

The background of the slide is a photograph of an oil drilling rig in a desert landscape at sunset. The sky is filled with orange and yellow clouds, and the rig is silhouetted against the bright horizon. The rig is a tall, lattice-structured tower with various platforms and equipment. The overall scene is industrial and dramatic.

Shielding \$150,000 in Active Income: A Direct Working Interest Case Study

How a Dallas orthopedic surgeon evaluated IRC Section 263(c) Intangible Drilling Cost Elections, the Section 469(c)(3) Working Interest Exception, and Entrepreneurial Joint Venture Participation to offset a one-time active income spike.

CONSIDERATION-STAGE CASE STUDY

ILLUSTRATIVE COMPOSITE PROFILE

Case Classification & At a Glance Summary

❏ **Important Disclosure:** This is an illustrative, composite profile built from verified statutory mechanics. This is not a named Summit Ventures participant and no specific individual's tax return is referenced. Dollar figures are hypothetical and presented to demonstrate how the underlying statutory framework operates — not as a projection, guarantee, or universal outcome.

Profession

Orthopedic surgeon, private practice, Dallas, Texas

Trigger Event

One-time surgical center distribution added
~\$150,000 of additional active income on top of base W-2 and 1099 earnings

Tax Exposure

Entirely federal — Texas levies no state individual income tax — concentrated at the top marginal bracket

Mechanism Evaluated

Direct working interest capital contribution into a producing field program with the IDC election under IRC Section 263(c)

\$150K

Active Income Spike

One-time surgical center distribution

37%

Top Federal Rate

Rate made permanent under the One Big Beautiful Bill Act

\$200K

Capital Contribution

Hypothetical direct working interest contribution

75%

IDC Allocation

Intangible drilling cost share per specific AFE documentation

Governing statute for active income offset: **IRC Section 469(c)(3)(A)**, the working interest exception to the passive activity loss rules. Structure used: direct holding of the working interest — not participation through a liability-limiting fund, LP, or LLC.

Participant Profile, Trigger & Situation

The participant in this composite profile is a surgeon in her early fifties running an established orthopedic practice in the Dallas–Fort Worth market. Her W-2 and K-1 income from the practice typically placed her near, but not above, the top federal bracket. In the year in question, a surgical center she held an equity stake in made a one-time special distribution, adding approximately \$150,000 of active income on top of her normal compensation.

That single event pushed her taxable income well past the 2026 top marginal threshold of \$640,600 for a single filer, meaning the incremental distribution was taxed almost entirely at the top 37 percent federal rate — a rate structure made permanent under the One Big Beautiful Bill Act with no scheduled reversion.^[1]

She had already maximized the standard menu available to high-income professionals: full 401(k) deferral, a backdoor Roth IRA (her direct income placed her above the 2026 Roth MAGI phase-out range of \$153,000 to \$168,000 for single filers), and a defined contribution profit sharing component through her practice.^[9] None of these levers scale with a lumpy, one-time spike in active income.

She was not looking for a syndicated shelter or a product marketed on a projected return. She wanted to understand whether a documented, statutory mechanism existed that could offset active income directly, and what structural requirements governed whether that mechanism actually applied to her.

Challenge & Decision Criteria

The central challenge was not finding a deduction. Numerous structures advertise tax deductions tied to oil and gas participation. The challenge was understanding which structures actually qualify under the Internal Revenue Code to offset active, ordinary income rather than merely offsetting passive income — and what specific legal and operational conditions have to be met for that qualification to hold.

Her evaluation criteria, developed with her CPA, were:

Statutory Legitimacy

Does the mechanism rely on a real statutory election, or on an aggressive interpretation that invites audit exposure?

Active Income Offset

Does the structure preserve the ability to offset active W-2 and K-1 income, or does it default to passive treatment?

Ownership Structure

What ownership structure is required to qualify, and does it conflict with her preference for limited personal liability exposure?

Cost Documentation

What portion of the capital contribution is substantiated by actual drilling cost documentation rather than a marketed percentage?

Ongoing Obligations

What ongoing obligations, governance rights, and reporting she would receive as a participant — not just a one-time filing?

