

The background of the slide is a photograph of an offshore oil rig. The rig is a complex of steel structures, including a tall derrick and various platforms, situated in the middle of the ocean. The sky is filled with soft, orange-hued clouds, suggesting a sunset or sunrise. The overall tone of the image is professional and industrial.

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

A Professional Brief on IRC 263(c), the Working Interest Passive Loss Exception, and Institutional Grade Participation Structures for High Income Clients

PROFESSIONAL BRIEF

SUMMIT VENTURES

Executive Takeaway: Why This Matters

Every fourth quarter, advisors across disciplines field the same call: a client has an income spike, a missed exchange deadline, or a business sale that just closed, and they are asking what can legally be done before year end. Most advisors do not have a reliable, compliant answer rooted in statute rather than marketing.

Oil and gas working interests, structured correctly, are one of the oldest and most defensible tools in the Internal Revenue Code for addressing exactly this problem.

The tax outcome a client receives from a working interest is determined almost entirely by how the interest is held and documented — not by the sponsor's marketing claims.

For advisors, understanding that distinction is what separates a defensible recommendation from a reputational liability.

The Core Problem Advisors Face

Client has a sudden income spike or business sale

Missed exchange deadline or tightening window

No reliable, statute-rooted answer before year end

Sponsor landscape is uneven and marketing is vague

Context: Why This Category Is Underused

Clients increasingly ask about alternative assets, and the oil and gas working interest category has existed in the Code since before 1954, yet it remains underused in most advisory practices because the sponsor landscape is uneven.

Programs That Fall Short

Some programs are run as pooled funds or limited partnership interests marketed with return projections and vague tax language. These structures may reference the tax code in marketing materials without actually being built on the statutory framework.

Programs Built on Statute

Others are structured as genuine direct working interest participation, governed by statute, and documented the way an operating business would be — with K-1 reporting a CPA can defend at audit without reservation.

For CPAs, RIAs, qualified intermediaries, business brokers, estate planning attorneys, and commercial real estate brokers, the distinction matters because it determines whether a referral or recommendation holds up under IRS scrutiny and whether the client's K-1 reporting is something a CPA can defend at audit without reservation.

The Three Statutory Provisions That Do the Structural Work

The opportunity for advisory practices is not "finding a tax shelter." It is understanding a statutory framework well enough to recognize which programs are built on it correctly. Three provisions do the structural work:

1	2	3
IRC Section 263(c) + Treas. Reg. 1.612-4 Allows an operator or working interest holder to elect to expense intangible drilling costs in the year incurred rather than capitalizing them. Intangible drilling costs are the non-salvageable costs of drilling — labor, fuel, drilling mud, and site preparation. Tangible costs such as casing and wellhead equipment are capitalized and depreciated.	IRC Section 469(c)(3)(A) The provision that actually allows a working interest loss to offset a client's active income, including W-2 wages, 1099 income, and K-1 distributions from other business activity. The statute excludes from the passive activity rules any working interest held directly or through an entity that does not limit the taxpayer's liability. An LLC or limited partnership interest fails this test.	IRC Section 465 + Sections 611 & 613A Section 465 caps the deduction at the client's actual at-risk economic exposure — cash contributed and recourse debt, not nonrecourse financing. Section 57(a)(2) governs AMT treatment of excess intangible drilling costs. Sections 611 and 613A provide a percentage depletion allowance on gross production income — an ongoing benefit distinct from the upfront IDC deduction.

Key Findings for Advisory Practices

Entity Structure Is Everything

The entity structure, not the asset class, is the single fact that determines whether a working interest loss can offset active income under Section 469(c)(3). A fund share or LP interest does not qualify; a direct or non-liability-limiting interest does.

Year-End Timing Rules Apply

IRC Section 461(h) economic performance rules limit how much intangible drilling cost can be prepaid at year end for a well that will not begin drilling for months, subject to a recognized **ninety day drilling exception** that advisors should confirm in any December closing.

Revenue Ruling 68-331: Real Property Status

Revenue Ruling 68-331 established that a working interest in a producing oil and gas lease is real property, like kind to a fee interest in other real estate, under the predecessor to current Section 1031. This is directly relevant for qualified intermediaries and commercial real estate brokers working with clients against an exchange deadline.

