

Offsetting a Peak Pass-Through Income Year Without Stepping Away From the Business

A Consideration-Stage Case Study on How an Active Operating CEO Evaluated a Direct Working-Interest Joint Venture to Shelter Concentrated K-1 Income While Keeping Full Attention on Company Operations

Explore This Structure for Your Situation

Case Classification & At-a-Glance Summary

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Participant Type

Founder-CEO, privately held specialty industrial services company, pass-through S corporation structure

Income Profile

Annual K-1 distribution consistently above $750,000 for three consecutive fiscal years, driven by profitable growth — not a sale event

Decision Point

Fourth-quarter tax planning window; current-year distribution projected to be the largest in company history

Structure Evaluated

Direct working-interest participation in an operated joint venture drilling program

Statutory basis: IRC Section 263(c) and Treasury Regulation 1.612-4 intangible drilling cost election, IRC Section 469(c)(3)(A) working interest exception to the passive activity loss rules, IRC Section 465 at-risk limitation, IRC Section 57(a)(2) alternative minimum tax preference treatment.

Time constraint: No capacity for a second operating role, a board seat, or a material participation hours commitment.

Participant Profile, Trigger & Situation

The participant is the founder and CEO of a privately held specialty industrial maintenance and coatings contractor operating across several regional hubs in the Gulf Coast corridor. The company is structured as a pass-through S corporation. Growth has come from reinvestment rather than acquisition: crew expansion, additional rolling equipment, and yard capacity, all funded out of retained earnings. That reinvestment pattern is deliberate and has worked. It has also meant that, outside of the business itself, the CEO's personal balance sheet is thin. Most of the household's net worth sits inside the operating company's equity value, a single illiquid asset tied to one industry and one set of customer contracts.

The trigger for this case was a third-quarter management review. Two large municipal contracts closed in the same fiscal year, both ahead of schedule, both unusually profitable. The company's CPA flagged that the resulting K-1 pass-through distribution would be the highest in the company's history and would push the CEO's taxable income further into the top federal bracket. The 2026 brackets use seven marginal rates — 10%, 12%, 22%, 24%, 32%, 35%, and 37% — and a single filer reaches the 37% rate only above $640,600, while married couples filing jointly reach the 37% rate only above $768,700. That top marginal rate of 37 percent applies to taxable income above $640,600 for single filers and above $768,600 for married couples filing jointly, with the rate structure itself made permanent rather than reverting upward, under 2025 federal budget reconciliation legislation.

> "I cannot take on a second job to fix this." — The CEO's framing. This is not an exit case. The company was performing well and the plan was to keep running it, not sell it.

Challenge & Decision Criteria

The challenge had three parts. First, the surplus cash flow needed to be addressed before December 31 of the current tax year, since the distribution had already occurred and the liability was fixed. Second, whatever structure was used had to offset active income — the K-1 distribution and the CEO's W-2 compensation — not merely income already classified as passive under the tax code. Third, the structure could not require a second set of operating decisions. The CEO already worked a full schedule running the company. Anything requiring board meetings, site visits, or a material participation hours commitment was disqualifying on its face.

Those three requirements became the evaluation criteria the CEO's advisory team used to screen alternatives: does it offset active income, does it diversify the personal balance sheet away from the operating company, and does it require operational hours the CEO does not have.

Criterion 1: Offset Active Income

Must address K-1 pass-through distributions and W-2 compensation — not passive-category income only

Criterion 2: Diversify the Balance Sheet

Must move capital away from the single illiquid operating company equity position

Criterion 3: No Operational Hours Required

Must not require board seats, site visits, or a material participation hours commitment

Options Evaluated & Approach Selected

The advisory team mapped four paths.

1 Reinvest Back Into the Company

The default pattern. Would not diversify the balance sheet and would not change the current-year tax exposure.

2 Passive Real Estate Limited Partnership

At this income level, limited help. The standard $25,000 real estate loss allowance phases out between $100,000 and $150,000 of modified adjusted gross income — well below this CEO's income. The limited partnership structure does not carry an active-income offset path comparable to a working interest.