Two Paths: Options & Approach

Her CPA identified two broadly available paths for oil and gas participation. The structural distinction between them is the deciding factor for whether the deduction can reach active income at all.

Path 1: Pooled Fund (LP or LLC)

These vehicles are straightforward to administer and widely marketed, but because they are organized as liability-limiting entities, they generally **do not satisfy IRC Section 469(c)(3)(A)**, which excludes a working interest from passive activity treatment only when the taxpayer holds it "directly or through an entity which does not limit the liability of the taxpayer."**[2]**

Losses generated inside a liability-limiting fund typically remain passive and can only offset passive income — which would not have addressed her active income spike at all.

Path 2: Direct Working Interest (Entrepreneurial JV) ✓ Selected

Direct working interest participation in a producing field program structured as an entrepreneurial joint venture, where she holds the interest directly rather than through a liability-shielding wrapper.

This structure preserves the **Section 469(c)(3)(A) exception**, meaning otherwise passive losses — including the IDC deduction — can offset active income with no AGI-based phase-out, unlike the \$25,000 special allowance available to real estate activities, which phases out entirely at \$150,000 of modified adjusted gross income.**[2][3]**

She elected to evaluate this path with Summit Ventures as an entrepreneurial JV platform, reviewing the joint operating agreement, the AFE documentation for the specific wells under consideration, and the governance rights attached to her position as a working interest owner before making a capital contribution decision.

Implementation: Step-by-Step Mechanics

Her advisory team walked through the mechanics in sequence, ensuring each structural requirement was satisfied before proceeding to the next step.

1 Capital Contribution & Entity Review

She reviewed the operating structure to confirm the participation would be held directly, preserving the 469(c)(3)(A) exception, rather than through a liability-limiting wrapper that would convert the activity to passive.

2 AFE Review for IDC and TDC Allocation

The specific AFE for the wells under consideration itemized intangible costs (labor, fuel, chemicals, and drilling services with no salvage value) separately from tangible drilling costs, or TDC (casing, tubing, wellhead equipment, which retain salvage value and are depreciated rather than expensed).[6] Her capital contribution of \$200,000 was allocated according to that specific AFE, with intangible costs representing 75 percent of the total — confirmed by the well's own cost documentation and falling within the industry-documented 60 to 80 percent range.

3 IDC Election Under Section 263(c)

Her tax preparer made the election under IRC Section 263(c) and Treasury Regulation 1.612-4 to expense the intangible drilling costs in the year incurred rather than capitalize them, subject to the IRC Section 461(h) economic performance rule, which generally requires drilling to commence within 90 days for year-end costs to be currently deductible.[4]

4 At-Risk Basis Confirmation

Under IRC Section 465, her deductible loss was limited to amounts she actually had at risk — which in a direct cash capital contribution equals the cash contributed, with no financed or non-recourse leverage inflating the deduction beyond her actual economic exposure.[7]

5 AMT Exposure Review

Her preparer separately modeled the alternative minimum tax treatment. Excess IDC is a tax preference item under IRC Section 57(a)(2)(A) only to the extent it exceeds 65 percent of her net income from oil, gas, and geothermal properties for the year, and a further exception under Section 57(a)(2)(E) allows independent producers to elect out of some or all of that preference, with the resulting AMTI reduction capped at 40 percent of AMTI computed without the exception.[8] This two-part test was modeled explicitly rather than assumed away.

6 K-1 Reporting

The resulting Schedule K-1 reported the deduction with nonpassive coding, consistent with the 469(c)(3)(A) classification, allowing it to be applied against her Form 1040 active income rather than being trapped against passive income only.

