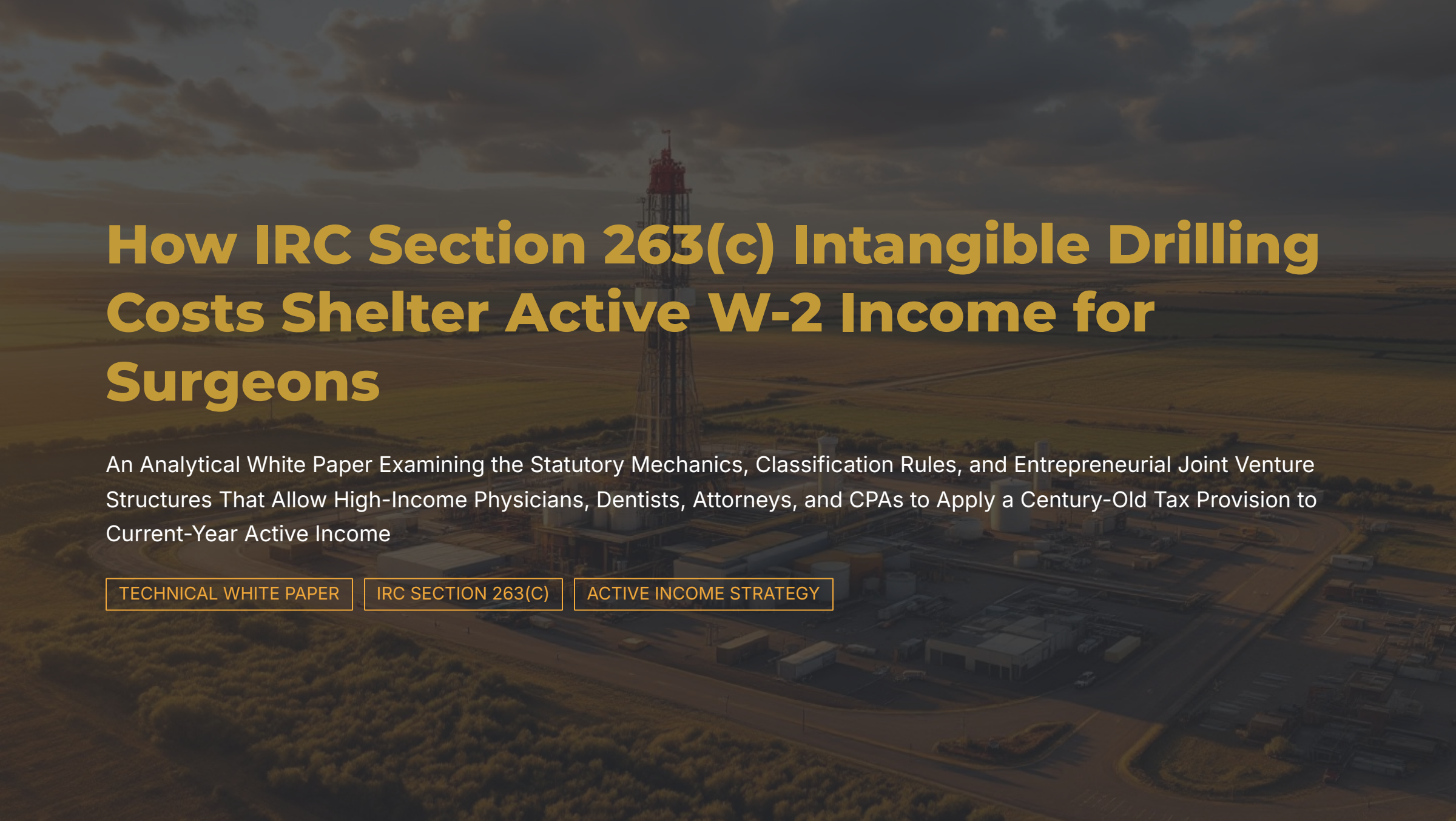


An aerial photograph of an oil drilling rig and an industrial facility, likely a refinery or processing plant, set against a dramatic, cloudy sky at dusk or dawn. The rig is a tall, lattice-structured tower with a red top section. The industrial facility consists of various buildings, storage tanks, and piping. The foreground shows a road and some vegetation.

