

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

A Professional Brief on Statutory Tax Mechanics, Entity Structure, and Due Diligence Considerations for Advisory Practices

SUMMIT VENTURES | PROFESSIONAL BRIEF

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Executive Takeaway and Why It Matters

High-income clients are asking their advisors a question that most practices are not equipped to answer with precision: is there a statutory, IRS-recognized way to reduce a large active-income spike before year end, without relying on a syndicated shelter or an opinion that will not hold up under examination. For CPAs, tax professionals, RIAs, qualified intermediaries, business brokers and M&A advisors, estate planning attorneys, and commercial real estate brokers, the direct working interest in an oil and gas well is one of the oldest provisions in the Internal Revenue Code and one of the least understood outside a narrow circle of energy-focused practitioners.

This brief is written peer to peer. It is not a product pitch. It is intended to give advisory professionals a working technical vocabulary for how Section 263(c) intangible drilling cost elections, the Section 469(c)(3) working interest exception, and related at-risk and depletion provisions interact, so that when a client raises the topic, the advisor can evaluate it on the merits rather than defer or decline out of unfamiliarity.

The core finding worth carrying into any client conversation: How the interest is held, not merely what it is, determines whether these provisions apply.

Who This Brief Serves

- CPAs & Tax Professionals
- Registered Investment Advisors
- Qualified Intermediaries
- Business Brokers & M&A Advisors
- Estate Planning Attorneys
- Commercial Real Estate Brokers

The Core Statutory Provisions

- IRC Section 263(c) — IDC Election
- IRC Section 469(c)(3) — Working Interest Exception
- IRC Section 465 — At-Risk Rules
- IRC Sections 611 & 613A — Depletion
- IRC Section 57(a)(2) — AMT Preference

The Planning Opportunity

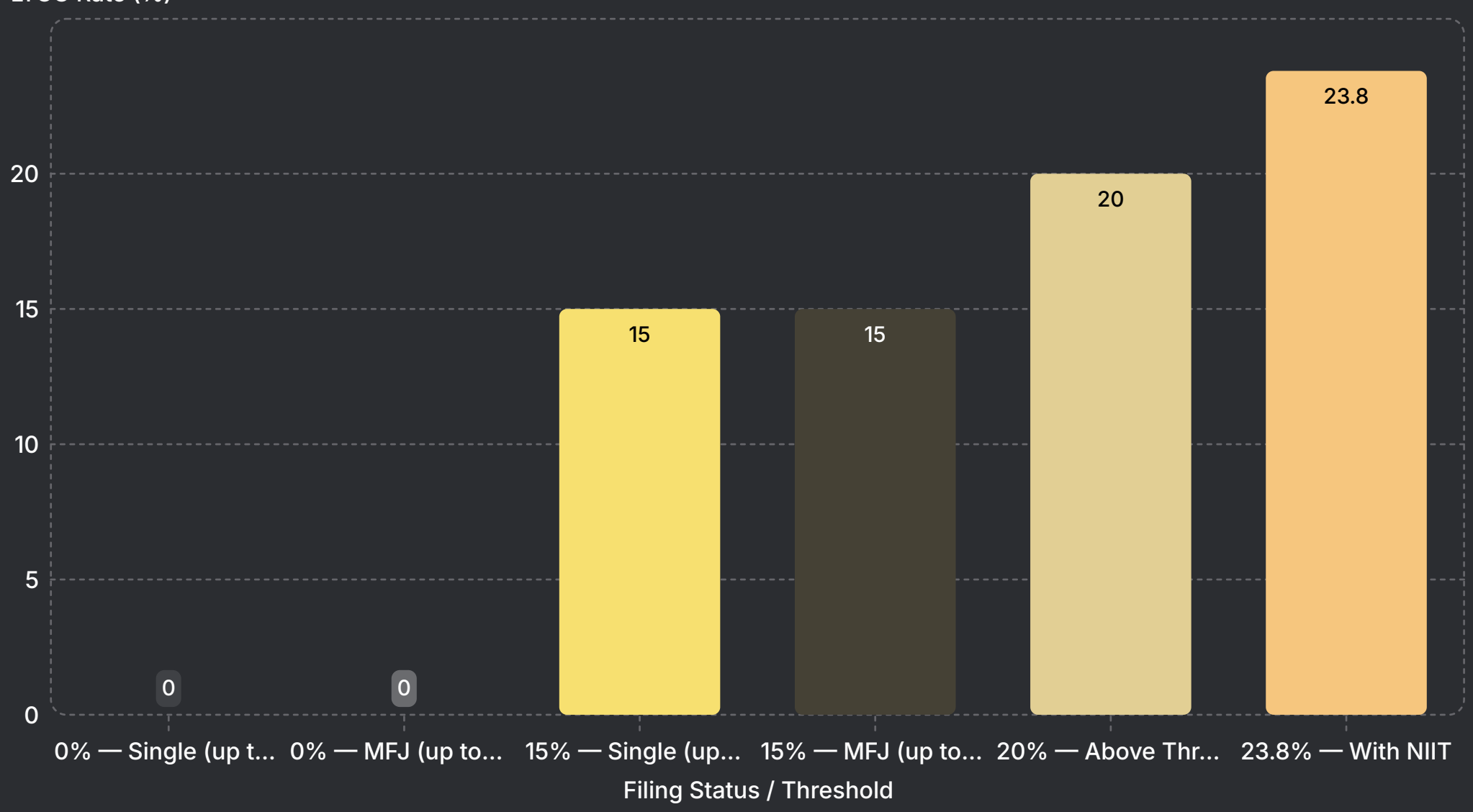
- Active income offset — statutory, citable
- No material participation test required
- 1031 exchange replacement property eligibility
- Ongoing depletion allowance post-production
- Decades of IRS guidance and Code history

