

An aerial photograph of an oil drilling rig in a desert landscape at dusk. The rig is a tall, slender structure with a red top, surrounded by various support buildings, storage tanks, and equipment. The scene is dimly lit, with the rig's lights providing a focal point against the darkening sky and the silhouettes of the surrounding terrain.

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 CPAs in the Highest Tax Brackets

Explore Summit Ventures

Introduction: Why High Earners Look to Oil & Gas

If you are a physician, dentist, attorney, or financial professional earning in the \$150,000 to \$400,000 or higher range, you have likely already maximized the standard tax deferral tools available to you. A 401(k), a backdoor Roth, a defined benefit plan if your practice structure allows one. These tools are useful, but they share a common limitation: they are capped, and the caps do not scale with high-bracket active income. For 2026, the top federal rate of 37 percent, made permanent under the One Big Beautiful Bill Act, begins at \$640,600 of taxable income for single filers and \$768,600 for married filing jointly (IRS Revenue Procedure 2025-32). Combined 401(k) deferral and employer contribution limits top out at \$72,000 for 2026 (IRS IR-2025-111), an amount that barely registers against six and seven figure annual tax liabilities.

Once the standard tools are exhausted, high earners who want current-year tax relief that scales with active income tend to arrive at the same asset class: domestic oil and gas development, where the tax code at 26 U.S.C. Section 263(c) has permitted a current-year election for intangible drilling costs since 1916. But within that asset class, there are two fundamentally different ways to participate, and the legal structure chosen determines whether the resulting losses offset active W-2 or 1099 income at all. This guide compares direct working interest ownership against pooled oil and gas fund structures (LPs and LLCs organized as blind pool vehicles) across ownership rights, governance, liquidity, tax treatment, risk exposure, and administrative complexity, so that you and your CPA can evaluate which structure, if either, fits your circumstances.

37%

Top Federal Rate

Permanent under the One Big Beautiful Bill Act for 2026

\$72K

401(k) Combined Limit

Maximum combined deferral and employer contribution for 2026

1916

IDC Election Since

Year the intangible drilling cost current-year election was established in the tax code

What Is Being Compared

Two structures are evaluated here:

Option A: Direct Working Interest Ownership

Held directly or through an entity that does not limit the owner's liability for operations — a general partnership or a joint venture structure — where the business participant holds a fractional working interest in a specific, identified well or set of wells, with governance rights defined in an operating or joint venture agreement.

Option B: Pooled Oil and Gas Funds

Typically organized as limited partnerships or limited liability companies, where the sponsor raises committed capital from numerous investors, retains discretion over which prospects the fund acquires, and charges a layered fee structure in exchange for limiting each investor's personal liability to the amount invested.

Both structures can involve exposure to the same underlying asset class — oil and gas wells on United States soil. What differs is who controls the decisions, who bears liability, how the capital is deployed, and critically, how the resulting losses and income are characterized under the Internal Revenue Code.

Evaluation Criteria

A high-bracket professional evaluating either structure, together with a CPA or tax attorney, should weigh the following seven factors:

1	Ownership Rights What does the participant actually hold a claim to — a specific well or a pro rata slice of a fund's discretionary portfolio?
2	Participation & Governance Does the participant have a documented role and voting or consent rights, or is the participant a passive limited partner in the legal sense?
3	Liability Exposure Is liability limited by statute (LP, LLC) or unlimited by structure (general partnership, joint venture)? This single fact determines tax characterization under IRC 469(c)(3)(A).
4	Tax Treatment of Losses Can first-year intangible drilling cost deductions offset active income, or are they trapped as passive losses?
5	Liquidity & Hold Period How long is capital committed, and what mechanisms, if any, exist for an exit before the asset naturally depletes?
6	Fee Load What portion of invested capital is consumed by management fees, acquisition fees, and carried interest before it reaches the wellhead?
7	Administrative Complexity What tax reporting (Schedule C versus Schedule K-1), recordkeeping, and at-risk basis tracking does the structure require of the participant and their CPA?

