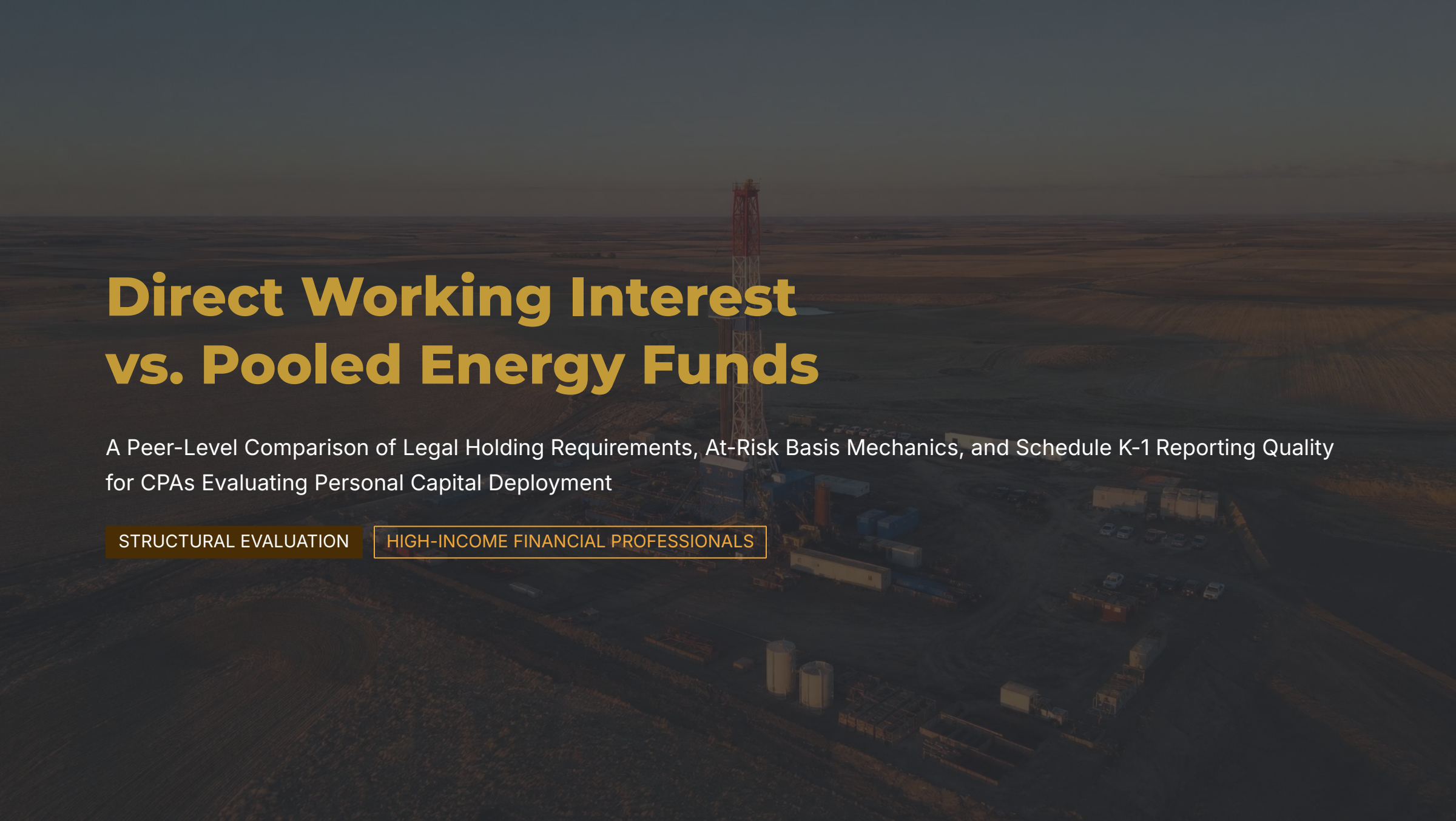

Direct Working Interest vs. Pooled Energy Funds

A Peer-Level Comparison of Legal Holding Requirements, At-Risk Basis Mechanics, and Schedule K-1 Reporting Quality for CPAs Evaluating Personal Capital Deployment

