

Direct Working Interest vs. Oil and Gas Funds

A Decision Stage Comparison Guide to Ownership Structure, Governance Rights, and Tax Treatment Under IRC Section 263(c) and Section 469(c)(3)(A)

For high-earning professionals navigating the top federal bracket — physicians, surgeons, attorneys, CPAs — the standard retirement toolkit falls short. This guide compares two structurally different paths into oil and gas so you and your CPA can evaluate which model fits your specific tax position and risk tolerance.

EDUCATIONAL COMPARISON | NOT TAX ADVICE

Introduction: The High-Earner's Tax Problem

Physicians, surgeons, dentists, attorneys, CPAs, and other high earning professionals share a common financial pattern. Active income from a practice, partnership, or W-2 position places them in the top federal bracket, and the standard toolkit — a 401k, a backdoor Roth, a SEP IRA — does not scale with that income.

$24,500

401k Elective Deferral

2026 limit for elective deferrals

$72,000

Section 415(c) Limit

Combined defined contribution ceiling

$7,500

IRA Limit

Annual IRA contribution cap

$640,600

Top Bracket Threshold

Single filers under Rev. Proc. 2025-32

For a professional earning $400,000 or more, these limits shelter a small fraction of total income, leaving the remainder exposed at the top marginal rate, which under Rev. Proc. 2025-32 begins at $640,600 for single filers and $768,600 for married filing jointly.

Once a professional has reached this point, two structurally different paths into oil and gas typically surface in the same conversation: a direct working interest in specific wells, or a pooled oil and gas fund organized as a limited partnership or limited liability company. Both sit inside the same tax code. Both involve the same underlying asset class, producing oil and gas wells. Yet the ownership structure chosen determines whether intangible drilling cost deductions can offset active income at all, how much governance input the participant retains, how capital is committed and released, and how long capital remains committed before cash flow or liquidation proceeds return.

This is an educational comparison, not a recommendation for any specific participant. Tax treatment depends on individual circumstances, basis, at-risk amount, and the specific structure of any given opportunity, and should always be confirmed with a qualified CPA or tax attorney before capital is committed.

What Is Being Compared

The distinction between these two structures is not cosmetic. It is the difference between holding the asset and holding a claim on an entity that holds the asset — and under the Internal Revenue Code, that distinction is the single factor that decides whether the resulting losses can offset active income.

Option A: Direct Working Interest

The participant holds an undivided fractional interest directly in the oil and gas lease itself, as an owner of the operating rights, typically through a joint operating agreement (JOA) alongside the operator and other working interest owners.

Liability for operations is not limited by the ownership form itself; the participant holds the working interest directly or through an entity that does not limit their liability with respect to that interest.

Option B: Oil and Gas Fund

The participant commits capital to a pooled vehicle, structured as a limited partnership or limited liability company, which in turn acquires interests in a portfolio of wells or projects on behalf of all fund participants.

The fund entity itself is typically the working interest owner of record; the individual's interest is an interest in the fund, not a direct interest in the underlying leases.

Six Evaluation Criteria

A sound comparison for this persona rests on six criteria, each weighted toward the professional's stated priorities: immediate tax relief, long-term cash flow, wealth preservation, and a structure simple enough to coordinate with an existing CPA relationship without becoming a second job.

1	**Ownership and Legal Rights** What does the participant actually hold: a direct interest in the lease, or an interest in an intermediary entity.
2	**Tax Treatment of Losses** Whether elected intangible drilling costs and other deductions can offset active W-2 or 1099 income, or are limited to passive income under Section 469.
3	**Participation and Governance** The degree of visibility into, and input on, decisions such as the AFE, well design, and operating budget.
4	**Liquidity and Capital Horizon** How and when capital is returned, and what mechanisms exist, if any, to exit before a well or fund's natural life cycle ends.
5	**Fee and Cost Load** What is deducted from gross production revenue, or from capital, before it reaches the participant, and by whom.
6	**Administrative Complexity** The ongoing reporting, K-1 preparation, and recordkeeping burden placed on the participant and their CPA.

Option A: Direct Working Interest Ownership

A direct working interest is defined functionally, not by marketing language. Treasury Regulation 1.612-4(a), issued under IRC Section 263(c), identifies the operator as one who holds a working or operating interest in a mineral property, whether as the fee owner or under a lease or other contract granting operating rights. That operator status is what allows intangible drilling costs (IDCs) — the labor, fuel, chemicals, and other costs with no salvage value that are consumed in drilling and completing a well — to be elected as a current year deduction rather than capitalized.