Revenue Ruling 78-135: Entity vs. Direct Interest

Revenue Ruling 78-135 clarifies that a general partnership interest itself — as opposed to the underlying working interest — does not qualify for like kind exchange treatment. The distinction between holding the asset directly and holding an interest in an entity that owns the asset recurs across both the passive loss exception and the exchange analysis.

K-1 Reporting Must Reflect Active Treatment

K-1 reporting for a properly structured working interest should reflect nonpassive, active treatment consistent with Section 469(c)(3) — a specific line-item detail a reviewing CPA can and should confirm before relying on the schedule.

Depletion Is a Separate, Recurring Benefit

Depletion under Sections 611 and 613A applies to gross income from production and is a separate, recurring benefit from the one-time intangible drilling cost election — a distinction worth clarifying for clients who conflate the two.

Analysis: Participation Model and Structural Elements

Participation Model

Summit Ventures operates as an entrepreneurial joint venture platform rather than a pooled investment fund. Clients who become active JV members take a working interest position directly, which preserves the statutory tests described above rather than converting the position into a passive fund share.

Capital contribution and governance rights are documented the way an operating business interest would be, with reporting built around the realities of how the IRS evaluates working interest holders rather than around fund administration conventions.

The Single Structural Question

The single structural question an advisor should ask about any working interest program is **how the client's name actually sits on the asset**. Direct ownership, or ownership through an entity that does not limit liability, is what keeps both the Section 469(c)(3) active income offset and the Revenue Ruling 68-331 like kind treatment available.

An LLC or LP wrapper may simplify administration for a sponsor, but it closes both doors for the client. This is the detail that distinguishes a program built on the statute from a program that merely references the statute in its marketing.

- ❏ The single structural question: Does the client's name sit directly on the asset — or is it wrapped in an LLC or LP that limits liability and forfeits the statutory benefits?

Tax and Legal Considerations by Advisor Role

Each advisory discipline engages with working interest structures through a different lens. Here is what each role should focus on:



CPAs & Tax Professionals

Confirm the Authorization for Expenditure documentation supporting the IDC allocation, verify at-risk basis under Section 465, and check the K-1 box coding for active versus passive treatment before filing.



Registered Investment Advisors

Confirm that reporting, governance rights, and capital account documentation meet the same institutional standard the advisor would expect from any other alternative asset allocation. Focus on suitability and disclosure.



Qualified Intermediaries

Revenue Ruling 68-331 and 78-135 are the operative citations. Confirm the client will hold a direct working interest rather than a partnership or fund interest before treating the position as qualified replacement property.



Business Brokers & M&A Advisors

The relevant moment is the post-closing conversation. A seller facing ordinary income or capital gains exposure may benefit from understanding the IDC election as one of several legitimate year end planning tools — not a replacement for the client's own tax counsel.



Estate Planning Attorneys

Direct working interest positions carry their own valuation, transfer, and basis considerations that differ from securities or fund interests. Evaluate as part of a broader wealth transfer plan rather than in isolation.



Commercial Real Estate Brokers

The parallel to a 1031 exchange timeline is useful context when a client's identification window is tightening. Any exchange decision should be confirmed with the client's qualified intermediary and tax counsel before the 45-day identification deadline.

Recommendations and Due Diligence Checklist

1 Confirm Entity Structure First

Ask the sponsor directly whether the client's position is a direct working interest or an interest in an LLC, LP, trust, or fund. This single fact determines both the Section 469(c)(3) and Revenue Ruling 68-331 analysis. Get it confirmed in writing, not assumed from marketing language.

2 Request the AFE and IDC Methodology

Request the Authorization for Expenditure and the intangible drilling cost allocation methodology before filing, rather than relying on a sponsor's summary percentage. Tax treatment depends on the specific cost structure of the well, individual circumstances, and the client's at-risk basis.

3 Review K-1 Box Coding

Review K-1 box coding for active or nonpassive designation under Section 469(c)(3) as part of standard return preparation, not as an afterthought.

