

Direct Working Interest Ownership vs. Oil and Gas Funds: What High Earners Choose

A Decision Stage Comparison Guide on Ownership Structure, IRC Section 263(c) Tax Treatment, Governance, and Cash Flow for Physicians, Dentists, Attorneys, and CPAs

COMPARISON GUIDE | TAX STRATEGY | HIGH EARNERS

Introduction

If you are a physician, dentist, attorney, or CPA earning $150,000 to $400,000 or more annually, you already know that conventional tax planning stalls at a certain income tier. A 401(k), a backdoor Roth, and a backdoor IRA matter, but together they shelter a small fraction of a high earner's taxable income. Once a professional identifies domestic oil and gas development as a statutory, IRS acknowledged category of current year tax relief under IRC Section 263(c), a second and equally important question follows: should that capital be deployed as a direct working interest owner, or allocated into a pooled oil and gas fund.

This is not a cosmetic distinction. The legal structure you select determines whether your share of intangible drilling cost (IDC) deductions can offset your active W-2, 1099, or K-1 income at all, how much governance and transparency you retain over the asset, how liquid your capital is, and how much of your eventual production revenue is absorbed by management fees and carried interest before it reaches you. This guide compares both structures on their own terms, using verified statutory citations rather than promotional claims, so that you and your CPA can evaluate which model, if either, fits your tax position and risk tolerance.

$150K+

Annual Income Tier

Where conventional tax planning begins to stall for high earners

263(c)

IRC Section

Statutory basis for current year intangible drilling cost deductions

469

IRC Section

Passive activity loss rules — the critical structural dividing line

What Is Compared

This guide evaluates two distinct methods of participating in the economics of domestic oil and gas development:

Option A — Direct Working Interest Ownership

A participant acquires a direct fractional working interest in a specific well or group of wells, typically as a business participant in an entrepreneurial joint venture governed by a joint operating agreement (JOA), or as a working interest owner holding the asset directly or through an entity that does not limit liability.

Option B — Oil and Gas Fund

A participant contributes capital to a pooled investment vehicle, commonly structured as a limited partnership (LP) or limited liability company (LLC), where a third party manager or general partner acquires and manages a portfolio of oil and gas assets on behalf of all fund investors.

Both approaches provide exposure to the same underlying asset class, domestic hydrocarbon production, and both can qualify for industry specific tax provisions under the Internal Revenue Code. The difference lies almost entirely in legal structure: who bears liability, who holds operational authority, and whose tax treatment applies once that structure is set.

Evaluation Criteria

A disciplined comparison should be based on seven factors, each of which has a distinct statutory or contractual basis:

1	**Ownership & Legal Structure** How the interest is held and what rights attach to it.
2	**Participation & Operator Status** Whether the participant meets the definition of an operator under Treasury Regulation 1.612-4(a).
3	**Governance & Control** Who approves capital expenditures, well design, and operational decisions.
4	**Liquidity** How and when capital can be recovered or transferred.
5	**Tax Treatment** Whether IDC deductions can offset active income, and how depletion and AMT provisions apply.
6	**Risk & Exposure** How concentration, fee structure, and at-risk basis affect the participant's economic position.
7	**Administrative Complexity** What ongoing reporting, elections, and recordkeeping are required.

Each is addressed below for both structures before being placed side by side.

Option A: Direct Working Interest Ownership

A direct working interest is acquired when a participant holds a fractional ownership position in a well as a business participant, either individually or through an entity that does not limit liability, such as a general partnership structure. This is the threshold question for almost every downstream tax benefit discussed in this guide.

Operator Status & IDC Treatment

Treasury Regulation 1.612-4(a), issued under IRC Section 263(c), defines an operator as one who holds a working or operating interest in a property, whether as fee owner or under a lease or contract granting operating rights. A direct working interest owner typically meets this definition, which allows the participant to elect to deduct intangible drilling costs — the non-salvageable costs of labor, drilling fluid, site preparation, and similar expenditures — in the year incurred rather than capitalizing them over the life of the well. Up to 100 percent of the eligible IDC portion of a given authorization for expenditure (AFE) can qualify for this current year election. The actual percentage for any specific well depends on that well's engineering design, the mix of intangible versus tangible costs, the participant's basis and at-risk amount under IRC Section 465, and the participant's individual tax position. This figure should always be confirmed against the specific AFE with a qualified CPA before any election is made.