The tax mechanics that follow from direct ownership rest on a second, separate statutory provision: IRC Section 469(c)(3)(A). The passive activity loss rules generally limit deductions from passive activities to income from other passive activities. Section 469(c)(3)(A) carves out a specific exception, stating that the passive activity definition "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." In plain terms: if the participant's liability with respect to the well is not limited by the form of ownership, the resulting loss is not a passive loss. It can be applied against active income, including W-2 wages, 1099 professional income, and K-1 income from an operating practice, in the year it is incurred, subject to basis and the at-risk rules under IRC Section 465.

> Up to 100 percent of eligible intangible drilling costs can qualify for this current-year election, though the actual figure for any given AFE depends on the well's engineering design, the participant's at-risk basis, and their individual tax position — and should be confirmed with a qualified CPA before the election is made.

The remaining tangible drilling costs (casing, wellheads, and other equipment with salvage value) are generally capitalized and recovered through depreciation rather than an immediate deduction.

Two further provisions shape the multi-year picture. First, excess IDCs can be an alternative minimum tax preference item under IRC Section 57(a)(2)(A), but Section 57(a)(2)(E) provides an independent producer exception: the preference is calculated only on the amount by which excess IDCs exceed 65 percent of the taxpayer's net income from oil, gas, and geothermal properties, and the resulting AMTI reduction is capped at 40 percent of AMTI computed without the preference. In practice, this means drilling deductions generally cannot reduce AMTI below roughly 60 percent of pre-deduction income — a meaningful but bounded effect that a CPA should model before the election is finalized. Second, once a well is producing, IRC Sections 611 and 613A permit independent producers to claim a 15 percent percentage depletion allowance against gross income from the property, a recurring deduction layered on top of ongoing production income in later years.

Governance under direct ownership runs through the joint operating agreement and the AFE process. As a working interest owner, the participant typically receives notice of, and in many structures a vote or consent right on, material operating decisions, well proposals, and budget authorizations, alongside the operator and co-owners. This is active participation in an entrepreneurial joint venture, not a passive claim on someone else's decisions. It also means the participant is exposed to cash calls for their proportionate share of operating costs and capital expenditures over the life of the well — a commitment that should be sized against the participant's at-risk basis and liquidity position, not assumed away.

Option B: Oil and Gas Fund

A pooled oil and gas fund is typically organized as a limited partnership or limited liability company, which is precisely the structural feature that changes its tax treatment. Because the LP or LLC form limits the liability of its investors with respect to the underlying working interests the entity holds, Section 469(c)(3)(A)'s exception for working interests held through an entity that does not limit liability is foreclosed. The resulting losses — including any IDCs the fund itself elects at the entity level — default to passive treatment at the investor level.

For a professional whose income is overwhelmingly active (practice income, W-2 wages, 1099 fees), a passive loss generally cannot be used to offset that income in the year it arises; it can typically only offset other passive income, or carry forward, until the investor has passive income to absorb it or disposes of the entire interest in a fully taxable transaction.

This is directly analogous to the $25,000 passive loss allowance available to real estate investors under IRS Publication 925, which itself phases out between $100,000 and $150,000 of modified adjusted gross income — a range nearly every physician, partner, or senior associate in this persona has already exceeded. The fund structure does not recreate that allowance for oil and gas; it simply defaults the losses to passive, with no comparable phase-in allowance at all.

Most oil and gas funds raise capital under SEC Regulation D, commonly Rule 506(c), and are typically limited to accredited investors as defined under Rule 501: an individual with a net worth exceeding $1 million excluding the value of a primary residence, or income exceeding $200,000 individually ($300,000 jointly) in each of the prior two years. This eligibility bar does not change the underlying tax result; it is a separate securities law requirement layered on top of the entity's own LP or LLC structure.

Management Fee

Roughly 1 to 2 percent of committed capital or net asset value annually.

Acquisition Fee

Roughly 1 to 5 percent of purchase price when assets are added to the portfolio.

Carried Interest

Commonly around 20 percent of profits once a preferred return threshold of roughly 8 to 10 percent has been met.

Combined Annual Fee Load

Commonly cited in the 2 to 4 percent range before any carried interest is applied. Every dollar directed to these layers is a dollar that does not reach the investor's distribution.

