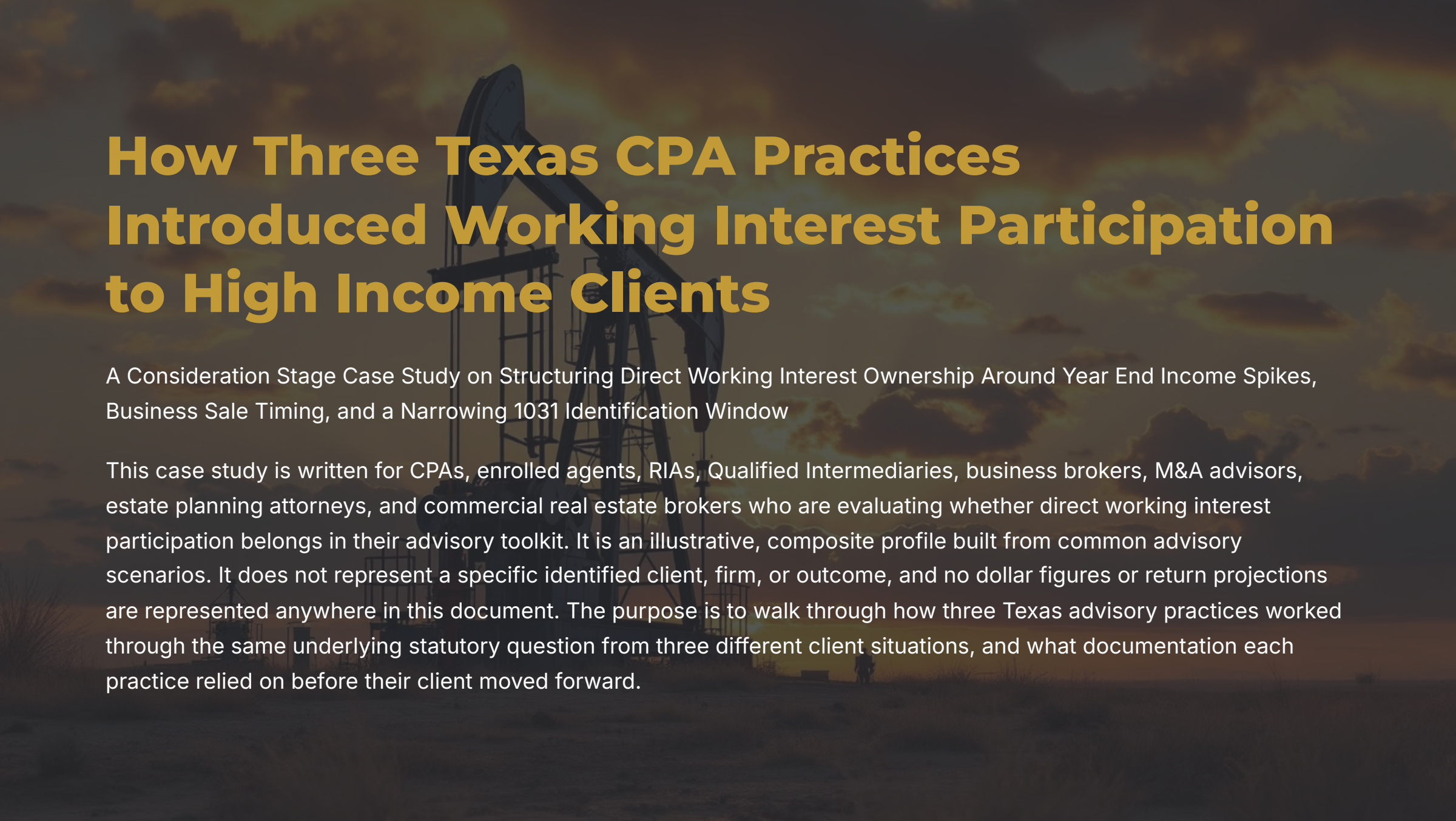


The background of the slide is a photograph of an oil pumpjack in a desert landscape at sunset. The sky is filled with orange and yellow clouds, and the pumpjack is silhouetted against the bright light of the setting sun. The overall tone is professional and industrial.

