

An aerial photograph of an oil drilling rig in a desert landscape at dusk. The rig is a tall, complex structure with various platforms and pipes. The sky is a mix of orange and blue, and the ground is flat and arid. The overall tone is professional and industrial.

Direct Working Interest Ownership vs. Oil and Gas Funds

A Comparative Guide to Ownership Structure, Statutory Tax Treatment, Governance Rights, and Cash Flow Mechanics for Physicians, Dentists, Attorneys, and Financial Professionals

COMPARATIVE GUIDE

TAX STRATEGY

ENERGY INVESTMENT

Introduction: The High-Earner's Tax Problem

Physicians, dentists, attorneys, and CPAs who reach the top federal bracket face a narrow menu of scalable tax strategies. For 2026, the 37 percent federal bracket begins at **\$640,600 of taxable income for a single filer** and **\$768,600 for a married couple filing jointly**, a structure the One Big Beautiful Bill Act made permanent rather than allowing it to revert to 39.6 percent.

Standard deferral vehicles were never built to absorb income at this scale. The 2026 401(k) employee deferral limit is \$24,500, the combined employee-and-employer limit is \$72,000, and even the Traditional and Roth IRA limit sits at \$7,500, with Roth eligibility phased out entirely above \$252,000 of modified adjusted gross income for joint filers. A professional earning \$400,000 or more cannot shelter a meaningful percentage of that income through a 401(k) or backdoor Roth alone.

Energy asset ownership is one of the few remaining strategies in the Internal Revenue Code that attaches a statutory tax treatment to the classification of an activity rather than to the owner's income level, filing status, or hours worked. Once a reader understands that this benefit exists, the next decision is structural: should capital be contributed as a direct working interest owner, or allocated into a pooled oil and gas fund organized as a limited partnership or limited liability company. That structural choice, more than any single percentage or return figure, determines whether the statutory benefit is available at all.

2026 Contribution Limits at a Glance

\$24.5K

401(k) Employee Deferral

\$72K

Combined 401(k) Limit

\$7.5K

IRA Limit

These limits are insufficient for professionals earning \$400,000 or more annually.

What Is Being Compared

This guide compares two legitimate paths into the same underlying asset class — U.S. onshore oil and gas production:

Option A: Direct Working Interest Ownership

A business participant holds a fractional operating interest in a specific well or group of wells directly, or through an entity structure that does not limit the participant's liability, consistent with a general partnership or joint operating agreement model.

Option B: Oil and Gas Funds

Commonly structured as a limited partnership or LLC that pools capital from many participants into a blind-pool or semi-blind-pool portfolio of wells, royalties, or related energy assets, with a fund sponsor or manager making allocation and operating decisions on the group's behalf.

Both paths can provide exposure to drilling activity and production income. The comparison below focuses on where they diverge: **statutory tax classification, governance rights, fee structure, and the degree of operational transparency** available to the capital contributor.

Seven Evaluation Criteria

A professional evaluating either structure, together with their tax and legal advisors, should weigh seven factors:

1

Ownership & Legal Rights

Rights to the underlying asset

2

Operational Participation

Degree of involvement in drilling decisions

3

Governance & Control

Control over capital deployment

4

Access & Liquidity

Transfer or exit considerations

5

Statutory Tax Treatment

Losses, deductions, and depletion

6

Exposure & Limitations

Structural limitations specific to each model

7

Administrative Complexity

Reporting burden and compliance

Option A: Direct Working Interest Ownership

A direct working interest is an undivided fractional interest in the mineral lease and the wellbore itself. The business participant is a co-owner of the operating rights, not a shareholder in a separate legal entity that owns the rights on their behalf. This distinction is the foundation of the structure's statutory tax treatment.

Intangible Drilling Costs (IDC)

Treasury Regulation 1.612-4(a), issued under IRC Section 263(c), defines an operator eligible to elect current deduction of intangible drilling costs as "one who holds a working or operating interest... either as a fee owner or under a lease or any other form of contract granting working or operating rights." A direct working interest owner meets this definition cleanly.

