

Direct Working Interest Structuring

What CPAs and Tax Professionals Need to Confirm Before Year End

A Professional Brief on the IRC Section 469(c)(3)(A) Direct Holding Requirement, Audit-Ready K-1 Reporting, and AFE Documentation Standards

PROFESSIONAL BRIEF | YEAR-END TAX PLANNING | OIL & GAS

Executive Takeaway: Why This Matters

Every fourth quarter, CPA firms serving high-income clients field the same request: a mechanism to offset a year-end spike in ordinary income before December 31. Oil and gas working interest participation is one of the few categories in the Internal Revenue Code built for exactly this purpose, but the mechanism that allows intangible drilling cost (IDC) deductions to offset active W-2, 1099, or K-1 income is not the IDC election itself.

> ⚠ The critical mechanism is **IRC Section 469(c)(3)(A)** — the working interest exception to the passive activity loss rules — and it only applies when the client holds the interest **directly** or through an entity that does not limit liability.

This single structural fact is the recurring point of failure in syndicated energy offerings marketed to CPA referral networks. A pooled LP or LLC structure can still generate a Schedule K-1 with IDC line items, but if the vehicle limits the holder's liability, the exception is forfeited and the losses revert to passive treatment, available only against passive income.

When a preparer offsets a client's active income using losses from a liability-limited syndication, the return carries an audit exposure that traces back to a documentation gap, not a tax planning failure. Firms evaluating this category need a framework that confirms direct holding in writing, before the K-1 is prepared, not after an examination begins.

Statutory Context: Section 263(c) vs. Section 469(c)(3)(A)

Section 263(c) — What Most CPAs Know

Section 263(c) and Treasury Regulation 1.612-4 permit a working interest holder to elect to expense intangible drilling costs — such as labor, fuel, drilling mud, and site preparation — in the year incurred rather than capitalizing them.

This election has existed in substantially its current form since the Internal Revenue Code of 1954, with Treasury guidance tracing back to 1916. It is well understood by most tax professionals as the statutory basis for the category's deduction profile.

Section 263(c) governs deduction timing and character. It does not, by itself, determine whether the deduction can offset a client's active income.

Section 469(c)(3)(A) — The Critical Distinction

That determination rests on IRC Section 469(c)(3)(A), which states that passive activity *"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."*

No material participation or hours-based test applies, unlike the real estate professional status rules under Section 469(c)(7). The exception turns entirely on entity structure and the nature of the holding.

This makes it one of the few income-offset mechanisms in the Code that does **not** require the client to log participation hours — but it demands precise structural compliance.

The Key Issue: Structure Determines Everything

CPAs advising clients on year-end ordinary income mitigation are increasingly encountering offerings that present themselves as working interest participation while structuring the client's actual holding as an LP limited partnership unit or an LLC membership interest in a fund. Both entity types limit the holder's liability by design. Under the plain language of Section 469(c)(3)(A), that liability limitation forecloses the exception regardless of how the sponsor's marketing materials characterize the deduction.

The practical consequence for the preparer is twofold:

K-1 Documentation Risk

The K-1 issued by such a syndication may show IDC pass-through without clarifying that the underlying interest is held through a liability-limiting entity, leaving the preparer to determine passive-versus-active classification without the documentation to support an active position.

Independent Application of Rules

Because Section 465 at-risk rules and Section 469 passive activity rules are independently applied, a structure that fails the direct-holding test cannot be cured by at-risk basis alone. The structural failure is not a math problem — it is a legal one.

The opportunity for firms evaluating this category is to work from a framework where direct holding, AFE-level cost documentation, and K-1 coding are confirmed in writing by the sponsor before the engagement proceeds, rather than reconstructed during a client examination.

Key Findings: Eight Critical Points

1 Direct Holding Requirement

IRC Section 469(c)(3)(A) requires that the working interest be held directly, or through an entity that does not limit the taxpayer's liability, such as a general partnership or direct assignment. LP and LLC fund structures do not meet this test.

2 No Material Participation Test

No material participation or hours test applies to the working interest exception, which differentiates it from the real estate professional status standard under Section 469(c)(7).

3 At-Risk Rules Apply Independently

IRC Section 465 at-risk rules apply independently of Section 469. A client's deduction is limited to actual economic exposure — cash contributed plus qualifying recourse debt. Nonrecourse financing does not increase at-risk basis.

4 AMT Preference Item Threshold

IRC Section 57(a)(2)(B) treats excess intangible drilling costs as an AMT preference item only to the extent the excess IDC deduction exceeds 65 percent of the taxpayer's net income from oil, gas, and geothermal properties for the year — an exception preparers should model before year end.

1 Percentage Depletion Allowance

IRC Sections 611 and 613A permit independent producers an ongoing 15 percent percentage depletion allowance against gross income from production — a recurring benefit once a well is producing, separate from the upfront IDC election.

2 Economic Performance Timing

IRC Section 461(h) economic performance rules generally require that drilling activity begin within 90 days of a December payment for the IDC election to apply to that tax year — a timing detail directly relevant to year-end engagement deadlines.

3 Well-Specific AFE Required

The Authorization for Expenditure (AFE) issued for each well is the underlying engineering and cost document that establishes the split between intangible and tangible costs for a specific interest. A client-specific AFE — not a fund-level composite estimate — is the appropriate support for the IDC election claimed on that client's return.

4 K-1 Must Reflect Active Classification

Schedule K-1 reporting for a properly structured direct working interest should reflect nonpassive, active classification consistent with the entity's liability structure, supported by documentation the preparer can retain in the client file.