Option A: Direct Working Interest Ownership

A direct working interest is an undivided fractional interest in the mineral lease and the physical well itself. The owner is treated, for tax purposes, as an operator under 26 CFR Section 1.612-4(a), which defines an operator as one who holds a working or operating interest in a property, whether as the fee owner or under a lease or other contract granting operating rights. That operator status is what permits the current-year election of intangible drilling costs (wages, fuel, chemicals, and other costs with no salvage value) under IRC Section 263(c), rather than requiring those costs to be capitalized and recovered over the life of the well.

The structural detail that matters most for a high-bracket professional is IRC Section 469(c)(3)(A), the statutory carve-out from the passive activity loss rules. The provision 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 with respect to such interest." In practical terms, when a business participant holds a working interest directly, or through a general partnership or joint venture structure that does not cap personal liability, the resulting first-year IDC deduction is treated as a loss from an active business, available to offset W-2 wages, 1099 income, and other active earnings, with no income-based phase-out of the kind that limits the \$25,000 real estate allowance between \$100,000 and \$150,000 of modified adjusted gross income (IRS Publication 925).

This unlimited-liability feature is also what defines the participation model. Because the business participant is treated as engaged in an active trade or business rather than a passive investment, Summit Ventures structures its joint ventures around real governance rights: documented consent rights over material operational decisions, access to well-level financial and production reporting, and a defined operating agreement that spells out the participant's role as an entrepreneurial partner rather than a passive capital source. Deduction eligibility is tied to at-risk basis under IRC Section 465, meaning the participant's capital contribution, and any portion of acquisition debt for which the participant is personally liable, establishes the ceiling on deductible losses for the year.

The magnitude of the first-year deduction depends on the specific well's engineering design — the ratio of intangible costs (labor, drilling fluids, site preparation) to tangible, depreciable equipment costs in that well's authorization for expenditure. Up to 100 percent of eligible intangible drilling costs can qualify for the current-year election, though the actual figure for any specific well depends on that well's engineering design, the participant's at-risk basis, and their individual tax position, and should always be confirmed with a qualified CPA before any capital contribution is made.

Once a well reaches production, the owner's share of revenue is also eligible for the percentage depletion allowance under IRC Sections 611 and 613A, generally 15 percent for independent producers within applicable production limits, which shelters a portion of ongoing production income in addition to the upfront IDC benefit.

One additional technical point worth raising with your CPA: excess intangible drilling costs are a preference item for alternative minimum tax purposes only to the extent they exceed 65 percent of the taxpayer's net income from oil, gas, and geothermal properties for the year under IRC Section 57(a)(2)(A), and an independent producer exception under Section 57(a)(2)(E) further caps any AMT add-back at 40 percent of alternative minimum taxable income. For most business participants with a single well-sized capital contribution relative to their overall income, this preference rarely eliminates the practical benefit of the election, but it is a calculation your CPA should run before year end.

Option B: Oil and Gas Funds (LP/LLC)

A pooled oil and gas fund is a limited partnership or limited liability company that raises committed capital from a group of investors and deploys it, at the sponsor's discretion, across a portfolio of wells, prospects, or related ventures that the sponsor identifies after the capital has been committed. This is frequently referred to in the industry as a blind pool structure, since the specific assets are often not fully identified at the time an investor commits capital.

⚠ Because the LP or LLC wrapper exists specifically to limit each investor's personal liability to their capital contribution, the fund structure forecloses the 469(c)(3)(A) exception. The statute is explicit that the carve-out does not apply to a working interest held "through an entity which does limit the liability of the taxpayer."

As a result, losses generated inside a limited-liability fund default to passive treatment under the general passive activity loss rules, meaning they can generally only offset passive income, not the investor's W-2 salary, 1099 earnings, or other active income, absent a separate active participation determination that most fund investors do not meet.

Fund access is also typically restricted to accredited investors under SEC Rule 501 of Regulation D, defined as an individual with a net worth exceeding \$1 million excluding primary residence, or income exceeding \$200,000 individually (or \$300,000 jointly) in each of the prior two years. Industry benchmarks compiled from publicly available fund disclosures indicate pooled oil and gas vehicles commonly carry:

<p>Management Fee</p> <p>1–2% of committed capital or net asset value annually</p>	<p>Acquisition Fee</p> <p>1–5% of purchase price at the time assets are added to the portfolio</p>	<p>Carried Interest</p> <p>20–30% on profits above a preferred return hurdle typically set at 8–10%</p>
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Layered together, these charges can represent a combined annual fee load of several percentage points before any carried interest is applied — a structural cost that sits between the investor's capital and the wellhead regardless of how the underlying wells perform.