How IRC Section 263(c) Intangible Drilling Costs Shelter Active W-2 Income for Surgeons

An Analytical White Paper Examining the Statutory Mechanics, Classification Rules, and Entrepreneurial Joint Venture Structures That Allow High-Income Physicians, Dentists, Attorneys, and CPAs to Apply a Century-Old Tax Provision to Current-Year Active Income

TECHNICAL WHITE PAPER

IRC SECTION 263(C)

ACTIVE INCOME STRATEGY

Executive Summary

Every April, a narrow band of high-earning professionals, surgeons in particular, confronts the same structural problem: income that is almost entirely W-2 or K-1 active compensation, taxed at the top marginal bracket, with few remaining statutory levers to pull. A 401(k), a backdoor Roth, and a defined benefit plan matter, but none of them scale with a seven-figure surgical practice or a partnership distribution.

This white paper examines one of the oldest provisions in the federal tax code, Internal Revenue Code Section 263(c), governing the treatment of intangible drilling costs, and explains precisely why this provision, when paired with the working interest exception under Section 469(c)(3), is one of the few remaining statutory mechanisms that can offset active, ordinary income rather than merely deferring it.

What This Paper Covers

- Verified statutory text and illustrative application
- Structural distinction between direct working interest ownership and pooled fund participation
- Professional due diligence questions for tax advisors
- The operative sequence across IRC Sections 263(c), 469, 465, 57, 611, and 461(h)

What This Paper Is Not

This is not a sales document. It is a technical briefing on a documented statutory framework that Congress has maintained, with modification, since 1916. The analysis separates verified statutory text from illustrative application and outlines the professional due diligence questions a surgeon, dentist, attorney, or CPA should raise with their own tax advisor before evaluating a working interest position.

Why This Issue Matters

High-income professionals share a common tax profile: concentrated, active income with limited ability to convert it into the capital gains or passive categories that benefit from preferential rates or deferral. A surgeon earning \$600,000 to \$1,200,000 annually in W-2 or 1099 compensation sits in the top federal bracket, which under IRS Revenue Procedure 2025-32 begins at \$640,600 of taxable income for a single filer and \$768,600 for a married couple filing jointly, with the One Big Beautiful Bill Act having made the 37 percent top marginal rate permanent.

Retirement account contribution limits, while adjusted annually, cap out well below what this income tier requires for meaningful tax impact. For 2026, the IRS set the 401(k) employee deferral limit at \$24,500, with a combined employee and employer limit of \$72,000. Even with catch-up contributions, these vehicles cannot absorb a six or seven-figure spike in active income from a bonus year, a surgical center distribution, or a partnership buy-in.

\$640K

Top Bracket Threshold

Single filer threshold where 37% rate begins (2026)

37%

Top Marginal Rate

Now permanently fixed under the One Big Beautiful Bill Act

\$72K

401(k) Combined Limit

Maximum employee + employer contribution for 2026

\$150K

MAGI Phase-Out

Real estate \$25K special allowance phases out entirely above this threshold

This leaves a narrow set of statutory options that apply specifically to active, not passive, income. Most tax-advantaged structures marketed to high earners, including real estate limited partnerships, oil and gas funds organized as LLCs, and most syndicated vehicles, are subject to the passive activity loss rules under IRC Section 469. Under those rules, losses generated by a passive activity can generally only offset passive income, not the wages, 1099 compensation, or K-1 distributions that make up the bulk of a surgeon's or attorney's taxable income.

Real estate offers a narrow \$25,000 special allowance that phases out entirely once modified adjusted gross income exceeds \$150,000, a threshold most readers of this paper cleared years ago. The working interest exception inside Section 469 is structurally different, and understanding why requires separating two statutes that are frequently and incorrectly conflated in commercial marketing materials: Section 263(c), which governs how a cost is classified and when it may be deducted, and Section 469(c)(3), which governs whether that deduction can touch active income at all.

Foundational Concepts: What Are Intangible Drilling Costs?

Intangible drilling costs, commonly abbreviated IDC, refer to the expenditures required to drill and prepare an oil or gas well for production that have no salvage value once incurred. This includes labor, fuel, drilling mud, chemicals, site preparation, and hauling.