Intangible drilling costs — the labor, drilling fluids, chemicals, and other expenditures with no salvage value — may be elected for current deduction in the year incurred rather than capitalized and recovered over the life of the well. Depending on the specific well's intangible-versus-tangible cost split, up to 100 percent of eligible intangible drilling costs can qualify for this current-year election, though the actual figure for any given AFE depends on the well's engineering design, the participant's at-risk basis, and their individual tax position, and should be confirmed with a qualified CPA before the election is made. Tangible drilling costs — items such as casing, wellheads, and pumping equipment that retain salvage value — are capitalized and depreciated.

The Section 469(c)(3)(A) Exception

The more consequential statutory feature is IRC Section 469(c)(3)(A), the working interest exception to the passive activity loss rules. The statute states that 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."

Because a direct working interest satisfies this exact language, losses generated by the activity — including elected intangible drilling cost deductions — are treated as **active losses**. They may offset W-2 wages, 1099 income, and K-1 income from an active trade or business, with no income-based phase-out of the kind that limits real estate's \$25,000 passive loss allowance for taxpayers above \$100,000 of modified adjusted gross income.

Additional Statutory Layers

IRC Section 465 limits deductible losses to the amount the participant has at risk in the activity. IRC Section 57(a)(2) addresses the alternative minimum tax treatment of excess intangible drilling costs: the excess is a preference item only above 65 percent of the participant's net income from oil, gas, and geothermal properties for the year, and independent producers receive a further exception under Section 57(a)(2)(E) capped at 40 percent of alternative minimum taxable income. Once a well reaches production, IRC Sections 611 and 613A permit independent producers to claim a **15 percent percentage depletion allowance** against gross income from the property, a deduction that continues annually for the life of the production.

- Governance under a direct structure runs through a joint operating agreement. The business participant has contractual rights to operational reporting, AFE (authorization for expenditure) approval on major decisions, and line-item visibility into drilling and lease operating costs — rather than discretionary allocation decisions made by a third-party fund manager.

Option B: Oil and Gas Funds

How Fund Structures Work

An oil and gas fund pools capital from many participants into a single limited partnership or limited liability company. The fund itself — not the individual participant — holds the working interests, royalties, or other energy assets in the portfolio. Participants hold a security interest in the fund entity, typically evidenced by a partnership unit or membership interest, and receive a K-1 reflecting their share of the fund's results.

Because the fund entity is organized specifically to limit each participant's personal liability to their capital contribution, the arrangement falls outside the Section 469(c)(3)(A) exception, which requires the interest to be held "directly or through an entity which does not limit the liability of the taxpayer." As a general matter, losses passed through from a liability-limiting fund vehicle are treated as **passive losses** under Section 469, available to offset only passive income from other sources — not the participant's active W-2, 1099, or K-1 wages.

Typical Fund Fee Architecture

Fund structures carry a fee architecture layered between the capital contributed and the wellhead. Independent industry sources describing pooled oil and gas fund structures note:

Management Fee

1–2% of committed capital or net asset value annually

Acquisition Fees

1–5% of purchase price

Carried Interest

~20% of profits once a preferred return hurdle of 8–10% has been met

Combined Annual Load

2–4% plus a 20% profit share before any return reaches the participant

Governance in a fund structure is centralized with the sponsor or general partner. Participants typically have limited or no vote on individual well selection, drilling sequencing, or operating budget decisions, and rely on periodic fund-level reporting rather than well-by-well operational visibility.

Side-by-Side Comparison

The table below summarizes how direct working interest ownership and oil and gas funds differ across every key evaluation dimension.