How Three Texas CPA Practices Introduced Working Interest Participation to High Income Clients

A Consideration Stage Case Study on Structuring Direct Working Interest Ownership Around Year End Income Spikes, Business Sale Timing, and a Narrowing 1031 Identification Window

This case study is written for CPAs, enrolled agents, RIAs, Qualified Intermediaries, business brokers, M&A advisors, estate planning attorneys, and commercial real estate brokers who are evaluating whether direct working interest participation belongs in their advisory toolkit. It is an illustrative, composite profile built from common advisory scenarios. It does not represent a specific identified client, firm, or outcome, and no dollar figures or return projections are represented anywhere in this document. The purpose is to walk through how three Texas advisory practices worked through the same underlying statutory question from three different client situations, and what documentation each practice relied on before their client moved forward.

Case Classification and At a Glance Summary

ILLUSTRATIVE COMPOSITE · CONSIDERATION STAGE

Case Type

Three parallel, independently fictionalized advisory scenarios, each anchored to a real and recurring client trigger named in Summit Ventures' advisor alignment framework: a year end ordinary income spike, an ordinary income component inside a business sale, and a 1031 exchange identification window that was running out.

Participants

Three Texas CPA practices, each already serving high income individual or business owner clients, each independently evaluating a client situation where traditional planning tools — maxed retirement deferrals, standard itemized deductions, a straightforward 1031 replacement — were no longer sufficient.

Common Thread

In all three cases, the deciding factor was not the existence of a tax benefit in the abstract. It was **how the working interest was held**. A direct working interest, or an interest held through an entity that does not limit the taxpayer's liability, sits outside the passive activity rules under **IRC Section 469(c)(3)(A)**. That same direct holding structure is also what the IRS treated as real property eligible for like kind exchange treatment in **Revenue Ruling 68-331**. One structural fact answered two different advisors' questions.

Funnel Stage Addressed

Consideration. Each advisor already understood the general existence of oil and gas tax provisions. What each needed was a clear-eyed look at structure, documentation, and where the line sits between a legitimate statutory election and something that would not hold up under review.

Participant Profile, Trigger, and Situation

1

Austin — Year End Income Spike

A mid-size CPA practice serving physician groups, technology executives, and professional partners came into December with several clients facing an unplanned jump in W-2 and K-1 income: year end bonuses, a vested equity event, and a partnership distribution that pushed two clients well into the top federal bracket. The clients had already maxed out 401(k) deferrals and backdoor Roth contributions. The firm's existing playbook — accelerate deductible expenses, defer invoices, review entity structure — could not move the needle far enough before December 31.

2

Houston — Business Sale with Ordinary Income Component

A CPA embedded inside a business brokerage was advising the seller of a lower middle market manufacturing company. Most of the sale proceeds qualified for long term capital gains treatment, but a meaningful slice was going to be taxed as ordinary income: depreciation recapture on equipment and a deferred compensation payout triggered at closing. The business broker had flagged this to the CPA as a planning gap the client had not anticipated when they agreed to the deal structure.

3

Dallas Fort Worth — Narrowing 1031 Window

A CPA working alongside a Qualified Intermediary was supporting a client who had sold a commercial property and was deep into a Section 1031 exchange. Two of the three identified replacement properties fell out of contract as financing and inspection issues emerged, and the 45 day identification window was closing with one property left and a growing concern that it alone might not absorb the full exchange value without creating boot.

Challenge and Decision Criteria

Each advisor was solving a related but distinct problem, and each applied the same filter before considering any option: does this rest on a clear statutory provision, or does it depend on an aggressive interpretation that would not survive scrutiny. None of the three advisors wanted to introduce a client to something that could later become a source of professional liability, client distrust, or an uncomfortable conversation with the IRS.

The shared decision criteria across all three practices were:



Statutory Foundation

The structure had to rest on an identifiable section of the Internal Revenue Code or a published Revenue Ruling, not a generic "tax strategy" pitch.



Clean Documentation

The documentation had to be clean enough that the advisor could review it themselves: an AFE breakdown, an operating agreement showing how the interest is held, and K-1 reporting that matched how the client's tax position needed to be coded.



Timeline Fit

The Austin case needed a mechanism that could close before year end. The DFW case needed an answer the Q1 and counsel could evaluate against the remaining days in the identification window. The Houston case needed something that could absorb ordinary income specifically, not just capital gain.



Advisor Role Clarity

None of the three CPAs wanted to become the energy expert of record. They needed a partner that could stand behind the documentation and support the filing, while the final tax and legal determination remained with the client's own advisors.

Options and Approach

Austin

The firm considered accelerating deductible business expenses and reviewing whether a cost segregation study on an owned office property could help, but the income in question was W-2 and K-1, not rental real estate, so cost segregation did not address the actual income type. The firm also reviewed whether a conservation easement contribution made sense and ruled it out given the heightened IRS examination attention that category has received in recent years. The CPA ultimately evaluated a direct working interest capital contribution, reviewed specifically for whether the interest would be held directly (or through an entity that does not limit liability) so that it would fall under the **IRC Section 469(c)(3)(A)** working interest exception to the passive activity loss rules, rather than defaulting to passive treatment the way a fund or LP membership interest would.

