Evaluating a Statutory Tax Mechanism for a One-Time Active Income Spike

A Consideration-Stage Case Study Examining How IRC Section 263(c) Intangible Drilling Cost Elections and the Section 469(c)(3) Working Interest Exception Apply to a **$150,000 Active Income Increase in Year One**

DALLAS ORTHOPEDIC SURGEON CASE STUDY | ILLUSTRATIVE COMPOSITE PROFILE

This case study presents an illustrative, composite profile built from patterns Summit Ventures regularly observes among physician, surgeon, dentist, attorney, and CPA business participants who face concentrated, high-bracket active income. It is not a real, identifiable individual, and no specific dollar outcome described below should be read as a guarantee, prediction, or representation of what any participant will experience. All figures are illustrative only and should be confirmed against an actual Authorization for Expenditure (AFE), at-risk basis calculation, and tax return by a licensed CPA before any election is made.

Case Classification & At-a-Glance Summary

Case Type

Illustrative composite profile, Consideration funnel stage

Primary Persona

Physicians and surgeons — identical mechanism applicable to dentists, attorneys, and CPAs/financial professionals

Core Mechanism

IRC Section 263(c) election for intangible drilling costs (IDCs), combined with IRC Section 469(c)(3)(A) working interest exception

Participation Structure

Direct working interest capital contribution in a Summit Ventures entrepreneurial joint venture, governed by a joint operating agreement

$200K

Illustrative Capital Contribution

$150K

Year One Intangible Cost Deduction

Illustrative figure

37%

Top Marginal Rate

2026 federal ordinary income

15%

Statutory Depletion

Ongoing percentage depletion allowance

Statutes referenced throughout: **26 U.S.C. 263(c), 469(c)(3)(A), 465, 57(a)(2)(A) and (E), 611, 613A, 461(h), and 461(I)**

Participant Profile, Trigger & Situation

The participant in this composite profile is a mid-career orthopedic surgeon practicing in the Dallas-Fort Worth area, structured as a partner in an independent orthopedic group with an ownership stake in an affiliated ambulatory surgical center. Combined W-2, 1099, and K-1 income in a typical year runs in the **$450,000 to $600,000 range**. Texas imposes no state individual income tax, so the surgeon's exposure to this income is almost entirely federal, which simplifies the planning conversation but does not reduce the size of the federal liability itself.

In the trigger year, the surgical center completed a partnership distribution tied to a facility buyout, adding a one-time **$150,000** to the surgeon's active income on top of the normal practice income. Under the 2026 federal ordinary income brackets established by IRS Revenue Procedure 2025-32, and made structurally permanent by the One Big Beautiful Bill Act (OBBBA), 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. Because the surgeon's baseline income already sat near this threshold, the additional $150,000 was taxed almost entirely at the top marginal rate — a detail the surgeon's CPA flagged during a routine third-quarter projection call.

The surgeon had already reached the practical ceiling on the standard toolkit available to high-income W-2 and K-1 earners. The 2026 elective deferral limit for a 401(k) is $24,500, with a combined employee-and-employer limit of $72,000 under IRS Notice 2025-67 and IR-2025-111. Backdoor Roth contributions were also effectively closed off, since the 2026 Roth IRA MAGI phase-out range for a single filer runs from $153,000 to $168,000, well below the surgeon's actual income.

None of these mechanisms, however well used in ordinary years, were built to absorb a single, concentrated, one-time spike of this size. This is the structural gap that defines the Consideration stage for this persona: the existing passive-investment toolkit of 401(k) plans, backdoor Roth contributions, real estate syndications subject to the Section 469 passive loss rules, and conventional brokerage holdings simply does not scale with a one-time active income event.

Before evaluating Summit Ventures, the surgeon had reviewed several oil and gas offerings marketed broadly for their deduction potential. A recurring pattern emerged: many of these offerings were structured as limited partnership or LLC fund units, a detail that matters enormously for the tax outcome but is rarely emphasized in marketing materials. This profile is representative of the broader professional audience Summit Ventures works with, since the underlying issue — a mismatch between standard retirement and brokerage tools and a concentrated active income event — is driven by income classification rather than by profession. Dentists completing a practice buy-in, attorneys receiving a partnership capital distribution, and CPAs with a one-time advisory success fee face the identical structural mismatch.