4 Confirm Year-End Timing

For year end timing, confirm Section 461(h) economic performance and the ninety day drilling exception before advising a client that a December capital contribution will produce a current year deduction.

Key Questions to Ask Any Sponsor

- Does the client hold the working interest directly, or through an entity that limits liability — confirmed in writing rather than assumed from marketing language?
- What documentation supports the intangible drilling cost allocation, and has it been reviewed against the Authorization for Expenditure?
- Does the client have sufficient at-risk basis under Section 465 to support the deduction being contemplated?
- For exchange-related conversations, is the client acquiring a direct working interest, or a fund or partnership interest that would not satisfy Revenue Ruling 68-331?
- Does the K-1 reflect active or nonpassive treatment consistent with Section 469(c)(3), and is that consistent with how the interest is actually held?
- What back office support, reporting cadence, and professional documentation does the sponsor provide to the client's own CPA or attorney during tax season?

Implications by Advisor Discipline

CPAs

Getting this structure right protects against the audit exposure that comes from accepting a K-1 at face value without confirming the underlying entity type.

RIAs

Being able to evaluate an alternative asset allocation with the same institutional rigor applied to any other recommendation, rather than treating energy participation as a niche product outside normal due diligence.

QIs & CRE Brokers

Understanding Revenue Ruling 68-331 means being able to have an informed conversation with a client whose exchange timeline is at risk, without making a legal determination that belongs to the client's own counsel.

Business Brokers & Estate Attorneys

A legitimate, statute-grounded working interest program is a credible addition to a post-transaction or wealth transfer conversation, provided the advisor can speak to the structural requirements with precision rather than generality.

Sources and Statutory References

- **26 U.S.C. § 263(c) + Treas. Reg. 1.612-4:** Statutory basis for the intangible drilling cost election.
- **26 U.S.C. § 469(c)(3)(A):** Excludes directly held, or non-liability-limiting, working interests from passive activity loss rules.
- **26 U.S.C. § 465:** At-risk limitation rules governing the deductible amount based on cash and recourse debt.
- **26 U.S.C. § 57(a)(2):** AMT treatment of excess intangible drilling costs for independent producers.
- **26 U.S.C. §§ 611 and 613A:** Percentage depletion allowance on gross income from oil and gas production.
- **26 U.S.C. § 461(h):** Economic performance timing rules relevant to year end IDC prepayment, including the ninety day drilling exception.
- **Rev. Rul. 68-331 (1968-1 C.B. 352):** Working interest in a producing oil and gas lease is real property, like kind to a fee interest in other real estate.
- **Rev. Rul. 78-135:** A general partnership interest itself does not qualify for like kind exchange treatment.

Summary and Next Steps

The statutory basis for using oil and gas working interests in year end planning, business exit conversations, and exchange timelines has existed for decades. What has changed is the quality bar advisors should apply before relying on it.

The entity structure behind a working interest position, confirmed in writing and reflected accurately on the client's K-1, is what determines whether the Section 469(c)(3) active income offset and the Revenue Ruling 68-331 like kind treatment actually apply. Advisors who build that confirmation into their standard review process are positioned to bring clients a credible, IRS-recognized planning tool rather than a product that merely references the tax code.

Recommended Next Steps

Advisors evaluating oil and gas working interest programs for client conversations are encouraged to request the underlying operating agreement, the Authorization for Expenditure methodology, and a sample K-1 before the next filing season, and to review these directly with the client's own CPA or tax counsel.

Summit Ventures operates as an entrepreneurial joint venture platform built around direct working interest participation, governance rights for active JV members, and reporting designed to support — not replace — an advisor's own technical review. For advisors who want a deeper technical walkthrough of the structure described in this brief, including sample documentation and K-1 scheduling, a working session with Summit's technical team is available on request.

[Request a Technical Walkthrough with Summit Ventures](#)



Request the Operating Agreement

Confirm direct working interest structure in writing



Review the AFE Methodology

Verify IDC allocation before filing



Examine a Sample K-1

Confirm active/nonpassive box coding under § 469(c)(3)



Schedule a Working Session

Deep technical walkthrough with Summit's team on request