

Evaluating a Direct Working Interest Response to a Year One Active Income Spike

A Consideration Stage Case Study Examining IRC 263(c) Intangible Drilling Cost Elections, the IRC 469(c)(3) Working Interest Exception, and Entrepreneurial JV Structuring for High Bracket Professionals

CASE STUDY | CONSIDERATION STAGE | DALLAS, TEXAS

Case Classification & At-a-Glance Summary

This is an anonymized, illustrative composite profile. Figures are illustrative only — not a projection, prediction, or guarantee of any future tax or financial outcome.

Participant Type

W-2 and 1099 active income earner, orthopedic surgeon, Dallas, Texas

Trigger Event

One-time active income increase of ~$150,000 from a surgical center ownership distribution layered on top of ordinary W-2 compensation

Structure Evaluated

Direct working interest capital contribution into a Summit Ventures entrepreneurial JV producing well program, held individually

Core Mechanism

IRC 263(c) election to currently expense intangible drilling costs, combined with the IRC 469(c)(3)(A) working interest exception

$200K

Illustrative Capital Contribution

$150K

Year One IDC Deduction

Confirmed via well-specific AFE only

37%

Top Federal Bracket

Made permanent under the One Big Beautiful Bill Act

15%

Percentage Depletion

For independent producers under IRC 611/613A

Participant Profile, Trigger, and Situation

The participant in this illustrative profile is a Dallas based orthopedic surgeon in their mid forties, practicing within a multi physician surgical group. Their income is almost entirely active: a base W-2 salary from the group practice, supplemented in the trigger year by a one-time distribution tied to a partial ownership stake in an ambulatory surgical center. Texas has no state individual income tax, so the participant's full exposure on this spike falls under the federal code.

Going into the trigger year, the participant had already exhausted the standard menu of tax deferral tools available to a high income W-2 earner: a maxed employee deferral into a 401(k), a backdoor Roth IRA conversion, and modest itemized deductions tied to mortgage interest and charitable giving. Under the 2026 federal retirement contribution limits published by the IRS (Notice 2025-67, referenced in IR-2025-111), the maximum employee 401(k) deferral is $24,500, with a combined employer and employee limit of $72,000. Even at the maximum, these tools could absorb only a small fraction of the one-time $150,000 spike, because they are built for steady annual accumulation, not for offsetting a concentrated single-year increase in active income.

The spike pushed the participant's taxable income further into the top federal bracket. Under 2026 brackets set by IRS Revenue Procedure 2025-32, the top 37 percent rate begins at $640,600 of taxable income for a single filer and $768,600 for a married couple filing jointly; the One Big Beautiful Bill Act made this 37 percent top rate structure permanent rather than allowing a scheduled reversion to 39.6 percent. For a participant already filing near the top of the bracket structure, the entire incremental distribution was taxed at the marginal rate, with no FICA offset available since the distribution was not W-2 wage income subject to payroll tax caps.

This profile is representative of the broader composite audience Summit Ventures works with: physicians and surgeons, dentists, attorneys, and CPAs or other financial professionals facing concentrated, high bracket income years. The specific triggering event varies (a partnership distribution, a bonus year, a liquidity event, a change in filing status) but the underlying pattern is consistent: active, ordinary-rate income that standard retirement account structures cannot absorb at scale, because the mechanism is driven by how the income is classified under the tax code, not by the participant's specific profession.

Challenge and Decision Criteria

The central challenge the participant brought to their CPA was straightforward to state and difficult to solve with conventional tools: how does a high earning, risk averse professional meaningfully reduce the tax burden on a one-time active income spike, using a mechanism grounded in existing statute rather than a syndicated shelter product with uncertain audit durability.

The participant and their advisor established several decision criteria before evaluating any specific structure:

Statutory Grounding

The mechanism needed to rest on a clearly codified section of the Internal Revenue Code, not an aggressive or novel interpretation.

Active Income Offset

The deduction needed to be capable of offsetting active (W-2 and 1099) income directly, since the participant had no meaningful passive income against which to apply a loss.

