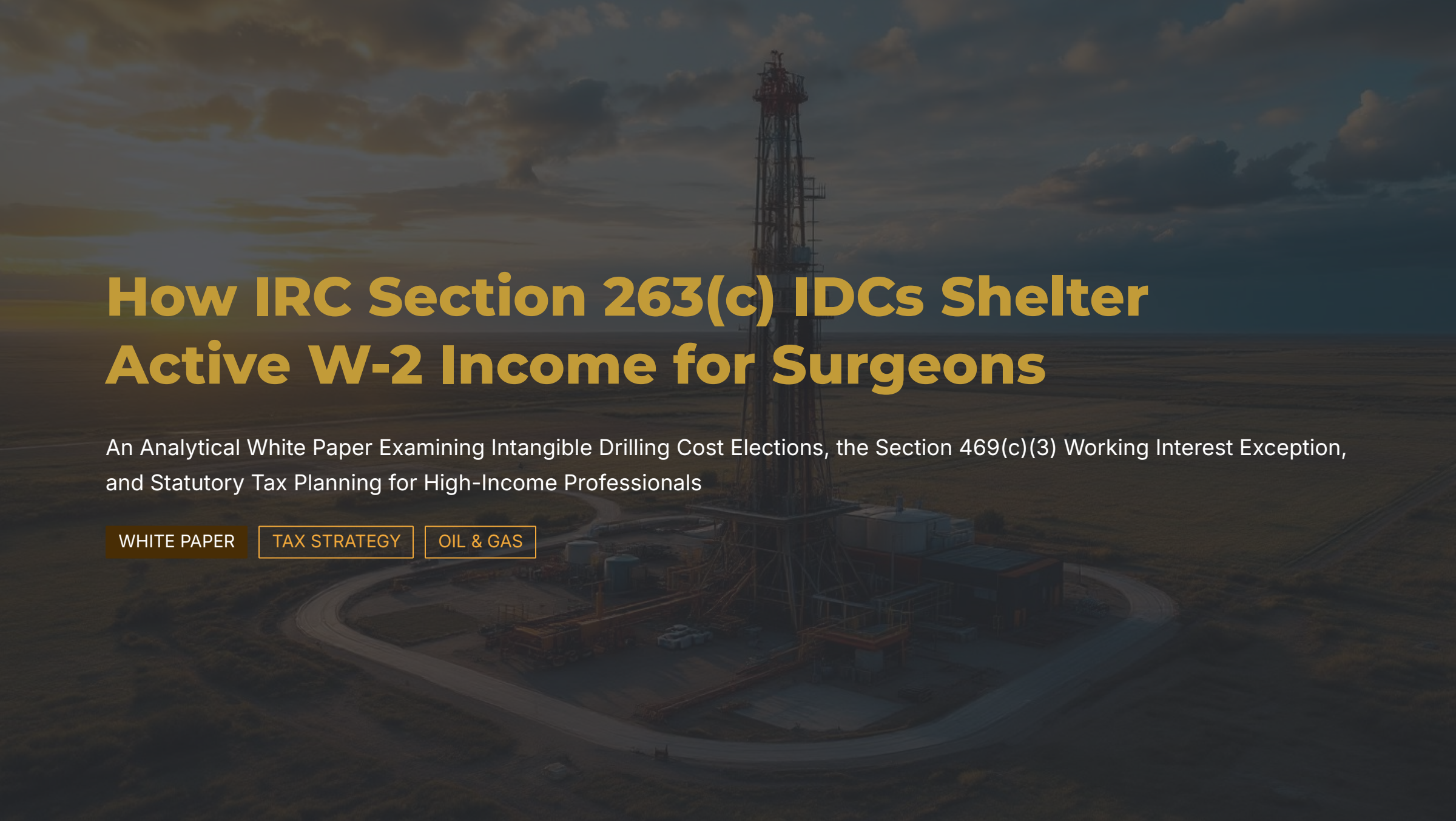


How IRC Section 263(c) IDCs Shelter Active W-2 Income for Surgeons

An Analytical White Paper Examining Intangible Drilling Cost Elections, the Section 469(c)(3) Working Interest Exception, and Statutory Tax Planning for High-Income Professionals

