

The background of the entire page is a photograph of an oil drilling rig. The rig is a complex structure of metal towers, pipes, and cranes. It is silhouetted against a sky that is a mix of dark blue and orange, suggesting a sunset or sunrise. The lighting is dramatic, with the rig's structure highlighted by the low sun. The overall mood is industrial and professional.

What CPAs and Financial Advisors Need to Know About Oil and Gas Working Interests

A Professional Brief on Statutory Tax Mechanics, Working Interest Ownership, and Client Planning Applications

PROFESSIONAL ADVISORY BRIEF

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Executive Takeaway & Why It Matters

Advisors across tax, wealth management, transaction, and estate practices regularly encounter the same client scenario: a liquidity event, a concentrated income year, or a planning deadline creates a tax problem that conventional tools cannot fully solve. Oil and gas working interests, governed by a specific and long-standing set of Internal Revenue Code provisions, represent one of the few asset classes where the tax treatment is both statutory and well-documented rather than aggressive or novel.

For advisors, the relevant question is rarely whether this asset class exists. It is whether the specific ownership structure in front of them actually satisfies the Code sections that make the tax treatment work, and whether the reporting behind it will hold up to CPA review and IRS scrutiny.

- ❏ This brief focuses on statutory mechanics rather than return expectations — because the mechanics are what determine whether a client's position is compliant, defensible, and correctly reported.

Written For

- CPAs and tax professionals
- Registered investment advisors
- Qualified intermediaries
- Business brokers and M&A advisors
- Estate planning attorneys
- Commercial real estate brokers

Context: When Clients Need Answers

High-income clients generate tax problems on predictable timelines: a business sale closes in Q4, a bonus or carried-interest distribution pushes a client into a higher bracket, a 1031 exchange clock is running out of identified replacement property, or an estate plan needs an asset class that diversifies away from securities and real estate without introducing operational complexity for the client personally. Advisors are expected to have an answer in these moments, and most conventional tax planning tools — retirement plan deferrals, charitable structures, opportunity zones — have contribution caps, timing restrictions, or suitability limits that do not scale to a seven-figure liquidity event.

Direct participation in oil and gas development is one of the few categories where Congress built a specific statutory framework for active, direct ownership. The framework is decades old: the intangible drilling cost deduction traces to 1916 Treasury guidance and was codified as IRC Section 263(c) in the Internal Revenue Code of 1954. It has survived multiple rounds of tax reform, including the 2017 Tax Cuts and Jobs Act and the 2025 One Big Beautiful Bill Act (OBBBA), which made 100 percent bonus depreciation under IRC Section 168(k) permanent for qualified property acquired after January 19, 2025, reversing the prior phase-down schedule. The durability of this framework, not its novelty, is what makes it a legitimate subject for a professional advisory conversation.

1916

IDC Deduction Origin

Traces to 1916 Treasury guidance, codified as IRC §263(c) in 1954

100%

Bonus Depreciation

Permanent under OBBBA for qualifying property acquired after Jan 19, 2025

§469

Active Income Exception

IRC §469(c)(3)(A) — the working interest exception to passive activity loss rules

The Central Issue: Two Statutory Questions

The central issue advisors face is not whether oil and gas working interests carry tax advantages. It is distinguishing between two separate statutory questions that are frequently conflated in client-facing marketing material.

Question 1: Classification & Timing

IRC Section 263(c) and Treasury Regulation 1.612-4 allow a working interest holder to elect to expense intangible drilling costs (IDCs) — the non-salvageable costs of drilling (labor, fuel, drilling mud, chemicals, site preparation, hauling) — in the year incurred rather than capitalizing them.

Tangible drilling costs (casing, wellhead equipment, tanks) are capitalized and depreciated, generally under MACRS, and now benefit from permanent 100 percent bonus depreciation under OBBBA for qualifying property placed in service after January 19, 2025.

Question 2: Offsetting Active Income

Section 263(c) governs classification and timing only. It does not, by itself, determine whether a loss can offset a client's W-2 wages, 1099 income, or K-1 distributions from an operating business.

That determination is governed by IRC Section 469(c)(3)(A), the working interest exception to the passive activity loss rules, 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 with respect to such interest."

- ❏ This is the provision that allows a correctly structured working interest to offset active income **without** the material participation or hours-based tests that apply to other active-income strategies, such as real estate professional status.

The opportunity for advisors is to become the professional who can explain this distinction correctly, rather than the one who has to walk it back after a client's position is challenged on audit.

Key Findings: What Advisors Must Know

Entity Structure Is the Determining Fact

The Section 469(c)(3)(A) exception applies only when the client holds the working interest directly, or through an entity that does not limit liability, such as a general partnership. An LLC, limited partnership, or fund interest that shields the client from liability does not qualify for the active-income offset, regardless of how the underlying asset is marketed.