Operational Transparency

The structure needed to preserve direct accountability and line of sight into the underlying asset, consistent with a preference for transparency over an opaque, pooled financial product.

Defensible Paper Trail

It needed to produce a defensible paper trail, including documented capital contribution and a well-specific cost breakdown.

Full Reporting Clarity

The participant needed to understand, before contributing capital, how the position would be reported and what ongoing obligations (at-risk basis tracking, AMT exposure, depletion calculations) would follow in later years.

Options and Structural Approach

The participant's advisor outlined three broad categories of response to the spike.

1

Option 1: Do Nothing

Absorb the liability, relying only on existing itemized deductions. This preserved simplicity but left the full marginal impact of the spike in place.

2

Option 2: Passive Fund Allocation

Evaluate a real estate syndication or diversified alternative asset fund. These structures can offer diversification and professional management, but losses generated inside most passive vehicles are limited under IRC Section 469 to offsetting other passive income — which the participant did not have in meaningful quantity. A passive structure would not have reached the active income spike at all.

3

Option 3: Direct Working Interest (Selected)

A direct working interest capital contribution into a producing oil and gas well program structured as an entrepreneurial joint venture. IRC Section 469(c)(3)(A) excludes a working interest in an oil or gas property from the general definition of a passive activity, provided the participant's form of ownership does not limit liability. This statutory distinction was the deciding factor: losses and deductions generated by a properly structured, directly held working interest position could offset active W-2 and 1099 income in the same tax year.

Held through a liability-limiting entity such as a standard LLC or limited partnership interest, the same working interest would be treated as passive, and the IRC 469(c)(3)(A) exception would not apply.

Implementation: Five Documented Steps

Once the participant and their CPA selected direct working interest participation as the structural approach, the implementation proceeded through five documented steps.

01

Entity and Ownership Review

The participant's advisor confirmed that the Summit Ventures entrepreneurial JV program offered a direct working interest position rather than a liability-limiting fund interest — the prerequisite for the IRC 469(c)(3)(A) exception to apply at all.

02

AFE and Cost Component Review

Before any capital was contributed, the advisor reviewed the well's Authorization for Expenditure, which itemizes the projected intangible drilling costs (labor, drilling fluids, fuel, and other costs with no salvage value) separately from tangible drilling costs (casing, wellheads, tanks, and other equipment with ongoing salvage value). This AFE-specific breakdown — not a generic industry average — is what ultimately determines the deductible intangible cost amount for a given well.

03

IRC 263(c) Election

Treasury Regulation 1.612-4(a) permits an operator — defined broadly enough to include a working interest holder bearing the cost of drilling — to elect to currently expense intangible drilling costs rather than capitalize them over the life of the well. The participant's CPA made this election in connection with the applicable tax return.

04

At-Risk Basis Confirmation (IRC 465)

The participant's deductible loss in any year is limited to the amount they have at risk in the activity, generally the cash contributed plus any amounts for which they are personally liable. The advisor confirmed the $200,000 capital contribution established sufficient at-risk basis to support the deduction being claimed.

05

AMT and Ongoing Reporting Review

The advisor flagged that under IRC Section 57(a)(2)(A), excess intangible drilling costs become 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. IRC Section 57(a)(2)(E) further provides independent producers a measure of relief, generally limited so the adjustment cannot reduce alternative minimum taxable income by more than 40 percent of what it would otherwise have been. The advisor modeled this exposure before the election was finalized.

Explanation and Outcome (Illustrative)

> The figures in this section are illustrative only, built to demonstrate how the mechanics interact, and are not a projection, prediction, or guaranteed outcome for any participant.

In this illustrative scenario, the participant contributed $200,000 of capital into a Summit Ventures entrepreneurial JV producing well program, held directly as a working interest. Based on the specific well's AFE, the intangible cost component supported a Year One deduction of approximately $150,000 under the IRC 263(c) election — a figure selected here specifically because it roughly matches the size of the participant's one-time active income spike, allowing the deduction to directly offset the marginal income that pushed the participant into the top bracket for that year.