The Structural Gap

Standard tools that fall short for a one-time active income spike:

- 401(k) / Cash Balance Plans — multi-year commitment, cannot absorb a single-year spike
- Backdoor Roth — MAGI phase-out at $153K–$168K, far below this surgeon's income
- Real Estate Syndications — passive by default under IRC §469; $25K allowance phases out above $150K MAGI
- LP/LLC Oil & Gas Funds — liability-limiting structure forfeits the §469(c)(3)(A) exception
- Conventional Brokerage — no mechanism to offset active income

Who Faces This Same Problem

- Physicians & Surgeons
- Dentists completing a practice buy-in
- Attorneys receiving a partnership capital distribution
- CPAs with a one-time advisory success fee

Challenge & Decision Criteria

The challenge was not simply finding "a deduction." It was finding a mechanism that satisfied several evaluation criteria simultaneously, since the surgeon's CPA was unwilling to recommend anything that could not withstand scrutiny on each of these points:

1. Statutory Basis

The mechanism needed to rest on a specific, longstanding Internal Revenue Code provision rather than an aggressive or novel interpretation. IRC Section 263(c) has permitted the election to currently deduct intangible drilling costs since **1916**, later codified as Section 263(c) of the Internal Revenue Code of 1954, and has remained a stable feature of the code through multiple tax reform cycles.

2. Active vs. Passive Classification

The deduction needed to offset **active W-2, 1099, and K-1 income**, not merely passive income — which is where most real estate and fund-based alternatives fall short for this income tier.

3. Entity Structure

The surgeon's CPA specifically wanted to understand whether the holding structure was a **direct working interest** or an interest in a liability-limiting entity, since this distinction determines whether Section 469(c)(3)(A) applies at all.

4. At-Risk Basis

The surgeon wanted clarity on how much of the capital contribution would actually support a deduction under the **at-risk limitation rules of IRC Section 465**.

5. AMT Exposure

Given the size of the one-time income spike, the surgeon's CPA wanted the **alternative minimum tax preference treatment** of excess intangible drilling costs under IRC Section 57(a)(2) reviewed in advance, not discovered at filing.

6. Depletion & Ongoing Treatment

Beyond Year One, the surgeon wanted to understand what tax treatment, if any, applies once a well begins producing — specifically the **percentage depletion allowance** under IRC Sections 611 and 613A.

Options Evaluated

Four categories of approach were evaluated against these criteria.

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Option 1: Additional Qualified Retirement Contributions

Cash balance or defined benefit plan layered on top of the existing 401(k). These plans can meaningfully increase tax-deferred contribution capacity in future years, but they require a multi-year funding commitment and could not, by themselves, absorb a single one-time spike within the same tax year it occurred. **Result: Insufficient for this scenario.**

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Option 2: Real Estate Syndications

Under IRC Section 469, rental real estate losses are passive by default, and the $25,000 active participation allowance phases out entirely once modified adjusted gross income exceeds $150,000 — a threshold the surgeon's income is well above. This effectively eliminated real estate syndications as a mechanism for offsetting active income in this case. **Result: Eliminated.**

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Option 3: Pooled Oil & Gas Fund (LP/LLC Units)

The surgeon's CPA flagged that this structure generally limits the participant's personal liability by design — which is precisely the feature that forecloses the Section 469(c)(3)(A) working interest exception. Losses from such a fund typically default to passive treatment, meaning they could offset future passive income but not the active income spike that triggered the search. **Result: Forfeits the key statutory exception.**

