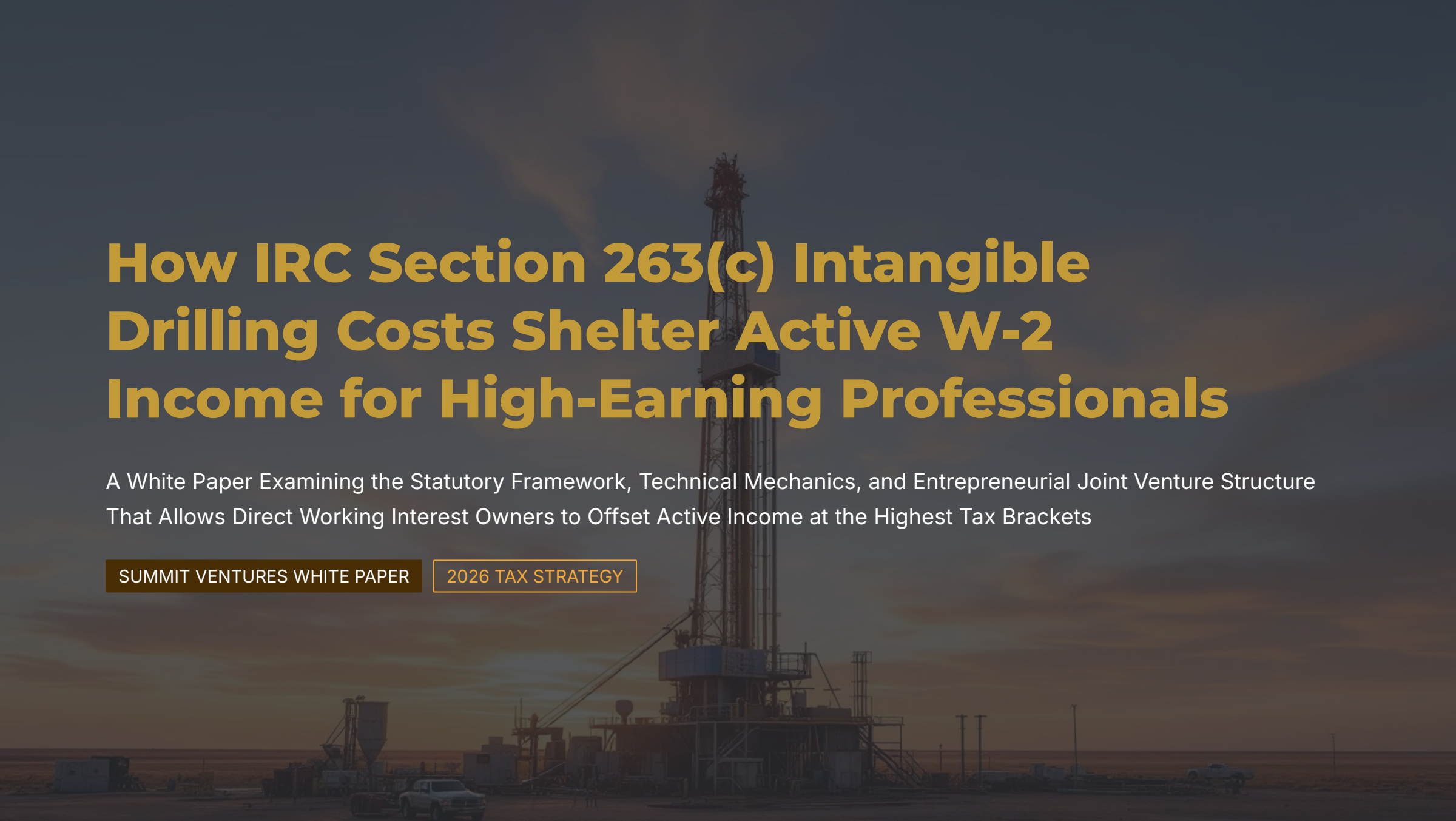


How IRC Section 263(c) Intangible Drilling Costs Shelter Active W-2 Income for High-Earning Professionals

A White Paper Examining the Statutory Framework, Technical Mechanics, and Entrepreneurial Joint Venture Structure That Allows Direct Working Interest Owners to Offset Active Income at the Highest Tax Brackets

SUMMIT VENTURES WHITE PAPER

2026 TAX STRATEGY

Executive Summary

Physicians, surgeons, dentists, attorneys, and the CPAs and financial professionals who advise them share a recurring structural problem: their income is overwhelmingly active, W-2 or 1099 in character, and it is taxed at the highest marginal federal brackets with comparatively few statutory tools available to reduce it. Retirement vehicles such as the 401(k) and backdoor Roth IRA were never designed to scale with seven-figure incomes, and most alternative asset classes marketed to this audience offer capital gains deferral rather than a direct, current-year offset to active earnings.