Direct-Holding Governs 1031 Eligibility Too

Revenue Ruling 68-331 held that a lessee's working interest in a producing oil and gas lease is real property, like-kind to a fee interest in improved real estate, for purposes of Section 1031(a). However, Revenue Ruling 78-135 clarifies that a general partnership interest itself does not qualify for 1031 nonrecognition treatment. The client must hold an actual direct or undivided working interest — not an interest in the entity that holds it — for either the 469(c)(3) active-income exception or 1031 like-kind treatment to apply.

Deductions Are Subject to Independent Limitations

IRC Section 465 caps deductible losses at the client's actual economic exposure in cash and recourse debt; nonrecourse financing does not increase the at-risk basis the way it can in some real estate structures. IRC Section 461(h) economic performance rules generally require that drilling activity begin within 90 days of a year-end IDC prepayment for the deduction to be respected in that tax year.

AMT Exposure Has a Specific Statutory Relief Valve

Excess IDC is a tax preference item for independent producers under IRC Section 57(a)(2), but the preference does not apply to the extent the excess IDC deduction does not exceed 65 percent of the client's net income from oil and gas properties for that year, per Section 57(a)(2)(B). This is a frequently misunderstood mechanic that deserves explicit modeling rather than a flat assumption either way.

Depletion Is a Recurring Benefit

Once a well is producing, IRC Sections 611 and 613A permit independent producers to claim a 15 percent percentage depletion allowance against gross income from the property, which can continue to apply even after the client's cost basis in the property reaches zero.

Reporting Quality Determines Audit Resilience

A K-1 for a direct working interest should reflect the client's active or nonpassive classification consistently across Box 1, Box 12, Box 13, and Box 20, so the CPA preparing the return is not left to make an independent determination about the character of the income or loss.

Analysis: The Summit Ventures Participation Model

Summit Ventures operates as an entrepreneurial joint venture platform. Clients who participate do so as working interest owners and active JV members, holding a direct interest in the underlying wells rather than a share in a pooled fund or trust. This structure is deliberate: it is what allows the Section 469(c)(3)(A) and Revenue Ruling 68-331 analyses above to apply in the first place. Governance rights, operational transparency around drilling and development decisions, and a clear capital contribution structure accompany the ownership position, consistent with how an entrepreneurial JV functions rather than a passive financial product.

Structural Elements Advisors Should Verify

Before a client moves forward with any working interest opportunity, whether through Summit or any other operator, advisors should confirm:

01	02
Legal Form of Holding	IDC & Tangible Cost Allocation
Direct interest or general-partnership-style entity — not an LLC or LP membership interest	The allocation methodology behind the IDC and tangible cost split for the specific wells involved
03	04
Timing of Drilling	Tax Opinion Letter
Timing of drilling relative to any year-end capital contribution, for Section 461(h) purposes	Whether the operator provides a tax opinion letter addressing the entity structure and the 469(c)(3)/1031 analysis for the specific holding

Tax & Legal Considerations by Advisor Role

The practical application of working interest mechanics differs meaningfully depending on the advisor's professional role and client relationship. Here is how each discipline should frame the conversation.



CPAs & Tax Professionals

The practical value is a client position that can be modeled with the same statutory rigor as any other return line item: the IDC election under 263(c), the active-income offset test under 469(c)(3)(A), the at-risk limitation under 465, and the AMT preference exception under 57(a)(2)(B). Summit provides standardized K-1 scheduling with consistent active/nonpassive coding, intended to reduce the back-and-forth that typically occurs during tax season when a client arrives with incomplete or ambiguous reporting from an energy program.



Registered Investment Advisors

The relevant conversation is less about the deduction itself and more about how a direct working interest fits within a client's broader allocation away from publicly traded securities, where correlation to the client's existing concentrated positions — an operating business, a real estate portfolio, a public equity stake — can be a meaningful diversification consideration independent of the tax mechanics.



Qualified Intermediaries

The Rev Rul 68-331/78-135 analysis is the central technical point: a direct working interest can serve as replacement property in a 1031 exchange, but only if the client's exchange documentation reflects a direct interest rather than an entity interest. This distinction should be confirmed before an identification deadline, not after.



Business Brokers & M&A Advisors

The relevant moment is the period immediately following a transaction close, when a client has realized proceeds and is facing a concentrated income year with limited remaining planning windows. A direct working interest capital contribution, structured and documented correctly, is one of the few year-end-compatible options available at that point in the calendar.

Estate Planning Attorneys

A direct working interest is a distinct asset class for diversification and succession planning purposes, with its own depletion, basis, and transfer considerations that should be addressed specifically in estate documents rather than treated as a generic alternative asset.