3 Diversified Securities Account

Would address diversification but not the current-year tax exposure, since dividend and interest income is taxed in the year received with no comparable first-year cost-based deduction.

4 Direct Working Interest Joint Venture ✓ Selected

Under IRC Section 469(c)(3)(A), a working interest held directly — or through an entity that does not limit the holder's liability — is excluded from the definition of a passive activity. That exclusion allows intangible drilling costs to offset active income, including K-1 distributions and W-2 compensation. Critically, Section 469(c)(3) carries no material participation hours test.

A working interest held through a liability-limited vehicle such as a standard limited partnership or LLC loses the Section 469(c)(3)(A) exception entirely — entity structure is the deciding factor.

Implementation: Three Phases to Year-End

The advisory team's review and the CEO's own evaluation moved in three phases ahead of year-end.

Phase 1: Cost Classification & Basis Review

The CEO's CPA and the operator reviewed the authorization for expenditure for the specific well program, separating intangible drilling cost components — labor, fuel, drilling mud, and other items without salvage value — from tangible drilling cost components such as casing and wellhead equipment, consistent with Treasury Regulation 1.612-4. The CPA confirmed at-risk basis under IRC Section 465 and reviewed the potential alternative minimum tax preference item for excess intangible drilling costs under IRC Section 57(a)(2).

Phase 2: Capital Contribution & Documentation

The capital contribution was executed and documented ahead of the calendar year-end close, since the intangible drilling cost election under Section 263(c) is tied to the tax year in which costs are paid or incurred. The joint operating agreement was reviewed for governance terms, including reporting cadence and the consent thresholds that apply before further authorizations for expenditure are approved — giving the CEO visibility into decisions without requiring an operational seat.

Phase 3: Active Development Program Participation

The CEO's participation was applied to an active development program involving a workover and recompletion on an existing wellbore with established production history, rather than a wildcat exploration well. The operator's engineering team targeted a specific uphole zone with prior offset production data, using the existing wellbore to reduce drilling time relative to a new-drill program. Baseline production from the recompletion was reported to participants through the operator's standard monthly reporting package.

Results

The direct consequence evaluated by the CEO's CPA was a current-year reduction in taxable pass-through income tied to the elected intangible drilling cost deduction, sized to the specific authorization for expenditure and the CEO's own cost basis — not a fixed percentage applied across the industry. Actual tax treatment in any case depends on the specific IDC and TDC classification of the well program, the participant's individual tax position, applicable federal and state tax treatment, and the guidance of the participant's own CPA. This case does not represent a guaranteed dollar outcome, a specific deduction percentage, or a projected return.

Beyond the current-year tax mechanics, two outcomes mattered more to this CEO going forward.

- **Balance sheet diversification:** The capital contribution created a position in an asset class with a production and revenue cycle uncorrelated to the operating company's municipal contract backlog — a modest first step toward diversifying a personal balance sheet that had been almost entirely concentrated in one business.
- **Time commitment matched the promise:** Quarterly reporting review, no weekly operational hours, no additional seat at a second company. The core business continued to receive the CEO's full attention.

Key Outcome Markers

0

Additional Operating Roles Required

Q4

Year-End Execution Window

3

Phases to Implementation

Illustrative Mechanics Summary

The table below maps each decision factor to the mechanism applied and its statutory or structural basis.

Decision Factor	Mechanism Applied	Statutory / Structural Basis
Entity structure for holding the working interest	Direct holding or holding through an entity that does not limit liability	IRC Section 469(c)(3)(A)
Classification of active income to be offset	K-1 pass-through distribution and W-2 compensation, not passive-category income	IRC Section 469(c)(3)(A) working interest exception
Cost component classification	Separation of intangible drilling costs from tangible drilling costs on the authorization for expenditure	IRC Section 263(c), Treasury Regulation 1.612-4
Deduction eligibility ceiling	Confirmation of amount at risk before any deduction is claimed	IRC Section 465
Alternative minimum tax exposure review	Preference item analysis for excess intangible drilling costs	IRC Section 57(a)(2)
Time commitment required of the participant	No material participation hours test, unlike the real estate professional standard	IRC Section 469(c)(3) (contrast with Section 469(c)(7))
Governance visibility without operational role	Joint operating agreement reporting cadence and consent thresholds reviewed in place of a board or operating seat	Joint operating agreement terms specific to the program