This paper examines a narrower and more technical question: how does the federal tax code actually allow a direct working interest in an oil and gas well to generate a deduction against active income in the same year the capital is contributed, rather than years later through depreciation or upon eventual sale? The answer rests on the interaction of two separate Code provisions that are frequently conflated in industry marketing. IRC Section 263(c), through Treasury Regulation 1.612-4, governs the election to expense intangible drilling costs (IDCs) in the year incurred. IRC Section 469(c)(3) is the separate provision that determines whether that deduction is permitted to offset active income at all, and it turns entirely on how the interest is held.

This white paper walks through the mechanics of both provisions, the at-risk and alternative minimum tax layers that modify the benefit, the historical origin of the IDC election, and the structural requirement — direct holding of the working interest — that separates a statutory tax position from a passive shelter that the IRS would recharacterize. It closes with a framework of questions every professional and advisor should raise before evaluating participation in a direct energy program.

Two Provisions. One Outcome.

IRC § 263(c) governs the timing and classification of the deduction — current expense vs. capitalized cost.

IRC § 469(c)(3) determines whether that deduction can offset active income — and it turns entirely on how the interest is held.

Both must work together correctly. This paper explains exactly how.

Introduction: Why the Topic Matters

For a surgeon earning $450,000 in W-2 compensation, an attorney drawing $380,000 in partnership guaranteed payments, or a dentist netting $310,000 from a practice, the federal income tax calculation is largely mechanical. Active income is active income. It is reported, withheld against, and taxed at ordinary rates with few remaining levers once standard retirement contributions are maxed out.

$24,500

401(k) Employee Deferral

2026 employee contribution limit

$72,000

Combined Limit

Employee + employer combined 2026 cap

$7,500

IRA Limit

Traditional or Roth IRA 2026 limit

$168K

Roth Phase-Out

Single filer MAGI threshold where Roth IRA phases out entirely

A household earning $700,000 cannot shelter a material percentage of that income through retirement accounts alone, and the Roth IRA itself phases out entirely above $168,000 in modified adjusted gross income for single filers and $252,000 for joint filers. This is the structural gap that direct participation in intangible drilling cost elections is built to address: not as a replacement for retirement planning, but as a statutory mechanism specifically available to taxpayers who hold a direct economic interest in the drilling and completion of an oil or gas well, and who structure that interest correctly.

Foundational Concepts

Three terms recur throughout this paper and should be defined precisely before proceeding.

Intangible Drilling Costs (IDCs)

The non-salvageable expenditures required to drill and prepare a well for production: labor, drilling fluid and chemicals, site preparation, hauling, and similar costs that have no residual equipment value if the well is abandoned. Tangible costs, by contrast, include casing, wellhead equipment, and storage tanks — items that retain value and are capitalized and depreciated under IRC Section 168 over a seven-year schedule rather than expensed immediately.

Working Interest

A direct ownership stake in the mineral lease that carries both the right to a share of production and the obligation to share in drilling and operating costs. This is distinct from a royalty interest, which receives a share of revenue without bearing cost responsibility, and distinct from a fund or limited partnership unit, which represents an indirect claim on a pooled vehicle rather than direct ownership of the lease itself.

Active Income

W-2 wages, 1099 contractor income, and guaranteed payments or ordinary K-1 income from a business in which the taxpayer materially participates — as opposed to income the Code classifies as passive.

The Problem: A Structural Gap in High-Income Tax Planning

The core challenge facing this audience is not a lack of deductions in the abstract. It is the absence of deductions that are:

1 Statutory Rather Than Promotional

Grounded in the actual Code, not a marketed structure that depends on aggressive interpretation.