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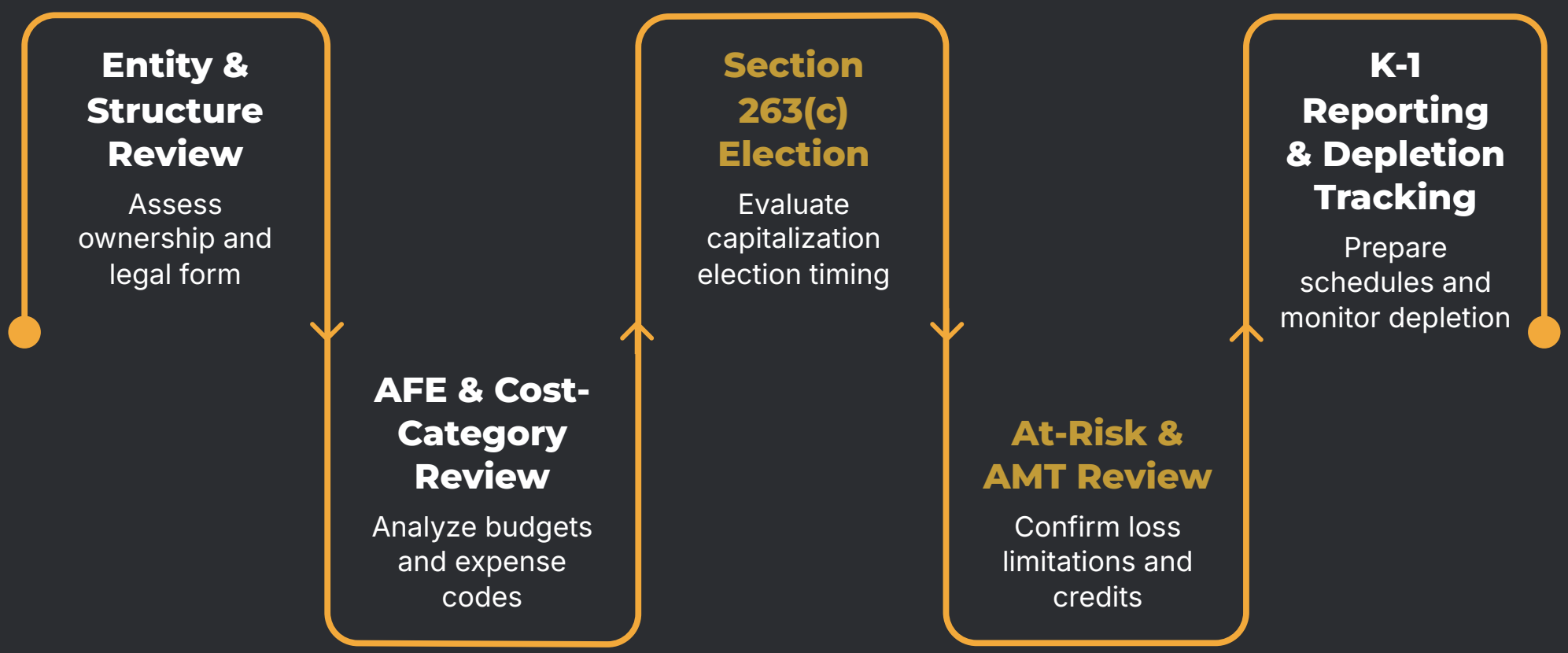
Option 4: Direct Working Interest — Summit Ventures Joint Venture

Under this model, the participant holds a direct working interest, governed by a joint operating agreement, rather than units in a liability-limiting fund vehicle. This structural choice is what allows the Section 469(c)(3)(A) exception to remain available. **Result: Selected for further evaluation.**

Implementation: Five Coordinated Steps

Once the surgeon and CPA selected direct working interest participation as the approach warranting further evaluation, the process moved through five coordinated steps.



Step 1: Entity & Structure Review

The CPA and the surgeon's attorney confirmed that the proposed holding would be a direct assignment of working interest, governed by a joint operating agreement, and not an interest in an LP or LLC that would limit the surgeon's personal liability for operations. This step is the foundation for everything that follows, since it is what the statute actually requires: Section 469(c)(3)(A) excludes from the definition of a passive activity *"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."*

Step 2: AFE & Cost-Category Review

The operator's Authorization for Expenditure was reviewed line by line with the CPA to confirm the division between **intangible costs** (labor, fuel, drilling mud, and other items with no salvage value) and **tangible costs** (casing, wellhead equipment, and other items with salvage value). This split is unique to each well's engineering design and is never assumed to be a fixed or universal percentage; it is confirmed only through the specific AFE for the specific well.

Step 3: The Section 263(c) Election

The election to currently deduct intangible drilling costs, rather than capitalize them, was made consistent with Treasury Regulation 1.612-4. Timing was addressed under IRC Section 461(h)'s economic performance rule, which generally requires that drilling activity commence within 90 days of year-end for a late-in-the-year capital contribution to support a current-year deduction.

Step 4: At-Risk & AMT Review

The surgeon's at-risk basis under IRC Section 465 was confirmed to equal the full $200,000 cash capital contribution, since no nonrecourse financing was used. The CPA separately modeled the alternative minimum tax preference rules under Section 57(a)(2)(A), under which excess intangible drilling costs become 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, and Section 57(a)(2)(E), which allows independent producers a further election limiting the resulting AMTI add-back to no more than 40 percent of AMTI computed without the preference.

The CPA also confirmed the Section 461(l) excess business loss limitation, which in 2026 caps net business losses usable against other income at **$256,000 for a single filer** and **$512,000 for a married couple filing jointly**, as a final check in the loss-limitation sequence that runs from basis, to at-risk under 465, to passive activity under 469, to excess business loss under 461(l).