Lessons Learned & Key Takeaways

"I didn't have room in my week for a second company. What I needed was a structure where the tax mechanics did the work on their own, without pulling me into another set of operating decisions I didn't have time to make well."

This statement is a composite illustration of sentiment commonly expressed by active operators evaluating this structure. It is not attributed to any identifiable individual and is not a testimonial.

1

Entity Structure Is the Deciding Factor

Entity structure — not income level or industry — determines whether a working interest loss can offset active income. A liability-limited holding vehicle forfeits the Section 469(c)(3)(A) exception and the position defaults to passive treatment.

2

No Hours Test Is the Key Distinction

The absence of a material participation hours test is the feature that made this structure workable for a time-constrained operating CEO. That is a meaningful distinction from the real estate professional standard, which requires more than 750 annual hours in real property trades.

3

Timing Discipline Matters

The intangible drilling cost election is tied to the tax year in which costs are paid or incurred, which is why the advisory team moved the authorization for expenditure review and capital contribution ahead of the calendar year-end close.

4

Diversification Without Correlation

Diversification value came from the production cash flow's lack of correlation to the operating company's own revenue cycle — not from a projected rate of return, since no specific return was promised or implied.

5

Governance ≠ Operational Involvement

Reviewing joint operating agreement terms and monthly reporting preserved visibility for the CEO without requiring a committee seat or weekly time commitment.

Questions for Evaluation & Closing Perspective

Questions to Bring to Your Advisory Team

- Does your current entity holding structure — direct ownership, general partnership, or a liability-limited vehicle — preserve the Section 469(c)(3)(A) working interest exception, or would it default to passive treatment?
- Has your CPA confirmed your at-risk basis under Section 465 ahead of year-end, before any intangible drilling cost deduction is modeled?
- What is your realistic quarterly bandwidth for reviewing joint operating agreement reporting, separate from taking an operational or governance seat?
- How concentrated is your personal balance sheet in your operating company today, and what would a modest diversification step look like without reducing your reinvestment in the business?
- Is the current-year timing of your K-1 distribution or W-2 compensation such that a year-end decision window applies to your own tax planning?

Closing Perspective

The pattern in this case is specific to one recurring situation: an operator with concentrated, high pass-through or W-2 income, limited bandwidth for a second operating commitment, and a year-end planning window. It is not a substitute for individual tax or financial advice, and the mechanics described here depend on the specific authorization for expenditure, the participant's entity structure, and professional guidance tailored to that participant's circumstances.

Active operators evaluating this kind of structure should review their own entity holding format, at-risk basis, and alternative minimum tax exposure with their CPA before treating any of the mechanics above as applicable to their own tax year.

Sources & References

- Tax Foundation, "2026 Tax Brackets and Federal Income Tax Rates," taxfoundation.org, citing IRS Revenue Procedure 2025-32
- q3adv.com, "2026 Tax Brackets: Full IRS Rate Tables by Filing Status," citing IRS Revenue Procedure 2025-32
- 26 U.S.C. Section 469(c)(3)(A) — working interest exception to the passive activity loss rules
- 26 U.S.C. Section 263(c) and Treasury Regulation 1.612-4 — intangible drilling cost election
- 26 U.S.C. Section 465 — at-risk limitation on allowable deductions
- 26 U.S.C. Section 57(a)(2) — AMT preference treatment for excess intangible drilling costs
- IRS Publication 925 — passive activity loss rules and real estate rental loss allowance phase-out
- 26 U.S.C. Section 469(c)(7) — real estate professional material participation standard, referenced for contrast only

Discuss Your Situation With Our Team