How a Dallas Orthopedic Surgeon Shielded $150,000 of Active Income in Year One

An Illustrative Case Study on Direct Working Interest Participation, IRC Section 263(c) Intangible Drilling Costs, and the Statutory Mechanics Behind Offsetting W-2 and 1099 Income

This case study presents an anonymized, illustrative composite scenario built from publicly available statutory tax law. It does not describe an identified Summit Ventures participant, and no specific financial outcome is promised or guaranteed. Every figure is a hypothetical illustration intended to show how the mechanics of IRC Section 263(c) and related provisions interact with a high-earning professional's tax return. Tax treatment always depends on individual facts, entity structure, and timely professional guidance.

Case Classification & At-a-Glance Summary

Case Type

Illustrative composite, consideration-stage

Primary Statute

IRC Section 263(c) — intangible drilling cost election

Participant Type

High-earning active-income professional (orthopedic surgeon, composite profile)

Structure Used

Direct working interest capital contribution in a producing-field joint venture program, held individually rather than through a liability-limiting entity

Supporting Statutes

- IRC Section 469(c)(3) — working interest exception to passive-loss rules
- IRC Section 465 — at-risk limitation
- IRC Section 57(a)(2)(A) — AMT preference treatment
- IRC Sections 611 and 613A — percentage depletion

$200K

Capital Contribution

$150K

Year One IDC Deduction

The remaining tangible cost basis of approximately $50,000 is recovered through depreciation under MACRS with IRC Section 168(k) bonus depreciation, subject to placed-in-service confirmation.

Participant Profile, Trigger & Situation

The composite participant in this case is a Dallas-based orthopedic surgeon in a multi-physician practice. Texas does not levy a state individual income tax, so the surgeon's exposure to this situation was entirely a function of federal brackets. In the tax year under review, a one-time ambulatory surgical center distribution added approximately $150,000 of active income on top of regular W-2 and 1099 compensation from surgical and consulting work. That spike pushed a meaningful share of the year's income into the top federal bracket, which for 2026 begins above $640,600 of taxable income for a single filer and $768,600 for a married couple filing jointly under the permanently extended top marginal rate structure.

The surgeon had already maximized the standard toolkit available to a W-2 and 1099 earner: the solo 401(k) or employer plan up to the 2026 combined limit of $72,000, and a backdoor Roth IRA to work around the direct Roth contribution phase-out that begins at $153,000 of modified adjusted gross income for a single filer. Those tools are valuable, but they are capped by statute and do not scale with a one-time six-figure income event. The surgeon also held a passive real estate fund position and a handful of brokerage accounts, neither of which could offset active income because passive losses under IRC Section 469 generally may only offset passive income, not wages or self-employment earnings.

This profile is representative of the broader professional audience Summit Ventures works with, including dentists, attorneys, and CPAs who reach similar income thresholds through partnership distributions, bonus compensation, or a strong year in private practice. The underlying mechanism in this case is driven by how the income is classified under the tax code, not by the specific medical, dental, legal, or accounting profession involved. Any active-income earner facing a comparable bracket event confronts the same structural question: what statutory, non-syndicated mechanism exists to offset active income directly, rather than relying on a passive vehicle that cannot reach it.

Challenge & Decision Criteria

The surgeon's CPA framed the core problem clearly: the existing retirement and tax-deferred toolkit could not absorb a one-time active-income spike of this size, and standard brokerage or real estate holdings generate passive income or capital gains that are taxed favorably but do nothing to offset the current year's ordinary income exposure. The decision criteria the surgeon and the CPA applied before evaluating any option included the following.

1 Statutory Foundation

The mechanism had to rest on an established statutory provision, not a promotional or syndicated tax-shelter structure.

2 Active Income Offset

Any deduction had to apply against active income specifically, since the spike in question was W-2 and 1099 income, not passive income.

3 Entity Structure Review

The entity structure had to be reviewed carefully, since certain tax benefits under the Internal Revenue Code depend on how an interest is held.

4 Verifiable Operational Data

The underlying asset had to produce verifiable operational data (an authorization for expenditure, ongoing production reporting) rather than rely on unaudited projections.

5 CPA Compatibility

The commitment had to fit within the surgeon's existing CPA relationship rather than require abandoning established tax preparation and planning processes.

Options Evaluated & Approach Selected

The surgeon's CPA reviewed three broad categories before recommending a direct working interest structure.

Option 1: Passive Real Estate or Fund Vehicle

These structures can generate attractive depreciation benefits, but under IRC Section 469 those losses are passive by default and can only offset passive income unless the participant qualifies as a real estate professional — a high bar that a full-time surgeon could not meet.