Liquidity in these structures is also materially constrained. Fund documents commonly describe committed hold periods ranging from roughly one year to eleven years depending on the vehicle, with periodic distributions often targeted to begin within six months of fund close, net income substantially reinvested during the fund's early years, and a shift toward full distribution and eventual liquidation of remaining assets only as the fund approaches the end of its stated three to five year target life. Some sponsors have announced intentions to develop secondary trading arrangements for fund interests, but such arrangements are typically described as pending regulatory approval and are not a guaranteed feature of the structure.

Side-by-Side Comparison

The table below summarizes the key structural differences across every major evaluation dimension.

Category	Direct Working Interest Ownership	Oil and Gas Funds (LP/LLC)
Ownership	Fractional working interest in a specific, identified well or well set, documented in a joint operating agreement	Pro rata interest in a pooled vehicle whose underlying assets are selected at sponsor discretion, often after capital is committed
Participation	Active business participant with a defined operational role under the joint venture agreement	Limited partner or member, generally without operational involvement in asset selection or execution
Governance & Control	Documented consent rights on material decisions, access to well-level reporting, direct line to the operator	Governance concentrated with the general partner or managing member; investor rights generally limited to informational and consent rights defined in the fund's operating agreement
Liquidity	Tied to the life of the specific well, generally illiquid until production winds down or the interest is sold or assigned	Hold periods commonly span one to eleven years with distributions typically phased through the fund's lifecycle; early secondary trading options not guaranteed
Tax Treatment	Working interest held directly or through a liability-unlimited entity preserves the IRC 469(c)(3)(A) exception, allowing eligible IDC losses to offset active income, subject to at-risk basis under IRC 465	Limited liability default places losses into passive activity treatment under IRC 469, generally usable only against passive income absent a qualifying active participation exception
Exposure & Limitations	Concentrated exposure to a single well or small well set; unlimited liability exposure for the participant by structure; geological and operational risk borne directly	Diversification across a larger asset pool, but liability limitation is paired with fee layering (management, acquisition, and carried interest) that reduces the capital reaching the wellhead
Complexity	Schedule C or partnership-level active business reporting, at-risk basis tracking, and direct coordination with the operator required from the participant's CPA	Schedule K-1 reporting from the fund, generally simpler for the participant's CPA to process but offering less transparency into well-level economics

Advantages, Limitations & Best-Fit Scenarios

Direct Working Interest — Advantages

- Documented path to offsetting active income in the current tax year
- Direct governance rights over a specific, identified asset
- Depletion-sheltered production income once a well comes online
- Full transparency into well-level economics and reporting

Direct Working Interest — Limitations

- Concentration in a smaller number of wells
- Unlimited liability exposure inherent to the structure that preserves active tax treatment
- Administrative discipline required to track at-risk basis and coordinate with the operator each tax season

Oil and Gas Funds — Advantages

- Diversification across a broader portfolio of wells and prospects
- Simpler Schedule K-1 reporting for an investor's CPA
- Limited personal liability capped at capital invested

Oil and Gas Funds — Limitations

- Loss of the active-income tax offset due to passive activity classification
- Multi-layer fee structure sitting between committed capital and well-level economics
- Extended hold periods with limited early exit options
- Reduced transparency into which specific assets the sponsor ultimately selects

Best-Fit Scenarios

Direct Working Interest Is Best For:

A business participant who has substantial active W-2 or 1099 income in the current year specifically needing an offset, who is comfortable with concentrated exposure to a smaller number of identified wells, whose CPA is prepared to track at-risk basis and file the appropriate active business reporting, and who values direct governance rights and well-level transparency over broad diversification.

A Pooled Fund Structure Is Best For:

An investor who already has substantial passive income from other sources that a passive-activity loss could offset, who prioritizes diversification and simplified K-1 reporting over active governance rights, and who is comfortable with sponsor discretion over asset selection and a multi-year committed hold period.

