# Evaluating Direct Energy Participation Opportunities: A Case Study

How a Law Firm Equity Partner Reviewed a Working Interest Structure to Address a One-Time K-1 Distribution Spike Without Adding Hours to an Already Full Billable Calendar

This case study presents an anonymized, composite profile built from recurring patterns Summit Ventures observes among law firm partners evaluating direct energy participation. The individual, firm, practice area, and dollar figures are illustrative only and are not a projection, promise, or guarantee of any specific tax or financial outcome for any participant.

# Case Classification & At-a-Glance Summary

### Case Type

Illustrative composite, consideration-stage tax and structure evaluation

### Participant Profile

Equity partner, mid-size commercial litigation firm, Southeastern United States

### Income Character

Active partnership distributive share (K-1), subject to self-employment tax, taxed at ordinary rates

### Structure Reviewed

Direct working interest in a multi-well development program, governed by a Joint Operating Agreement (JOA) and supported by a well-specific Authorization for Expenditure (AFE)

### Core Tax Question

Whether a direct working interest can offset a one-time active income spike under IRC Section 263(c) without triggering the material participation hours test that applies to rental real estate under IRC Section 469(c)(7).

### Core Compliance Question

Whether the governing agreement for the energy interest can be furnished to the firm's general counsel or risk committee for outside business activity review without raising the disclosure complications associated with a pooled offering or securities-style investment.

# Participant Profile, Trigger & Situation

The composite partner has practiced commercial litigation for just over fifteen years and became an equity partner at a regional firm several years ago. Annual billable hour expectations at the firm sit within the range most commonly reported across mid-size and large firms nationally, with industry data placing average billable hour requirements at roughly **1,892 hours per year** overall and closer to **1,930 hours per year** at the largest firms. For an equity partner who also carries origination duties, client relationship management, and firm governance responsibilities, the realistic time commitment during active litigation cycles routinely exceeds the stated minimum.

The trigger event in this composite was a single contested matter that resolved favorably late in the tax year, producing an unusually large K-1 distributive share allocation from the firm's capital account true-up. Because partnership income derived from active participation in the practice of law is not characterized as passive income under the Internal Revenue Code, the full amount was taxed as ordinary active income and was also subject to self-employment tax, pushing the partner's total taxable income into the top federal marginal bracket, which for 2026 begins above **$640,600 for single filers** and **$768,600 for married filing jointly**, under IRS Rev. Proc. 2025-32.

Like many professionals in this position, the partner had already maximized available qualified retirement plan deferrals. The 2026 limits are fixed by statute and do not scale to a one-time distribution event of this size; a traditional 401(k) employee deferral is limited to a set annual figure with a modest combined employer-employee ceiling, regardless of how large a single year's active income happens to be. The partner's existing financial holdings, including a diversified portfolio and a minority interest in a passive real estate fund, offered no additional current-year offset because losses generated by passive holdings can only offset passive income, not the active K-1 distribution that created the spike.

This profile is representative of a broader pattern Summit Ventures sees across high-income professionals paid through K-1 distributions, including law firm partners, physician partners, and other business owners whose active income is concentrated and whose schedules leave minimal room for hands-on management of a second active trade or business.

# Challenge & Decision Criteria

The partner's evaluation centered on five criteria, each shaped by professional obligations unique to practicing attorneys:

