Evaluating a Statutory Tax Strategy: How a Dallas Orthopedic Surgeon Shielded $150,000 in Active Income in Year One

A Case Study on Intangible Drilling Cost Elections Under IRC Section 263(c) and the Active Income Offset Preserved by Section 469(c)(3)

This case study presents an anonymized, illustrative composite built from common fact patterns seen among physicians, surgeons, dentists, attorneys, and CPAs who contribute capital directly into entrepreneurial joint venture oil and gas programs. It is intended for professional education and evaluation purposes only. All figures are labeled illustrative. Every participant's tax position depends on individual circumstances and should be confirmed with a qualified CPA or tax attorney before any election is made.

Case Classification: At a Glance

Case Type

Illustrative, anonymized composite built for educational purposes only

Profession

Orthopedic surgeon in private practice — profile common to physicians, dentists, attorneys, and CPAs

Location

Dallas, Texas

Trigger Event

One-time active income spike of $150,000 from a surgical center profit distribution

Structure Evaluated

Direct working interest capital contribution into a Summit Ventures entrepreneurial joint venture producing field drilling program — not a pooled fund or limited partnership unit

Primary Statutory Mechanism

IRC Section 263(c) election to currently deduct intangible drilling costs, combined with the Section 469(c)(3)(A) working interest exception to the passive activity loss rules

Capital Contribution

$200,000 illustrative

Year One Deduction

$150,000 applied against active income (illustrative)

Participant Profile, Trigger, and Situation

The composite participant is a Dallas-based orthopedic surgeon in his mid-forties, operating through a professional practice that generates a mix of W-2 compensation and 1099 distributions from an affiliated ambulatory surgical center. His baseline annual taxable income already places him near the top of the federal bracket structure. In the year this case describes, a surgical center partner buyout produced an additional one-time distribution of $150,000, pushing a meaningful portion of that year's income into the top marginal bracket. For 2026, that top 37 percent federal bracket begins at $640,600 for single filers and $768,600 for married filing jointly, under the schedule set by IRS Revenue Procedure 2025-32. Texas imposes no state individual income tax, so his entire exposure on this spike was federal.

Like most professionals in this income tier, he had already maximized the standard deferral tools available to him. The 2026 contribution limits under IRS Notice 2025-67 and IR-2025-111 cap employee 401(k) deferrals at $24,500 and combined employer and employee contributions at $72,000, and his income placed him above the Roth IRA eligibility phaseout range of $153,000 to $168,000 for single filers, which is why backdoor Roth conversions were already part of his existing structure. None of these tools scale to absorb a six-figure, one-time active income event. That gap — a one-time spike that standard retirement vehicles cannot touch — is the specific problem this case addresses.

This profile is representative of the broader professional audience this case is written for. Physicians, dentists, attorneys, and CPAs share the same underlying tax mechanics regardless of specialty, because the relevant distinction under the Internal Revenue Code is how income is classified — active versus passive — not what profession generates it.

Challenge and Decision Criteria

The Core Problem

The participant's CPA had already exhausted the conventional playbook. What he needed was a mechanism that could offset active income directly — not simply defer it — and that rested on an established statutory election rather than a promotional or syndicated structure. He also carried a specific concern, shared widely across this audience, about committing capital to unvetted high-yield alternative assets or balance sheet-heavy operations without a proven operating track record or a clearly documented legal execution structure.

Six Evaluation Criteria Set Before Considering Any Structure

1. The deduction must rest on an identifiable section of the Internal Revenue Code, not a marketing claim about tax savings.
2. The deduction must offset active W-2 and 1099 income directly, not merely shelter passive income he did not have.
3. The underlying asset must be a specific, identifiable producing property with available engineering documentation, not a blind pooled vehicle.
4. The holding structure must preserve direct working interest status, since the relevant passive loss exception depends on how the interest is held, not merely on what it invests in.
5. The arrangement must integrate into his existing CPA relationship without requiring a new entity structure he did not understand.
6. Beyond the Year One event, the structure should offer the possibility of ongoing production-based cash flow rather than a single transaction.

Options Evaluated and Approach Selected

Three categories of approach were evaluated against these criteria.

Option 1: Conventional Deferral Tools

Relying further on conventional deferral tools, including a cash balance plan layered on top of his existing 401(k). This was **ruled out** for the current year because contribution limits are fixed regardless of a one-time income spike, and a cash balance plan requires lead time to establish that a single tax year event does not allow for.

Option 2: Pooled Oil and Gas Fund Interest

A pooled oil and gas fund interest, structured as limited partnership or LLC units. This raised a specific structural question his CPA flagged early: Section 469(c)(3)(A) excludes a working interest from the passive activity definition only when the taxpayer holds it directly or through an entity that does not limit the taxpayer's liability. Many pooled fund structures are organized specifically to limit each participant's liability, which as a general matter removes the working interest exception and causes any resulting loss to revert to passive treatment — unusable against active income. This made a pooled fund **unsuitable** for his stated objective.