Option 2: Limited Partnership in Oil & Gas Program

These programs often market intangible drilling cost deductions, but IRC Section 469(c)(3) is explicit that the working interest exception applies only when the interest is held directly, or through an entity that does not limit the taxpayer's liability. A limited partnership or LLC that limits liability forfeits the active-income offset and reverts the deduction to passive treatment.

Option 3: Direct Working Interest ✓ Selected

A direct working interest capital contribution into a Summit Ventures entrepreneurial joint venture program, structured so the surgeon held the interest directly as a business participant with full operational exposure and governance rights consistent with Section 469(c)(3). This preserved the statutory active-income offset while giving the surgeon fractional working interest ownership in a producing-field development program.

The direct working interest structure preserved the statutory active-income offset and provided the authorization for expenditure and ongoing production data needed to substantiate the position to the IRS if ever questioned.

Implementation: Five Coordinated Steps

The implementation proceeded through five coordinated steps, with the surgeon's existing CPA involved throughout rather than replaced.

Entity and Holding Review

Summit Ventures and the surgeon's CPA confirmed that the working interest would be held directly, satisfying the IRC Section 469(c)(3) requirement that the taxpayer not limit liability through the holding vehicle.

Authorization for Expenditure & Cost Review

The CPA reviewed the authorization for expenditure (AFE) for the specific well program, which itemizes intangible costs (labor, drilling fluids, site preparation) separately from tangible, salvage-value equipment (casing, wellhead, tanks). The intangible share of total well cost is unique to each well's engineering design and is confirmed only through that well's AFE.

Section 263(c) Election

The surgeon's CPA made the election under IRC Section 263(c) and Treasury Regulation 1.612-4 to currently expense the intangible drilling cost portion of the capital contribution rather than capitalize it, consistent with the statute's treatment of intangible drilling and development costs for an operator.

At-Risk and AMT Review

The CPA confirmed the surgeon's at-risk basis under IRC Section 465 (limited to actual cash contributed, since no nonrecourse financing was used) and reviewed the alternative minimum tax preference rules under IRC Section 57(a)(2)(A), which treat excess intangible drilling costs as a 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.

K-1 Reporting and Depletion Setup

The working interest income and deductions were reported on the surgeon's Schedule K-1 with active, non-passive coding, and the CPA set up ongoing percentage depletion tracking under IRC Sections 611 and 613A for future production income once the wells began generating revenue.

Explanation & Illustrative Outcome

The figures below are an illustrative composite, not a verified result from an identified participant, and are provided to show how the mechanics work rather than to project or promise any specific outcome.

In this illustration, the surgeon made a $200,000 capital contribution to the working interest program. Based on that specific well's AFE, the intangible cost component (the majority of total well cost, as is typical for this type of development, though the exact proportion varies by well and is never assumed to be fixed) produced an illustrative **$150,000 Year One deduction** under the IRC Section 263(c) election. That deduction applied directly against the surgeon's active income for the year, including the one-time $150,000 surgical center distribution that had triggered the original planning conversation.

The remaining approximately $50,000 of tangible, salvage-value equipment cost was capitalized and depreciated under the Modified Accelerated Cost Recovery System, with the One Big Beautiful Bill Act's permanent restoration of 100 percent bonus depreciation under IRC Section 168(k) applicable to qualifying property placed in service after January 19, 2025, subject to confirmation with a qualified tax professional based on placed-in-service dates and any applicable elections.

Because the interest was held directly rather than through a liability-limiting entity, the deduction offset active income on the surgeon's return rather than being trapped as a passive loss with no current-year use. Once the wells reached production, the surgeon's K-1 began reflecting working interest revenue alongside ongoing percentage depletion under Sections 611 and 613A, giving the surgeon a continuing operational position in the underlying wells rather than a one-time tax event alone.

$200K

Capital Contribution

Total illustrative investment into the working interest program

$150K

Year One IDC Deduction

Under IRC Section 263(c) election, applied against active income

$50K

Tangible Cost Basis

Capitalized and depreciated under MACRS with IRC 168(k) bonus depreciation

Illustrative Metrics Table

Metric	Illustrative Value / Treatment
Illustrative capital contribution	$200,000
Illustrative Year One IDC deduction under IRC 263(c)	$150,000
Active income spike offset in the same tax year	$150,000 (ambulatory surgical center distribution)
Remaining tangible cost basis	Approximately $50,000
Depreciation treatment of tangible basis	MACRS with IRC 168(k) bonus depreciation, subject to placed-in-service confirmation
At-risk basis under IRC 465	Limited to cash contributed; no nonrecourse financing used
AMT preference threshold under IRC 57(a)(2)(A)	Excess IDC above 65 percent of net oil, gas, and geothermal income
Ongoing depletion rate under IRC 611/613A	Statutory percentage depletion on future production revenue
Entity structure	Direct working interest, held individually, consistent with IRC 469(c)(3)

> "What mattered to me was not a sales pitch, it was the statute. My CPA could point to Section 263(c) and Section 469(c)(3) and explain exactly why a direct working interest, held the right way, could offset the active income I actually had that year. The authorization for expenditure gave us real numbers to work from instead of a projection. That is what let us move forward with confidence."