| | |
|---|---|
| 1 | **No Excessive Time Commitment**<br>The structure could not require the time commitment associated with rental real estate's material participation framework. Qualifying rental real estate losses as nonpassive under IRC Section 469(c)(7) requires more than 750 hours of service in a real property trade or business and more than half of all personal service hours in real property activity — structurally foreclosed for most actively billing attorneys. |
| 2 | **Statutory Basis for Active Income Offset**<br>The structure needed a statutory basis for offsetting active income specifically, not merely a deferral mechanism. IRC Section 263(c), together with Treas. Reg. 1.612-4, allows an election to deduct intangible drilling costs (IDC) in the year incurred rather than capitalizing them. |
| 3 | **Transparent Governance Documentation**<br>The governing documentation needed to be transparent enough to satisfy the firm's internal outside business activity review, mirroring the conflict identification discipline attorneys already apply under ABA Model Rule 1.7. A clearly drafted JOA is far easier to present for review than an interest in a pooled fund with layered, indirect ownership. |
| 4 | **Preserve the Working Interest Exception**<br>The structure needed to avoid the liability-limiting features that convert a working interest into a passive activity by default. Under IRC Section 469(c)(3)(A), the working interest exception applies only where the taxpayer holds the interest directly or through an entity that does not limit the taxpayer's liability. |
| 5 | **Full Tax Exposure Review**<br>The structure needed to be evaluated for at-risk basis under IRC Section 465, alternative minimum tax exposure under IRC Section 57(a)(2), and the excess business loss limitation under IRC Section 461(l), given the size of the one-time K-1 spike relative to the partner's overall basis position. |

# Options Evaluated & Approach Selected

The partner, working with outside tax counsel and a CPA, reviewed three categories of structure before narrowing to a direct working interest.

### ❌ Option 1: Increased Retirement Plan Contributions

Rejected on mechanical grounds. The 2026 limits are fixed and modest relative to a one-time six-figure spike, and the Roth IRA contribution path phases out entirely well below the partner's income level.

### ❌ Option 2: Additional Rental Real Estate

Rejected because the billable hour commitment required to clear the IRC Section 469(c)(7) two-part test was not achievable alongside a full litigation docket, and because even active participation in rental real estate carries its own phase-out under IRC Section 469(i), eliminated entirely above $150,000 of modified adjusted gross income.

### ❌ Option 3: Pooled Oil & Gas Fund

Evaluated and set aside. Because a limited partner's liability is capped by the entity itself, the IRC Section 469(c)(3)(A) exception does not apply, and losses from that structure default to passive treatment — offsetting only passive income rather than the active K-1 income that created the exposure.

### ✅ Selected: Direct Working Interest

A direct working interest in a multi-well development program, held individually rather than through a liability-limiting entity, governed by a Joint Operating Agreement that specifies the operator, the non-operating working interest owners, the cost-sharing mechanics, and the authorization for expenditure process for each well. Consistent with the long-standing federal analysis in *Williamson v. Tucker*, which distinguishes interests where the holder retains meaningful control and liability exposure from pooled arrangements that function as securities.

# Implementation: Five Steps




Each step was executed in sequence by the partner, outside tax counsel, and the firm's CPA, ensuring both tax compliance and internal governance requirements were satisfied before capital was committed.

### 1 Entity and Holding Review

Tax counsel confirmed the working interest would be held directly by the partner, with no liability-limiting wrapper, to preserve the IRC Section 469(c)(3)(A) exception regardless of the partner's available hours.

### 2 Outside Business Activity Disclosure

The partner submitted the Joint Operating Agreement and the well-specific Authorization for Expenditure to the firm's general counsel for review under the firm's outside business interest policy, alongside a brief summary of the ownership percentage, capital contribution, and absence of any client-facing or firm-adverse relationship with the operator.

### 3 AFE and Cost Classification Review

The CPA and tax counsel reviewed the Authorization for Expenditure to confirm which costs qualify as intangible drilling costs eligible for the Section 263(c) election and which costs are tangible equipment costs eligible for cost recovery. Up to 100 percent of eligible intangible drilling costs can qualify for a current-year deduction, with the actual proportion depending on that well's engineering design, the participant's basis and at-risk amount, and individual tax circumstances.

### 4 At-Risk, AMT, and Excess Business Loss Review

The CPA confirmed the partner's at-risk basis under IRC Section 465 (limited to cash contributed and qualifying recourse debt), modeled the AMT preference treatment under IRC Section 57(a)(2)(A) and the related independent producer exception under 57(a)(2)(E), and confirmed the contribution and resulting deduction would remain within the 2026 excess business loss thresholds of $256,000 for single filers and $512,000 for married filing jointly under IRC Section 461(l).