Context: A Century of Statutory Precedent

Oil and gas tax provisions are not a new or speculative corner of the Code. The intangible drilling cost (IDC) deduction traces to 1916 Treasury guidance and was codified as IRC Section 263(c) in the Internal Revenue Code of 1954, with the operative election mechanics set out in Treasury Regulation 1.612-4. For more than a century, Congress has deliberately incentivized direct capital formation in domestic oil and gas development through the tax code rather than through subsidy programs, and the provisions have survived multiple rounds of broader tax reform largely intact.

What has changed is the planning environment around these provisions. The One Big Beautiful Bill Act, signed July 4, 2025, made 100 percent bonus depreciation under IRC Section 168(k) permanent for qualifying property acquired after January 19, 2025, reversing the prior phase-down schedule that was set to reduce bonus depreciation toward zero by 2027.

For 2026, federal long-term capital gains brackets run 0 percent up to $49,450 single and $98,900 married filing jointly, 15 percent up to $545,500 single and $613,700 married filing jointly, and 20 percent above those thresholds, with a top effective rate of 23.8 percent once the 3.8 percent Net Investment Income Tax applies. Clients realizing a business sale, a concentrated stock position, a 1031 exchange failure, or simply an unusually strong income year are evaluating these brackets in real time, and many are asking whether an operating business deduction, rather than a capital gains deferral tool, might be part of the answer.



2026 federal long-term capital gains rate brackets, as published by the IRS. Top effective rate of 23.8% includes the 3.8% Net Investment Income Tax.

The Planning Gap: Structural, Not Informational

Two Distinct Risks for the Advisor

Professional Reputation Risk: Either steering a client away from a legitimate statutory strategy out of caution, or worse, endorsing a loosely structured program that does not actually satisfy the Code's requirements.

Liquidity-Event Risk: A client facing a large, one-time active income spike — a business exit, a 1031 clock that will not close in time, a bonus or distribution year — with no proactive strategy on the table before year end.

The Opportunity

The opportunity is to separate the asset class from the marketing noise around it. Oil and gas working interest tax treatment is governed by specific, citable statutory sections. An advisor who understands those sections can evaluate any program, including Summit Ventures, against a fixed technical standard rather than a sales narrative.

Most advisors know that oil and gas carries "tax benefits" in general terms, but few can explain the mechanism with enough precision to recommend it, document it, or defend it on exam. That gap creates the structural planning problem this brief is designed to address.

