

Direct Working Interest Ownership vs. Limited Liability Entities

A Comparative Analysis of Liability Governance, Section 469(c)(3)(A) Active Income Treatment, General Partnership Conversion Mechanics, Insurance Coverage Layers, and Direct Title Structures for Oil and Gas Working Interests Held Within Client Estate Plans

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Reader Question and Executive Comparison

When a client's estate plan is expected to hold a working interest in an oil and gas well, the entity question looks deceptively familiar to estate counsel. Most clients' operating businesses, rental real estate, and investment portfolios are held inside an LLC, family limited partnership, or similar liability-limiting entity for exactly the reasons counsel would expect: creditor protection, simplified administration, and compatibility with valuation-discount gifting strategies. A working interest in oil and gas behaves differently under the Internal Revenue Code, and applying the same default entity structure can quietly strip away the tax characteristic that made the asset attractive in the first place.

The core question this guide addresses is: should a working interest be held directly by the client, through a revocable trust, or through a true general partnership or tenancy-in-common arrangement under a joint operating agreement, or should it instead be held inside an LLC or limited partnership the way the rest of the client's holdings typically are structured. The answer turns on a single statutory test under Internal Revenue Code **Section 469(c)(3)(A)**, which excludes a working interest from the passive activity loss rules only where the taxpayer holds the interest *"directly or through an entity which does not limit the liability of the taxpayer"* [1]. Liability exposure and tax characterization are tied together by this one clause, which means the liability-limiting features estate counsel reaches for by default are the same features that convert an otherwise active-income-offsetting deduction into a passive loss.

> This guide compares the two structural paths objectively, across ownership, participation, governance, liquidity, tax treatment, liability exposure, and administrative complexity, and then walks through the structuring mechanics estate counsel will need when a client's facts call for direct or general partnership holding: how an existing LLC or LP-held interest can be converted to direct or general partnership form, how the resulting personal liability exposure is typically managed through layered insurance rather than entity structure, and how title to the underlying real property interest should be documented and recorded.

Option A

Direct Working Interest Ownership — satisfies Section 469(c)(3)(A); active income treatment preserved; unlimited personal liability

Option B

Limited Liability Entities — liability capped at contributed amount; losses default to passive activity treatment under Section 469

The Core Tension

The liability-limiting features that protect the client are the same features that convert active deductions into passive losses — no single structure optimizes both

What Is Compared and Evaluation Criteria

Option A: Direct Working Interest Ownership

Covers four closely related holding forms that each satisfy the "does not limit liability" language of Section 469(c)(3)(A):

- Outright individual ownership of record title to the working interest
- Ownership through a revocable living trust disregarded for federal income tax purposes under the grantor trust rules
- Co-ownership with other working interest owners as tenants in common under a joint operating agreement (JOA)
- Ownership through an actual general partnership in which each partner bears unlimited, typically joint and several, liability for partnership obligations [2]

Option B: Limited Liability Entities

Covers working interests held inside a limited liability company or a limited partnership, including family limited partnerships and family LLCs commonly used for multigenerational wealth transfer and valuation-discount gifting. In both forms, the entity itself — not the individual member or limited partner — holds record title to the working interest and bears first-line liability for well operations, while the member's or limited partner's exposure is generally capped at the amount contributed (plus any undistributed profits) [3].

Seven Evaluation Criteria

1. Ownership and title mechanics
2. Day-to-day and governance participation
3. Decision authority under the controlling joint operating agreement
4. Liquidity and transferability
5. Federal income tax treatment of losses and deductions
6. The nature and limits of liability exposure
7. Administrative complexity across the client's lifetime and through a transfer at death

Option A: Direct Working Interest Ownership — Deep Dive

A working interest held directly, through a disregarded revocable trust, through tenancy-in-common co-ownership under a JOA, or through a general partnership satisfies Section 469(c)(3)(A) because none of these holding forms interposes a liability shield between the client and the well's obligations. For the revocable trust variant specifically, this works because a revocable living trust is, by definition, a grantor trust under Internal Revenue Code Section 676: the grantor retains the power to revoke, so the trust's assets, income, and tax attributes are treated as the grantor's own for federal income tax purposes, and the trust is not treated as a separate taxpayer while it remains revocable [4]. That transparency means a working interest assigned into a revocable trust for probate avoidance purposes generally continues to be treated as held "directly" by the client for Section 469(c)(3)(A) purposes, because the IRS disregards the trust entirely for income tax reporting.

