

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

A Professional Brief on Working Interest Ownership, IRC 263(c) and 469(c)(3) Mechanics, and K-1 Reporting for Advisors Serving High-Income Clients

PROFESSIONAL BRIEF | PEER-TO-PEER | STATUTORY TAX PLANNING

Executive Takeaway and Why It Matters

Your clients earning $600K and above are asking about tax reduction strategies you may not have a specific answer for. Direct working interest ownership in oil and gas wells has been part of the Internal Revenue Code since the Revenue Act era, and it remains one of the few statutory mechanisms that allows a deduction to offset active income dollar for dollar, without an hours-based material participation test. Most advisory practices still treat oil and gas as a retail product rather than a structural tax category, which means most CPAs, RIAs, QIs, business brokers, estate attorneys, and CRE brokers are leaving a legitimate planning tool out of the client conversation entirely.

This brief is written peer to peer. It is not a product pitch. It explains the statutory mechanics behind intangible drilling cost (IDC) deductions, the working interest exception to the passive activity loss rules, the percentage depletion allowance, and the 1031 like-kind treatment of working interests, so that you can evaluate whether this category belongs in a given client's planning conversation and know what questions to ask if it does.

Who This Brief Is For

CPAs & Tax Professionals

RIAs & Wealth Advisors

Qualified Intermediaries

Business Brokers & M&A Advisors

Estate Planning Attorneys

CRE Brokers

Context: The Planning Problems High-Income Clients Bring

High-income clients routinely present planning problems that do not have clean solutions inside a traditional portfolio: a year-end W-2 or K-1 income spike from a bonus, a business sale, or a concentrated stock liquidation; a 1031 exchange where suitable replacement real property cannot be identified inside the 45-day window; or a liquidity event that needs a legitimate, IRS-recognized home for redeployed capital. Advisors are often left recommending deferral strategies, charitable structures, or simply absorbing the tax hit, because the alternative asset conversations they are familiar with (DSTs, qualified opportunity zones, private funds) do not always fit the client's timeline or objectives.

Direct working interest ownership in oil and gas wells sits in a different statutory category than most alternative assets your clients ask about. It is governed by specific Code sections and a body of Revenue Rulings that predate most modern alternative investment structures, and the tax treatment depends entirely on how the interest is held, not on the underlying commodity or operator. That distinction is the single most important thing for an advisor to understand before a client conversation goes further.

1

Year-End Income Spike

Bonus, business sale, or concentrated stock liquidation

2

1031 Timeline Pressure

45-day window closing, no suitable replacement property identified

3

Liquidity Event

Capital needs an IRS-recognized, audit-defensible home

4

Working Interest Solution

Statutory, multi-decade regulatory history — not a novel structure

Key Issue and Opportunity: Form of Ownership Is Everything

> The planning opportunity and the professional risk both come from the same mechanical fact: eligibility for active income treatment and for 1031 like-kind treatment both turn on the legal form of ownership.

A working interest held directly, or through an entity that does not limit the taxpayer's liability (such as a general partnership), is treated differently under the Code than a membership interest in an LLC, a limited partnership interest, or a fund or trust share. Get the structure wrong, and a client's deduction can be recharacterized as passive, or a 1031 exchange can fail entirely. Get it right, and the client has access to a deduction mechanism that has existed in the Code since 1954 and a like-kind treatment that the IRS itself has affirmed in a published ruling.

The Opportunity by Advisor Role

For CPAs and RIAs: A statutory, audit-defensible answer to "what else can we do before December 31."

For QIs, business brokers, and CRE brokers: A qualified replacement property or post-sale redeployment conversation grounded in a specific Revenue Ruling rather than a general alternative asset pitch.

For estate planning attorneys: An additional asset class with documented reporting that supports review inside a broader wealth transfer plan.

The Risk: Structure Determines Everything

✓ Direct or General Partnership

469(c)(3) exception applies — active income offset available

✗ LLC, LP, or Fund Structure

Exception does not apply — losses treated as passive regardless of K-1 labeling

Key Findings: The Statutory Mechanics

The following findings represent the core IRC provisions and Revenue Rulings every advisor must understand before evaluating this category for a client. These are the mechanics — not marketing assumptions.

1

IRC 263(c) — IDC Deduction Election

Allows a working interest holder to elect to expense intangible drilling costs (IDC) in the year incurred rather than capitalizing them. IDC generally includes labor, fuel, site preparation, and other non-salvageable drilling costs; tangible costs such as casing and wellhead equipment are capitalized and depreciated. The specific IDC-to-tangible-cost split is confirmed through the operator's AFE, not a flat industry assumption.