### 5 K-1 and Return Coordination

The partner's personal CPA coordinated the energy working interest's own K-1 reporting with the law firm's partnership K-1, confirming the self-employment tax treatment of the firm distribution was unaffected by the separate working interest election, since the Section 263(c) election addresses income tax exposure and does not alter self-employment tax on the underlying law firm earnings.

# Illustrative Outcome & Metrics

In this illustrative composite, the partner contributed $250,000 of capital toward a direct working interest position across a multi-well program. These figures are illustrative only, reflect one composite scenario, and are not a projection of results for any other participant, well, or tax year.

**$250K**

**Capital Contribution**

Direct working interest, no liability-limiting wrapper

**$190K**

**Year One IDC Deduction**

Confirmed against the governing AFE, applied against active income

**$60K**

**Tangible Cost Basis**

Eligible for 100% bonus depreciation under IRC Section 168(k)

**15%**

**Percentage Depletion**

Of gross income from the property once producing, under IRC Sections 611 and 613A

| Metric | Detail |
|---|---|
| Passive Activity Treatment | Not applicable; IRC Section 469(c)(3)(A) working interest exception preserved by direct holding, independent of hours worked |
| Real Estate Professional Comparison | IRC Section 469(c)(7) requires more than 750 hours and more than half of all personal service hours — a test the partner's billable schedule could not satisfy |
| At-Risk Basis | Confirmed under IRC Section 465, limited to cash contributed and qualifying recourse debt |
| AMT Preference Exposure | Reviewed under IRC Section 57(a)(2)(A) and the independent producer exception under 57(a)(2)(E) |
| Excess Business Loss Threshold (2026) | $256,000 single filers / $512,000 married filing jointly under IRC Section 461(l) |
| Firm Compliance Review | JOA and AFE submitted to general counsel under the firm's outside business activity policy, consistent with ABA Model Rule 1.7 |

The firm's general counsel reviewed the Joint Operating Agreement within the normal outside business activity review cycle and did not identify a conflict, citing the clarity of the ownership percentage, the absence of any client-facing role for the operator, and the direct, non-pooled nature of the holding as factors that simplified the review relative to a fund-style submission reviewed for another partner the same year.

# Illustrative Reflection

The following reflection is a composite statement built from patterns Summit Ventures observes among law firm partners, not a verified testimonial from a named individual.

> "The part that mattered most to our general counsel was not the tax treatment, it was the governance document. A Joint Operating Agreement that names the operator, spells out my percentage, and shows exactly how expenditures get authorized is something our risk committee can actually review in an afternoon. That is a very different conversation than trying to explain a fund structure with three layers between my capital and the wells."

## Assumptions Underlying This Case Study

This case study assumes a composite partner in the top federal marginal bracket with sufficient cash and at-risk basis to support the illustrative contribution, a one-time rather than recurring active income spike, and a firm with an established outside business activity disclosure policy, which is common but not universal across law firms. It also assumes the specific wells underlying the working interest generate an AFE with a substantial intangible cost component, a proportion that is unique to each well's engineering design and is never assumed to be a fixed or universal percentage across different projects.

# Key Takeaways & Questions for Your Advisors

## Three Central Takeaways

### No Hours Test Required

The IRC Section 469(c)(3)(A) working interest exception does not require material participation hours, distinguishing it structurally from the real estate professional framework under IRC Section 469(c)(7) that most billable-hour professionals cannot realistically satisfy.

### Governance Transparency Matters

A clearly drafted Joint Operating Agreement and a well-specific AFE can materially simplify the internal disclosure and conflicts process that many law firms require before an equity partner commits capital to an outside business interest.

### Section 263(c) Is Independent of SE Tax

Current-year deductibility under Section 263(c) is independent of, and should not be confused with, the self-employment tax treatment of the underlying K-1 income that created the active income exposure in the first place.