Active Income Offset — IRC Section 469(c)(3)(A)

The provision that determines whether an IDC deduction can offset a professional's active income is not Section 263(c) itself, but IRC Section 469(c)(3)(A), the working interest exception to the passive activity loss rules. Its statutory language excludes from passive treatment "any working interest in any oil or gas property which the taxpayer holds directly or through an entity which does not limit the liability of the taxpayer." In plain terms, when a working interest is held directly, or through a structure that exposes the holder to the liabilities of the operation, elected IDC losses are treated as active losses, available to offset W-2 wages, 1099 income, and K-1 distributions from an active trade or business. There is no material participation or hours test, unlike the real estate professional standard, and no income based phase-out, in contrast to the $25,000 passive loss allowance for rental real estate, which phases out entirely between $100,000 and $150,000 of modified adjusted gross income under IRS Publication 925. For a professional already earning well above that threshold, this distinction is the structural reason direct ownership is evaluated at all.

At-Risk & AMT Considerations

IRC Section 465 limits the deduction to the participant's actual economic exposure — cash contributed plus recourse debt for which the participant is personally liable; nonrecourse financing generally does not increase the at-risk basis. Separately, IRC Section 57(a)(2) treats excess intangible drilling costs as an alternative minimum tax preference item, but only above 65 percent of the participant's net income from oil, gas, and geothermal properties, and an independent producer exception further limits the resulting AMTI reduction to 40 percent of alternative minimum taxable income. For most direct working interest participants who are not large integrated producers, this generally means the IDC election remains a meaningful current year planning tool even after AMT is considered, though the precise outcome depends on each participant's full tax return and should be modeled by a CPA before the election is finalized.

Ongoing Depletion — IRC Sections 611 & 613A

Once a well reaches production, IRC Sections 611 and 613A permit an independent producer to claim a 15 percent percentage depletion allowance against gross income from the property, a benefit that continues for the life of the well and is not limited to original cost basis, unlike cost depletion.

Governance & Participation

A direct working interest owner typically participates in decisions through the JOA and the AFE process: reviewing and approving the scope of work and estimated cost before a well is drilled or reworked, receiving operator reporting on production and expenses, and holding a direct fractional claim on monthly net revenue once the well produces. This is a structurally active position, consistent with the governance rights that support the 469(c)(3)(A) exception in the first place, since a participant who holds unlimited liability for an operation is generally also entitled to meaningful visibility into how that operation is run.

Option B: Oil and Gas Fund

An oil and gas fund pools capital from multiple participants into a single LP or LLC vehicle, with a general partner or manager responsible for sourcing, acquiring, and operating the underlying wells. Most funds that accept outside capital under an exempt offering do so under Rule 506(c) of Regulation D, which limits participation to accredited investors as defined in Rule 501 of Regulation D — generally an individual with a net worth exceeding $1 million excluding the value of a primary residence, or income exceeding $200,000 individually, or $300,000 jointly, in each of the prior two years.

Tax Treatment & The Passive Activity Question

The defining feature of a fund structure, for tax purposes, is that it limits the liability of its investors. This is precisely the condition that IRC Section 469(c)(3)(A) excludes from the working interest exception. Because fund investors hold an interest in an LP or LLC that shields them from the liabilities of the drilling operation, their share of any IDC deduction generally defaults to passive activity treatment under IRC Section 469, meaning it can only offset passive income — such as income from other passive activities or, in some structures, royalty income — rather than the fund investor's W-2 wages, 1099 income, or active K-1 distributions. This is a frequently misunderstood point: the fund can still pass through IDC deductions and depletion to investors, but the character of that deduction, active or passive, depends on the legal form of the holding, not on the underlying asset.

Fee Structure & Economic Dilution

Pooled fund structures in this space commonly carry a management fee of 1 to 2 percent of committed capital or net asset value annually, an acquisition fee of 1 to 5 percent of purchase price on assets as they are acquired, and a carried interest, commonly near 20 percent of profits, once a preferred return hurdle of roughly 8 to 10 percent has been met. Combined, these layers typically represent an annual fee load in the range of 2 to 4 percent plus a 20 percent carry on profits above the hurdle, a cost structure that reduces the share of gross well economics that ultimately reaches the investor, independent of how the underlying wells perform.

Liquidity & Lifecycle

Fund documents in this category commonly describe a lifecycle in which periodic distributions begin within roughly six months of the fund's close, with net income reinvested during the early years of the fund's life. As the fund approaches its target life, often three to five years, reinvestment stops and a larger share of net income is distributed, with any remaining assets liquidated and proceeds distributed, net of fees, at the end of the stated term. Hold periods across this category of offering commonly range from one to eleven years, and fund interests are generally not freely transferable; secondary liquidity, where offered at all, is typically limited and subject to the fund sponsor's discretion.