Option 3: Direct Working Interest — Selected ✓

A direct working interest capital contribution structured as an entrepreneurial joint venture, where the participant becomes a working interest owner in a specific, identifiable well program with governance rights and ongoing operational reporting. Because this structure can preserve direct holding consistent with Section 469(c)(3)(A), it was the only option of the three capable of meeting his primary objective of offsetting active income in the current tax year. He proceeded with this approach.

Implementation: Step-by-Step Execution

Working alongside his CPA and the Summit Ventures operations team, the participant moved through the following sequence.

1 Entity and Holding Structure Review

Before any capital moved, his CPA and attorney confirmed that the joint venture participation agreement preserved direct working interest status and did not limit his liability in a way that would convert the position to a passive interest under Section 469(c)(3)(A).

2 Authorization for Expenditure Review

The participant and his CPA reviewed the well's Authorization for Expenditure (AFE) line by line to distinguish intangible costs — labor, fuel, chemicals, and site preparation that carry no salvage value — from tangible costs such as casing, wellhead equipment, and tubing that do, consistent with the cost categories described in Treasury Regulation 1.612-4(a).

3 Section 263(c) Election

The participant elected to currently expense the intangible drilling cost component rather than capitalize it, consistent with the election available under IRC Section 263(c). Because the contribution was made with attention to the economic performance timing rule under IRC Section 461(h) — which generally requires drilling to commence within 90 days of a year-end prepayment for the costs to be currently deductible — the AFE and drilling schedule were confirmed against that requirement before year end.

4 At Risk Basis Confirmation

His CPA confirmed his at risk basis under IRC Section 465 was limited to the actual cash he contributed. This step matters because the at risk rules — not the size of the well's total cost — set the ceiling on how much loss a participant can apply against income in a given year.

5 Alternative Minimum Tax Review

Before finalizing the election, his CPA modeled his exposure under IRC Section 57(a)(2)(A), which treats excess intangible drilling costs as an AMT preference item only to the extent they exceed 65 percent of the taxpayer's net income from oil, gas, and geothermal properties for the year, and under the related independent producer exception in Section 57(a)(2)(E), which further limits this preference item to no more than 40 percent of alternative minimum taxable income. This modeling confirmed his expected position before the election was made, not after.

6 Schedule K-1 Reporting

The resulting income and deduction were reported to the participant as nonpassive, active working interest items, with his CPA confirming the applicable Box 1, 12, 13, and 20 classifications ahead of filing.

Explanation and Outcome (Illustrative)

The participant made a capital contribution of $200,000 into the specific well program's AFE. The intangible cost component confirmed by that AFE represented the majority of the well's total cost — a proportion that is unique to each well's engineering design and is never assumed to be a fixed percentage across different properties. For this illustrative composite, the intangible costs confirmed by the AFE, combined with the participant's at risk basis and individual tax position, produced a **Year One deduction against active income of $150,000** under the Section 263(c) election.

Because the holding structure preserved direct working interest status under Section 469(c)(3)(A), this deduction was available to offset the one-time $150,000 surgical center distribution directly against ordinary active income, rather than being limited to passive income he did not have or carried forward unused.

The remaining tangible completion cost — approximately $50,000 in this illustrative case — was capitalized for recovery under the applicable Modified Accelerated Cost Recovery System schedule. Under current law, qualifying tangible property may be eligible for a first-year bonus depreciation election at 100 percent under IRC Section 168(k), a provision the One Big Beautiful Bill Act made permanent. Whether and how this election applies to any specific tangible cost component depends on the participant's individual facts and should be confirmed with a CPA before relying on it.

His at risk basis equaled the cash he contributed, confirming that the deduction applied was not inflated through leverage he did not actually carry. Once the well reaches production, percentage depletion under IRC Sections 611 and 613A becomes available — generally equal to 15 percent of gross income from the property for independent producers, subject to applicable limitations — extending a smaller ongoing deduction well beyond the Year One event alongside any production-based cash flow the well generates.

$200K

Capital Contributed

Total illustrative capital contribution into the well program AFE

$150K

Year One Deduction

Applied against active income under IRC Section 263(c)

15%

Ongoing Depletion

Of gross income from the property once producing (Sections 611 and 613A)

Metrics Summary Table

Metric	Illustrative Value / Detail
Capital contribution	$200,000
One-time active income event addressed	$150,000
Year One deduction against active income (IRC Section 263(c))	$150,000 (illustrative)
At risk basis (IRC Section 465)	$200,000 — equal to cash contributed
Holding structure	Direct working interest, Section 469(c)(3)(A) preserved
AMT preference threshold monitored	65% of net oil, gas, and geothermal income — Section 57(a)(2)(A); 40% of AMTI independent producer exception — Section 57(a)(2)(E)
Ongoing depletion rate once producing	15% of gross income from the property (Sections 611 and 613A), subject to limitations
Schedule K-1 classification	Nonpassive, active working interest — Box 1