Intangible Drilling Costs (~$150,000)

Labor, drilling fluids, fuel, and other costs with no salvage value. Expensed in Year One under the IRC 263(c) election. Directly offsets active W-2 and 1099 income via the IRC 469(c)(3)(A) working interest exception. Reported as nonpassive on Schedule K-1.

Tangible Drilling Costs (~$50,000)

Casing, wellheads, tanks, and other equipment with ongoing salvage value. Generally capitalized and recovered over a seven-year MACRS schedule. The One Big Beautiful Bill Act made 100 percent first-year bonus depreciation under IRC Section 168(k) permanent for qualifying property — eligibility depends on asset classification and placed-in-service date, and should always be confirmed independently with a qualified CPA.

Beyond the Year One deduction, the participant's directly held working interest also carries forward an ongoing tax attribute: once the well begins producing, a percentage depletion allowance under IRC Sections 611 and 613A — generally 15 percent for independent producers — applies against the gross income the well generates, reducing the taxable portion of ongoing production income in future years. This is a separate, longer-horizon benefit from the Year One intangible cost deduction and is reported annually as production occurs.

On the participant's Schedule K-1, the working interest position is reported using nonpassive coding, consistent with the IRC 469(c)(3) exception, which is what allowed the deduction to offset the participant's active W-2 and 1099 income rather than being suspended against a nonexistent pool of passive income.

Metrics Summary

Metric	Detail
Capital contribution (illustrative)	$200,000
Trigger-year active income spike offset	~$150,000, matched to the participant's one-time surgical center distribution
Year One deduction mechanism	IRC 263(c) intangible drilling cost election
Tangible cost component (illustrative)	~$50,000, recovered via 7-year MACRS and, where eligible, IRC 168(k) bonus depreciation
At-risk basis established	Full $200,000 cash contribution, per IRC 465
AMT preference threshold referenced	IRC 57(a)(2)(A), 65% of net oil, gas, and geothermal income; independent producer relief under 57(a)(2)(E)
Ongoing production-year benefit	Percentage depletion allowance, generally 15% for independent producers under IRC 611/613A
K-1 reporting classification	Nonpassive, active income offset under IRC 469(c)(3)(A)
State income tax exposure	None (Texas has no individual income tax); federal exposure only

Assumptions, Key Takeaways & Illustrative Reflection

> "The distribution from the surgical center was the kind of number that looks great until you see what it does to your bracket. What mattered most to me was understanding that this wasn't a shelter built on a creative reading of the code. My CPA walked me through the actual statute, the AFE for the specific well, and what I'd be responsible for tracking in future years before I contributed a dollar. I wanted a structure where I could see exactly what the capital was funding and stay accountable for understanding it, not a black box."

The above reflection is a composite, written to represent how a participant in this situation might describe the decision process. It is not a verified quote from an actual client.

Key Assumptions to Discuss with Your Advisor

- The intangible cost proportion referenced in this illustration is never assumed to be fixed across wells; it is confirmed only through the specific well's AFE and varies by engineering design, depth, and completion method.
- The deduction's usefulness in offsetting active income depends entirely on maintaining direct working interest ownership under IRC 469(c)(3)(A); the same dollar amount contributed through a liability-limiting fund or LP interest would generally be treated as passive and would not reach active W-2 or 1099 income.
- At-risk basis under IRC 465 limits the deductible amount to what the participant has genuinely put at risk; a participant should never assume a deduction exceeding their actual at-risk basis will be sustained.
- The alternative minimum tax preference calculation under IRC 57(a)(2)(A) and the independent producer relief under 57(a)(2)(E) are participant-specific calculations that depend on each individual's full tax picture, not a flat adjustment that applies identically to every participant.
- Bonus depreciation treatment of tangible drilling costs depends on asset classification and placed-in-service timing under IRC 168(k) and should be confirmed for each specific well program, not assumed as a blanket benefit.