Governance & Control

A fund investor is a limited partner or member, not an operator. Well selection, AFE approval, and day to day operating decisions rest with the general partner or manager, and the investor's recourse is generally limited to the reporting and voting rights, if any, specified in the fund's governing documents. This structure offers diversification across a portfolio of wells selected by a professional manager, in exchange for reduced direct control over any single asset.

Side-by-Side Comparison

The following table places both structures across all seven evaluation criteria for direct reference.

Category	Direct Working Interest Ownership	Oil and Gas Fund
Ownership	Direct fractional ownership in a specific well or group of wells, held individually or through an entity that does not limit liability.	Limited partnership or membership interest in a pooled vehicle that owns a portfolio of wells; the participant does not hold direct title to any single asset.
Participation	Participant typically meets the Treasury Regulation 1.612-4(a) operator definition and engages directly with AFE review and well level decisions.	Participant is a passive capital contributor; the manager or general partner makes all operating decisions on the participant's behalf.
Governance & Control	Governed by a joint operating agreement; participant reviews and approves AFEs and receives direct operator reporting.	Governed by the fund's LP or LLC agreement; control rests with the general partner, subject to whatever investor reporting or voting rights the agreement specifies.
Liquidity	Generally illiquid and intended as a long duration position tied to the producing life of the well; transfer requires operator and partner coordination.	Generally illiquid during the fund term, commonly one to eleven years, with distributions phased according to the fund's lifecycle and limited or no secondary market.
Tax Treatment	May qualify under IRC Section 469(c)(3)(A) for active loss treatment on elected IDC deductions, subject to IRC Section 465 at-risk limits and IRC Section 57(a)(2) AMT preference rules; percentage depletion applies once producing under IRC Sections 611 and 613A.	IDC and depletion may pass through to investors, but because the fund structure limits investor liability, the resulting losses generally receive passive activity treatment under IRC Section 469, limiting their use to offsetting passive income.
Risk & Exposure	Concentrated exposure to the specific wells selected; participant bears direct, unlimited liability exposure tied to the working interest, bounded by at-risk basis for deduction purposes.	Diversified exposure across a portfolio of wells; participant's liability is limited to capital contributed, but economic return is reduced by management fees and carried interest layered above the asset level economics.
Complexity	Requires direct review of AFEs, JOA terms, and operator reporting, along with a formal IDC election and coordination with a CPA on basis and at-risk tracking.	Administratively simpler for the participant, who receives a single K-1 from the fund, but requires diligence on the manager's track record, fee structure, and fund governing documents during the subscription process.

Advantages, Limitations & Best-Fit Scenarios

Direct Working Interest — Advantages

- Preserves eligibility for the IRC Section 469(c)(3)(A) active loss exception — the only path by which elected IDC deductions can offset active W-2, 1099, or K-1 income without an income based phase-out.
- Provides direct governance visibility into AFE approval, drilling decisions, and operator reporting.
- Avoids the layered management fee and carried interest structure common to pooled vehicles, so a larger share of net well revenue flows to the participant.