Fund liquidity follows a lifecycle pattern rather than an ongoing market. A commonly disclosed pattern targets initial distributions within roughly six months of fund close, reinvestment of net income during the early years of the fund's life, a shift toward full distribution of net income as the fund approaches its target life of three to five years, and final liquidation of remaining assets with proceeds distributed net of fees at the end of a stated hold period, commonly ranging from one to eleven years depending on the specific offering. Until that point, the investor's capital is generally illiquid, since an active secondary market for fund interests is not a standard, broadly available feature of this asset class.

Side-by-Side Comparison

The table below maps each evaluation criterion directly against both structures, using the statutory and regulatory framework as the organizing principle.

Criterion	Direct Working Interest	Oil and Gas Fund
Ownership	Participant is the direct, named holder of an undivided fractional interest in the lease and operating rights, as recognized under Treas. Reg. 1.612-4(a).	The fund entity (LP or LLC) is the record holder of the working interest; the participant holds a limited partner or membership interest in that entity, one step removed from the asset itself.
Participation	Active JV member with direct standing under the joint operating agreement, including notice of, and often consent rights on, AFEs and material operating decisions.	Capital contributor with no direct standing under the operator's JOA; participation is delegated entirely to the fund manager, consistent with a passive capital commitment.
Governance	Governance rights run directly to the participant as working interest owner, subject to the terms of the specific JOA and the vote thresholds it establishes among co-owners.	Governance authority sits with the fund's general partner or managing member; individual investors typically have limited or no voting rights over specific well decisions.
Liquidity	Capital is committed to a specific well or set of wells for the productive life of that asset; there is no standardized secondary market, and cash flow timing follows the well's own production curve.	Capital is committed for a stated fund term, commonly one to eleven years, with distributions following a lifecycle pattern; interests are not broadly tradable before that term ends.
Tax Treatment	Section 469(c)(3)(A) applies; elected IDCs are not passive losses and can offset active W-2, 1099, and K-1 income, subject to basis and Section 465 at-risk rules. 15% percentage depletion available under Sections 611 and 613A once producing.	Because the LP or LLC form limits investor liability, the Section 469(c)(3)(A) exception does not apply; resulting losses generally default to passive treatment and can typically only offset other passive income or carry forward until the interest is disposed of in a fully taxable transaction.
Exposure	Exposure is concentrated in the specific wells the participant joins; capital calls for the participant's proportionate share of costs are a direct obligation under the JOA, sized against the participant's at-risk basis.	Exposure is diversified across the fund's full portfolio of wells, but is reduced by the combined management fee, acquisition fee, and carried interest layers before reaching the investor.
Complexity	Involves direct review of the AFE, JOA terms, and well-level K-1 reporting; typically coordinated through the operator and the participant's own CPA, with a learning curve concentrated at the outset of each well.	Involves a single fund-level subscription and a single annual K-1 covering the full portfolio — generally lower per-well administrative burden, offset by less visibility into any individual well's specific economics.

Advantages, Limitations, and Best-Fit Scenarios

Direct Working Interest

Primary Advantage: The Section 469(c)(3)(A) pathway — elected IDCs can offset active income in the year incurred. This is the specific mechanism that addresses the professional's stated goal of immediate tax relief against W-2 or 1099 earnings, something neither a 401k nor a backdoor Roth is designed to do at this income tier. It also places the participant on title as a genuine working interest owner, with governance standing under the JOA and direct, well-level visibility into the asset generating their cash flow.

Limitations: Capital is concentrated in specific wells rather than diversified across a portfolio, the participant carries direct exposure to cash calls under the AFE, and the deduction's magnitude depends on the specific well's engineering design and the participant's own basis and at-risk position — not a fixed percentage that applies uniformly across every opportunity.

Best Fit: A professional who has a specific need to offset a known, large amount of current-year active income, has sufficient at-risk basis and liquidity to support their proportionate share of the AFE and any subsequent cash calls, and is comfortable reviewing a JOA and well-level reporting alongside their CPA. It suits the physician or partner who wants both the current-year deduction mechanics and a genuine, governed ownership position they can explain in detail to their own advisor.

Oil and Gas Fund

Primary Advantage: Diversification and delegation — capital is spread across a portfolio of projects selected and managed by a dedicated team, with a single subscription and a single K-1, which reduces the administrative burden on the participant and their CPA.

Limitations: Structural and largely fixed. Because the pooled vehicle limits investor liability, the fund route forecloses the active-income offset that direct ownership preserves. The combined fee and carried interest load reduces the portion of production revenue that reaches the investor, and capital is generally committed for the fund's full term with limited interim liquidity.