Commercial Real Estate Brokers

The 1031 and direct-holding points are the two facts worth retaining: a seller facing a tight identification window may evaluate a direct working interest as qualified replacement property, but the broker should route that conversation to the client's QI and tax counsel rather than characterize it independently.

Recommendations for Advisors

1 Confirm Direct vs. Entity Interest in Writing

Before referring a client to any energy program, confirm in writing whether the holding is a direct interest or an entity interest that limits liability. This single fact determines both the 469(c)(3) active-income treatment and the 1031 eligibility analysis.

2 Review the Tax Opinion Letter Directly

Request the operator's tax opinion letter and review the entity structure language directly rather than relying on marketing summaries.

3 Model the AMT Exception Explicitly

Model the Section 57(a)(2)(B) AMT exception explicitly for clients with significant other preference items, rather than assuming the IDC deduction is automatically unaffected by AMT.

4 Confirm Year-End Timing Against IRC 461(h)

Confirm the timing of any year-end capital contribution against the IRC 461(h) 90-day economic performance standard before advising a client to close a position in December for current-year treatment.

5 Request a Sample K-1 in Advance

Request a sample K-1 and reporting schedule in advance of client onboarding so the CPA of record can confirm the active/nonpassive coding methodology before tax season begins.

Implications & Questions for Professional Discussion

Implications of Getting It Right — and Wrong

For advisors, the implication of getting this analysis right is straightforward: a correctly structured working interest position is a credible, statute-backed planning tool that withstands professional and regulatory scrutiny.

The implication of getting it wrong — by recommending a pooled fund or LLC interest under the assumption that it carries the same active-income or 1031 treatment as a direct working interest — is a client position that may be recharacterized on audit, with the advisor's name attached to the original recommendation.

 The distinction between direct ownership and entity ownership is not a technicality. It is the entire basis for the tax treatment discussed in this brief.

Questions for Professional Discussion

- Does the specific opportunity involve a direct working interest, or an interest in an entity that limits the client's liability?
- Has the entity structure been confirmed against the exact statutory language of IRC Section 469(c)(3)(A), rather than assumed from marketing materials?
- What does the operator's tax opinion letter say about the 1031 and active-income analysis for this specific holding, and has client-specific counsel reviewed it?
- How is the IDC-to-tangible-cost allocation determined for the specific wells involved, and is that methodology documented in a way the CPA of record can independently verify?
- What does the K-1 reporting schedule look like, and does it arrive with enough lead time for accurate current-year filing?
- For clients near the AMT threshold, has the 57(a)(2)(B) exception been modeled against the client's full income picture rather than assumed?

Next Steps & Sources

Advisors evaluating this category for a specific client situation should request three documents before proceeding: the entity formation documents confirming direct or unlimited-liability holding structure, the tax opinion letter addressing the 263(c)/469(c)(3) and, where relevant, the Rev Rul 68-331 analysis, and a sample K-1 reflecting the reporting format the client would receive.

Summit Ventures provides these materials as part of its back-office educational support for advisors, along with a direct line to its tax and operations team for CPA-to-CPA technical questions during due diligence or return preparation. This is intended as a resource for the advisor's own evaluation process, not a substitute for independent tax or legal advice specific to each client's circumstances.

Clients considering this category should always be directed to confirm the specific tax treatment of any individual opportunity with their own qualified CPA or tax attorney before making a capital contribution.

The category itself is not new, and the statutory provisions discussed here have been part of the Code for decades. What continues to separate a defensible client position from a vulnerable one is whether the advisor confirmed the structural facts before the client signed anything — and that confirmation is squarely within the scope of the advisory relationship this brief is written to support.

Sources & References

IRC Section 263(c) and Treasury Regulation 1.612-4 (intangible drilling cost election) · IRC Section 469(c)(3)(A) (working interest exception to passive activity loss rules) · IRC Section 465 (at-risk limitation) and Section 461(h) (economic performance, 90-day drilling exception) · IRC Sections 57(a)(2) and 57(a)(2)(B) (excess IDC AMT preference and 65% net oil and gas income relief exception) · IRC Sections 611 and 613A (percentage depletion allowance for independent producers) · Revenue Ruling 68-331, 1968-1 C.B. 352 · Revenue Ruling 78-135 · One Big Beautiful Bill Act (signed July 4, 2025) and IRS Notice 2026-11 · BassEXP, AE Tax Advisors, Weaver, Anchor1031.

Advisors should confirm current-year tax bracket figures, bonus depreciation status, and any subsequent statutory or regulatory updates with their own research or qualified tax counsel before applying this material to a specific client situation.

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