Step 5: K-1 Reporting & Ongoing Depletion Tracking

The working interest income and loss is reported on Schedule K-1 as nonpassive, consistent with the direct-holding structure, and the surgeon's return preparer coded the entries accordingly. Looking forward, once the well reaches production, the **15 percent statutory percentage depletion allowance** under IRC Sections 611 and 613A applies to gross income from the property in each subsequent year, independent of the Year One intangible cost deduction.

Explanation & Illustrative Outcome

In this composite scenario, the surgeon made a $200,000 capital contribution to a direct working interest position in a Summit Ventures producing-field program. The AFE for the specific well confirmed that intangible costs represented the substantial majority of total well cost — a proportion that reflects that well's particular engineering design and is never treated as a fixed or universal figure across different wells.

Up to 100 percent of eligible intangible drilling costs can qualify for the current-year election under Section 263(c), though the actual figure for any given AFE depends on the well's engineering design, the participant's at-risk basis, and the participant's individual tax position, and should always be confirmed with a qualified CPA before the election is made. In this illustrative scenario, the confirmed intangible allocation supported a **$150,000 Year One deduction** — a figure used here only to illustrate the mechanism and not as a projection of what any future participant will receive.

Because this $150,000 figure happened to approximate the size of the surgeon's one-time active income spike, the illustrative deduction offset a comparable amount of income taxed at the 37 percent marginal rate. The remaining approximately $50,000 of tangible, completion-related cost was placed in service after January 19, 2025, making it eligible for **100 percent bonus depreciation** under OBBBA's permanent restoration of IRC Section 168(k), subject to the specific placed-in-service date and asset class confirmed by the operator and the surgeon's own tax preparer.

> The outcome turned on the structural choice made in the first implementation step. Because the working interest was held directly — through an entity that does not limit the surgeon's liability — the Section 469(c)(3)(A) exception applied, and the loss was treated as nonpassive, available to offset the surgeon's active W-2, 1099, and K-1 income rather than being trapped against passive income only.
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> Had the same capital instead been placed into an LP or LLC fund structure, the surgeon's CPA noted that the identical dollar amount of intangible cost would most likely have defaulted to passive treatment, available only against other passive income, with no ability to touch the active income spike that initiated the search.

Illustrative Mechanics Summary

The table below summarizes the key decision factors, mechanisms applied, statutory bases, and illustrative figures from this composite case study.

Decision Factor	Mechanism Applied	Statutory Basis	Illustrative Figure
Capital contribution structure	Direct working interest under a joint operating agreement, not LP/LLC fund units	469(c)(3)(A)	$200,000
Year One intangible cost deduction	263(c) election on AFE-confirmed intangible allocation	263(c); Treas. Reg. 1.612-4	$150,000 (illustrative)
Remaining tangible cost treatment	Bonus depreciation on completion equipment placed in service after 1/19/2025	168(k) (OBBBA permanent restoration)	~$50,000 (illustrative)
At-risk basis	Cash capital contribution, no nonrecourse leverage assumed	465	$200,000
AMT preference exposure	Reviewed against net oil/gas income and AMTI thresholds	57(a)(2)(A) / 57(a)(2)(E)	65% / 40% statutory thresholds
Excess business loss check	Confirmed loss fell within annual limitation	461(l)	$256,000 single / $512,000 MFJ (2026)
Ongoing depletion	Percentage depletion once well enters production	611 / 613A	15% statutory rate
Return reporting	Nonpassive working interest income/loss	Schedule K-1	Box 1/12/13/20 coding

> *"What mattered to me was not just the size of the deduction. It was understanding exactly why it worked — the difference between holding a direct interest and buying into a fund, and being able to walk my CPA through the AFE line by line before we filed anything. I wanted a mechanism I could explain to my own advisor in plain statutory terms, not something I had to take on faith."*
>
> — Composite illustration built from recurring themes Summit Ventures hears from physicians, dentists, attorneys, and CPAs evaluating this mechanism. Not attributed to any real, identifiable participant.

Key Takeaways & Questions for Your Advisor

Four Takeaways That Carry Across This Case

1 Structure Determines Tax Classification First

A direct working interest and an LP or LLC fund unit can represent economically similar capital at risk while producing entirely different tax outcomes under Section 469. Evaluating entity structure before evaluating deduction size is the single most consequential step.

2 Documented Statutory Framework Since 1916

This mechanism rests on a documented statutory framework dating to 1916 and codified in 1954 — not a marketing claim — which is precisely what made it defensible to a conservative CPA.

3 Same-Year Implementation Required

A one-time active income spike requires a mechanism that can be evaluated and implemented within the same tax year, unlike retirement plans that build capacity gradually.