STRUCTURAL EVALUATION

HIGH-INCOME FINANCIAL PROFESSIONALS

Introduction: The Question Behind the Deduction

You likely understand Section 263(c) better than most people who will ever ask you about it. You have reviewed enough oil and gas K-1s on behalf of clients to know that the deduction exists, that intangible drilling costs can be expensed in the year incurred rather than capitalized, and that the industry built an entire sales vocabulary around it. What you have probably spent less time underwriting is a narrower, more structural question: when the capital is your own, does the legal form of the holding actually deliver what the marketing implies, or does it quietly default into the passive basket the moment the ink dries on the subscription agreement.

That question has nothing to do with whether intangible drilling costs are real. They are. It has everything to do with three mechanical gates that sit between a signed capital commitment and a usable deduction on your own Form 1040: how the interest is legally held, how your at-risk basis is computed, and how clean the Schedule K-1 actually is when it lands on your desk.

This guide works through those three gates side by side for two structures you have almost certainly seen cross your own desk or a client's: a direct working interest held outside a liability-limiting wrapper, and a pooled oil and gas fund or syndication organized as an LP or LLC. Neither structure is presented here as categorically superior. The purpose is to give you the specific statutory and reporting criteria to underwrite the decision the way you would underwrite it for a client, before any personal capital moves.

1	2	3
Gate 1	**Gate 2**	**Gate 3**
Legal form of the holding	At-risk basis computation	Schedule K-1 reporting quality

What Is Compared

Option A: Direct Working Interest

Direct working interest ownership, held either directly as a fee or leasehold interest, or through an entity that does not limit the liability of the participant — a general partnership or an unincorporated joint venture operating under a standard Joint Operating Agreement (JOA).

Summit Ventures structures participation on this basis, with business participants holding a direct working interest position and governance rights under the operating agreement rather than a security in a pooled vehicle.

Option B: Pooled Oil and Gas Fund or Syndication

A pooled oil and gas fund or syndication, typically organized as a limited partnership or limited liability company, in which the participant holds a limited partner or member interest.

The fund or its general partner acts as the operator of record on the underlying wells; the participant's relationship to the wells is indirect, mediated through fund-level ownership.

Evaluation Criteria

The comparison is scored against the three criteria embedded in your own diligence objective, plus four supporting factors that determine whether those three hold up in practice:

1	**Legal Holding Structure** Measured against IRC Section 469(c)(3)(A) working interest exception and Treasury Regulation 1.612-4(a) operator definition.
2	**At-Risk Basis Treatment** Under IRC Section 465, including whether nonrecourse financing is embedded in the structure.
3	**Schedule K-1 Reporting Quality** Including Box 1 versus Box 2 classification, supplemental statement detail, and support for Form 6198.
4	**Governance & Operational Control** Over authorizations for expenditure (AFEs) and well-level decisions.
5	**Liquidity & Transfer Mechanics** How and when capital can be moved or exited from the structure.
6	**AMT Exposure & Fee Load** Alternative minimum tax exposure under IRC Section 57(a)(2) and fee/carried-interest load between capital contributed and capital deployed at the wellhead.

Option A: Direct Working Interest Ownership

Legal Holding Requirement

Treasury Regulation 1.612-4(a) defines an operator for purposes of Section 263(c) as one who holds a working or operating interest, either as a fee owner or under a lease or any other form of contract granting working or operating rights. That is a factual and legal test, not a marketing label. A direct working interest participant satisfies it by holding an actual undivided interest in the lease, with a seat at the table on AFEs and operational decisions under the JOA, rather than a security interest in an entity that in turn holds the lease.