The key takeaway for a Consideration stage reader evaluating this type of structure is that the tax mechanics are driven by statute, not by Summit Ventures' own representations: IRC 263(c), 469(c)(3)(A), 465, 57(a)(2), and 611/613A all exist independently of any specific JV program, and a reader's evaluation should center on how a given program's ownership structure, AFE documentation, and operational transparency align with those statutory requirements.

Questions for Professional Advisor Discussion

This case illustrates a structural pattern, not a guaranteed path: a high earning professional facing a concentrated active income spike evaluated a direct working interest position specifically because it offered a statutory mechanism capable of reaching active income, paired with the kind of documented, operationally transparent participation that a risk averse, time constrained professional could evaluate alongside their own advisor rather than accept on faith. The underlying code sections — IRC 263(c), 469(c)(3)(A), 465, 57(a)(2), and 611/613A — apply to any correctly structured direct working interest position, and a reader considering a similar response to their own concentrated income year should work through each of the discussion questions below with a qualified CPA or tax attorney before contributing capital to any entrepreneurial JV program.

1

Active vs. Passive Income Mix

Does my current and projected income composition (active W-2/1099 versus passive) make an active income offset mechanism like IRC 469(c)(3)(A) relevant to my situation, or would a passive structure better fit my income mix?

2

AFE Cost Allocation

What portion of a specific well's projected cost is classified as intangible versus tangible on its AFE, and how does that allocation compare to the general industry range for similar well types?

3

At-Risk Basis Tracking

How would my at-risk basis under IRC 465 be calculated for a specific capital contribution, and what ongoing tracking would I be responsible for in future tax years?

4

AMT Exposure

Based on my full income picture, would an intangible drilling cost deduction of this size trigger the alternative minimum tax preference threshold under IRC 57(a)(2)(A), and would the independent producer relief under 57(a)(2)(E) apply to me?

5

Governance and Transparency

What governance rights and operational transparency does a specific entrepreneurial JV program provide so that I can evaluate the underlying asset directly rather than relying solely on summary reporting?

6

Percentage Depletion

How does percentage depletion under IRC 611/613A affect my tax treatment of ongoing production income once a well I hold a working interest in begins producing?

7

Documentation Expectations

What documentation should I expect to receive (AFE, K-1, operating agreement, governance materials) before and after making a capital contribution, and how does that documentation support my own tax position if reviewed?

Ready to Evaluate Your Own Concentrated Income Year?

Work through these questions with a qualified CPA or tax attorney alongside Summit Ventures' program documentation. The statutory framework is in place — the question is whether your specific facts align with it.

Explore Summit Ventures Programs

Sources and References

- Tax Foundation, 2026 Federal Income Tax Brackets, citing IRS Revenue Procedure 2025-32 (top 37 percent rate begins at $640,600 single / $768,600 married filing jointly; One Big Beautiful Bill Act made the 37 percent top rate permanent).
- Cornell Legal Information Institute, 26 U.S.C. 469(c)(3), full statutory text of the working interest exception to the passive activity definition.
- 26 U.S.C. 263(c) and Treasury Regulation 1.612-4(a), statutory and regulatory basis for the intangible drilling cost expensing election and the definition of an operator.
- 26 U.S.C. 465, at-risk limitation on allowable losses.
- 26 U.S.C. 57(a)(2)(A) and 57(a)(2)(E), alternative minimum tax preference treatment of excess intangible drilling costs and the independent producer exception.
- 26 U.S.C. 611 and 613A, percentage depletion allowance for independent producers.
- Internal Revenue Service, IR-2025-111 and Notice 2025-67, 2026 retirement plan contribution limits ($24,500 employee 401(k) deferral; $72,000 combined employer and employee limit).
- BassEXP, "Section 469 Working Interest: Active vs. Passive," educational overview of the working interest passive loss exception.
- AE Tax Advisors, "Oil and Gas Working Interest Tax Deduction," educational overview of IDC and at-risk mechanics for working interest holders.
- Anchor1031, educational resource distinguishing intangible drilling costs from tangible drilling costs and their respective tax treatment.