4 Tax Benefit Continues Beyond Year One

Percentage depletion under Sections 611 and 613A continues once a well produces, layering an ongoing attribute on top of the initial intangible cost election.

Several assumptions underlie this illustrative case and should not be treated as universal. The scenario assumes 2026 tax-year brackets and retirement limits, Texas residency with no state income tax, a cash capital contribution with no nonrecourse financing, and a direct working interest structure confirmed by counsel to satisfy Section 469(c)(3)(A). The intangible cost allocation is never assumed to be a fixed percentage; it is confirmed only through the specific AFE for the specific well, and will differ across wells, operators, and basins. All dollar figures are illustrative and are not a representation of what any future participant will experience.

Questions for Professional Advisor Discussion

1. Does my proposed participation structure — direct working interest versus LP or LLC fund units — actually preserve the Section 469(c)(3)(A) active-income exception given how it is documented in the operating agreement?
2. What does the specific AFE show as the confirmed division between intangible and tangible costs for the well or wells I am contributing capital to?
3. How does my at-risk basis under IRC Section 465 compare to my total capital contribution, and is any portion of the arrangement financed with nonrecourse debt?
4. Based on my projected net oil and gas income and AMTI for the year, what is my realistic exposure under Section 57(a)(2)(A) and 57(a)(2)(E)?
5. Does my overall business loss position fall within the Section 461(l) excess business loss limitation for my filing status this year?
6. How will the working interest be reported on my Schedule K-1, and does the coding reflect nonpassive, active treatment on my personal return?
7. What is the expected production timeline for this well, and how should I plan for percentage depletion reporting under Sections 611 and 613A in future years?

⚠ Every one of these questions should be worked through directly with a licensed CPA or tax attorney before any capital contribution or election is made. Summit Ventures provides the operational transparency, the AFE documentation, and the governance structure that make these questions answerable; it does not and cannot substitute for individualized professional tax advice.

The Broader Pattern & Next Steps

This case illustrates a broader pattern that Summit Ventures sees repeatedly among physicians, surgeons, dentists, attorneys, and CPAs carrying concentrated active income into the highest federal brackets. The standard toolkit built around 401(k) contributions, backdoor Roth conversions, and passive real estate holdings was never designed to absorb a one-time active income event, and most broadly marketed oil and gas offerings are structured in ways that quietly forfeit the very statutory exception that makes an active-income offset possible in the first place.

Evaluating the entity structure before evaluating the deduction size is the single most consequential step a high-income professional and their CPA can take when considering this mechanism, and it is the step this case study is built to demonstrate.

Operational Transparency

Summit Ventures provides full AFE documentation so your CPA can confirm the intangible/tangible cost split for the specific well before any election is made.

Governance Structure

Direct working interest participation governed by a joint operating agreement — the structure the statute actually requires for the §469(c)(3)(A) exception to apply.

Statutory Foundation

A mechanism resting on IRC §263(c) — codified since 1954, stable through multiple tax reform cycles, and defensible to a conservative CPA.

Sources & References

[1] Tax Foundation, 2026 Federal Income Tax Brackets, reflecting IRS Revenue Procedure 2025-32 (top 37 percent rate begins at $640,600 single / $768,600 married filing jointly; OBBBA made the 37 percent top rate structure permanent). [2] Cornell Legal Information Institute, 26 U.S.C. 469(c)(3)(A), full statutory text on the working interest exception to the passive activity loss rules. [3] BassEXP, "Section 469 Working Interest: Active vs. Passive." [4] 26 U.S.C. 263(c) and Treasury Regulation 1.612-4, intangible drilling cost election mechanics and the statutory "operator" definition. [5] AE Tax Advisors, oil and gas working interest tax deduction education article. [6] Anchor1031, intangible drilling cost versus tangible drilling cost education resource. [7] 26 U.S.C. 465, at-risk limitation rules. [8] 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. [9] 26 U.S.C. 611 and 613A, percentage depletion allowance for independent producers. [10] 26 U.S.C. 461(l), excess business loss limitation, and IRS inflation-adjusted 2026 thresholds. [11] IRS IR-2025-111 and Notice 2025-67, 2026 qualified retirement plan contribution limits and Roth IRA MAGI phase-out ranges. [12] IRS Notice 2026-11 and OBBBA statutory text, permanent 100 percent bonus depreciation under IRC Section 168(k) for qualifying property placed in service after January 19, 2025.

Ready to evaluate whether a direct working interest structure is appropriate for your situation?

Work through the questions in this case study with your CPA — and explore how Summit Ventures provides the documentation and governance structure to make those conversations possible.

Explore Summit Ventures | Request AFE Documentation