The statute that actually determines whether the resulting loss can offset your active income is a separate provision: IRC Section 469(c)(3)(A), which states 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. There is no material participation or hours test attached to this exception, unlike the real estate professional standard you apply to clients claiming the $25,000 special allowance. The test is purely about the legal form of the holding. A general partnership interest, or a direct undivided interest, clears it. An LLC or LP interest does not, regardless of how actively the limited partner monitors the investment.

At-Risk Basis Mechanics

IRC Section 465 caps deductible losses at the amount the participant has at risk, defined as cash contributed plus the amount of debt for which the participant is personally liable (recourse debt) or has pledged qualifying property to secure. Nonrecourse debt does not increase at-risk basis. Because a direct working interest structure typically funds the capital contribution in cash rather than layering fund-level nonrecourse financing underneath the participant, the at-risk basis for a direct holding generally tracks the actual cash contributed to the AFE, with no separate reconciliation required to strip out financing the participant was never personally exposed to.

Schedule K-1 Reporting Quality

For a working interest held directly or through a liability-unlimited entity, a properly prepared K-1 should report the resulting income or loss as nonpassive, generally in Box 1 (ordinary business income or loss), with supplemental statements itemizing intangible drilling cost elections, tangible drilling cost additions to the depreciable basis, and percentage depletion information under IRC Sections 611 and 613A. Because the loss limitation ordering runs basis, then at-risk under Section 465, then the passive activity rules under Section 469, then the excess business loss limitation under Section 461(l) (the 2026 threshold is $256,000 single and $512,000 married filing jointly), a working participant who clears the Section 469(c)(3)(A) exception still needs a K-1 and supporting statements detailed enough to complete Form 6198 for the at-risk computation. A well-prepared direct working interest K-1 should make that computation straightforward: the capital contribution, the IDC election amount, and the resulting basis are traceable line items, not a single netted fund-level number.

Ongoing Tax Layers

Once a well produces, the 15 percent percentage depletion allowance under Sections 611 and 613A applies to gross income from the property for independent producers, continuing even after cost basis is exhausted. Excess intangible drilling costs are an alternative minimum tax preference item under Section 57(a)(2)(A) only to the extent they exceed 65 percent of the taxpayer's net income from oil, gas, and geothermal properties for the year; a separate independent producer exception under Section 57(a)(2)(E) limits the resulting reduction in alternative minimum taxable income to 40 percent of AMTI. Both apply identically regardless of which structure is used; they are a function of the activity, not the wrapper.

Option B: Pooled Oil and Gas Fund or Syndication

Legal Holding Structure

In a fund or syndication organized as an LP or LLC, the fund itself, or its general partner, is the operator under Treasury Regulation 1.612-4(a). The participant holds a limited partner or member interest in that entity. That interest, by its legal form, limits the liability of the participant to the amount invested, which is precisely the condition Section 469(c)(3)(A) excludes from the working interest exception. The provision's own text draws the line at an entity which does not limit the liability of the taxpayer; an LP or LLC interest is, by design, exactly such a liability-limiting entity.

The result is that losses allocated through the fund default to passive treatment under Section 469, regardless of how deeply the limited partner reviews drilling programs, attends investor calls, or understands the underlying geology. Passive losses can only offset passive income in the current year; unused amounts are suspended under Section 469(b) and carried forward until there is passive income to absorb them or the interest is disposed of in a fully taxable transaction.

At-Risk Basis Mechanics

Fund-level capital structures commonly include financing at the entity level that is nonrecourse to the limited partner. Even where a participant's capital account shows a full allocation of intangible drilling costs, the at-risk basis available to absorb that loss under Section 465 may be smaller than the capital account suggests if any portion of the funded drilling program relied on debt the limited partner is not personally liable for. This creates a second, independent constraint layered on top of the passive activity limitation: a loss can fail to be usable even before it reaches the passive activity test, simply because the at-risk basis was never there to support it.