Intangible Drilling Costs (IDC)

No salvage value once incurred. Eligible for immediate expensing under Section 263(c).

- Labor and wages
- Fuel and power
- Drilling mud and chemicals
- Site preparation
- Hauling and logistics

✓ Expensed in the year incurred under IRC §263(c) and Treasury Regulation 1.612-4(a)

Tangible Drilling Costs (TDC)

Retain salvage value. Capitalized and depreciated over a seven-year schedule under MACRS established in IRC Section 168.

- Casing and pipe
- Wellhead equipment
- Storage tanks
- Pumping units
- Surface equipment

i Depreciated over 7-year MACRS schedule under IRC §168

The distinction matters because Section 263(c) and the implementing regulation at Treasury Regulation 1.612-4(a) permit a taxpayer who qualifies as an operator, defined as one who holds a working or operating interest in a well either as a fee owner or under a lease or other contract granting operating rights, to elect to expense intangible drilling costs in the year incurred rather than capitalizing and recovering them over the life of the well.

This election has existed, in substantially similar form, since a 1916 Treasury regulation, and was formally codified as Section 263(c) of the Internal Revenue Code of 1954. It survived the Tax Reform Act of 1986, which eliminated most other accelerated deductions and shelters of that era, and it remains intact today. The provision was designed, and has been defended by successive Congresses, as an incentive for the capital-intensive, high-risk business of domestic hydrocarbon exploration and development, where the bulk of drilling expenditure is consumed before a well produces a single barrel.

The proportion of a given well's authorized expenditure (the AFE, or authority for expenditure) that qualifies as intangible versus tangible cost varies by well design, formation, completion method, and operator. No participant should treat a percentage figure quoted in marketing material as a guaranteed outcome for their own capital contribution. The applicable classification, and the resulting current-year deduction, depends on the specific well, the participant's at-risk basis, and their individual tax position, and should always be confirmed with a qualified CPA before a capital contribution is made and before any election is filed.

The Two-Statute Framework: §263(c) and §469(c)(3)

Section 263(c) answers only one question: can this cost be expensed now, or must it be capitalized. It does not, by itself, determine whether the resulting deduction can offset a surgeon's W-2 salary. That second and more consequential question is answered by IRC Section 469, the passive activity loss provision enacted in the Tax Reform Act of 1986 specifically to prevent high-income taxpayers from using paper losses from passive ventures to shelter active income.



Section 469(c)(3)(A) carves out a narrow and specific exception for working interests in oil and gas property. The exact statutory language reads:

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." — IRC §469(c)(3)(A)

This single sentence is the structural hinge of the entire strategy, and it is the detail most frequently omitted or glossed over in generic marketing material. Three conditions must be satisfied simultaneously for a deduction to reach active income:

1 Qualify as IDC Under §263(c) The underlying cost must qualify as an intangible drilling cost under Section 263(c) and Treasury Regulation 1.612-4.	2 Direct Liability Exposure The taxpayer must hold the working interest directly, or through an entity that does not limit the taxpayer's liability, such as a general partnership. An LLC, LP, or any liability-shielding structure forecloses the §469(c)(3) exception entirely.	3 No Hours Test Required Unlike real estate professional status (750 hours annually), the working interest exception carries no material participation requirement — a critical distinction for surgeons billing 70-hour clinical weeks.
--	--	--

Additional Statutory Layers: §465, §57, and §611/613A

Two additional layers of the Internal Revenue Code constrain and refine, rather than eliminate, this benefit, and a technically credible discussion must address both directly.

IRC §465 — At-Risk Limitation

A participant's deduction cannot exceed their actual economic exposure, meaning cash contributed plus any recourse debt for which they are personally liable. Nonrecourse financing does not count toward at-risk basis in this context.

IRC §57(a)(2)(A) — AMT Preference Item

A portion of excess intangible drilling costs is treated as a preference item for AMT purposes, but only to the extent it exceeds 65 percent of the taxpayer's net income from oil, gas, and geothermal properties for that year.

IRC §57(a)(2)(E) — Independent Producer Exception

A non-integrated producer may elect to disregard all or part of that preference item, subject to a cap limiting the resulting reduction in alternative minimum taxable income to 40 percent of AMTI computed without the exception. This is a distinct statutory test from §57(a)(2)(A), not a restatement of the same threshold.