Analysis: Participation Model & Structural Elements

Participation Model

A direct working interest structure assigns the client an undivided interest in a specific well or group of wells, or places the client in a general partnership or joint operating arrangement that does not limit liability for operations. This differs materially from a fund or syndication, where the client purchases a security or membership interest in a pooled vehicle that owns the underlying wells.

The distinction is not cosmetic. It is the fact pattern Section 469(c)(3)(A) is written around, and it is the first item a CPA should confirm before accepting a client's K-1 at face value.

Structural Elements

The documents that evidence direct holding are identifiable and specific:

Assignment / Participation Agreement

Names the client as a direct holder of the working interest in a specific well or group of wells.

Joint Operating Agreement (JOA)

Describes the liability structure of the arrangement and confirms the client's non-limited-liability position.

Well-Specific AFE

Shows the projected intangible and tangible cost components before drilling begins — the foundation for the IDC election.

Structural Confirmation Memo

A written sponsor memorandum identifying the holding entity type and confirming it does not limit liability — suitable for the client file.

CPA Review Sequence: Statutory Layers in Order

For a managing partner or tax director reviewing this category for a client book, the review sequence should mirror the statutory layers in order. Firms that build this review into their standard engagement checklist convert a marketing claim into a documented tax position — which is the standard an examination will apply regardless of how the opportunity was originally presented to the client.



Confirm 469(c)(3)(A)

Confirm At-Risk Basis

Model Sec 57(a)(2)(B)

Confirm AFE / IDC Election

Confirm K-1 Nonpassive Codes

This review sequence is not a one-time exercise. Firms that build it into their standard due diligence process gain a repeatable framework for evaluating direct working interest opportunities as they arise, rather than treating each client inquiry as a one-off research project during the busiest weeks of the year.

Recommendations & Due Diligence Checklist

CPA firms evaluating direct working interest opportunities for client referral should request, before the engagement proceeds, the following items as a single package:

1

Written Structural Confirmation

A memorandum identifying how the interest is held and confirming it meets the direct-holding standard under 469(c)(3)(A) — suitable for retention in the client file.

2

Well-Specific AFE

The Authorization for Expenditure supporting the IDC and tangible cost split for the specific interest at issue — not a composite or fund-level estimate.

3

Sample K-1 Schedule

A sample K-1 in advance of tax season showing how the sponsor codes active versus passive classification, so the review can occur before the filing deadline rather than during it.

4

Direct Sponsor Contact

A confirmed direct line of communication with the sponsor's accounting or operations team during the compressed first-quarter filing period, when AFE and K-1 questions are most time-sensitive.

Due Diligence Questions to Ask Every Sponsor

Before advising any client to proceed, firms should be able to answer each of the following questions affirmatively and in writing:

Entity Structure

Does the offering document identify the specific entity type through which the client would hold the interest, and does that entity limit liability?

AFE Availability

Is a well-specific AFE available before the client's capital contribution, showing the projected intangible and tangible cost allocation for that interest?

469(c)(3)(A) Confirmation

Does the sponsor provide a written structural confirmation addressing the 469(c)(3)(A) direct-holding standard, suitable for the client file?

K-1 Coding Alignment

How does the Schedule K-1 code the allocation, and does that coding align with active or passive treatment given the entity structure?

At-Risk Basis

What is the client's at-risk basis under Section 465, and does it reflect cash and qualifying recourse debt only?

AMT Modeling

Has the Section 57(a)(2)(B) AMT exception been modeled against the client's net oil and gas income for the year?

Filing Period Support

What is the sponsor's point of contact for AFE and K-1 questions during the first-quarter filing period?

Summary, Implications & Next Steps

The deduction mechanics associated with oil and gas working interest participation are well documented, but the question that determines whether those mechanics help a specific client is narrower and more easily overlooked: **how the interest is held.**

For the Client

The difference between a direct holding and a liability-limited syndication determines whether a given year's drilling losses are usable against ordinary income at all.

For the CPA Firm

The difference determines whether the position taken on the return is supportable on audit using documentation retained at the time of filing, rather than reconstructed later from sponsor marketing materials.

For the Advisory Relationship

Firms that build a repeatable, documented review process around this distinction are positioned to evaluate future offerings in the category efficiently, rather than re-underwriting the structure from scratch each time a client raises the opportunity.

Next Steps

Firms evaluating this category for one or more clients ahead of year end should request the structural confirmation memorandum, the well-specific AFE, and a sample K-1 schedule as a single package before advising a client to proceed.

Summit Ventures provides these three items directly to reviewing CPA firms as part of its entrepreneurial joint venture structure, along with a direct accounting support line during the first-quarter filing period for AFE and K-1 coordination questions.

A technical discussion with Summit's team can walk through how a specific client's facts align with the 469(c)(3)(A) standard before any capital contribution is made. A firm that builds this review sequence into its standard due diligence process gains a repeatable framework for evaluating direct working interest opportunities as they arise.

IRC Section 469(c)(3)(A) requires direct holding, or holding through an entity that does not limit liability, before IDC losses can offset active income. Section 465 at-risk rules, the Section 57(a)(2)(B) AMT exception, and Section 611/613A depletion all apply on top of that threshold question — not in place of it.

A CPA firm that confirms direct holding in writing, reviews a well-specific AFE, and checks K-1 coding before the engagement proceeds is positioned to support the client's position on audit, independent of how the opportunity was sourced or marketed.

Schedule a Technical Discussion with Summit Ven...