2 Available Without a Material Participation Test

A practicing surgeon or litigating attorney has no time to satisfy an hours-based test. The right provision should not require it.

3 Structured to Withstand IRS Scrutiny

Correctly formed so the deduction does not collapse into a passive loss that cannot touch active income at all.

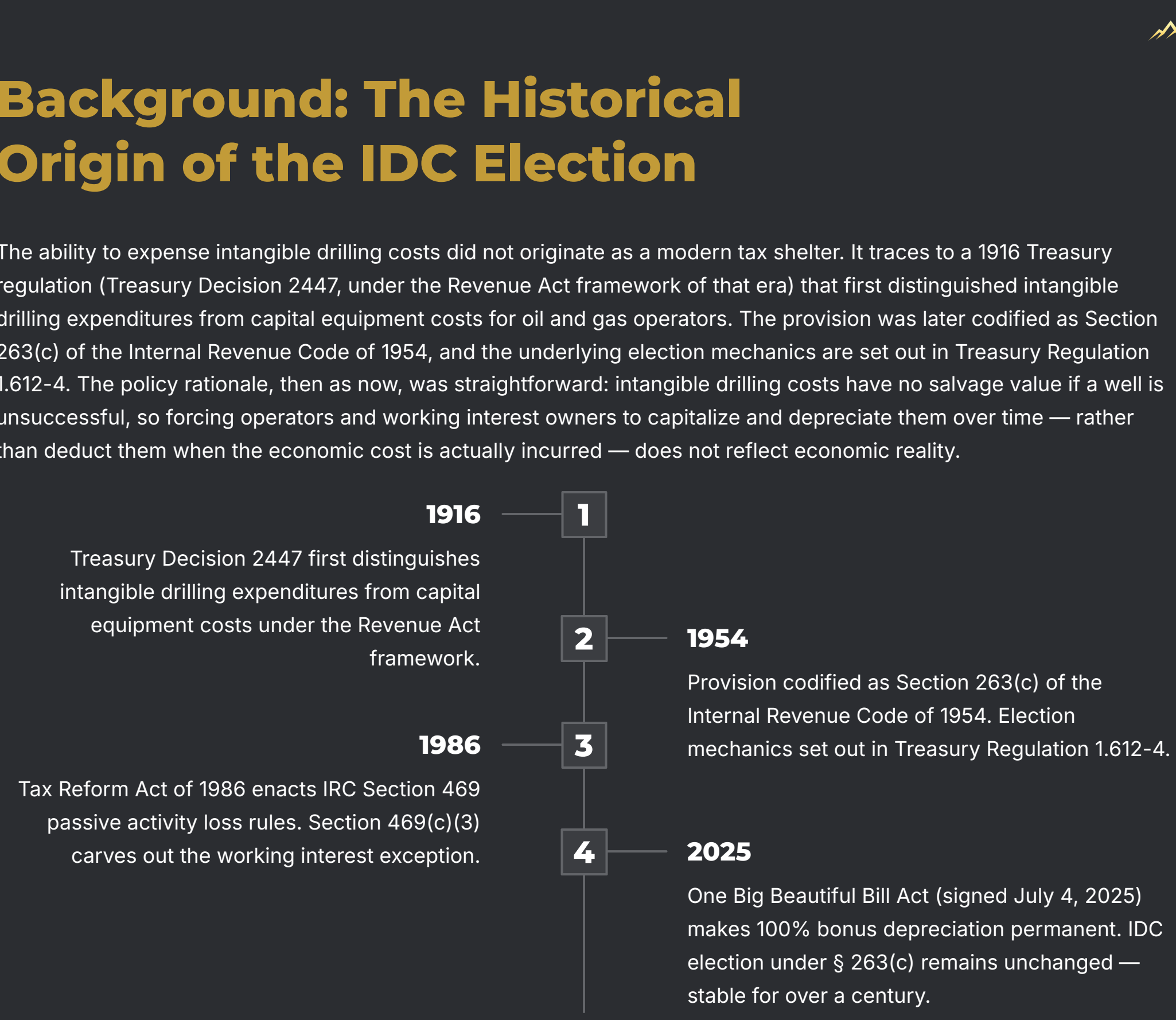
Many professionals in this income bracket have already been approached with alternative asset offerings: high-yield notes, unrated private credit, or balance-sheet-heavy operating businesses marketed on the promise of outsized yield. These structures may or may not perform, but they typically share one trait relevant to this paper: they do not provide a current-year deduction against active income, because they are not structured around a Code provision designed for that purpose.