Category	Direct Working Interest Ownership	Oil and Gas Funds
Ownership	Fractional operating interest held directly in the specific lease and wellbore; the participant is a co-owner of the asset	Security interest in a pooled LP or LLC entity; the fund, not the participant, owns the underlying assets
Participation	Active business participant under a joint operating agreement, with line-item visibility into AFEs and operating costs	Passive capital contribution; participant typically has no operational role in individual asset decisions
Governance & Control	Contractual approval rights over major expenditures through the operating agreement; direct access to well-level data	Decisions centralized with the fund sponsor or general partner; participants receive periodic, portfolio-level reporting
Liquidity	Transfer generally requires locating a buyer for the specific interest and operator consent; no secondary market	Fund units are also generally illiquid, with transfer restricted by the partnership or operating agreement and often no established secondary market
Tax Treatment	May qualify for the Section 469(c)(3)(A) working interest exception, allowing elected IDC deductions to offset active income, subject to Section 465 at-risk limits and Section 57(a)(2) AMT preference rules; depletion available under Sections 611/613A once producing	Generally structured as a liability-limiting entity, which as a general matter places losses outside the 469(c)(3)(A) exception and subjects them to the standard passive-loss rules; specific treatment depends on entity structure
Exposure & Limitations	Concentrated exposure to the specific wells in which the participant holds an interest; outcomes tied directly to those assets' performance	Diversified across a portfolio of assets selected by the sponsor; outcomes depend on sponsor selection quality and are reduced by the fee and carry structure before reaching participants
Complexity	Requires direct engagement with operating agreements, AFEs, and well-level tax records, typically coordinated with a CPA familiar with oil and gas accounting	Administratively simpler for the participant, who receives a single consolidated K-1 and relies on sponsor-prepared reporting

Advantages, Limitations & Best-Fit Scenarios

Direct Working Interest: Advantages

- Statutory eligibility for the active-income offset under Section 469(c)(3)(A)
- Direct governance rights through the operating agreement
- Absence of a fund-level fee and carry structure sitting between capital and production

Direct Working Interest: Limitations

- Concentration in a smaller number of specific wells
- Closer administrative relationship with operating agreements and AFEs
- No established secondary market for transferring the interest

Oil and Gas Funds: Advantages

- Diversification across a sponsor-selected portfolio
- Simpler single-K-1 reporting experience

Oil and Gas Funds: Limitations

- Layered fee and carried-interest structure described above
- Centralized decision-making that limits the participant's governance rights
- Entity structure's general effect of placing losses under the passive activity rules rather than the active-income exception

Best-Fit Scenarios

Direct Working Interest Is Best For...

A professional who has substantial active W-2, 1099, or K-1 income they want to directly offset in the current tax year, who is comfortable working with their CPA to track well-level AFEs and intangible drilling cost elections, and who values governance rights and direct asset ownership over portfolio diversification handled by a third party.

Oil and Gas Funds May Suit...

A participant primarily seeking diversified exposure to the asset class, who is less focused on offsetting current-year active income, and who prefers a single consolidated reporting relationship over direct engagement with operating agreements.

Many Professionals Use Both

Allocating a portion of capital to a direct working interest position specifically to address a current-year active-income tax objective, while using fund vehicles — where appropriate — for broader portfolio diversification.

Decision Guidance & Key Questions

Before allocating capital to either structure, a reader should work through the following sequence with their CPA or attorney:

- 1

Confirm Tax Bracket & Active Income

Confirm the current and projected marginal tax bracket and the specific active income the participant intends to address, since the magnitude of W-2, 1099, or K-1 income directly affects whether the active-income offset available through direct working interest ownership is a meaningful part of the overall tax strategy.
- 2

Review Entity Structure Documents

Request the specific entity structure documents — whether an operating agreement for a direct interest or a private placement memorandum and partnership agreement for a fund — and have legal counsel confirm whether the structure preserves or forecloses the Section 469(c)(3)(A) exception.
- 3

Analyze Fee & Carry Schedule

Request a detailed fee and carried-interest schedule for any fund under consideration, and compare the cumulative drag of management fees, acquisition fees, and profit-sharing provisions against the direct-ownership alternative's absence of a comparable fee layer.
- 4

Evaluate Governance Rights

Evaluate the governance rights attached to the specific interest, including AFE approval thresholds, reporting frequency, and operator qualifications, since these rights differ meaningfully between a direct working interest position and a fund unit.
- 5

Confirm At-Risk Basis & AMT Exposure

Confirm the at-risk basis calculation under Section 465 and the AMT preference exposure under Section 57(a)(2) with a CPA experienced in oil and gas taxation before finalizing any capital contribution, since these statutory limits apply regardless of which structure is selected.