WHITE PAPER | TAX STRATEGY | OIL & GAS

Executive Summary

Surgeons, physicians, dentists, and attorneys who clear $150,000 to $400,000 or more in annual federal and state income tax share a common structural problem: the standard deferral toolkit — 401(k) contributions, backdoor Roth conversions, and traditional IRA funding — was built for a much lower income tier and simply does not scale. A $24,500 employee deferral limit for 2026 does not move the needle against a seven-figure practice income or a large K-1 distribution.

This white paper examines a statutory mechanism that does scale: the election under Internal Revenue Code Section 263(c) to currently deduct intangible drilling costs (IDC) on a working interest in an oil and gas well, combined with the working interest exception to the passive activity loss rules under IRC Section 469(c)(3). Together, these two provisions — not one alone — are what allow a qualifying deduction to offset active income, including W-2 wages, 1099 income, and K-1 distributions from a practice or partnership.

This paper explains the mechanics, the statutory conditions that must be met, the layers of limitation that apply, and the questions a CPA or tax attorney should walk through before a professional considers this strategy.

IRC § 263(c)

Elect to currently deduct intangible drilling costs in the year incurred rather than capitalizing over the well's life.

IRC § 469(c)(3)

Working interest exception removes the passive activity classification — allowing losses to offset active W-2 and 1099 income.

Together, They Scale

Neither provision alone achieves the offset. The structural combination is what unlocks the statutory benefit for high-income professionals.

Why This Issue Matters

High-income professionals are disciplined savers who are accustomed to optimizing every lever available to them, yet most discover that the standard retirement and deferral vehicles cap out well below the scale of their tax exposure. A physician earning $600,000 in W-2 and 1099 income combined faces a top marginal federal rate of 37% on income above $640,600 for a single filer, or $768,600 for a married couple filing jointly, under the 2026 brackets made permanent by the One Big Beautiful Bill Act. Layer in state income tax, and the effective rate on the top slice of earnings can exceed 45% in many jurisdictions.

Meanwhile, the 2026 Roth IRA contribution phases out entirely for a single filer with modified adjusted gross income above $168,000 and for a married couple above $252,000, meaning many physicians cannot even use the backdoor Roth as a meaningful offset. The result is a structural mismatch: income scales with specialization and tenure, but the available statutory deductions do not.

Understanding how Section 263(c) interacts with Section 469(c)(3) matters because it is one of the few provisions in the Internal Revenue Code specifically designed to let a taxpayer convert a current-year capital contribution into a current-year deduction against ordinary, active income — without an income phase-out and without a material participation or hours test.

The Structural Mismatch

Income scales with specialization and tenure. Standard statutory deductions do not. This gap widens every year a professional advances in their career.

Key Income Thresholds (2026)

- Top federal rate of 37% kicks in above $640,600 (single) or $768,600 (MFJ)
- Roth IRA phases out above $168,000 (single) or $252,000 (MFJ)
- Effective combined rate can exceed 45% in high-tax states
- 401(k) employee deferral capped at $24,500 for 2026

Foundational Concepts: IDC vs. Tangible Drilling Costs

Intangible drilling costs are the labor, fuel, drilling mud, chemicals, site preparation, and hauling expenses incurred in drilling and completing an oil or gas well — costs that have no salvage value once incurred. Tangible drilling costs, by contrast, include casing, wellhead equipment, and tanks — items that retain salvage value and are capitalized and recovered through depreciation, typically on a seven-year MACRS schedule under IRC Section 168.