> "What mattered to me was not a projected number. It was that the deduction came from a section of the tax code I could read myself, that my CPA could confirm the AFE line by line before I signed anything, and that after Year One I still held a direct working interest in a producing well rather than a position in a fund I could not see into."
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> *— Illustrative composite reflection. This does not represent an actual Summit Ventures participant. It is a composite representation built from recurring decision factors described by professionals evaluating this structure.*

Key Takeaways and Assumptions

This case relies on several explicit assumptions. The capital contribution, AFE cost split, and resulting deduction are illustrative figures chosen to match the one-time income event described — not a guaranteed or typical outcome for any specific well. The actual intangible-to-tangible cost ratio on any well is determined by that well's engineering design and is confirmed only through its own AFE. At risk basis, marginal tax rate, and AMT exposure vary by individual and must be modeled by a qualified CPA before an election is made. Percentage depletion and future production-based cash flow depend on the well's actual performance once producing and are not assured.

Several takeaways apply broadly across this professional audience.

The Statutory Basis Is the Deciding Factor

Section 263(c) is a current-year election available to any operator, not a feature unique to a promotional program, which is why its availability does not depend on market conditions or sales claims.

Holding Form Determines the Exception

The holding form determines whether the Section 469(c)(3)(A) exception applies at all. A direct working interest — or an interest held through an entity that does not limit liability — preserves the active income offset. Many pooled or liability-limited structures do not.

At Risk Basis Caps the Usable Deduction

The at risk basis rule under Section 465 caps the usable deduction at actual cash contributed — a useful early check against any structure claiming deductions disproportionate to capital placed.

AMT Must Be Modeled Before the Election

AMT exposure under Section 57(a)(2) must be modeled before the election is made, not discovered afterward.

Standard Tools Don't Scale to One-Time Spikes

Standard capped contribution tools such as 401(k) deferrals and backdoor Roth conversions do not scale to absorb large one-time active income events — precisely the gap this structure is positioned to address for high-earning professionals.

Relevance Extends Beyond Year One

The ongoing depletion allowance and potential production-based cash flow mean the relevance of this structure, properly evaluated, extends beyond the single tax year in which the election is made.

Questions for Professional Advisor Discussion

This case illustrates how a direct, statutory mechanism — properly structured and reviewed alongside a qualified CPA and attorney — can address a specific and recurring problem for high-earning professionals: a one-time active income event that standard, capped retirement tools cannot absorb. The relevant statutory provisions — Section 263(c), Section 469(c)(3)(A), Section 465, Section 57(a)(2), and Sections 611 and 613A — apply to any professional holding a direct working interest, regardless of medical, dental, legal, or accounting specialty. Evaluating any specific opportunity against the decision criteria and professional advisor questions outlined below remains the appropriate starting point before any capital contribution is made, and nothing in this case study should be read as a substitute for that individualized professional review.

1

Does the specific joint venture holding structure being considered preserve direct working interest status under Section 469(c)(3)(A), or does it limit liability in a way that would revert any loss to passive treatment?

2

What does the well's actual Authorization for Expenditure show as the intangible versus tangible cost split, and has that been confirmed in writing before any capital contribution is made?

3

What is my at risk basis under Section 465 for this specific contribution, and does it match my total capital contribution or differ from it?

4

Where does my projected excess intangible drilling cost fall relative to the 65 percent of net oil and gas income threshold under Section 57(a)(2)(A), and does the independent producer exception under Section 57(a)(2)(E) apply to my position?

5

How will the Year One deduction and any later depletion be reported on my Schedule K-1, and has my CPA reviewed the specific box classifications before I file?

6

What governance rights and ongoing operational reporting will I receive as a working interest owner once the well begins producing, and how is that transparency structured and delivered?

Sources and References

[1] Tax Foundation, 2026 federal income tax brackets, based on IRS Revenue Procedure 2025-32 (37 percent top bracket begins at $640,600 single filers and $768,600 married filing jointly). [2] Cornell Legal Information Institute, 26 U.S.C. Section 469(c)(3)(A), statutory text of the working interest exception to the passive activity loss rules. [3] BassEXP, "Section 469 Working Interest: Active vs. Passive," educational analysis of the working interest exception. [4] 26 U.S.C. Section 263(c) and Treasury Regulation 1.612-4(a), intangible drilling cost election mechanics and the definition of an operator. [5] AE Tax Advisors, "Oil and Gas Working Interest Tax Deduction," educational resource on intangible drilling cost treatment. [6] Anchor1031, educational resource distinguishing intangible and tangible drilling costs. [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] 26 U.S.C. Sections 611 and 613A, percentage depletion allowance for independent producers. [10] IRS IR-2025-111 and Notice 2025-67, 2026 retirement plan contribution limits and Roth IRA eligibility phaseout ranges.

Ready to evaluate whether a direct working interest structure fits your tax situation?

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