Decision Guidance & Questions for Your Advisor

The determining question is rarely "oil and gas versus no oil and gas." It is whether the legal structure chosen actually accomplishes the tax objective the participant is seeking. A physician or attorney with \$200,000 or more in active income and no meaningful passive income has little use for a passive loss, however well diversified the fund generating it may be. Conversely, a CPA or financial professional who already generates passive income from other sources, or who is unwilling to accept the unlimited liability feature inherent to a working interest structure, may find that a fund's liability limitation is worth its fee load and the loss of active-income offset.

- ❏ Before committing capital to either structure, confirm in writing, with your CPA, exactly how the entity is organized (general partnership, joint venture, LP, or LLC), whether your liability is limited or unlimited with respect to the specific interest, and how that answer maps to IRC 469(c)(3)(A). The entity structure, not the marketing description, is what the IRS will look to.

Seven Questions to Bring to Your Advisor

1 Liability & Active Exception

Does this specific interest, as documented in the operating or partnership agreement, limit my personal liability, and if so, does that eliminate the 469(c)(3)(A) active-income exception?

2 At-Risk Basis

What is my at-risk basis under IRC 465 for this capital contribution, and does it fully support the first-year deduction being discussed?

3 IDC Allocation

What percentage of this specific well's authorization for expenditure is classified as intangible versus tangible cost, and who prepared that allocation?

4 Passive Income Availability

If I choose a fund structure instead, do I have passive income elsewhere sufficient to use a passive-activity loss in the year it is generated, or would it simply carry forward?

5 Combined Fee Load

What is the combined annual fee load, including management fee, acquisition fee, and carried interest hurdle, and how is it disclosed in the fund's governing documents?

6 Governance Rights

What governance rights, consent rights, or reporting access does the operating agreement grant me as a business participant, in writing?

7 Hold Period & Exit

What is the expected hold period for this specific asset, and what mechanisms, if any, exist before the well naturally depletes?

Conclusion & Next Steps

Choosing between direct working interest ownership and a pooled oil and gas fund is ultimately a question of which legal structure matches your specific tax position, your appetite for governance involvement, and your CPA's ability to administer the resulting reporting. Both structures provide exposure to the same underlying asset class, but the statutory treatment of losses, the liquidity profile, and the fee load between your capital and the wellhead differ materially.

The right next step is to bring the specific operating agreement, private placement memorandum, or joint venture agreement under consideration to your CPA or tax attorney, and walk through each of the questions above before any capital contribution is finalized.

IRC 469(c)(3)(A) Statutory exception for working interests in oil and gas property from the passive activity loss rules	IRC Section 263(c) Current-year election for intangible drilling costs — in place since 1916
IRC Sections 611 & 613A Percentage depletion allowance — generally 15% for independent producers within applicable production limits	IRC Section 465 At-risk limitation on deductible losses — establishes the ceiling on first-year deductions

Sources & References

[1] IRS Revenue Procedure 2025-32 — 2026 federal income tax brackets and the permanent 37% top rate under the One Big Beautiful Bill Act.

[2] IRS IR-2025-111 — 2026 retirement plan contribution limits, including the \$24,500 elective deferral limit and \$72,000 combined limit.

[3] 26 U.S.C. Section 469(c)(3)(A) — statutory exception for working interests in oil and gas property from the passive activity loss rules.

[4] IRS Publication 925 — Passive Activity and At-Risk Rules, including the real estate allowance phase-out between \$100,000 and \$150,000 of MAGI.

[5] SEC Rule 501 of Regulation D — definition of accredited investor based on net worth and income thresholds.

[6] AE Trust — industry commentary on private oil and gas fund management fee and carried interest structures.

[7] Invest In Energy — "Top 10 Oil and Gas Investment Firms for Accredited Investors," industry fee and hurdle rate benchmarking.

[8] Industry fund disclosure patterns describing phased distribution timelines, reinvestment during early fund years, and liquidation near the end of stated fund life.

[9] 26 CFR Section 1.612-4(a) — definition of operator for purposes of the intangible drilling cost election under IRC Section 263(c).

[10] 26 U.S.C. Sections 611 and 613A — percentage depletion allowance for independent producers.

[11] 26 U.S.C. Section 57(a)(2)(A) and (E) — AMT treatment of excess intangible drilling costs and the independent producer exception.

[12] 26 U.S.C. Section 465 — at-risk limitation on deductible losses.