IRC §§611 and 613A — Percentage Depletion

Once a well reaches production, independent producers may claim a 15 percent percentage depletion allowance against gross income from the property, calculated annually and, unlike cost depletion, not limited to the taxpayer's remaining basis in the asset. This converts a portion of future operating income into a partially shielded income stream for as long as the well produces — which can span decades for a conventional, proven-field well.

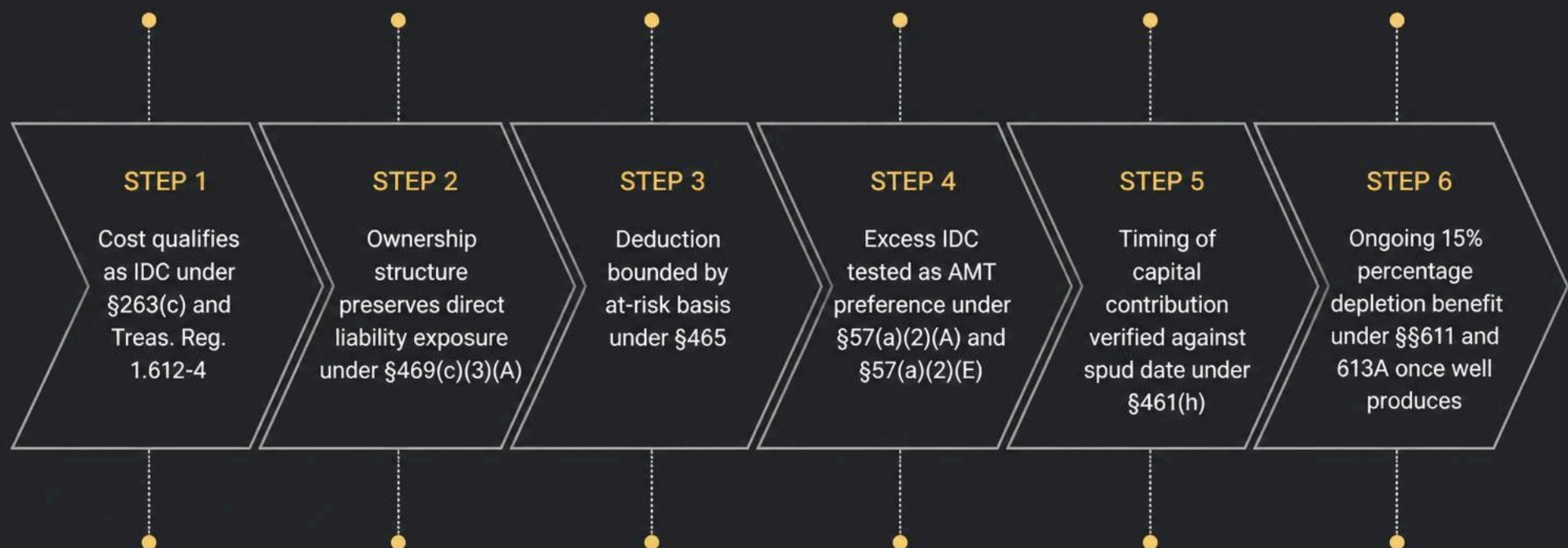
IRC §461(h) — Economic Performance Rule

Drilling activity must generally begin within a limited window, commonly cited as 90 days, of a year-end capital contribution for that year's IDC election to be respected. A capital contribution made in December against a well that will not spud for many months raises a timing question that a qualified CPA should review before the election is filed.

⚠ These are documented statutory frameworks, not proprietary techniques. Every citation traces to the Internal Revenue Code, Treasury regulations, or official IRS guidance. Both §57(a)(2) tests should be modeled by a qualified CPA against the participant's full tax position before an election is made.

The Operative Sequence: How It All Fits Together

Taken together, the operative sequence for a surgeon, dentist, attorney, or CPA evaluating this structure is as follows: the cost must first qualify as intangible under 263(c); the ownership vehicle must preserve direct liability exposure to satisfy 469(c)(3)(A); the deduction is then bounded by the participant's at-risk basis under Section 465; a portion of any excess may be a preference item under the two-part 57(a)(2) test; and once producing, the well generates an ongoing 15 percent depletion benefit under 611/613A. Every one of these is a documented statutory framework, not a proprietary technique, and every citation above traces to the Internal Revenue Code, Treasury regulations, or official IRS guidance.