Schedule K-1 Reporting Quality

Fund and syndication K-1s frequently aggregate results across a portfolio of wells into a single net Box 2 (passive) or Box 3 figure, with the underlying intangible drilling cost elections, tangible cost allocations, and depletion computations consolidated at the fund level rather than disaggregated per well. This is operationally convenient for the sponsor, who is managing one set of books across many participants, but it is the opposite of what you need to independently verify basis, at-risk amount, and the character of the income for a client file or your own return. Industry fee structures for these vehicles commonly run a 1 to 2 percent annual management fee on committed capital or net asset value, a 1 to 5 percent acquisition fee on purchase price, and a carried interest in the range of 20 percent of profits above an 8 to 10 percent preferred return hurdle, all of which sit between the capital contributed and the economics that eventually appear on the K-1.

Liquidity Profile

Pooled vehicles typically target a fund life of three to five years, with periodic distributions beginning within roughly six months of fund close, reinvestment of net income during the early years, and a shift toward full distribution and eventual liquidation as the fund approaches its target life, inside overall hold periods that commonly range from one to eleven years depending on the program. Exit before that point generally depends on the sponsor's discretion or a secondary transfer, not a right held by the limited partner.

Side-by-Side Comparison

Criterion	Direct Working Interest (Option A)	Pooled Fund / Syndication (Option B)
Ownership	Undivided working interest in the lease, held directly or through a liability-unlimited entity, as fee owner or under a JOA granting operating rights per 1.612-4(a).	Limited partner or member interest in an LP or LLC that in turn holds the working interest; the participant does not hold the underlying lease interest directly.
Participation	Participant is a named party to the operating agreement, with a direct contractual right to AFE notices, well data, and operational reporting.	Participant receives periodic fund-level reporting from the sponsor; no direct contractual relationship with the operator of the underlying wells.
Governance & Control	Voting and consent rights on AFEs and major operational decisions under the JOA; non-operating working interest owners retain contractual approval rights even without acting as operator.	Governance sits with the general partner or manager; limited partner approval rights are typically limited to matters specified in the fund's LP agreement, if any.
Liquidity	Transfer of a working interest is a conveyance of real property, generally requiring operator consent and documentation under the JOA; no public market.	Fund units are generally illiquid for the stated fund term, commonly one to eleven years, with exit tied to fund-level distribution or liquidation events or sponsor-facilitated secondary transfers, not a standing redemption right.
Tax Treatment	Clears the Section 469(c)(3)(A) exception; resulting income or loss is nonpassive, reportable on Schedule K-1 Box 1, subject to the Section 465 at-risk limitation based on cash contributed and any recourse debt.	LP or LLC interest limits participant liability, which generally fails the Section 469(c)(3)(A) test; losses default to passive treatment under Section 469, often reported in K-1 Box 2 or Box 3, and may also be constrained by Section 465 if fund-level financing is nonrecourse to the limited partner.
Exposure & Limitations	Capital is concentrated in the specific wells and AFEs the participant elects into; exposure is direct and well-specific, with no sponsor-level diversification layer and no fund manager discretion diluting the position.	Capital is pooled across a portfolio the sponsor selects and can rebalance; diversification is broader, but the participant's economics are filtered through the fund's fee load, carried interest, and the general partner's discretion over capital calls, reinvestment, and distribution timing.
Complexity	Requires the participant's return to reflect a direct Schedule C or Schedule E nonpassive working interest position, with Form 6198 support for the at-risk computation; administratively more granular but more transparent.	Single consolidated K-1 is simpler to receive but harder to independently verify; passive loss carryforwards under Section 469(b) require their own multi-year tracking schedule, and fund-level financing adds a layer of at-risk analysis the participant does not control.