Oil and gas intangible drilling cost elections are unusual in the tax code precisely because Congress built a mechanism — decades ago — that was designed from the outset to encourage direct capital participation in domestic drilling by allowing immediate expensing rather than capitalization.

⚠ Getting the IDC election right under Section 263(c) is necessary but not sufficient. If the underlying interest is held through the wrong kind of entity, the resulting deduction is still trapped as a passive loss under Section 469 and cannot offset a single dollar of W-2 or 1099 income.

Background: The Historical Origin of the IDC Election

The ability to expense intangible drilling costs did not originate as a modern tax shelter. It traces to a 1916 Treasury regulation (Treasury Decision 2447, under the Revenue Act framework of that era) that first distinguished intangible drilling expenditures from capital equipment costs for oil and gas operators. The provision was later codified as Section 263(c) of the Internal Revenue Code of 1954, and the underlying election mechanics are set out in Treasury Regulation 1.612-4. The policy rationale, then as now, was straightforward: intangible drilling costs have no salvage value if a well is unsuccessful, so forcing operators and working interest owners to capitalize and depreciate them over time — rather than deduct them when the economic cost is actually incurred — does not reflect economic reality.



This matters for context because it distinguishes the IDC election from recently enacted, politically contingent provisions that may sunset or phase down. Bonus depreciation under IRC Section 168(k), for example, was scheduled to phase down under the Tax Cuts and Jobs Act before the One Big Beautiful Bill Act, signed July 4, 2025, made 100 percent bonus depreciation permanent for qualifying property acquired after January 19, 2025. The IDC election under Section 263(c), by contrast, has operated on a stable, election-based first-year expensing basis for most of the past century and was not altered by that legislation.

The Market Context for 2026

U.S. crude oil production reached a record 13.6 million barrels per day in 2025, according to the U.S. Energy Information Administration, with the Permian Basin alone accounting for roughly 48 percent of that total, or approximately 6.6 million barrels per day. This figure is cited here as domestic production context, not as a return projection or forecast of any individual well's output. It illustrates that direct working interest participation sits inside an active, producing domestic industry rather than a speculative or emerging one — which is a relevant consideration for professionals evaluating where a statutory tax position is actually being applied.

Analysis: How the Two Provisions Work Together

How Section 263(c) Works Mechanically

Under Treasury Regulation 1.612-4, a taxpayer who holds an operating or working interest in an oil and gas property may elect to deduct intangible drilling costs in the taxable year they are paid or incurred, rather than capitalizing them into the basis of the property. Industry sources consistently describe IDCs as commonly representing somewhere in a range of 60 to 85 percent of total well cost, depending on well design, geology, and completion method. This is an industry-observed range, not a fixed or guaranteed percentage for any specific well or participant, and the actual allocation for any given program is confirmed through the Authorization for Expenditure (AFE) and the operator's accounting of actual costs incurred. The remaining tangible cost component — casing, wellhead, and surface equipment — is capitalized and depreciated on a seven-year schedule under Section 168.

The Provision That Actually Does the Work: Section 469(c)(3)

This is the single most misunderstood point in popular discussion of oil and gas tax benefits, and it is the reason this paper treats Section 263(c) and Section 469(c)(3) as two distinct and equally necessary components rather than a single "oil and gas deduction."

Section 263(c) governs only the timing and classification of the deduction — current expense versus capitalized cost. It says nothing about whether that deduction can offset active income. That question is governed separately by IRC Section 469, the passive activity loss rules enacted as part of the Tax Reform Act of 1986 to prevent taxpayers from using passive investments to shelter active wages.

> Section 469(c)(3)(A) carves out a specific, narrow exception: a working interest in an oil or gas property is excluded from the definition of a passive activity — provided the taxpayer holds that interest directly or through an entity that does not limit the taxpayer's liability.