2

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

Excludes from the passive activity rules "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." No hours-based material participation test applies — differentiating this from real estate professional status.

3

IRC 465 — At-Risk Limitation

A client's deduction is limited to actual economic exposure: cash contributed plus recourse debt for which the client is personally liable. Nonrecourse financing does not increase the at-risk basis. Applies independently of the passive activity analysis.

4

IRC 57(a)(2) — AMT Preference Item

Excess IDC is an AMT preference item for independent producers, with a statutory exception: the preference generally does not apply to the extent the excess IDC deduction does not exceed 65 percent of the taxpayer's net income from oil and gas properties for the year. This is a factual calculation performed annually.

Additional Statutory Provisions

IRC 611 & 613A — Percentage Depletion

Provides a **15 percent percentage depletion allowance** on gross income from production for independent producers. This continues as an ongoing deduction once a well is producing and after the client's cost basis has been fully recovered.

IRC 461(h) — Economic Performance

Limits a client's ability to prepay IDC in December for a well that will not spud for months, subject to a **90-day drilling exception**. A recurring year-end planning detail CPAs should flag before a client wires funds in late December expecting an immediate deduction.

Rev. Rul. 68-331 — 1031 Like-Kind Treatment

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 real estate**, for purposes of Section 1031(a). The client must hold an actual direct or undivided working interest — not a partnership or fund interest — for the exchange to work.

Rev. Rul. 78-135 — Partnership Exclusion

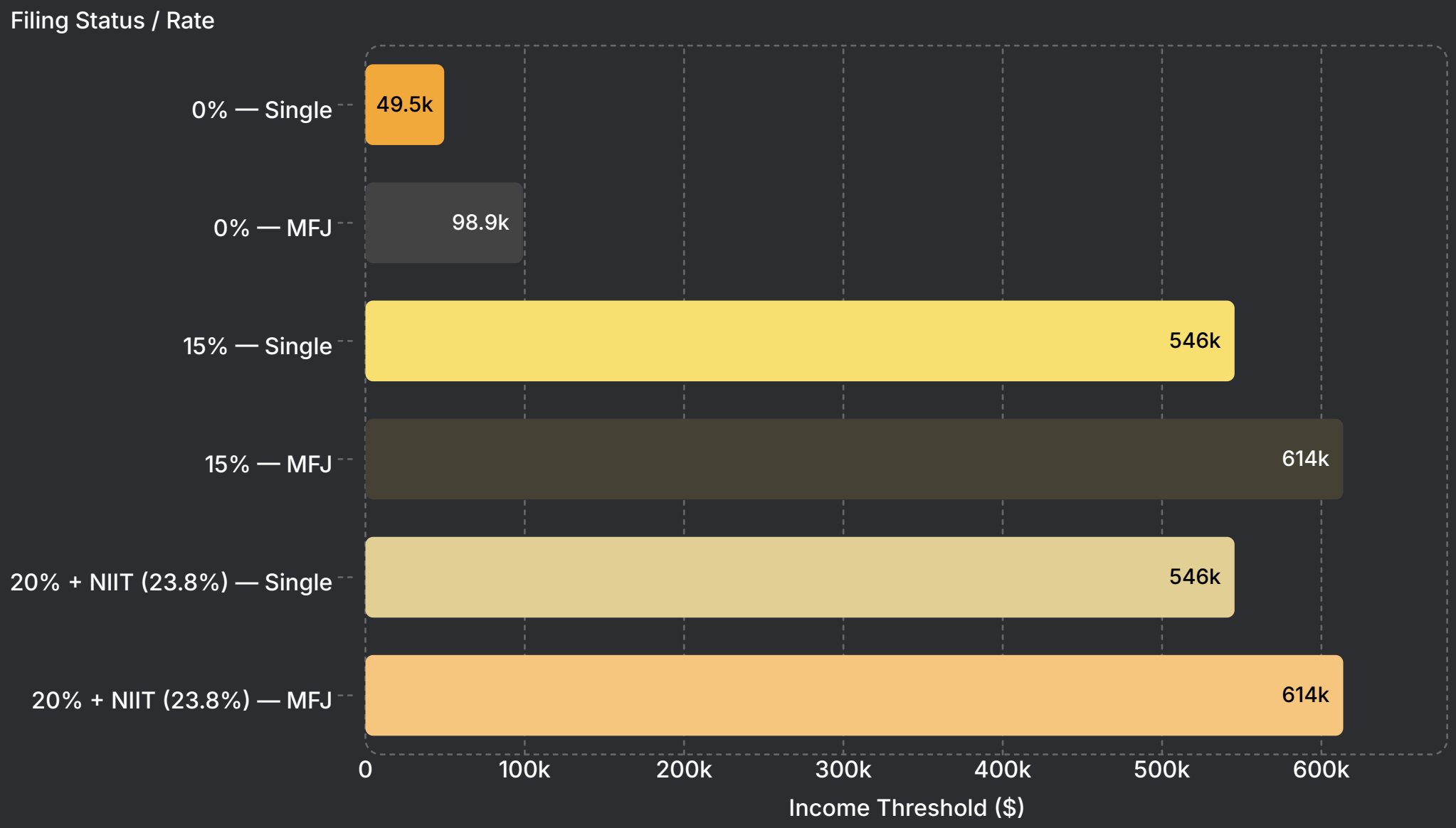
Clarifies that a general partnership interest itself does not qualify for 1031 nonrecognition. Royalty trusts and fund shares do not qualify for direct 1031 treatment. Each exchange needs independent qualification review.