Common Client Triggers

- Business sale or exit event
- 1031 exchange timeline that will not close
- Concentrated stock position realization
- Unusually strong bonus or distribution year

Key Findings: The Statutory Mechanics

1 IRC Section 263(c) — The IDC Election

IRC Section 263(c), implemented through Treasury Regulation 1.612-4, permits an operator or working interest owner to elect to expense intangible drilling costs — such as labor, fuel, drilling mud, chemicals, site preparation, and hauling — in the year incurred rather than capitalizing them. Tangible drilling costs, including casing, wellhead equipment, and tanks, are capitalized and recovered through depreciation, generally over a seven-year MACRS schedule under IRC Section 168.

2 IDC as a Percentage of Well Cost

Industry sources consistently document IDCs as representing an estimated 60 to 85 percent range of total well cost, though the actual split for any specific well is confirmed through the Authorization for Expenditure (AFE) and the operator's cost accounting, not a fixed universal percentage. This is a mechanics point, not a guaranteed outcome, and the exact allocation will vary by well and should be confirmed in each client's own K-1 and supporting schedules.

3 IRC Section 469(c)(3)(A) — The Working Interest Exception

The provision that determines whether an IDC loss can offset a client's active W-2, 1099, or K-1 income is IRC Section 469(c)(3)(A), the working interest exception to the passive activity loss rules. The statute excludes from "passive activity" any working interest in an oil or gas property "which the taxpayer holds directly or through an entity which does not limit the liability of the taxpayer." This is the single most consequential structural detail in the entire category: an LLC or limited partnership interest that limits the holder's liability does not qualify for this exception, while a direct interest or an interest held through a general partnership does. Unlike the real estate professional rules, Section 469(c)(3) carries no material participation or hours-tested requirement.

4 IRC Section 465 — At-Risk Rules & Section 461(h)

IRC Section 465 (the at-risk rules) still caps the deductible amount at the taxpayer's actual economic exposure, meaning cash contributed and recourse debt, not nonrecourse financing. IRC Section 461(h) economic performance rules also limit how late in the year IDC can be prepaid for a well that will not begin drilling for some time, subject to a 90-day drilling exception.

5 AMT Preference Item — Section 57(a)(2)

Excess IDC is an alternative minimum tax preference item under 26 U.S.C. Section 57(a)(2)(A), but only to the extent the excess exceeds 65 percent of the taxpayer's net income from oil, gas, and geothermal properties for the year. Independent producers receive further relief under Section 57(a)(2)(E), subject to its own 40 percent of AMTI cap. The practical effect commonly cited by tax practitioners is that IDC deductions generally cannot reduce a taxpayer's AMTI below roughly 60 percent of pre-deduction income — a detail worth confirming with the client's own AMT calculation rather than assuming it applies uniformly.

6 Percentage Depletion — Sections 611 and 613A

Once a well produces, IRC Sections 611 and 613A provide an ongoing 15 percent percentage depletion allowance against gross income from the property for independent producers and royalty owners — a benefit that continues even after the investor's cost basis in the property reaches zero.

7 1031 Exchange Eligibility — Rev. Rul. 68-331 and 78-135

Revenue Ruling 68-331 (1968-1 C.B. 352) holds that a lessee's working interest in a producing oil and gas lease is real property, like-kind to a fee interest in improved ranch or farm real estate, under Section 1031(a) of the 1954 Code. Revenue Ruling 78-135 adds an important limitation advisors should flag immediately: a general partnership interest itself does not qualify for 1031 nonrecognition treatment. The client must hold an actual direct or undivided working interest, not a partnership or fund interest, for the exchange to work.

Analysis: Structure, Documentation, and the Summit Ventures Model

Participation Model

Summit Ventures operates as an entrepreneurial joint venture platform rather than a pooled fund. Participants become working interest owners with a direct capital contribution into specific well programs, which preserves the direct-holding structure that both Section 469(c)(3) and Rev. Rul. 68-331 require. Governance rights, operational transparency around drilling and completion costs, and standardized K-1 scheduling are structured to support the advisor's own documentation and review process rather than to replace it.