Advantages and Limitations

Direct Working Interest — Advantages

- Clears the Section 469(c)(3)(A) exception by legal form rather than by an hours-based test, which matters for a professional with no spare bandwidth to track material participation hours.
- At-risk basis is generally transparent and tied directly to cash contributed.
- K-1 detail, when properly prepared, supports a clean Form 6198 computation and a defensible position on examination — precisely the documentation quality a CPA would require before signing a client's return and should expect for a personal filing.

Direct Working Interest — Limitations

- Concentration in specific wells and AFEs, no sponsor-level portfolio diversification.
- Real property conveyance process for any transfer.
- Governance responsibilities — such as reviewing AFEs — that a passive fund interest does not require.

Pooled Fund or Syndication — Advantages

- Broader diversification across a portfolio of wells selected and managed by a sponsor.
- A single consolidated reporting relationship rather than multiple direct operating agreements.

Pooled Fund or Syndication — Limitations

- The LP or LLC wrapper that provides liability protection is the same feature that forecloses the Section 469(c)(3)(A) exception, pushing losses into the passive basket by default.
- Fund-level nonrecourse financing can constrain at-risk basis independently of the passive activity rules.
- K-1 detail is frequently aggregated at the fund level, limiting the participant's ability to independently verify basis, at-risk amount, and income character without relying entirely on sponsor-prepared schedules.
- Management fees of 1 to 2 percent, acquisition fees of 1 to 5 percent, and carried interest near 20 percent above a preferred return sit between capital contributed and the number that ultimately reaches the K-1.

Best-Fit Scenarios

Direct Working Interest Fits When...

A professional's primary objective is offsetting current-year active income — specifically W-2, 1099, or K-1 distributive share income from a practice or firm — and who wants to hold the position in a form that clears the Section 469(c)(3)(A) exception by its legal structure rather than by tracking hours.

It also fits someone who wants K-1 and basis documentation granular enough to independently verify, or to defend on examination, without relying solely on a sponsor's consolidated reporting.

Pooled Fund Fits When...

A professional is primarily seeking portfolio-style exposure to a basket of wells with sponsor-managed selection and reinvestment, who has already accepted that the resulting losses will generally be passive and intends to use them against other passive income sources — such as royalty interests or other passive K-1 allocations — rather than against active earnings.

Decision Guidance & Due Diligence Checklist

Begin with the legal form of the holding, not the pro forma. Request the actual operating agreement or JOA, or the LP/LLC agreement, before reviewing any return projection. Confirm in writing which entity holds the working interest of record and whether that entity limits the liability of the participant. That single fact determines whether Section 469(c)(3)(A) is available at all.

Next, request a basis and at-risk schedule, not just a capital account statement. Ask specifically whether any portion of the capital deployed into drilling is financed with debt that is nonrecourse to you personally. If the sponsor cannot answer that question directly, treat the at-risk basis as unverified until they can.

Finally, request a sample K-1 and supplemental statement from a prior reporting period before committing capital, not after. Evaluate whether it reports income or loss as nonpassive with line-item support for the intangible drilling cost election, the tangible cost basis, and depletion, or whether it delivers a single aggregated passive number. The quality of that document is the clearest proxy available for how defensible the position will be if it is ever examined.



Questions for Your Own File or a Client's

- Does the entity holding the working interest of record limit the liability of the participant, and can that be confirmed from the governing agreement rather than from marketing materials?
- What is the participant's at-risk basis as of the most recent reporting period, and does any portion of the capital contribution rely on financing for which the participant is not personally liable?
- Does the K-1 report the resulting income or loss as nonpassive in Box 1, or as passive, and does the supplemental statement itemize the intangible drilling cost election separately from tangible cost additions and depletion?
- Is there a Form 6198 at-risk computation the sponsor or operator can support with documentation, or is the participant expected to construct that computation independently from fund-level statements?
- What governance rights, if any, does the participant hold over AFEs and major operational decisions, and how does that compare to the approval rights retained by a non-operating working interest owner under a standard JOA?
- What is the combined annual fee and carried interest load between capital contributed and capital actually deployed at the wellhead, and how is that disclosed in the governing documents?
- What is the stated liquidity mechanism, and what happens to unresolved passive loss carryforwards under Section 469(b) if the position is held past the fund's stated term?