⚠ IRC 461(h) Year-End Alert: Confirm the well's spud date before a client wires funds in late December. The 90-day drilling exception has specific requirements — do not assume an immediate deduction without confirming economic performance timing.

2025–2026 Legislative Update: One Big Beautiful Bill Act

The One Big Beautiful Bill Act, signed July 4, 2025, made 100 percent bonus depreciation under IRC Section 168(k) permanent for qualified property acquired after January 19, 2025, reversing the prior phase-down schedule. These figures matter when an advisor is comparing a client's marginal ordinary rate against a planning alternative.

2026 Federal Long-Term Capital Gains Brackets



The top effective rate of 23.8 percent (including the net investment income tax) is the benchmark against which a client's marginal ordinary income rate should be compared when evaluating the IDC deduction's dollar-for-dollar offset value.

Analysis: Structural Elements and Advisor-Role Guidance

Participation model. Summit Ventures operates as an entrepreneurial joint venture platform. Clients who choose to evaluate direct energy ownership become working interest owners and active JV members, not passive fund investors. Capital contribution, governance rights, and operational transparency are structured so that the holding form itself satisfies the direct-ownership and liability tests described in the findings above, which is the mechanical prerequisite for both the active income offset and the 1031 like-kind analysis your client's counsel will need to confirm independently.

Structural elements. Because eligibility under 469(c)(3)(A) and Rev Rul 68-331/78-135 depends on form, documentation matters as much as the underlying asset. Summit provides standardized, audit-ready K-1 scheduling with Box 1, 12, 13, and 20 detail, along with the allocation records an advisor needs to confirm active versus passive classification and depletion basis tracking. Tax opinion letters are available to support the 1031 and working interest analysis where a client's counsel requests independent documentation before closing a transaction.

CPAs & Tax Professionals

The practical entry point is year-end planning: a client facing a bonus, a business sale, or a concentrated gain needs a statutory offset to active income. The IDC and 469(c)(3) mechanics give you a defensible basis for that conversation, provided the holding structure is confirmed before year-end.

RIAs

The relevant frame is diversification and tax efficiency inside a broader alternative allocation, where direct energy ownership sits outside the correlation patterns of public equities and provides an ongoing depletion-sheltered income layer once a well is producing.

Qualified Intermediaries

The working interest's status as real property under Rev Rul 68-331 makes it a replacement property category worth knowing when a client's 45-day identification window is tightening and traditional real property options have not materialized.

Business Brokers & M&A Advisors

The conversation belongs after close: a seller receiving a large cash proceeds event has a capital deployment decision to make, and a statutory, IRS-recognized asset class with documented reporting is a credible option to raise alongside more familiar post-sale planning tools.

Estate Planning Attorneys

The value is an additional asset class with transparent governance and reporting that can be evaluated inside a broader wealth transfer or trust funding discussion, without displacing the attorney's own analysis of basis, step-up, or distribution mechanics.

CRE Brokers

The same 1031 and post-sale logic applies as for QIs: sellers facing a timeline problem or a gain they cannot fully defer through traditional replacement property have a statutory alternative worth understanding, even if the broker's role is simply to know the category exists and when to loop in the client's CPA and QI.

Recommendations, Due Diligence Questions, and Implications

Recommendations

1 Confirm the holding structure first

Ask whether the interest will be held directly or through an entity that limits liability — that single fact determines both the 469(c)(3) active income offset and the Rev Rul 68-331 like-kind analysis.