Structural Elements

Because entity structure determines statutory eligibility, the distinction between a direct working interest and a liability-limiting LLC or LP unit is the first thing worth confirming on any program an advisor reviews, including this one. Supporting documentation should include:

- The AFE-based IDC and tangible cost allocation
- The client's at-risk basis calculation under Section 465
- K-1 coding that properly reflects active, nonpassive treatment (commonly reflected in Box 1 ordinary business income or loss, with supplemental statements addressing Boxes 12, 13, and 20 for depletion and AMT items)

Advisors should request a tax opinion letter addressing the working interest classification before relying on the structure in client planning.

The Critical Structural Question

> Is the interest held directly, or through an entity that limits the taxpayer's liability?

This single question determines eligibility under Section 469(c)(3)(A), deductibility of IDC losses against active income, and qualification as like-kind real property under Rev. Rul. 68-331 for 1031 exchange purposes.

✓ Qualifies

Direct working interest or interest held through a general partnership (non-liability-limiting entity)

✗ Does Not Qualify

LLC or limited partnership interest that limits the holder's liability — disqualified under Section 469(c)(3)(A)

Tax and Legal Considerations by Advisor Role

The working interest exception interacts differently with each advisory discipline. Here is how the mechanics apply across the professional roles most likely to encounter this category.

CPAs & Tax Professionals

The working interest exception offers a planning lever for clients with a concentrated, time-sensitive active income event, where the Section 263(c) election and supporting AFE documentation need to be in place before the tax year closes. The practice value is in reviewing the operator's K-1 reporting discipline and confirming the direct-holding structure before signing off on the position.

RIAs & Fee-Based Planners

The relevant question is less about tax mechanics and more about portfolio fit: many high-net-worth and family office clients are already asking about direct, non-correlated real asset exposure, and a working interest position sits outside traditional securities allocations entirely, which changes how it should be discussed, documented, and coordinated with the client's CPA.

Qualified Intermediaries

The working interest's classification as real property under Revenue Ruling 68-331 makes it a replacement property category worth understanding, with the caveat from Revenue Ruling 78-135 that the exchange must involve an actual direct interest, not a fund or partnership unit, and that any such exchange should be reviewed alongside qualified legal counsel before an identification deadline is set.

Business Brokers & M&A Advisors

The planning window opens immediately after a closing, when a seller is facing ordinary income recapture, a large capital gain, or both, often with limited time before the next estimated tax deadline. A statutory, documentable strategy under Section 263(c) can be a more credible post-exit conversation than a generic "talk to your CPA" referral.

Estate Planning Attorneys

A direct working interest held outside a liability-limiting entity has its own transfer, basis, and depletion characteristics that differ meaningfully from a fund interest or a security, and these differences are relevant to how the asset is structured and ultimately titled within a broader estate plan.

Commercial Real Estate Brokers

Clients facing a 1031 timeline that will not close, or boot that will be fully taxed as capital gain, may benefit from understanding that a working interest is a distinct real property category under Rev. Rul. 68-331, separate from, and not a substitute for, a completed exchange into another commercial property.

Recommendations, Due Diligence Checklist & Implications

What to Request Before Forming a Professional Opinion

Advisors evaluating any oil and gas working interest program, whether for immediate client use or for future reference, should request the following before forming a professional opinion:

1

Authorization for Expenditure (AFE)

Showing the IDC and tangible cost split for the specific well or wells under consideration.

2

Entity Structure Confirmation

Written confirmation of the entity structure used to hold the interest, with legal counsel confirmation that it satisfies Section 469(c)(3)(A).

3

Sample K-1 & Tax Schedules

A sample K-1 and supporting tax schedules from a completed program year, demonstrating proper active, nonpassive treatment.

4

Tax Opinion Letter

A tax opinion letter addressing the working interest classification for Section 1031 purposes where relevant. None of these requests should be treated as unusual.

A program built on statutory mechanics should be able to produce all four of these items without friction.

Implications for the Advisor

For the advisor, the practical implication is straightforward: the working interest exception is a documentation-driven strategy, not a tax-rate hack. Its defensibility rests entirely on whether the interest is actually held directly or through a non-liability-limiting entity, whether the IDC allocation is supported by the AFE, and whether the client's at-risk basis is properly calculated. Advisors who build a standing checklist around these four items position themselves to evaluate any working interest program consistently, rather than relying on a single operator's marketing materials.