The distinction matters because Treasury Regulation 1.612-4, issued under IRC Section 263(c), allows a taxpayer who holds a working or operating interest — as a fee owner or under a lease or similar contract granting operating rights — to elect to currently deduct IDC in the year incurred rather than capitalizing and depreciating it over the life of the well. This election has a long history: it traces to 1916 Treasury guidance (Treasury Regulation 45, Article 223) and was formally codified as Section 263(c) of the Internal Revenue Code of 1954, a point confirmed in Revenue Ruling 71-206. It is a documented, **century-old statutory framework**, not a novel or obscure provision.

Across multiple independent industry sources, IDC commonly represents a substantial majority of total well cost, with cited ranges typically falling between 60% and 85% depending on well design, formation, and the specific authorization for expenditure (AFE) governing the program. That range is a documented industry benchmark, not a guarantee for any specific well or any specific participant's capital, and the actual split between intangible and tangible costs for a given program should always be confirmed against the governing AFE and reviewed with a CPA before any capital is committed.

Intangible Drilling Costs (IDC)

Labor, fuel, drilling mud, chemicals, site preparation, hauling. **No salvage value.** Eligible for current-year deduction under § 263(c). Typically 60%–85% of total well cost.

Tangible Drilling Costs

Casing, wellhead equipment, tanks. **Retain salvage value.** Capitalized and recovered through 7-year MACRS depreciation under IRC § 168. Eligible for 100% bonus depreciation under the One Big Beautiful Bill Act.

The IDC election traces to 1916 Treasury guidance and was codified in 1954 — this is a century-old statutory framework, not a novel tax shelter.

The Critical Distinction: § 263(c) Alone Does Not Offset W-2 Income

This is the point where generic marketing content about oil and gas tax benefits tends to go wrong, and where a careful professional should slow down. Section 263(c) governs only the timing and classification of the deduction — whether IDC is expensed now or capitalized and recovered later. It says nothing about what kind of income that deduction can offset. The provision that determines whether an IDC deduction can offset active W-2 wages, 1099 income, or K-1 distributions from a practice is a separate statute: **IRC Section 469(c)(3)(A)**, the working interest exception to the passive activity loss rules.

Section 469 generally treats a trade or business in which the taxpayer does not materially participate as a passive activity, meaning losses from that activity can only offset other income the tax code classifies as passive — not wages or active business income. Section 469(c)(3)(A) carves out a specific exception: a working interest in an oil or gas property is excluded from the definition of a passive activity altogether, provided the taxpayer holds the interest directly or through an entity that does not limit the taxpayer's liability, such as a general partnership.

⚠ An LLC or limited partnership interest — structures that shield the holder's personal liability — do not qualify for this exception. If a working interest sits inside a liability-limiting entity, the exception does not apply, and the activity reverts to standard passive treatment.

A second distinguishing feature of Section 469(c)(3) deserves emphasis for a time-poor professional audience: unlike the real estate professional exception under Section 469(c)(7), which requires more than 750 hours of personal service in real property trades and more than half of the taxpayer's total working time, the working interest exception carries **no hours test and no material participation requirement**. A surgeon running a full clinical schedule, a litigation partner billing 2,200 hours a year, or a CPA in the middle of busy season could never realistically commit 750 hours to a side activity. Section 469(c)(3) does not ask them to. The exception is tied to how the interest is held, not to how many hours the holder personally works in the field.

§ 469(c)(7) Real Estate Pro	§ 469(c)(3) Working Interest
Requires 750+ hours of personal service in real property trades AND more than half of total working time. Impossible for most active professionals.	**No hours test. No material participation requirement.** Exception is tied to how the interest is held — not how many hours the holder works in the field.

Analysis: The Full Statutory Stack

A complete picture requires looking beyond the headline provisions to the layers of limitation Congress built around them — each of which a CPA should model against the specific facts before a capital contribution is made.

1 IRC § 465 — At-Risk Rules

Limit any deduction to the amount the taxpayer actually has at risk in the activity — generally cash contributed plus recourse debt for which the taxpayer is personally liable. Nonrecourse financing does not count toward the at-risk basis in this context, which is a meaningful difference from how some real estate structures are financed.

