the statutory condition for the 469(c)(3) exception

Engage Your CPA

Have your personal tax advisor independently verify the structure against the statute before contributing capital

Sources & References

- [1] IRS Revenue Procedure 2025-32, 2026 federal income tax bracket thresholds, as summarized by Tax Foundation, taxfoundation.org
- [2] 26 U.S.C. 469(c)(3)(A), full statutory text via Cornell Legal Information Institute, law.cornell.edu
- [3] BassEXP, "Section 469 Working Interest: Active vs. Passive," bassexp.com
- [4] 26 U.S.C. 263(c) and Treasury Regulation 1.612-4, intangible drilling cost election mechanics
- [5] AE Tax Advisors, "Oil and Gas Working Interest Tax Deduction," aetaxadvisors.com
- [6] Anchor1031, intangible versus tangible drilling cost education resource, anchor1031.com
- [7] 26 U.S.C. 465, at-risk limitation rules
- [8] 26 U.S.C. 57(a)(2)(A) and 57(a)(2)(E), alternative minimum tax preference treatment for excess intangible drilling costs, independent producer exception
- [9] 26 U.S.C. 611 and 613A, percentage depletion allowance for independent producers