Houston

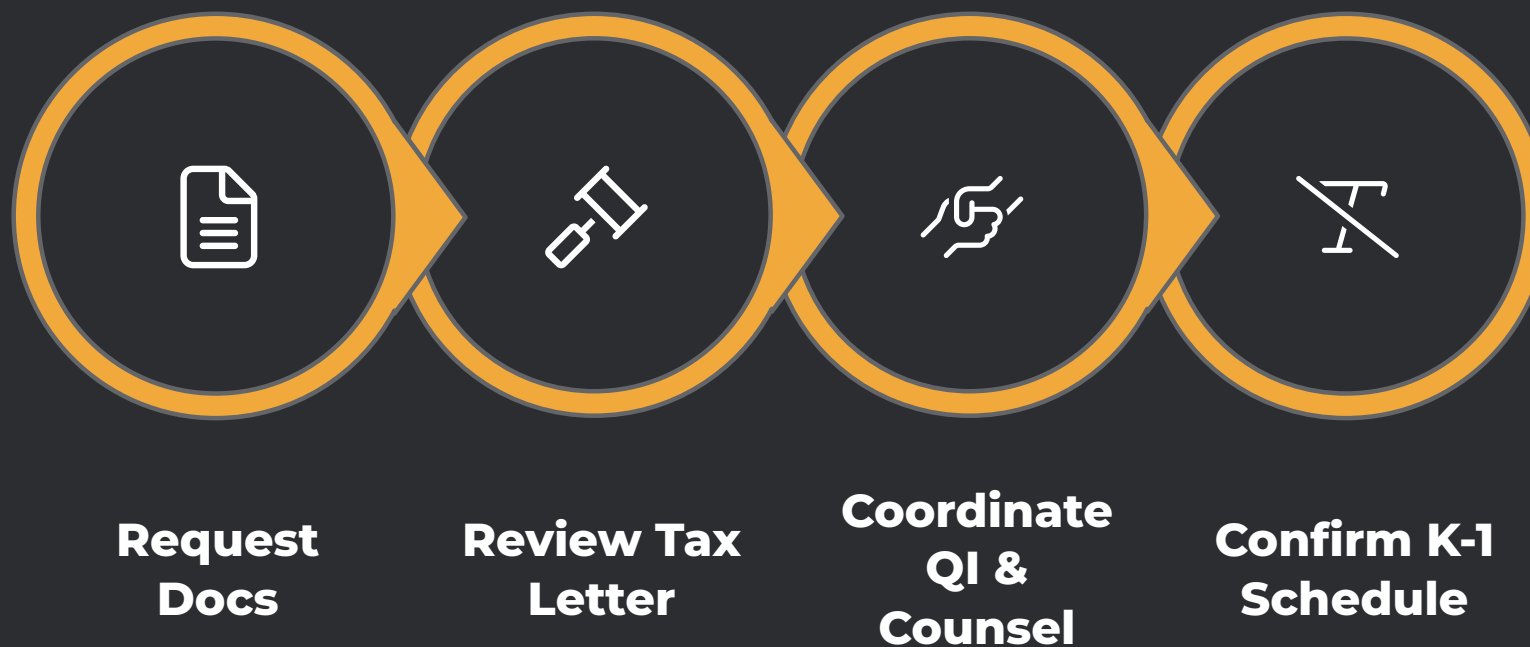
The business broker and CPA discussed a Qualified Opportunity Fund rollover for part of the proceeds, but the five to ten year hold requirement did not match the client's stated liquidity needs, and a QOF investment does not offset the ordinary income component the client was facing in the year of sale. The CPA instead evaluated a working interest capital contribution sized to the ordinary income portion of the sale, built around the **IRC Section 263(c) and Treasury Regulation 1.612-4** election to currently deduct intangible drilling costs, with **IRC Section 461(h)** economic performance rules and its 90 day drilling exception reviewed explicitly, since the sale closed late in the year and the CPA needed certainty that a year end capital contribution would still satisfy the economic performance requirement for the deduction to apply in that tax year.