Direct Working Interest — Limitations

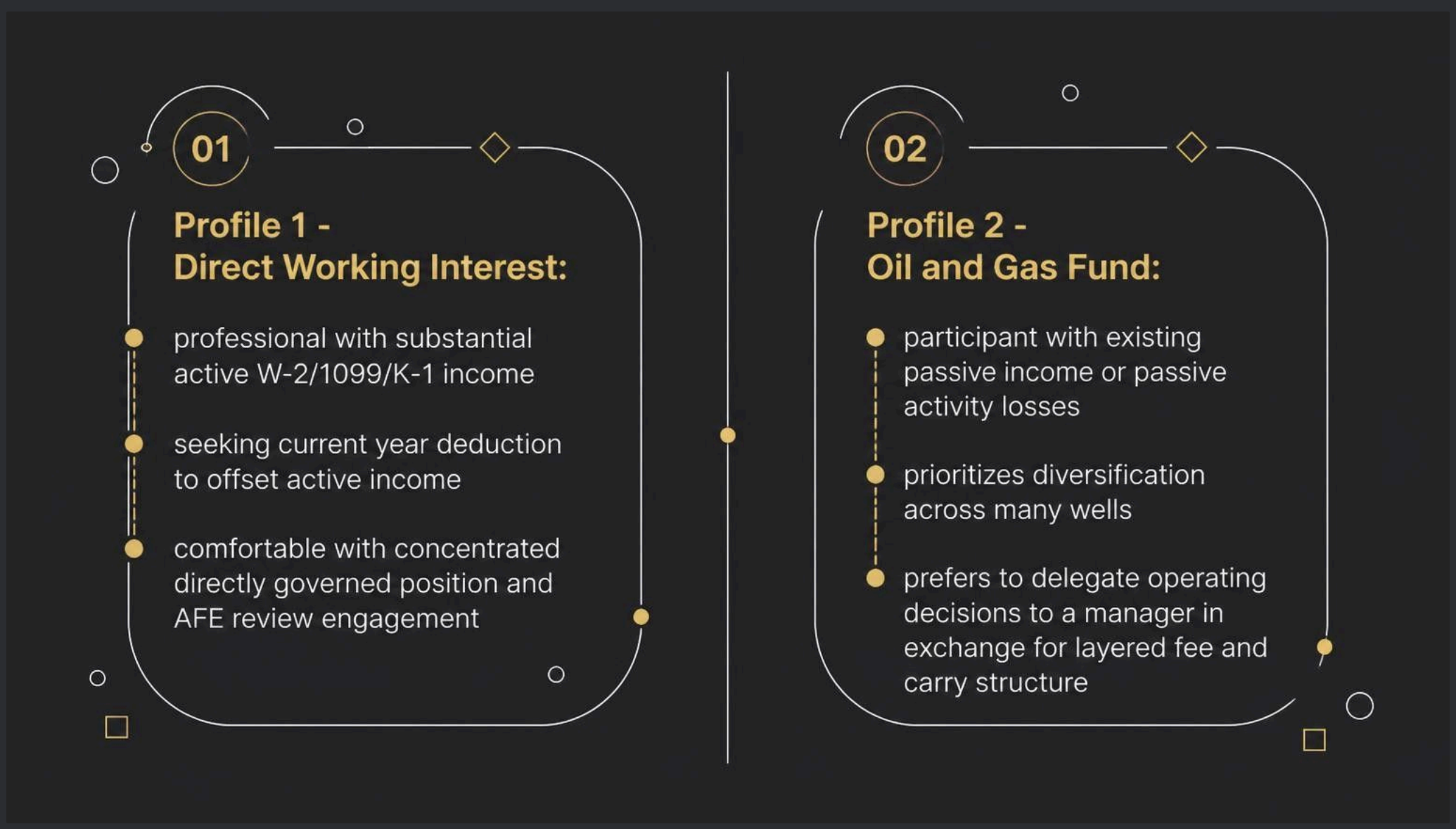
- Concentrates exposure in a smaller number of wells rather than a diversified portfolio.
- Requires the participant, with CPA support, to track basis and at-risk amounts and to actively review AFEs and operator reporting rather than delegating that work.
- Unlimited liability exposure tied to the working interest means the participant should understand the JOA's indemnification and insurance provisions before contributing capital.

Oil and Gas Fund — Advantages

- Diversifies capital across multiple wells, operators, or basins within a single vehicle.
- Delegates well selection, AFE review, and day to day operating decisions to a manager, reducing the administrative burden on the investor.
- Limits investor liability to the capital contributed, consistent with standard LP or LLC protections.

Oil and Gas Fund — Limitations

- The same liability limitation that protects the investor also forecloses the IRC Section 469(c)(3)(A) exception, so IDC related losses generally receive passive treatment and cannot offset active income for most investors.
- Management fees, acquisition fees, and carried interest reduce the share of gross production economics that reaches the investor.
- Fund terms commonly run one to eleven years with limited interim liquidity, and investor governance rights are typically narrower than those of a direct working interest owner.



Neither scenario is universal. A professional's facts — including existing passive income, at-risk basis, AMT exposure, liquidity needs, and overall portfolio concentration — should be reviewed individually with a CPA before either structure is selected.

Decision Guidance & Key Questions

Before selecting between these two structures, a professional and their advisor should work through the following sequence:

1 Confirm the Nature of Income to Offset

If the objective is reducing tax on active W-2, 1099, or K-1 income in the current year, the legal structure of the holding — not merely the asset class — determines whether that objective is achievable.

2 Review How Liability Is Allocated

Ask directly whether the interest is held as a working interest with unlimited liability exposure, as contemplated by IRC Section 469(c)(3)(A), or through an LP or LLC that limits liability, which defaults to passive treatment.

3 Request and Review Governing Documents

Request a JOA and AFE for a direct interest, or an LP or LLC agreement and private placement memorandum for a fund, and have your CPA and, where appropriate, your attorney review the tax, governance, and liquidity provisions before capital is contributed.