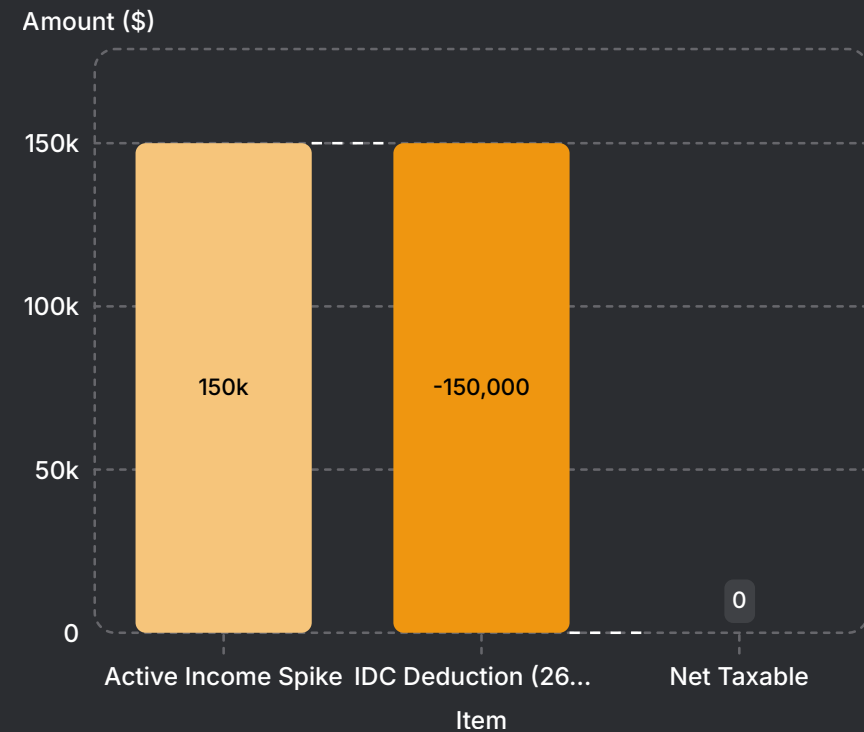
Explanation & Outcome (Illustrative)

Under this composite scenario, the \$200,000 capital contribution — allocated 75 percent to intangible drilling costs per the specific AFE — produced an illustrative first-year IDC deduction of approximately **\$150,000** under the Section 263(c) election.

Applied against the one-time \$150,000 active income spike, the deduction offset substantially all of the incremental income that would otherwise have been taxed at the top federal rate, before accounting for the separate AMT preference test described above.

The remaining \$50,000 of tangible completion equipment cost is not expensed in year one; it is recovered through depreciation over the applicable MACRS schedule, with the specific annual percentage depending on the tax year's bonus depreciation rules and her preparer's election.

- ❏ These figures are illustrative only, tied to one hypothetical AFE and one hypothetical participant's income position, and are not a projection of outcomes for any other business participant or well.



Illustrative offset of the \$150,000 active income spike via the Section 263(c) IDC election.

Illustrative Mechanics Summary

The following table summarizes the key metrics, governing statutes, and structural requirements for this composite illustrative scenario.

Metric / Element	Detail
Capital contribution (hypothetical)	\$200,000, held directly — not through a liability-limiting entity
AFE allocated intangible cost share	75% of this specific well's documented cost, within the 60–80% industry range
Illustrative year-one IDC deduction	~\$150,000, subject to Section 263(c) election and Section 461(h) timing
Governing statute for active income offset	IRC Section 469(c)(3)(A), direct holding requirement
At-risk basis ceiling	IRC Section 465, cash contributed only
AMT preference exposure	IRC Section 57(a)(2)(A), 65% of net oil and gas income threshold, with Section 57(a)(2)(E) independent producer relief capped at 40% of AMTI
Remaining tangible cost treatment	MACRS depreciation over the applicable recovery period
Ongoing production-era tax treatment	15% statutory percentage depletion for independent producers under IRC Sections 611 and 613A once the wells produce, separate from the year-one IDC event

"What mattered to me was not a marketed percentage. It was seeing the AFE, understanding why the structure had to be direct rather than through a fund, and knowing my CPA could model the AMT exposure before I made a capital contribution. That is a different conversation than the ones I had with the products my broker initially showed me."

— Composite illustration representing the type of evaluation process described in this case, not a quotation from an identifiable individual.

Assumptions, Key Takeaways & Questions for Your Advisor

Several assumptions underlie this illustrative scenario and should be treated as variables — not constants — for any business participant's own evaluation.

IDC Allocation Varies by Well

The 75% intangible cost allocation is specific to one hypothetical AFE. Actual allocations vary by well design, depth, and completion method, and are confirmed only by the specific well's own documentation — never by a marketed average.