Questions to Ask Your Advisor

Does this specific entity structure meet the direct-holding or unlimited-liability requirement of IRC Section 469(c)(3)(A), or does it limit my personal liability in a way that forecloses that exception?	What is my at-risk basis under IRC Section 465, and how does the specific AFE or capital call align with that basis?	What percentage of my elected intangible drilling costs, if any, could be treated as an alternative minimum tax preference item under Section 57(a)(2), given my net oil and gas income for the year?	What is the full fee and carried-interest schedule for this fund, including management fees, acquisition fees, and profit-sharing provisions above the preferred return hurdle?
What governance rights — including AFE approval thresholds and reporting frequency — am I entitled to under the operating agreement or partnership agreement?	Who is the operator or sponsor, what is their track record on the specific basin and well type under consideration, and what reporting will I receive once drilling begins?		

Closing Perspective

The choice between direct working interest ownership and an oil and gas fund is not a question of which structure is universally superior. It is a question of which structure aligns with a specific professional's income profile, governance preferences, and tax objectives for the year in question.

The statutory distinction is real and well documented: Section 469(c)(3)(A) draws a clean line based on whether the taxpayer holds the interest directly or through an entity that limits liability, and that line has direct consequences for whether elected intangible drilling costs can offset active income or are confined to the passive-loss rules. A professional who understands this distinction — and who works through the operating agreement, fee schedule, and at-risk calculations with qualified counsel before contributing capital — is positioned to make a genuinely informed decision rather than a generic one.

Summit Ventures structures its offerings as direct working interest positions precisely because that structure preserves these statutory rights for its business participants, and the firm encourages every prospective participant to review the specific AFE, operating agreement, and tax position with their own CPA and attorney before moving forward.

Sources & References

[1] Tax Foundation, "2026 Tax Brackets," based on IRS Revenue Procedure 2025-32; One Big Beautiful Bill Act permanence of the 37 percent top federal bracket.	[2] Internal Revenue Service, IR-2025-111, 2026 cost-of-living adjustments for retirement plan and IRA contribution limits.	[3] 26 CFR 1.612-4(a), operator definition for intangible drilling cost election purposes, issued under 26 U.S.C. Section 263(c).	[4] Anchor1031, educational resource distinguishing intangible drilling costs (no salvage value) from tangible drilling costs (salvage value).
[5] Cornell Legal Information Institute, 26 U.S.C. Section 469(c)(3)(A), working interest exception to the passive activity loss rules.	[6] Internal Revenue Service, Publication 925, passive activity loss rules and the \$25,000 special allowance phase-out for real estate activities.	[7] 26 U.S.C. Section 465, at-risk limitation on deductible losses.	[8] 26 U.S.C. Section 57(a)(2)(A) and 57(a)(2)(E), alternative minimum tax treatment of excess intangible drilling costs and the independent producer exception.
[9] 26 U.S.C. Sections 611 and 613A, percentage depletion allowance for independent producers.	[10] AE Trust, "Oil and Gas Investment Breakdown: Understanding Energy Sector Opportunities," fund fee and carried-interest structure benchmarks.	[11] Invest In Energy, "Top 10 Oil and Gas Investment Firms for Accredited Investors," independent confirmation of typical management fee and carried-interest ranges for pooled oil and gas funds.	

Ready to Explore Direct Working Interest Ownership?

Summit Ventures structures its offerings as direct working interest positions to preserve statutory rights for business participants. Review your specific AFE, operating agreement, and tax position with your own CPA and attorney — then connect with our team.

Connect with Summit Ventures