Dallas Fort Worth

With two replacement properties out of contract and the clock running, the QI and the client's real estate and tax counsel reviewed **Revenue Ruling 68-331**, which held that an operating working interest in a producing oil and gas lease is real property, like kind to a fee interest in real estate, for purposes of Section 1031 of the 1954 Code. The counsel team also reviewed **Revenue Ruling 78-135** as a contrast point, since that ruling confirmed a general partnership interest itself does not qualify for 1031 treatment. That contrast made the direct holding requirement unmistakable: the client would need to hold an actual working interest, not a limited partnership or fund membership interest, for the replacement property analysis to be available at all. The final determination on whether this specific property would satisfy the exchange rested with the client's own QI and counsel, not with any outside party.

Implementation

In each case, the advisory team requested the same category of documentation before moving forward: an AFE outlining the intangible versus tangible cost split for the specific well program, an operating agreement confirming how the interest would be held (directly, not through a liability limiting entity), and a written confirmation of that direct holding status that could sit in the client's file alongside the K-1.



For the Austin and Houston scenarios, the CPA requested a tax opinion letter addressing the IRC Section 469(c)(3)(A) working interest exception and, in the Houston case, the IRC Section 461(h) economic performance timing question, so that the position could be defended on the merits if ever reviewed. For the Dallas Fort Worth scenario, the QI and the client's own 1031 counsel conducted the like kind property analysis directly, using the operating agreement and direct holding confirmation as source documents, with Summit's role limited to providing accurate, complete documentation rather than rendering a 1031 opinion itself.

All three practices also flagged K-1 timing and formatting as a practical year round concern separate from the underlying tax question. Each CPA asked for a sample K-1 schedule in advance, showing how Box 1, Box 12, Box 13, and Box 20 items would be coded for a direct working interest holder claiming the IRC Section 469(c)(3)(A) exception, along with a confirmation that Schedule K-1s for the participating entity would be issued on a timeline that would not create a bottleneck during the firm's own busy season.

Scenario Summary: Documentation and Statutory Basis

Scenario	Trigger	Primary Statutory Mechanism Reviewed	Documentation Reviewed
Austin — Year End Income Spike	W-2 bonus, equity vesting, and partnership distribution pushing client into top bracket before year end	IRC Section 469(c)(3)(A) working interest exception to passive activity loss rules	AFE, operating agreement confirming direct holding, tax opinion letter, sample K-1 schedule (Box 1, 12, 13, 20)
Houston — Business Sale Ordinary Income Component	Depreciation recapture and deferred compensation payout taxed as ordinary income at closing	IRC Section 263(c) and Treasury Regulation 1.612-4 IDC election, with IRC Section 461(h) 90 day economic performance exception	AFE, tax opinion letter, operating agreement, sample K-1 schedule
Dallas Fort Worth — Narrowing 1031 Window	Two of three identified replacement properties fell out of contract inside the 45 day identification period	Revenue Ruling 68-331, contrasted with Revenue Ruling 78-135 on partnership interests	Operating agreement confirming direct holding, written direct holding confirmation, QI coordination memo

❏ Financial outcome represented: **None stated** in any of the three scenarios. This is an illustrative, composite narrative. No deduction amount, return figure, or financial projection is represented or implied.

Representative Perspectives

COMPOSITE · ILLUSTRATIVE · NOT ACTUAL PARTICIPANT STATEMENTS

“

Austin CPA — Composite

"My clients don't need another product pitch in December. What I needed was a structure where I could look at the operating agreement myself and confirm it actually sits outside the passive activity rules before I'd put my name next to it."

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Houston CPA — Composite

"The business broker brought me the ordinary income problem. What mattered to me was whether the IDC election would actually apply to a contribution made that late in the year, and the 461(h) analysis was the part I needed in writing."

”

“

Dallas Fort Worth CPA — Composite

"I wasn't going to make a 1031 call on my own. What I wanted was documentation clean enough that our QI and the client's counsel could do their own analysis against Revenue Ruling 68-331 without having to chase down missing paperwork."

”

Assumptions and Key Takeaways

Assumptions

All three scenarios are hypothetical composites built to illustrate a recurring structural question, not a report on an identified client, firm, or transaction. No operator, fund, or specific well program is named. Texas imposes no state individual income tax, so the underlying tax analysis in each scenario is a federal question only. Statutory references reflect current federal tax law as of the 2026 filing year; advisors should reconfirm applicable thresholds and provisions for the year in which an actual client transaction occurs.

The Single Most Important Structural Fact

The single structural decision that determines whether a working interest can offset active income under **IRC Section 469(c)(3)(A)**, and whether it can qualify as like kind replacement property under **Revenue Ruling 68-331**, is the same decision: is the interest held directly, or through an entity that does not limit the taxpayer's liability. An LLC or LP membership interest, or a fund share, generally fails both tests.