2 IRC § 57(a)(2) — AMT Preference

Intangible drilling costs are treated as a tax preference item for AMT purposes, but only to the extent the excess IDC deduction exceeds 65% of the taxpayer's net income from oil, gas, and geothermal properties for that taxable year. Independent producers receive a further exception under Section 57(a)(2)(E): the AMT preference is switched off for them, subject to a cap under which the AMTI reduction cannot exceed 40% of alternative minimum taxable income. The practical net effect is that drilling cost deductions generally cannot reduce a taxpayer's AMTI below roughly 60% of pre-deduction income.

3 IRC §§ 611 & 613A — Percentage Depletion

Once a well is in production, these sections provide an ongoing percentage depletion allowance — generally 15% of gross income from the property for independent producers and royalty owners — which continues to apply even after the participant's cost basis in the well has been fully recovered. This advantage distinguishes depletion from standard depreciation.

4 IRC § 461(h) — Economic Performance Rule

Generally limits how much IDC a taxpayer can prepay and deduct for a well that will not begin drilling for several months, subject to a 90-day drilling exception. A CPA reviewing a program late in the calendar year should confirm the drilling start date against this rule before relying on a current-year deduction.

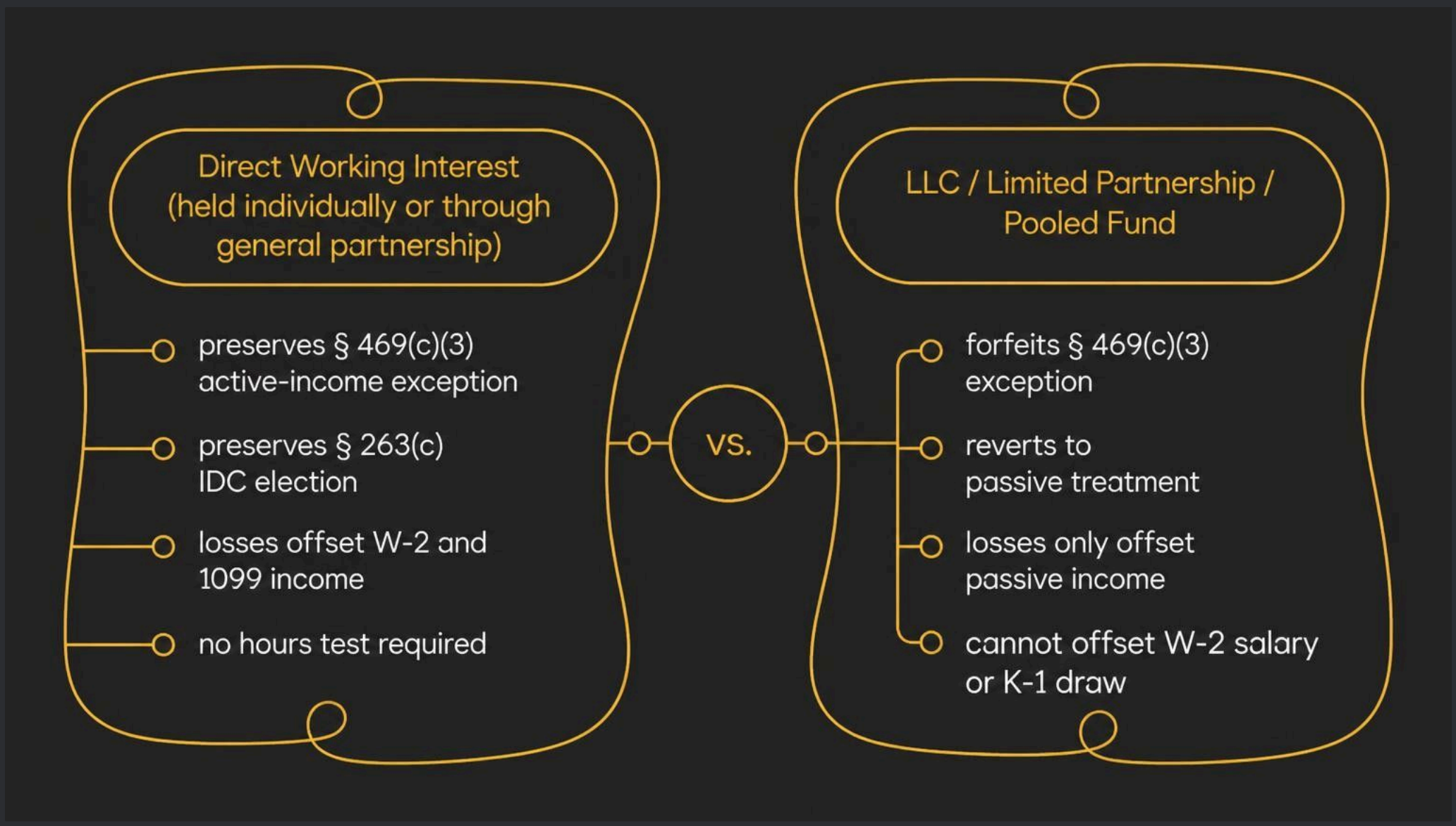
> The three-number relationship — 65%, 40%, and 60% — is worth having a CPA model explicitly against a specific year's income rather than assuming the full nominal deduction applies without limitation.