The mechanism is driven by the classification of the income and the structure of the ownership interest, not by the participant's occupation. A surgeon's W-2 compensation, a dental practice owner's K-1 distributions, a law firm partner's profit share, and a CPA's own practice income are all active income for purposes of Section 469, and all are equally eligible to be offset by a properly structured working interest loss, provided the liability and classification rules above are satisfied.

Structure Matters: Why the Ownership Vehicle Is Everything

The statutory mechanics above only produce the described result if the underlying ownership structure is built correctly from the outset, which is why the vehicle through which a professional participates matters as much as the well itself.

✗ Pooled Fund (LLC / LP)

A pooled fund organized as a limited liability company or limited partnership, however well run, generally limits the liability of its members by design. That design choice, which protects participants from downside operational liability, is precisely what forecloses the Section 469(c)(3)(A) working interest exception.

The resulting losses default to passive treatment, which means they can offset only passive income, not the active W-2 or K-1 income this paper is addressing.

✓ Entrepreneurial Joint Venture

Built around direct working interest ownership or participation through an entity that does not limit the member's liability, such as a general partnership arrangement among business participants.

This is the structural feature that Summit Ventures organizes its joint venture participation model around: business participants hold a direct working interest position in production-ready wells, with governance rights, operating agreement terms, and operational transparency that allow a CPA to independently verify the ownership structure required for the 469(c)(3) exception before a capital contribution is finalized.

The Four Stages of Participation

1

AFE Review

Review of the authority for expenditure and well engineering data that determines the intangible-versus-tangible cost split for that specific well.

2

CPA Confirmation

Confirmation of the ownership structure with the participant's own CPA or tax attorney to verify the entity does not limit liability in a way that would forfeit the §469(c)(3) exception.

3

JOA Execution

Execution of the joint operating agreement and capital contribution.

4

Ongoing Reporting

Ongoing operational reporting, including Schedule K-1 allocations that identify the nonpassive, active classification of resulting income and loss items in Box 1, Box 12, Box 13, and Box 20 as applicable.

Seven Questions for Your Professional Advisor

Before evaluating a working interest position, a surgeon, dentist, attorney, or CPA and their advisor should work through the following questions. A properly structured entrepreneurial joint venture should be able to produce the underlying documentation — including the operating agreement, the AFE, and historical K-1 reporting patterns — to support that independent review rather than asking a participant or their advisor to take the structure on faith.

1 Liability Structure

Does the proposed ownership structure hold the working interest directly, or through an entity that does not limit liability, in a manner that satisfies Section 469(c)(3)(A), or does it limit liability in a way that would default the resulting losses to passive treatment?

2 AFE Engineering Breakdown

What does the authority for expenditure for this specific well show as the intangible-versus-tangible cost allocation, and who prepared that engineering breakdown?

3 At-Risk Basis Under §465

What is my at-risk basis under Section 465 once cash contributed and any recourse debt are properly accounted for, and does any portion of the structure rely on nonrecourse financing that would not count toward that basis?

4 AMT Preference Calculations

Given my full income picture this year, how would the Section 57(a)(2)(A) and 57(a)(2)(E) alternative minimum tax preference calculations apply to an excess intangible drilling cost deduction of this size?

5 Spud Date Timing

When is this well expected to spud relative to my capital contribution date, and does that timing satisfy the Section 461(h) economic performance rule for a current-year election?

6 Governance and K-1 Reporting

What governance rights and ongoing operational reporting, including K-1 timing and Box-level classification, will I receive as a business participant, and how will my CPA verify the active, nonpassive classification each year the well produces?

7 Percentage Depletion Planning

How does the ongoing 15 percent percentage depletion allowance under Sections 611 and 613A factor into my multi-year tax planning once the well reaches production?

None of this replaces individualized tax advice. The applicable tax treatment depends on the participant's full financial picture, filing status, state of residence, and the specific terms of the operating agreement and AFE for the well in question.