This reflection is a composite illustration built to represent how a participant in this situation might describe the decision process, not a verified quotation from an identified individual.

Key Takeaways, Assumptions & Questions for Your Advisor

Assumptions to Confirm Independently

Several assumptions underlie this illustration and should be confirmed independently in any real situation.

- The intangible cost proportion of any well is set by that well's specific engineering design and AFE, not by any universal industry figure, and can vary meaningfully from one program to the next.
- The AMT preference calculation depends on the participant's full tax picture for the year, including any independent producer status, and should be modeled by a CPA before the election is made.
- Bonus depreciation treatment depends on placed-in-service timing and should be confirmed against current law at the time of the capital contribution.
- At-risk basis calculations depend on how the capital contribution is financed, and any use of debt financing changes the analysis under IRC Section 465.

> The entity structure used to hold a working interest is not a technicality — it is the mechanism that determines whether a deduction can offset active income at all under IRC Section 469(c)(3).

Questions for Professional Advisor Discussion

1. Does my current entity structure for any working interest preserve the IRC Section 469(c)(3) exception, or does it limit my liability in a way that converts the deduction to passive treatment?
2. What does the authorization for expenditure for this specific well show as the intangible versus tangible cost split, and how does that compare to the well's engineering design?
3. How does my at-risk basis under IRC Section 465 change if any portion of my capital contribution involves financing rather than cash?
4. Based on my full income picture this year, including any one-time distributions, where does the AMT preference threshold under IRC Section 57(a)(2)(A) fall for me?
5. How should the remaining tangible cost basis be depreciated given current placed-in-service rules under IRC Section 168(k)?
6. What ongoing reporting will I receive once the wells reach production, and how does percentage depletion under IRC Sections 611 and 613A apply to that future income?
7. How does this working interest position fit alongside my existing retirement contributions and other holdings for overall tax and wealth planning purposes?

Sources, References & Next Steps

Sources & References

1. Internal Revenue Code Section 263(c) and Treasury Regulation 1.612-4, intangible drilling and development cost election mechanics.
2. 26 U.S.C. Section 469(c)(3)(A), Cornell Legal Information Institute, working interest exception to the passive-loss rules and the direct-holding requirement.
3. 26 U.S.C. Section 465, at-risk limitation on deductible losses.
4. 26 U.S.C. Section 57(a)(2)(A) and Section 57(a)(2)(E), alternative minimum tax preference treatment for excess intangible drilling costs and the independent producer exception.
5. 26 U.S.C. Sections 611 and 613A, percentage depletion on oil and gas production income.
6. Internal Revenue Service Revenue Procedure 2025-32, as summarized by Tax Foundation, 2026 federal individual income tax brackets.
7. One Big Beautiful Bill Act, permanent restoration of 100 percent bonus depreciation under IRC Section 168(k) for qualifying property placed in service after January 19, 2025.
8. Internal Revenue Service IR-2025-111 and Notice 2025-67, 2026 retirement plan contribution limits.
9. AE Tax Advisors, "Oil and Gas Working Interest Tax Deduction," intangible versus tangible drilling cost distinction and economic performance rule under IRC Section 461(h).
10. Anchor1031, educational resource on intangible drilling costs, entity structure requirements under IRC Section 469(c)(3), and tangible cost depreciation treatment.

Work With Summit Ventures

Working through these questions with a qualified CPA or tax attorney before making any capital contribution is the appropriate way to evaluate whether a direct working interest structure fits a specific professional's situation.

Summit Ventures operates as an entrepreneurial joint venture platform built around direct participation, with authorization-for-expenditure transparency and governance rights that allow a business participant and their advisors to evaluate the underlying well economics on their own terms rather than on the basis of projected figures alone.

The structure exists to give active-income earners a statutory, operationally grounded option to place alongside the retirement and passive vehicles they already use — not to replace the professional guidance that any tax position of this kind requires.

Explore Direct Working Interest Participation