Finally, it is worth noting what this framework does not shelter. *Methvin v. Commissioner*, decided by the Tenth Circuit in 2016, addressed self-employment tax exposure for certain working interest holders — a reminder that the income tax treatment discussed in this paper is distinct from employment tax questions, which a CPA should evaluate separately based on the specific holding structure.

How the Structure Determines the Outcome

The through-line across all of the provisions above is structural, not promotional: **how the working interest is held determines what tax treatment is available.** A direct working interest — held either individually or through an entity that does not limit liability, such as a general partnership — preserves both the Section 469(c)(3) active-income exception and the Section 263(c) election to currently deduct IDC.

The same economic exposure to an oil and gas program, routed instead through an LLC, a limited partnership, or a pooled fund share, loses the 469(c)(3) exception entirely and reverts to passive treatment — meaning any losses can only offset other passive income, not a surgeon's W-2 salary or a law firm partner's K-1 draw.



This is the organizing principle behind Summit Ventures' entrepreneurial joint venture model. Business participants hold a direct working interest position, structured through a joint operating agreement rather than a liability-limiting fund wrapper — which is the specific structural condition Section 469(c)(3)(A) requires. Active JV members receive governance rights and operational transparency into the authorization for expenditure and ongoing production reporting for the wells in which they hold a position, and the capital contribution itself becomes a direct equity position in production-ready assets rather than a passive claim on a pooled vehicle. This structure does not change the statute. It is designed to meet the statute's existing, century-old conditions as written.

Recommendations: The CPA Checklist

A professional evaluating this strategy should treat it as a statutory classification question first and a capital allocation decision second. The sequence that tends to produce the most reliable outcome — and the one a CPA should walk through — is outlined below.

Confirm the Holding Structure

Verify in writing that the program involves a direct working interest — not an LLC or LP membership interest. This is the threshold question that determines whether § 469(c)(3) applies at all.

Request and Review the AFE

Obtain the authorization for expenditure for the specific well or program and have a CPA identify the actual intangible-to-tangible cost split — rather than relying on an industry-wide average.

Model AMT and At-Risk Basis

Model the § 57(a)(2) AMT preference and the § 465 at-risk basis against the professional's specific income and financing facts for the year. Confirm whether the 65%-of-net-income or 40%-of-AMTI limitation reduces the practical benefit.

Verify K-1 Coding

Confirm the K-1 received properly codes the activity as nonpassive under § 469, and that the issuer has confirmed this classification in writing. The K-1's box coding is the documentation the IRS will look to first.

Confirm § 461(h) Timing

Verify the timing of the capital contribution relative to the well's drilling start date satisfies the economic performance rule, including the 90-day drilling exception. Evaluate self-employment tax exposure separately.