Key Takeaways for Advisors Evaluating This Category

1 Direct Holding Is the Threshold Question

The single structural decision that determines whether a working interest can offset active income under IRC Section 469(c)(3)(A), and whether it can qualify as like kind replacement property under Revenue Ruling 68-331, is the same decision: is the interest held directly, or through an entity that does not limit the taxpayer's liability. An LLC or LP membership interest, or a fund share, generally fails both tests.

2 A Tax Opinion Letter Is Not a Formality

It is the document that lets the advisor stand behind the position with their own client, and it is the document a reviewing agent would look for first.

3 K-1 Scheduling Matters Year Round

Standardized K-1 scheduling, reviewed in advance of filing season, removes a recurring point of friction between energy participation and a CPA's existing workflow.

4 No Energy Expertise Required

None of the three advisors in this case study needed to become an energy operations expert. Each needed documentation precise enough to let them do the job they already do: confirm the statutory basis, confirm the paperwork, and keep the final call with the client and the client's own professional team.

Questions for Advisors Evaluating This Category

Before recommending or discussing a working interest structure with a client, consider asking:

- Is the interest being offered as a direct working interest, or through an LLC, LP, or fund membership interest that would limit the client's liability? That single fact determines whether **IRC Section 469(c)(3)(A)** and **Revenue Ruling 68-331** are even in play.
- Can the sponsor produce an AFE breaking out intangible versus tangible costs for the specific well program, not a generic industry range?
- Is a tax opinion letter available, and does it specifically address the client's situation (active income offset, 1031 like kind treatment, or both)?
- For a year end contribution, has the **IRC Section 461(h)** economic performance timing question, including the 90 day drilling exception, been addressed in writing?
- What does the K-1 schedule look like, and will it arrive on a timeline compatible with the firm's own filing season workload?
- Who is making the final 1031 qualification determination for a specific property, and is that documented as resting with the client's own QI and counsel rather than with the sponsor?

Three different Texas practices, three different client triggers, and one common lesson: the tax provisions behind working interest participation are not new or obscure, but the quality of the structure and the documentation behind it is what separates a defensible recommendation from a liability. Advisors who take the time to confirm how the interest is held, request the underlying paperwork before a client ever signs, and keep the final legal and tax determinations with their own trusted counsel are the ones who can bring this category into a client conversation with confidence rather than hesitation.

For advisors who want to understand this structure in more depth before the next client situation arises, a direct conversation with Summit Ventures' advisor support team — outside of any specific client transaction — is a reasonable next step to evaluate the documentation firsthand.

Connect with Summit Ventures' Advisor Support Team

Sources and References

- **IRC Section 263(c) and Treasury Regulation 1.612-4** — governing the election to expense intangible drilling costs. Used to describe the Houston scenario's IDC election mechanics.
- **IRC Section 469(c)(3)(A)** — the working interest exception to the passive activity loss rules, requiring direct holding or holding through an entity that does not limit the taxpayer's liability. Used as the central structural fact across all three scenarios.
- **IRC Section 465** — at risk limitation rules capping deductions at the taxpayer's actual economic exposure. Referenced as a documentation consideration in the Austin and Houston scenarios.
- **IRC Section 57(a)(2)(A)** — the excess intangible drilling cost preference item for alternative minimum tax purposes, with relief where excess IDC does not exceed 65 percent of the taxpayer's net income from oil and gas properties for the year. Referenced as a documentation consideration advisors should review with their own tax counsel.
- **IRC Sections 611 and 613A** — governing percentage depletion for independent producers. Referenced as an ongoing consideration once a well is in production.
- **IRC Section 461(h)** and its economic performance rules, including the 90 day drilling exception applicable to year end intangible drilling cost elections. Used in the Houston scenario's timing analysis.
- **Revenue Ruling 68-331 (1968-1 C.B. 352)** — holding that an operating working interest in a producing oil and gas lease is real property, like kind to a fee interest in real estate, for purposes of Section 1031. Used as the central authority in the Dallas Fort Worth scenario.
- **Revenue Ruling 78-135** — confirming that a general partnership interest does not itself qualify for Section 1031 nonrecognition treatment. Used as a contrast point reinforcing the direct holding requirement in the Dallas Fort Worth scenario.
- **Treasury Regulation 1.1031(k)-1** — governing the identification and receipt requirements for deferred like kind exchanges, including the 45 day identification period referenced in the Dallas Fort Worth scenario.