The structural distinction between these two paths is not a matter of opinion or sales framing. It is a function of which entity holds the working interest of record and whether that entity limits liability — a fact that is verifiable in the governing documents before any capital moves. For a CPA or financial professional evaluating this for personal account, the diligence exercise is the same one you would run for a client: confirm the legal form first, verify the at-risk basis independently of the capital account statement, and request a sample K-1 detailed enough to support the return position before committing. Those three checks, applied consistently, will tell you more about the suitability of either structure than any projected yield.

Sources, References & Next Steps

Statutory & Regulatory References

1. Treasury Regulation 1.612-4(a), operator definition for purposes of IRC Section 263(c): one who holds a working or operating interest, either as a fee owner or under a lease or any other form of contract granting working or operating rights.
2. IRC Section 469(c)(3)(A): 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.
3. IRC Section 469(b): suspended passive losses are carried forward and treated as a deduction allocable to the activity in the next taxable year.
4. IRC Section 465, at-risk limitation: deductible losses are limited to amounts for which the taxpayer is personally liable or has pledged qualifying property; nonrecourse financing generally does not increase at-risk basis.
5. IRC Section 57(a)(2)(A): excess intangible drilling costs are an alternative minimum tax preference item only to the extent they exceed 65 percent of the taxpayer's net income from oil, gas, and geothermal properties for the taxable year.
6. IRC Section 57(a)(2)(E): independent producer exception limiting the resulting reduction in alternative minimum taxable income to 40 percent of AMTI computed without regard to the exception.
7. IRC Sections 611 and 613A: percentage depletion allowance of 15 percent of gross income from the property for independent producers, continuing after cost basis is exhausted.
8. IRC Section 461(l), excess business loss limitation, 2026 thresholds of $256,000 single and $512,000 married filing jointly.
9. IRC Section 461(h), economic performance rules, including the 90-day drilling exception relevant to year-end intangible drilling cost prepayments.
10. IRS Publication 925, passive activity loss rules, including the $25,000 special allowance phase-out for real estate between $100,000 and $150,000 of modified adjusted gross income.
11. IRS Revenue Procedure 2025-32, 2026 federal income tax brackets, top 37 percent rate beginning at $640,600 single and $768,600 married filing jointly.
12. IRS IR-2025-111, 2026 retirement plan contribution limits, including the 401(k) employee deferral limit of $24,500 and combined limit of $72,000.
13. SEC Rule 501 and Rule 506(c) of Regulation D, accredited investor criteria, including net worth exceeding $1,000,000 excluding primary residence, or income exceeding $200,000 single or $300,000 joint in each of the prior two years.
14. Industry fee benchmarking for pooled oil and gas funds, including management fees of approximately 1 to 2 percent of committed capital or net asset value, acquisition fees of approximately 1 to 5 percent of purchase price, and carried interest near 20 percent of profits above an 8 to 10 percent preferred return.
15. Fund lifecycle disclosure pattern commonly used across pooled energy vehicles, including distributions targeted within approximately six months of fund close, reinvestment of net income in early years, a shift toward full distribution near a three to five year target fund life, and overall hold periods ranging from one to eleven years.

Evaluate Your Position with Summit Ventures

Summit Ventures structures direct working interest participation for high-income financial professionals who want the Section 469(c)(3)(A) exception by legal form — not by hours tracking — with K-1 documentation granular enough to independently verify and defend.

Apply the same three-check diligence framework to your own capital that you would apply for a client: confirm legal form, verify at-risk basis, and review a sample K-1 before committing.

Explore Direct Working Interest Oppor...

The structural distinction is verifiable in the governing documents before any capital moves. Start there.