> Tax efficiency at this income level is rarely about finding a single large deduction. It is about matching the legal structure of a capital contribution to the specific statutory language that governs how that structure is taxed.

Market Context: Domestic Oil & Gas in 2025

The broader backdrop for domestic oil and gas activity is worth noting briefly, since the deductions discussed in this paper apply to an active, producing industry rather than a theoretical one.

U.S. Production Record (2025)

The U.S. Energy Information Administration confirmed that U.S. crude oil production set a new record of **13.6 million barrels per day** in 2025, up from the prior record of 13.2 million barrels per day in 2024. The Permian Basin alone accounted for roughly **48% of total domestic output**.

Legislative Tailwind: One Big Beautiful Bill Act

Signed July 4, 2025, the One Big Beautiful Bill Act made **100% bonus depreciation under IRC Section 168(k) permanent** for qualifying property acquired after January 19, 2025, reversing the scheduled phase-down under prior law. That provision applies to tangible, depreciable equipment rather than to the IDC election itself, but it is a relevant piece of the current tax environment for any professional evaluating the tangible-cost side of a working interest program.

The Act also made the 2026 federal income tax brackets permanent, including the 37% top marginal rate thresholds referenced throughout this paper.

13.6M

Barrels Per Day

U.S. crude oil production record set in 2025 (EIA confirmed)

48%

Permian Basin Share

Of total domestic U.S. crude oil output in 2025

100%

Bonus Depreciation

Made permanent for qualifying tangible property under the One Big Beautiful Bill Act

60%+

IDC of Well Cost

Typical intangible drilling cost share of total well cost (industry benchmark range: 60%–85%)

Questions for Discussion With Your CPA or Tax Attorney

A high-income professional's tax exposure rarely has a single fix, and Section 263(c) is not a substitute for a broader planning conversation with a qualified CPA or tax attorney. What it offers is a documented, century-old statutory pathway — reinforced by the Section 469(c)(3) working interest exception — that is structurally capable of offsetting active income in a way that standard deferral vehicles are not built to do at this income tier.

1	**Holding Structure** Does the specific program under consideration involve a direct working interest, or does it route exposure through an LLC, limited partnership, or fund interest that would forfeit the Section 469(c)(3) exception?
2	**AFE Cost Split** What does the governing authorization for expenditure show as the actual intangible-to-tangible cost split for this specific well or program, rather than an industry-wide average?
3	**AMT Preference** Based on my specific income for the year, where does the Section 57(a)(2) AMT preference calculation land, and does the 65%-of-net-income or 40%-of-AMTI limitation reduce the practical benefit?
4	**At-Risk Basis** What is my at-risk basis under Section 465, accounting for cash contributed and any recourse debt, and does any portion of the structure rely on nonrecourse financing that would not count?
5	**K-1 Coding** Will the K-1 I receive code this activity as nonpassive under Section 469, and has the issuer confirmed this classification in writing?
6	**§ 461(h) Timing** Does the timing of my capital contribution relative to the well's drilling start date satisfy the Section 461(h) economic performance rule, including the 90-day drilling exception?
7	**Self-Employment Tax** Separately from income tax treatment, has my CPA evaluated any self-employment tax exposure associated with how the interest is held?

The provisions reward precision: how the interest is held, how the AFE allocates cost, and how the K-1 is coded all determine whether the statutory benefit is actually available in a given year. Surgeons, physicians, dentists, attorneys, and the CPAs who advise them are well positioned to evaluate this kind of structural, rules-based planning — since it rewards exactly the kind of careful, document-driven diligence this audience already applies in their own professions.

Summit Ventures operates as an entrepreneurial joint venture platform built specifically around direct working interest participation, governance rights, and operational transparency — the structural conditions this statutory framework requires — and welcomes a conversation with a participant's own CPA or attorney as part of evaluating whether this structure fits their specific circumstances.

Schedule a Conversation with Summit Ventures