## Questions for Professional Advisor Discussion

1. Does my firm's partnership agreement or outside business activity policy require disclosure of a direct working interest, and if so, what documentation does general counsel or the risk committee typically request?
2. Does my specific holding structure — individual ownership or an entity that does not limit liability — actually preserve the IRC Section 469(c)(3)(A) working interest exception for my situation?
3. What portion of the Authorization for Expenditure for a specific well qualifies as intangible drilling cost under IRC Section 263(c) and Treas. Reg. 1.612-4, and how does my CPA intend to document that allocation?
4. Given my at-risk basis under IRC Section 465 and my overall income for the year, how does the IRC Section 57(a)(2) alternative minimum tax preference analysis affect my expected deduction?
5. Does my anticipated contribution and deduction remain within the 2026 excess business loss thresholds under IRC Section 461(l), and what happens to any amount above that threshold?
6. How does the self-employment tax treatment of my law firm K-1 distribution interact — or not interact — with the income tax treatment of a working interest deduction?
7. What ongoing reporting, K-1s, AFE updates, or JOA amendments should I expect to provide to my firm's compliance function for as long as I hold the interest?

# About Summit Ventures

Summit Ventures structures its working interest offerings as direct, individually held positions governed by Joint Operating Agreements, specifically because that structure preserves the statutory working interest exception under IRC Section 469(c)(3)(A) regardless of a business participant's available hours, and because transparent governance documentation is often easier for a law firm's internal compliance process to evaluate than a pooled, multi-layer offering.

Attorneys and their advisors evaluating this type of structure should request the governing Joint Operating Agreement and the well-specific Authorization for Expenditure early in the review process, share both documents with their CPA, tax counsel, and firm compliance contact, and confirm every figure discussed here against their own individual facts before making a capital contribution.

### Request the JOA & AFE Early

Share both documents with your CPA, tax counsel, and firm compliance contact before committing capital.

### Confirm Against Your Own Facts

Every figure in this case study is illustrative. All tax treatment depends on your specific facts and governing documents.

### Engage Qualified Advisors

Always confirm structure, deductibility, and compliance obligations with a qualified CPA and tax counsel before any capital contribution is made.

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## Ready to Explore Direct Energy Participation?

Connect with Summit Ventures to request governing documentation and begin your advisor review process.

Connect with Summit Ventures

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## Sources & References


1. Cornell Legal Information Institute, 26 U.S.C. Section 469(c)(3)(A), statutory text of the working interest exception to the passive activity rules, requiring direct holding or holding through an entity that does not limit the taxpayer's liability.
2. Cornell Legal Information Institute and related secondary analysis, 26 U.S.C. Section 469(c)(7)(B), the two-part real estate professional test requiring more than 750 hours and more than half of all personal service hours in real property trades or businesses in which the taxpayer materially participates.
3. 26 U.S.C. Section 263(c) and Treas. Reg. Section 1.612-4, intangible drilling cost election mechanics.
4. 26 U.S.C. Section 465, at-risk limitation on deductible losses.
5. 26 U.S.C. Section 57(a)(2)(A) and Section 57(a)(2)(E), alternative minimum tax preference treatment of excess intangible drilling costs and the independent producer exception.
6. 26 U.S.C. Sections 611 and 613A, percentage depletion allowance for independent producers.
7. 26 U.S.C. Section 461(l), excess business loss limitation, 2026 inflation-adjusted thresholds.
8. IRS Notice 2026-11 and the underlying 2025 tax legislation (OBBBA), permanent 100 percent bonus depreciation under IRC Section 168(k) for qualifying property placed in service after January 19, 2025.
9. Tax Foundation, summary of 2026 federal individual income tax brackets per IRS Rev. Proc. 2025-32.
10. Williamson v. Tucker, 645 F.2d 404 (5th Cir. 1981), federal appellate analysis distinguishing joint venture and working interest holdings where the holder retains governance and liability exposure from pooled arrangements treated as securities.
11. NALP, Directory of Legal Employers billable hour requirement data, reporting an average requirement of approximately 1,892 hours per year overall and approximately 1,930 hours per year at firms of more than 700 attorneys.
12. American Bar Association, Model Rule of Professional Conduct 1.7, Comment, describing the expectation that lawyers adopt reasonable, documented procedures to identify persons and interests relevant to a conflict of interest review.