2 Coordinate with all advisors early

IDC timing (461(h)), at-risk basis (465), and AMT exposure (57(a)(2)) interact with decisions the CPA, RIA, QI, and attorney may each be making independently.

3 Request a tax opinion letter

Audit-ready K-1 documentation should be a standard part of due diligence, not an exception.

4 Revisit annually

Treat percentage depletion and bonus depreciation under the current OBBBA framework as ongoing planning variables, since statutory parameters and thresholds are adjusted over time.

Due Diligence Questions to Ask

Is the interest being offered as a **direct working interest**, or as a membership or limited partnership interest that would limit the client's liability and change the 469(c)(3) analysis?

What does the **AFE show** for the IDC versus tangible cost split on this specific well, and has that been confirmed in writing rather than assumed from an industry range?

Does the client's **at-risk basis under IRC 465** actually support the deduction being discussed, once nonrecourse debt is excluded?

For a 1031 conversation, is the asset a **working interest in a producing lease** consistent with Rev Rul 68-331, or a fund, trust, or royalty interest that would not qualify?

What does the **K-1 show in Box 1, 12, 13, and 20**, and does the allocation support the active versus passive classification the client is expecting?

Has the client's attorney or CPA **independently reviewed a tax opinion letter** before the transaction closes?

Implications

For advisors, the implication is categorical rather than transactional: this is a statutory tax structure with a multi-decade regulatory history, not a speculative product that needs to be vetted from scratch each time a client asks. Advisors who understand the 263(c)/469(c)(3) mechanics and the 1031 working interest precedent are positioned to have a more technical, more defensible conversation than one built around general alternative asset marketing claims. For clients, the implication is that a properly structured working interest can address a specific, time-sensitive planning problem using a tool the IRS has already defined and ruled on, rather than a novel structure whose tax treatment is uncertain.

Summary, Sources, and Next Steps

> The tax treatment of a working interest in oil and gas turns on how it is held, not on the commodity itself.

IRC 263(c) governs IDC deduction timing. IRC 469(c)(3)(A) determines whether that deduction can offset active income, and only applies to interests held directly or through an entity that does not limit liability. IRC 465 caps the deduction at real economic exposure. IRC 57(a)(2) governs AMT exposure on excess IDC, with a 65 percent of net oil and gas income exception. IRC 611/613A provides an ongoing 15 percent depletion allowance. Rev Rul 68-331 and 78-135 establish that a direct working interest — not a partnership or fund interest — can qualify as like-kind real property under Section 1031. These are the mechanics an advisor needs on hand before evaluating whether a client's situation — whether a year-end income spike, a 1031 timeline problem, or a post-sale capital deployment decision — warrants a closer look at this category.

If this category is relevant to a client conversation you are already having, a technical briefing with Summit Ventures' back office team can walk through the specific statutory analysis, K-1 structure, and documentation available for your practice, without asking you to manage an energy portfolio or change your existing advisory model. The conversation is structured as professional education and documentation review, consistent with how you would vet any statutory tax structure before bringing it to a client.

Working interest ownership in oil and gas is not a new category, but it is an underused one in most advisory practices, largely because the statutory mechanics are more detailed than a typical alternative asset conversation. For CPAs, RIAs, QIs, business brokers, estate attorneys, and CRE brokers serving high-income clients, understanding how 263(c), 469(c)(3), 465, 57(a)(2), 611/613A, and Rev Rul 68-331/78-135 fit together is the foundation for deciding whether, and how, this category belongs in a given client's plan.

Schedule a Technical Briefing with Summit Ventures

Sources and References

- Internal Revenue Code Section 263(c) and Treasury Regulation 1.612-4 (intangible drilling cost election)
- Internal Revenue Code Section 469(c)(3)(A) (working interest exception to passive activity loss rules), Cornell Legal Information Institute, 26 U.S.C. 469
- Internal Revenue Code Section 465 (at-risk limitation)
- Internal Revenue Code Section 57(a)(2) (excess IDC as AMT preference item for independent producers, 65 percent of net oil and gas income exception)
- Internal Revenue Code Sections 611 and 613A (percentage depletion allowance, independent producers)
- Internal Revenue Code Section 461(h) (economic performance rule, 90-day drilling exception)
- 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))
- Revenue Ruling 78-135 (general partnership interest does not qualify for Section 1031 nonrecognition)
- One Big Beautiful Bill Act (signed July 4, 2025) and IRC Section 168(k) permanent bonus depreciation provisions
- 2026 federal long-term capital gains rate thresholds and net investment income tax (23.8 percent top effective rate)