Tenancy-in-common co-ownership under a JOA requires a closer look. Several working interest owners who jointly develop a lease under a JOA can, under the right facts, be treated as a "qualified partnership" for federal tax purposes, which historically meant a blank partnership return rather than full Subchapter K treatment. The Tax Court's 1953 decision in *Bentex Oil Corp. v. Commissioner* disrupted that assumption, holding that parties operating under a JOA had in fact formed a partnership, which forced Congress to create a statutory fix: Internal Revenue Code Section 761(a) [5]. Co-owners operating under a JOA can elect out of Subchapter K entirely if they (a) own the property as co-owners, (b) reserve the right to separately take in kind or dispose of their respective shares of production, (c) do not jointly market the oil or gas produced, and (d) can determine their own income without computing partnership-level taxable income, consistent with Treasury Regulation Section 1.761-2(a)(3) [6].

> ⚠ An actual general partnership is the most liability-exposed version of Option A. Partners in a true general partnership are personally liable, typically on a joint and several basis, for partnership obligations — including well costs, environmental remediation, and plugging and abandonment liabilities that can exceed the amount originally contributed [2] [7].

Making (or being deemed to have made) a valid 761(a) election allows each co-owner to take its own IDC election, depletion computation, and depreciation schedule directly, rather than at a partnership level, while still being treated as holding the interest directly or through an unincorporated co-ownership that does not itself limit anyone's liability.

Across all four variants of Option A, income and loss are typically reported on the owner's own return as business income rather than passive investment income (commonly Schedule C treatment for a working interest owner, rather than Schedule E), and working interest income is generally subject to self-employment tax, a consequence that does not apply to royalty income or to passive interests held through an LP [8]. Governance in Option A flows from the JOA itself: each working interest owner of record, as defined under Treasury Regulation Section 1.612-4(a) covering fee owners and lessees with an operating interest, has direct voting and consent rights on authorities for expenditure (AFEs), well proposals, non-consent elections, and operator removal, rather than delegating those rights to a managing member or general partner of an intervening entity [9].

Option B: Working Interest Held Through a Limited Liability Entity

When a working interest is assigned into an LLC or a limited partnership, the entity becomes the working interest owner of record under the JOA, and the client's exposure converts into a membership interest or limited partnership interest. Liability is capped at the amount contributed plus any undistributed profits; the member or limited partner is not personally exposed to capital calls, environmental remediation costs, or the well's plugging and abandonment liability beyond that contributed amount [3].

That same liability cap is what disqualifies the interest from the Section 469(c)(3)(A) exception. The statute does not look at how actively a member participates, how many governance rights the operating agreement grants, or how the entity is taxed; it looks only at whether the holding structure limits liability. Once it does, losses generated by the working interest default to passive activity treatment under the general Section 469 framework, meaning the deductions can offset only passive income, not the client's W-2 wages, 1099 income, or active K-1 distributions from an operating business, regardless of the entity's governance provisions. Intangible drilling cost deductions, percentage depletion under Sections 611 and 613A, and the at-risk limitation of Section 465 still apply at the entity or owner level, and the excess-IDC alternative minimum tax preference item under Section 57(a)(2) is unaffected by entity choice, but the active-versus-passive characterization is decided entirely by the liability question, not by the tax mechanics underneath it.

Discounted Gifting Advantage

Family limited partnerships and family LLCs remain the standard vehicle for discounted gifting of fractional interests to multiple generations, because minority and marketability discounts are generally available on gifted LP or LLC interests in a way they are not on an undivided direct working interest.

Centralized Governance

Centralized governance through a managing member or general partner reduces the operational burden on family members who have no interest in reviewing AFEs or voting on well proposals.

Simplified Administration

Consolidated entity-level K-1 reporting can simplify administration across a large family group of beneficiaries, offsetting some of the complexity of entity formation and maintenance.