Best Fit: A professional whose priority is broad portfolio exposure to the asset class with minimal individual well-level administration, who has substantial passive income from other sources (rental real estate, other fund interests, or prior passive carryforwards) that can absorb passive losses, and who places a higher value on delegated management and diversification than on the active-income offset itself. For a professional whose income is almost entirely active, however, this is the structural trade-off that most directly works against the stated goal of immediate tax relief.

Decision Guidance and Questions for Your Advisor

The decision between these two structures turns less on which asset performs better and more on which tax result the participant's own return actually needs. A CPA modeling this decision for a high earning client should typically work through the following sequence:

Assess At-Risk Basis

Determine available at-risk basis capacity.

Model AMT Preference

Estimate Section 57(a)(2) AMT preference impact.



Quantify Active Income

Measure active income and marginal tax rate.

Compare Passive Capacity

Compare against passive income capacity limits.

Because the governing statute, Section 469(c)(3)(A), turns entirely on whether liability is limited by the ownership form, this is a legal and structural question first, and a performance question second. Any specific opportunity — whether structured as a direct working interest or a fund interest — should be reviewed against its own governing documents, specifically the JOA, the operating agreement, and the private placement memorandum, with a qualified CPA or tax attorney before capital is committed.

Eight Questions to Bring to Your CPA or Tax Advisor

1 Marginal Rate Analysis

Based on my projected W-2, 1099, and K-1 income this year, what is my effective marginal rate, and how much current-year active income offset would materially change my total tax liability?

2 At-Risk Basis Under Section 465

Do I have sufficient at-risk basis under Section 465 to support a direct working interest position and its associated cash call exposure under a joint operating agreement?

3 AMT Independent Producer Exception

How would the Section 57(a)(2) independent producer AMT exception apply to my specific projected net oil and gas income for the year, and what is the practical ceiling on the deduction in my case?

4 Passive Income Capacity

Do I currently have, or do I expect to generate, passive income from other sources that could absorb a passive loss if I instead chose a fund structure?

5 JOA Governance and Cash Call Exposure

What does the specific joint operating agreement or operating agreement say about my governance rights, consent thresholds, and exposure to future cash calls?

6 Percentage Depletion After-Tax Impact

How does the percentage depletion allowance under Sections 611 and 613A affect my after-tax cash flow once a specific well reaches production?

7 Fund Fee Load Comparison

What combined fee and carried interest load applies to a specific fund opportunity, and how does that load compare to the administrative cost of direct participation?

8 Coordination with Existing Structure

How should this decision be coordinated with my existing retirement account structure and any other passive activities already on my return?

Conclusion and Next Steps

Working interest ownership and pooled fund participation are not competing products so much as two different legal relationships with the same underlying asset class, and the Internal Revenue Code treats each relationship differently because the economic reality is different. A high earning professional evaluating this decision is best served by starting with their own tax position — active income level, at-risk capacity, and existing passive activity — and working backward to the structure that actually produces the result they need, rather than starting with a headline deduction figure and working forward.

The oil and gas sector itself remains a significant contributor to the broader economy, supporting an estimated 10.6 million American jobs and contributing roughly 2.1 trillion dollars to the U.S. economy according to the American Petroleum Institute, with the U.S. Energy Information Administration's September 2026 Short-Term Energy Outlook forecasting record domestic crude production averaging 13.8 million barrels per day in 2026, surpassing the prior 13.7 million barrel per day record set in 2025. That scale provides useful context for why this asset class continues to draw attention from high earning professionals, but it is not, on its own, a substitute for the specific, individualized tax and legal review this decision requires.

Sources and References

[1] Treas. Reg. 1.612-4(a) — IRC §263(c) IDC elections
[2] IRC §469(c)(3)(A) — passive activity exception
[3] IRC §465 — at-risk limitation
[4] IRC §57(a)(2)(A) and (E) — AMT preference and independent producer exception
[5] IRC §§611 and 613A — percentage depletion
[6] Rev. Proc. 2025-32 — 2026 federal tax brackets
[7] IRS IR-2025-111 — 2026 retirement plan limits
[8] IRS Publication 925 — Passive Activity and At-Risk Rules
[9] SEC Rule 501 and Rule 506(c), Regulation D
[10] Industry benchmark data on pooled oil and gas fund fee structures
[11] U.S. EIA Short-Term Energy Outlook, September 2026
[12] American Petroleum Institute, Industry Explained

This guide is for educational purposes only. It does not constitute tax, legal, or investment advice. Always consult a qualified CPA or tax attorney before committing capital to any oil and gas investment structure.

Ready to explore how direct working interest ownership may fit your specific tax position?

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