AMT Modeling Is Not Optional

The \$150,000 deduction figure assumes the participant's AMT position does not independently limit the benefit. The Section 57(a)(2) modeling step must be completed explicitly for each participant's specific year.

Direct Holding Is the Linchpin

The active income offset depends entirely on preserving direct holding under Section 469(c)(3)(A). Participating through a liability-limiting LP or LLC wrapper would have converted the same dollar figures into a passive loss, offsetting only passive income.

The structural lesson generalizes beyond this one composite case: for a high-income professional with concentrated, lumpy active income, the deciding factor is rarely whether a deduction exists. It is whether the ownership structure satisfies the specific Code section that allows that deduction to reach active income in the first place — and whether the participant has the documentation, governance access, and advisor coordination to substantiate the election if examined.

Questions for Professional Advisor Discussion

Before evaluating a similar structure, a business participant and their CPA should discuss:

1. Does the proposed structure hold the working interest directly, or through an entity that limits liability, and how does that affect Section 469(c)(3)(A) eligibility?
2. What does the specific AFE for the wells under consideration show for the intangible versus tangible cost split, as opposed to a marketed range?
3. How would a one-time active income event interact with the Section 57(a)(2) AMT preference calculation in the participant's specific year?
4. What is the at-risk basis under Section 465, and does the capital contribution structure involve any financing that could limit the deductible amount?
5. What governance rights, reporting cadence, and operational transparency does the participant receive as a working interest owner after the capital contribution is made?
6. How does percentage depletion under Sections 611 and 613A apply once the wells reach production, separate from the year-one IDC event?

This composite case illustrates a recurring pattern among physicians, dentists, attorneys, and other high-income professionals evaluating direct energy participation: the statutory mechanics are well documented and have existed in some form since 1916, but the benefit is only as strong as the structure built around it.^[5] A direct working interest held as an active JV member, supported by AFE-level documentation and coordinated AMT and at-risk modeling, is a fundamentally different evaluation than a marketed deduction percentage attached to a pooled fund. Professionals carrying concentrated, high-bracket active income are best served by working through this structural distinction with their own CPA before treating any illustrative figure as applicable to their own return.

Sources, References & Next Steps

Sources & References

1. Tax Foundation, 2026 federal income tax brackets, based on IRS Revenue Procedure 2025-32; top 37% bracket begins at \$640,600 (single) and \$768,600 (married filing jointly), rate structure made permanent under the One Big Beautiful Bill Act.
2. Cornell Legal Information Institute, 26 U.S.C. Section 469(c)(3)(A), full statutory text on the working interest exception to passive activity treatment.
3. Internal Revenue Service Publication 925 and IRC Section 469, special allowance and phase-out rules for passive real estate activities, contrasted against the working interest exception.
4. 26 U.S.C. Section 263(c) and Treasury Regulation 1.612-4, intangible drilling cost election mechanics; 26 U.S.C. Section 461(h), economic performance and the 90-day drilling exception for year-end cost timing.
5. Historical origin of the intangible drilling cost election, codified in United States tax law since 1916 and carried forward through subsequent tax reform.
6. Industry and professional tax education resources describing the distinction between intangible drilling costs (no salvage value) and tangible drilling costs (retain salvage value and are depreciated).
7. 26 U.S.C. Section 465, at-risk limitation on deductible losses.
8. 26 U.S.C. Section 57(a)(2)(A) and Section 57(a)(2)(E), alternative minimum tax preference treatment of excess intangible drilling costs and the independent producer exception.
9. Internal Revenue Service, 2026 retirement plan contribution limits (401(k) elective deferral and combined limits) and Roth IRA modified adjusted gross income phase-out ranges.

Ready to Evaluate Your Own Situation?

This case study is designed to help high-income professionals understand the statutory framework — not to replace personalized tax advice. The next step is a structured conversation with your CPA and an experienced direct working interest platform.

Summit Ventures works with physicians, attorneys, and other high-bracket professionals to evaluate direct energy participation structures built on documented AFE allocations, transparent governance, and coordinated advisor access.

[Explore Summit Ventures](#)

📄 All figures in this document are illustrative and hypothetical. Consult your qualified tax advisor before making any investment or tax planning decision.