Comparison Table: Direct Working Interest vs. Limited Liability Entity

Category	Direct Working Interest (Option A)	Limited Liability Entity (Option B)
Ownership & Title	Record title held by the individual, a disregarded revocable trust, tenants in common under a JOA, or a general partnership; recorded in the county or parish real property records against the underlying lease.	Record title held by the LLC or limited partnership; the client holds a membership or limited partnership interest, not direct record title to the leasehold.
Participation	Each owner of record participates individually in AFE consent, non-consent elections, and well proposals under the JOA.	Participation is typically delegated to a managing member or general partner; individual members vote only on matters reserved in the operating or partnership agreement.
Governance & Control	Governance rights run directly to the client as a named working interest owner under the controlling JOA.	Governance is centralized at the entity level, which supports multigenerational administration but reduces any single family member's direct decision authority.
Liquidity	Transfer requires a recorded assignment of the undivided real property interest, title curative work, and operator consent where required by the JOA.	Transfer of membership or limited partnership interests is generally simpler to document and can be sized in fractional increments for gifting programs.
Tax Treatment	Generally satisfies Section 469(c)(3)(A); intangible drilling cost deductions and depletion may offset active income, subject to the Section 465 at-risk limitation and the Section 57(a)(2) excess-IDC AMT preference [1] [10].	Liability-limiting structure forecloses the Section 469(c)(3)(A) exception; losses default to passive activity treatment and may offset only passive income, regardless of the entity's governance provisions.
Exposure & Limitations	Personal liability is unlimited and, in a true general partnership, joint and several; exposure can exceed the amount originally contributed and typically requires layered insurance to manage [7].	Liability is capped at the amount contributed plus undistributed profits; the entity, not the individual owner, bears first-line exposure to well-related claims.
Complexity	Requires attention to real property recording, coordination of a Section 761(a) election among co-owners where applicable, and self-employment tax reporting.	Entity-level formation, state filings, operating or partnership agreement drafting, and consolidated K-1 administration, offset by simpler downstream gifting mechanics.

Advantages, Limitations, and Best-Fit Scenarios

Advantages & Limitations of Option A

The advantage of Option A is that it is the only structure that reliably preserves the Section 469(c)(3)(A) active income characterization, while also giving the client a direct governance voice under the JOA as a named working interest owner rather than as a passive member of an intervening entity. Its principal limitation is that the same feature that preserves the tax treatment — unlimited personal liability — also exposes the client's other assets to well-related claims, and it is a less natural fit for multigenerational gifting, since fractional direct interests do not carry the valuation discounts typically available on LLC or LP units.

Advantages & Limitations of Option B

The advantage of Option B is liability containment and compatibility with established discounted gifting and family governance techniques. Its limitation — and the specific concern this guide was built to address — is that the liability cap is not separable from the tax outcome: an estate plan that moves a working interest into an LLC or FLP for asset protection or gifting reasons will, as a direct consequence, convert the interest's losses to passive treatment under Section 469, even if the entity's operating agreement otherwise preserves every governance right the client previously held directly.

Best-Fit Scenarios: Option A

Option A tends to fit:

- Clients whose primary planning objective is preserving the ability to offset active income in the years IDC deductions are generated
- Clients prepared to accept personal liability layered with a robust insurance program rather than an entity-based shield
- Smaller family groups where direct governance participation is valued
- Situations where a revocable trust is already in place purely for probate avoidance and the client understands that a revocable trust does not provide meaningful creditor protection during the grantor's lifetime [11]

Best-Fit Scenarios: Option B

Option B tends to fit:

- Clients whose primary objective is multigenerational transfer through discounted gifting
- Clients with limited risk tolerance for personal exposure to well liabilities
- Larger family groups with beneficiaries who will never participate in operational decisions
- Situations where the client already holds other income sources capable of absorbing passive losses, such as other working interests or passive real estate, so that the passive characterization under Option B does not meaningfully reduce the economic value of the deduction

Structural Mechanics for Estate Counsel

General Partnership Conversion Mechanics

Where a client's facts call for converting an LLC-held or LP-held working interest back into direct or general partnership form, the conversion typically proceeds in a defined sequence.