Closing Perspective & Next Steps

The statutory framework examined in this paper is not new and not obscure. It is a documented, congressionally maintained provision: Section 263(c) has governed the treatment of intangible drilling costs since 1916, and the working interest exception under Section 469(c)(3) has applied the same way since the passive activity loss rules were written into the Tax Reform Act of 1986.

What has changed is the tax environment surrounding it: the One Big Beautiful Bill Act permanently fixed the top marginal rate at 37 percent and made 100 percent bonus depreciation permanent under Section 168(k) for qualifying property, while domestic production itself continues to set records, with the U.S. Energy Information Administration confirming crude oil output reached a new high of 13.6 million barrels per day in 2025, and projecting marketed natural gas production will set a further record in 2026. The American Petroleum Institute separately reports that the oil and natural gas industry supported 10.6 million American jobs and contributed \$2.1 trillion to the U.S. economy in 2023, underscoring that the asset class behind this tax treatment is an active, producing segment of the domestic economy, not a speculative or theoretical one.

13.6M bbl/day U.S. crude oil production record set in 2025 (EIA)	10.6M Jobs American jobs supported by oil and natural gas industry in 2023 (API)
\$2.1 Trillion Oil and gas industry contribution to U.S. economy in 2023 (API)	Since 1916 The IDC election has existed in substantially similar form for over a century

For a surgeon, dentist, attorney, or CPA who has already maximized the standard menu of retirement and deferral vehicles and is now watching active income taxed at the top marginal rate year after year, the correct next step is not a purchase decision. It is a structural conversation, with a qualified CPA or tax attorney, about whether a direct working interest position, held in a manner that preserves the Section 469(c)(3) exception, fits a specific tax and liquidity profile.

Summit Ventures operates as an entrepreneurial joint venture platform built specifically to support that conversation, providing the AFE documentation, operating agreement structure, and K-1 reporting transparency that allow a professional's own advisor to verify every statutory element described in this paper before a single dollar of capital is contributed. Readers are encouraged to continue researching the statutory sections cited throughout this paper directly and to bring the advisor discussion questions above into their next planning conversation.

Begin Your Advisor Conversation with Summit Ventures

Sources and References

[1] Cornell Legal Information Institute, 26 U.S.C. Section 263(c) and Treasury Regulation 1.612-4(a), intangible drilling cost election and operator definition.

[2] Cornell Legal Information Institute, 26 U.S.C. Section 469(c)(3)(A), working interest exception to the passive activity loss rules, exact statutory text.

[3] BassEXP, "Section 469 Working Interest: Active vs. Passive," material participation and hours-test comparison.

[4] BassEXP, "How Oil and Gas Investments Offset W-2 Income," active income offset mechanics.

[5] AE Tax Advisors, "Oil and Gas Working Interest Tax Deduction," economic performance and election timing.

[6] Anchor1031, intangible versus tangible drilling cost education resource, MACRS depreciation treatment.

[7] 26 U.S.C. Section 465, at-risk limitation on deductions.

[8] 26 U.S.C. Section 57(a)(2)(A), excess intangible drilling cost alternative minimum tax preference item, 65 percent of net oil and gas income threshold.

[9] 26 U.S.C. Section 57(a)(2)(E) and IRS Office of Chief Counsel Memorandum 201235010, independent producer alternative minimum tax exception, 40 percent of AMTI cap.

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

[11] 26 U.S.C. Section 461(h), economic performance rule and the 90-day drilling exception.

[12] Tax Foundation, "2026 Tax Brackets," based on IRS Revenue Procedure 2025-32.

[13] Internal Revenue Service, IR-2025-111, 2026 retirement plan contribution limits.

[14] Kleinman Center for Energy Policy, University of Pennsylvania, history of intangible drilling cost tax treatment and its 1916 origin.

[15] U.S. Energy Information Administration, "U.S. crude oil production rose in 2025, setting a new record."

[16] U.S. Energy Information Administration, "United States on track for record natural gas production in 2026."

[17] American Petroleum Institute, "Industry Explained," 2023 employment and economic contribution data.

[18] Grant Thornton, summary of the One Big Beautiful Bill Act, permanent 100 percent bonus depreciation under IRC Section 168(k).