4 Model At-Risk and AMT Impact

Model the at-risk and AMT impact of the specific contribution amount against your full return, since the magnitude of the benefit depends on your basis, your other oil and gas income if any, and your broader AMT position — not on a flat percentage assumption.

5 Weigh Governance Engagement Against Diversification

A direct working interest asks more of the participant's attention through AFE review and operator reporting, while a fund asks less attention in exchange for reduced control and layered fees.

Eight Questions to Ask Before Committing Capital

1. Does this specific interest meet the IRC Section 469(c)(3)(A) definition of a working interest held directly or through an entity that does not limit liability, and has that determination been confirmed in writing by counsel or the sponsor?
2. What portion of the AFE for this well is classified as intangible drilling cost versus tangible equipment cost, and how was that allocation determined?
3. What is my current at-risk basis under IRC Section 465, and how would this contribution affect it?
4. Based on my other income sources, including any existing passive income, would IDC deductions from this specific structure be more useful as active or passive losses?
5. What is my expected AMT exposure under IRC Section 57(a)(2) if I make this election, and has that been modeled against my full return?
6. If evaluating a fund, what is the total annual fee load, including management fee, acquisition fee, and carried interest, and how does that compare to the direct ownership alternative?
7. What governance rights, reporting cadence, and AFE approval process apply to this specific opportunity, and how do they compare between the direct and fund structures under consideration?
8. What is the expected hold period and liquidity profile of this specific opportunity, and does that align with my broader portfolio and cash flow planning horizon?

Closing Perspective

> The choice between direct working interest ownership and an oil and gas fund is ultimately a question of legal structure — and legal structure is what determines tax treatment, not the underlying wells themselves.

A high earning professional who wants an intangible drilling cost deduction to offset active income needs a structure that satisfies IRC Section 469(c)(3)(A), which generally means direct ownership or participation through an entity that does not limit liability. A professional who prioritizes diversification, delegated management, and a simpler annual tax document — and who has other passive income to absorb passive losses — may find a fund structure better suited to those priorities, understood with full awareness of its fee layers and passive characterization.

Both paths sit within the same statutory framework that Congress has maintained for domestic oil and gas development for decades. Neither should be selected based on headline tax percentages alone. The right next step is to bring the specific opportunity — whether a direct working interest offering or a fund's private placement memorandum — to your CPA and, where appropriate, your attorney, so that the ownership structure, the AFE or fund terms, and your own basis, at-risk, and AMT position can be reviewed together before any capital contribution is made.

IRC § 263(c)

Statutory basis for electing to deduct intangible drilling costs in the year incurred.

IRC § 469(c)(3)(A)

Working interest exception — the structural key to active loss treatment for direct owners.

IRC § 465

At-risk limitation governing the deductible amount based on actual economic exposure.

IRC §§ 611 & 613A

15% percentage depletion allowance for independent producers on producing wells.

Sources & References

1. Treasury Regulation 1.612-4(a), definition of operator for intangible drilling cost election purposes under IRC Section 263(c).
2. 26 U.S.C. Section 469(c)(3)(A), working interest exception to passive activity loss rules, exact statutory text: "shall not include any working interest in any oil or gas property which the taxpayer holds directly or through an entity which does not limit the liability of the taxpayer."
3. 26 U.S.C. Section 465, at-risk limitation on deductibility.
4. 26 U.S.C. Section 57(a)(2), excess intangible drilling costs as an alternative minimum tax preference item, including the independent producer exception limiting the AMTI reduction.
5. 26 U.S.C. Sections 611 and 613A, percentage depletion allowance for independent producers.
6. IRS Publication 925, Passive Activity and At-Risk Rules, including the $25,000 rental real estate passive loss allowance and its phase-out between $100,000 and $150,000 of modified adjusted gross income.
7. SEC Rule 501 and Rule 506(c) of Regulation D, Securities Act of 1933, definition of accredited investor and exempt offering conditions commonly used by pooled oil and gas fund sponsors.
8. Industry fee benchmarking for pooled oil and gas fund structures: management fees of 1 to 2 percent of committed capital or net asset value, acquisition fees of 1 to 5 percent of purchase price, and carried interest near 20 percent above an 8 to 10 percent preferred return hurdle.
9. Industry disclosure patterns for pooled fund lifecycle and liquidity terms, including distribution timing within approximately six months of fund close, reinvestment during early fund years, and transition to full distribution and liquidation near a three to five year target fund life, with hold periods commonly ranging from one to eleven years.

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