1

Entity Distribution

The entity distributes or assigns the undivided working interest out to its members or partners in kind, in proportion to their respective ownership percentages, terminating the entity's role as record titleholder.

2

Recorded Assignment

The former members or partners execute a recorded assignment of working interest naming themselves individually, a disregarded revocable trust, or a newly formed general partnership as the direct holder of record title.

3

JOA Joinder

The co-owners enter into, or are joined to, a JOA that identifies them as the working interest owners and designates an operator, consistent with Treasury Regulation Section 1.612-4(a) [9].

4

Section 761(a) Election

Where the resulting holding is tenancy-in-common co-ownership, the co-owners should affirmatively elect out of Subchapter K under Section 761(a) and confirm in writing that the arrangement satisfies the co-ownership, separate-disposition, and no-joint-marketing requirements of Treasury Regulation Section 1.761-2(a)(3), to avoid the *Bentex Oil Corp.* result of inadvertent partnership classification [5] [6].

5

Structuring Memorandum

Counsel typically obtains a written structuring memorandum or tax opinion confirming that the converted holding independently satisfies the direct-or-unlimited-liability test of Section 469(c)(3)(A) before the client relies on the active income characterization in a given tax year.

Insurance Coverage Layers

Because direct or general partnership holding removes the entity-based liability shield, the practical risk management tool shifts from entity structure to an insurance program layered specifically for upstream oil and gas exposure. The JOA itself typically requires the operator to carry or provide insurance for the benefit of the joint account, set out in a dedicated insurance exhibit to the operating agreement [12]. A typical layered program for an operator and its working interest owners includes:

- **Primary commercial general liability** coverage for third-party bodily injury and property damage, which on energy risks commonly arrives with pollution and explosion, collapse, and underground hazard (XCU) exclusions that must be specifically endorsed back in
- **Control of well (operator's extra expense)** coverage for the cost of regaining control of a blowout, including re-drilling and cleanup
- **Pollution legal liability**, carried separately from the general liability policy because standard liability forms typically exclude most pollution losses
- **Workers' compensation and employer's liability**, with stop-gap coverage required in monopolistic states
- **Umbrella or excess liability** layered above the underlying general liability, auto, and employer's liability limits, commonly ranging from five million to twenty-five million dollars depending on well depth, operator requirements, and the scope of operations [13] [14]

Estate counsel reviewing a client's direct or general partnership holding should request the operator's current certificate of insurance and the underlying insurance exhibit, confirm that the client (or the client's trust or partnership) is named as an additional insured or included within the joint account coverage, and confirm that the umbrella follows form over the underlying pollution and control-of-well coverage rather than excluding it.

Direct Title Structures

A working interest is an interest in the underlying oil and gas lease, and direct title should be evidenced the same way any other real property interest would be: through a recorded assignment of working interest filed in the county or parish real property records where the leasehold is located, distinct from a membership interest assignment or a general ledger entry on an entity's books. Estate counsel confirming a direct title structure should verify that the recorded assignment names the correct holder — whether that is the client individually, the client's revocable trust by its formal trust name, or a general partnership — that the JOA and any AFE issued for the well identify the same party consistently as a working interest owner of record, and that the chain of title contains no unresolved gaps that could trigger the JOA's title-failure provisions. At the client's death, a working interest includible in the gross estate generally receives a basis adjustment under Internal Revenue Code Section 1014 to its fair market value as of the date of death, which in turn resets the depletable basis available to the client's heirs for future percentage or cost depletion computations under Sections 611 and 613A, a coordination point estate counsel will want to confirm with the client's tax preparer when the working interest passes through the estate rather than remaining in an already-funded revocable trust.

Decision Guidance and Questions for Estate Counsel

The entity question for a client's working interest should be resolved by first asking which objective predominates for that specific asset: **current-year active income offset**, or **multigenerational wealth transfer through discounted gifting**. These two objectives pull in opposite directions under current law, and no single entity choice optimizes both simultaneously. Where active income offset predominates, counsel should confirm direct, revocable trust, or general partnership holding, document the Section 761(a) election where tenancy-in-common co-ownership is involved, and build out the insurance program described above to manage the resulting personal exposure. Where discounted multigenerational transfer predominates, counsel should accept that losses will be characterized as passive under Section 469 and plan the client's broader passive income sources accordingly, rather than relying on the working interest itself to shelter active income.