The practical consequence is significant and differs sharply from other passive-loss exceptions professionals may already be familiar with, such as real estate professional status. Qualifying for the real estate professional exception requires a demanding hours-based material participation test — generally 750 hours and more than half of the taxpayer's personal services in real property trades — a standard that is simply incompatible with the schedule of a practicing surgeon, a trial attorney, or a managing dentist. **Section 469(c)(3) imposes no such hours test.** The exception is available because of how the interest is legally held, not because of how many hours the taxpayer spends on-site.

Structure Determines Outcome

If the same economic interest is held through a limited liability company or limited partnership — the kind of entity most retail investment funds use specifically to shield investors from liability — the working interest exception under Section 469(c)(3) is **lost.**

The deduction reverts to passive treatment and can only offset other income the Code classifies as passive — not the W-2 wages, 1099 income, or active K-1 distributions this audience is trying to shelter.

A direct, undivided working interest position — or one held through an entity that does not limit liability — is what preserves the active-income offset.

This is why the legal structure of a participation vehicle is not a secondary detail. It is the mechanism itself.

Additional Layers That Modify the Benefit

Three further Code provisions shape the actual deduction available to any individual participant, and a complete technical picture requires all three.

1

IRC Section 465 — At-Risk Limitation

Caps the deduction at the taxpayer's actual economic exposure: cash contributed plus any recourse debt for which the taxpayer is personally liable. Nonrecourse financing does not count toward at-risk basis for this purpose.

2

IRC Section 57(a)(2) — AMT Treatment

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. Section 57(a)(2)(E) provides a separate exception for independent producers, subject to a cap: the resulting reduction in AMTI cannot exceed 40 percent of AMTI computed without regard to that reduction. The combined, practical effect is that IDC deductions generally cannot reduce AMTI below roughly 60 percent of pre-deduction income for independent producers claiming the exception. This 65/40/60 relationship is a meaningful planning constraint, not a disqualifying one — and it is precisely the kind of detail a CPA should model before a participant finalizes a capital contribution.

3

IRC Section 461(h) — Economic Performance Rule

Applies the economic performance rule to IDC timing, which matters for year-end planning. A taxpayer generally cannot prepay and deduct IDCs for a well that will not begin drilling within a limited window — commonly described as a 90-day drilling exception — meaning late-December capital contributions for wells with delayed spud dates may not generate a current-year deduction.

The Ongoing Depletion Benefit

Once a well reaches production, IRC Sections 611 and 613A provide an ongoing, separate benefit: a **15 percent percentage depletion allowance** against gross income from the property for independent producers and royalty owners, available year after year as the well produces, independent of the original IDC election.

What the Statute Does Not Shelter

A complete technical picture also requires noting what Section 469(c)(3) does not do. Holding a working interest directly, rather than through a liability-limiting entity, can expose the holder to self-employment tax treatment questions on related income in certain fact patterns — an issue examined in *Methvin v. Commissioner* before the Tenth Circuit. This is precisely the kind of nuance that belongs in a conversation with a CPA or tax attorney before structuring a capital contribution, not a detail to gloss over in pursuit of a larger headline deduction figure.

Solution: The Summit Ventures Framework

Summit Ventures operates as an entrepreneurial joint venture platform built specifically around the structural requirement described above: active JV members hold a direct working interest position, or participate through an entity structure designed not to limit liability in the manner that would forfeit the Section 469(c)(3) exception. This is the foundational design decision — not an afterthought — because it is the only structure under which the IDC deduction generated through Section 263(c) can actually reach a member's active W-2, 1099, or K-1 income.

Direct Working Interest Ownership

Business participants hold an actual fractional interest in the producing or production-ready well — not a share in a pooled fund or a security issued by a sponsor. This is the structural foundation that preserves both the active-income offset and the character of the position as a direct business interest rather than a passive financial product.

Operational Transparency

Active JV members receive documentation tied to the actual Authorization for Expenditure for the well, so the IDC-to-tangible-cost allocation reflects confirmed, well-specific costs rather than a marketed percentage applied uniformly across unrelated projects.

Governance Rights

Participation in an entrepreneurial joint venture structure carries decision rights and shared operational exposure that a limited partnership unit in a passive fund does not — consistent with the legal substance required under Section 469(c)(3).

Long Operating Horizon

Once a well is producing, it generates monthly cash flow to working interest owners for the productive life of the asset, during which the ongoing percentage depletion allowance under Sections 611 and 613A continues to apply — separate from and in addition to the original first-year IDC election.