Questions to Work Through Before Client Conversations

Before bringing this strategy into a client conversation, advisors may want to work through the following with their own counsel or the operator in question.

Entity Structure

Does the proposed structure hold the interest directly, or through an entity that limits liability in a way that would disqualify it under Section 469(c)(3)(A)?

AFE Documentation

Is the IDC versus tangible cost split documented through an AFE specific to the well, rather than quoted as a flat percentage across all programs?

At-Risk Basis Tracking

How is the client's at-risk basis under Section 465 calculated and tracked year over year?

K-1 Reporting Package

What does the K-1 reporting package look like, and does it arrive with enough lead time for a complete return?

1031 Exchange Eligibility

If a 1031 exchange is involved, has counsel confirmed the interest is a direct or undivided working interest rather than a partnership unit, consistent with Revenue Ruling 78-135?

AMT Exposure Modeling

What AMT exposure, if any, results from excess IDC under Section 57(a)(2), and has that been modeled against the client's full return?

Summary, Next Steps & Sources

Summary

The working interest exception under Section 469(c)(3), paired with the Section 263(c) intangible drilling cost election, gives advisors a statutory, citable framework for evaluating a category of client requests that is becoming more common rather than less. The determining factor across every planning scenario in this brief — active income offset, AMT exposure, depletion, and 1031 eligibility — comes back to the same structural question: is the interest held directly, or through an entity that limits liability?

Advisors who anchor their evaluation to that single question, and to the supporting documentation outlined above, are equipped to assess any working interest program on its technical merits, including Summit Ventures' entrepreneurial joint venture structure, as one option among the alternatives their clients may bring to the table.

Next Steps

Advisors interested in a deeper technical review can request Summit Ventures' back-office educational materials, including sample K-1 packages, AFE documentation formats, and tax opinion letter templates, for internal practice reference before any client is introduced to the structure. This is intended as a resource for the advisor's own technical diligence and ongoing member onboarding process, not as a referral arrangement, and advisors are encouraged to review all materials alongside their own legal and tax counsel.

Clients navigating a liquidity event, a 1031 exchange timeline, or a concentrated income year are increasingly going to raise this category on their own. Advisors who have already done the technical homework will be the ones positioned to have that conversation with the client, rather than the operator who approached the client directly.

The provisions covered in this brief — Section 263(c), Section 469(c)(3), Section 465, Section 57(a)(2), Sections 611 and 613A, and Revenue Rulings 68-331 and 78-135 — have been part of the federal tax code and IRS guidance for decades. What has shifted is client demand for advisors who can discuss them with precision rather than in general terms, and that shift is now showing up across tax planning, wealth management, exchange coordination, transaction advisory, estate planning, and commercial real estate conversations alike.

Request Summit Ventures Technical Materials

Sources and References

- Internal Revenue Code Section 263(c) and Treasury Regulation 1.612-4 (intangible drilling cost election mechanics)
- Internal Revenue Code Section 469(c)(3)(A) (working interest exception to passive activity loss rules, direct-holding and liability-limiting entity language), Cornell Legal Information Institute, 26 U.S.C. 469
- Internal Revenue Code Section 465 (at-risk limitation rules)
- 26 U.S.C. Section 57(a)(2)(A) and Section 57(a)(2)(E) (excess intangible drilling cost as an alternative minimum tax preference item and the independent producer exception)
- Internal Revenue Code Sections 611 and 613A (percentage depletion allowance for independent producers and royalty owners)
- Internal Revenue Code Section 461(h) (economic performance rules and the 90-day drilling exception)
- Internal Revenue Code Section 168(k) as amended by the One Big Beautiful Bill Act, signed July 4, 2025 (permanent 100 percent bonus depreciation for qualifying property acquired after January 19, 2025)
- Revenue Ruling 68-331, 1968-1 C.B. 352 (working interest in a producing oil and gas lease as like-kind real property under Section 1031(a) of the 1954 Code)
- Revenue Ruling 78-135 (general partnership interest does not qualify for Section 1031 nonrecognition treatment)
- 2026 federal long-term capital gains rate brackets and Net Investment Income Tax threshold, as published by the Internal Revenue Service for the 2026 tax year