1 Primary Planning Purpose

For this specific client, does the working interest's primary planning purpose favor active income offset, or does it favor discounted multigenerational transfer, and has that priority been documented in the planning file?

2 Grantor Trust Confirmation

If the interest will be held in a revocable trust, has the trust been confirmed to remain a grantor trust under Sections 671 through 679 for as long as the client intends to rely on direct holding treatment?

3 Section 761(a) Election

If multiple co-owners will hold the interest as tenants in common under a JOA, has a Section 761(a) election out of Subchapter K been made or documented as deemed made, and do the facts satisfy the co-ownership, separate-disposition, and no-joint-marketing requirements of Treasury Regulation Section 1.761-2(a)(3)?

4 Community Property Review

Has the client's other separate or community property been reviewed for exposure if the working interest is held through a general partnership with joint and several liability among co-owners?

5 Insurance Verification

Has the operator's current insurance exhibit and certificate of insurance been obtained and reviewed, including control of well, pollution legal liability, and umbrella limits, and does the client's holding entity appear as an additional insured or within the joint account coverage?

6 Recorded Title Consistency

Is the assignment of working interest properly recorded in the county or parish real property records, and does the JOA and any AFE consistently identify the same party as the working interest owner of record?

7 FLP/LLC Conversion Warning

If the interest will later be funded into an FLP or family LLC for gifting purposes, has the client been advised that doing so will convert the interest's losses to passive treatment under Section 469, regardless of the governance rights retained in the operating or partnership agreement?

8 Section 1014 Basis Coordination

At the client's death, has the depletable basis reset under Section 1014 been coordinated with the client's tax preparer for whichever heir or trust receives the working interest?

Working through these questions with the client's CPA before the entity structure is finalized allows estate counsel to make the liability and tax tradeoffs explicit, rather than defaulting to the same LLC or family limited partnership structure used for the rest of the client's holdings. The statutory test under Section 469(c)(3)(A) does not bend to governance language in an operating agreement, and the liability exposure on the direct side does not bend to good intentions; both sides of this comparison require deliberate structuring, accurate recorded title, and a verified insurance program matched to the operator's actual coverage, so that the client's estate plan reflects an informed choice rather than an inherited default.

Summit Ventures: Supporting Estate Counsel

Summit Ventures supports this analysis for estate counsel by making available full joint operating agreements, the operator's liability coverage schedules, and legal structuring briefs describing how a given well's working interest is held of record, so that estate counsel can independently verify — before advising a client — whether a specific participation satisfies the direct-or-unlimited-liability requirement of Section 469(c)(3)(A) and how the operator's insurance program is layered against the client's resulting exposure. This review supports estate counsel's own analysis; it does not substitute for independent legal or tax advice specific to the client's facts.

Full JOA Access

Complete joint operating agreements available for counsel review, confirming working interest ownership of record and operator designations

Insurance Coverage Schedules

Operator's liability coverage schedules including control of well, pollution legal liability, and umbrella limits for independent verification

Legal Structuring Briefs

Structuring briefs describing how a given well's working interest is held of record and how the Section 469(c)(3)(A) test is satisfied

> The statutory test under Section 469(c)(3)(A) does not bend to governance language in an operating agreement, and the liability exposure on the direct side does not bend to good intentions. Both sides of this comparison require deliberate structuring, accurate recorded title, and a verified insurance program matched to the operator's actual coverage — so that the client's estate plan reflects an informed choice rather than an inherited default.

Sources: [1] IRC §469(c)(3)(A) · [2] usenergyinvesting.com · [3] anchor1031.com · [4] IRC §676 · [5] Bentex Oil Corp. v. Commissioner, 20 T.C. 565 (1953) · [6] Treas. Reg. §1.761-2(a)(3) · [7] Falcon West Energy / Bramble Solutions · [8] usenergyinvesting.com · [9] Treas. Reg. §1.612-4(a) · [10] IRC §§465, 57(a)(2) · [11] LegaLees / TaxSharkInc · [12] A.A.P.L. Form 610 · [13] Alliance Risk · [14] Bramble Solutions

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