This framework is not a substitute for professional guidance, and it is not presented as a guaranteed outcome. It is a description of how the statutory mechanics above are implemented operationally, so that a CPA, tax attorney, or financial professional reviewing the structure on a client's behalf can verify — line by line — that the legal form matches what Section 469(c)(3) requires.

Learn More at Summit Ventures

Recommendations and Implications

For the professional evaluating this strategy, three implications follow directly from the analysis above.

Never Treat the Deduction Percentage as a Fixed Number

The 60 to 85 percent range cited throughout industry sources is useful for initial planning conversations with a CPA, but the figure that matters is the one confirmed against the actual costs of the specific well or wells in which capital is contributed. The deduction percentage should never be treated as a fixed number quoted before a specific well's AFE is reviewed.

Review Entity Structure Before Capital Is Contributed

A professional's own CPA or tax attorney should confirm in writing that the holding structure preserves — rather than forfeits — the Section 469(c)(3) working interest exception. This single structural question determines whether the entire strategy accomplishes its stated purpose. The entity structure through which a position is held should be reviewed before, not after, capital is contributed.

Model This Strategy Alongside the Full Tax Picture

This strategy should be modeled alongside a professional's full tax picture for the year, including the AMT preference calculation under Section 57(a)(2), at-risk basis under Section 465, and the excess business loss limitation under Section 461(l) — which for 2026 sits at $512,000 for married filing jointly taxpayers. A deduction that is technically available but exceeds at-risk basis, or that triggers AMT exposure beyond the 65/40/60 relationship described above, does not deliver the full benefit a participant may expect from a first-year percentage alone.

> The broader implication for this audience is that intangible drilling cost elections occupy a different category than most alternative assets marketed to high-income professionals. The benefit is not a yield promise or a return projection. It is a statutory election, grounded in a century-old provision of the tax code, that becomes available specifically because of how an interest is held and specifically because the taxpayer is directly exposed to the economics of drilling a well. Evaluating it requires the same rigor a professional would apply to any other statutory election: confirm the facts, confirm the structure, and confirm the result with a qualified advisor before relying on it.

Questions for Professional Advisor Discussion

Before evaluating or confirming participation in a direct working interest program, professionals and their advisors should work through the following:

Entity Structure & § 469(c)(3)

Does the specific holding structure offered preserve the Section 469(c)(3) working interest exception, or does it use an LLC, LP, or fund structure that would cause the deduction to revert to passive treatment?

Confirmed IDC Allocation

What is the confirmed IDC-to-tangible-cost allocation for the specific well or wells involved, as documented in the Authorization for Expenditure — rather than a generalized industry percentage?

At-Risk Basis Under § 465

What is the participant's at-risk basis under Section 465, accounting only for cash contributed and any recourse debt for which the participant is personally liable?

AMT Preference Calculation

How does the Section 57(a)(2) AMT preference calculation interact with the participant's broader income picture for the year, and does the participant qualify for the independent producer exception under Section 57(a)(2)(E)?

Timing & § 461(h) Economic Performance

Does the timing of the capital contribution align with the Section 461(h) economic performance rule and the 90-day drilling exception, or does a delayed spud date push the deduction into a later tax year than expected?

Production Timeline & Depletion

What is the expected timeline for the well to reach production, and how does the ongoing Section 611/613A percentage depletion allowance factor into the participant's multi-year tax planning once production begins?

Full-Picture Integration

How does this strategy interact with the participant's existing retirement contributions, excess business loss limitation under Section 461(l), and overall marginal bracket position for the year?

Reviewing these questions with a CPA, tax attorney, or financial professional before contributing capital is the appropriate first step for any professional considering this strategy — not a formality to complete afterward. The structural details examined throughout this paper — direct holding, confirmed cost allocation, at-risk basis, and AMT interaction — are precisely the details that separate a defensible statutory tax position from a position that cannot withstand review. For physicians, surgeons, dentists, attorneys, and the financial professionals who advise them, understanding this distinction is the foundation for any further evaluation of direct energy participation as part of a broader, professionally reviewed tax and wealth strategy.

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Ready to Evaluate Direct Working Interest Participation?

Speak with the Summit Ventures team to review how the statutory framework described in this white paper applies to your specific tax situation — before contributing capital.

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