

Tax-Aware Direct Working Interest Participation for Private Pilots

Applying the Statutory Working Interest Exception to Flight Pay, Profit Sharing, and Duty-Time-Constrained Tax Planning

WHITE PAPER | IRC SECTION 469(C)(3) | SUMMIT VENTURES

Executive Summary

Professional and private pilots, particularly senior widebody captains at major carriers, routinely earn active income that clears the top federal tax bracket once base pay, overtime, profit-sharing distributions, and signing or retention bonuses are combined. Unlike many high-income professionals who can shift hours or restructure a practice to pursue certain tax strategies, pilots operate under federal duty-time regulation that caps flying hours by rule, not by personal choice. This single fact eliminates several hours-based tax strategies as a practical matter and makes a statutory mechanism that requires no hours test particularly relevant to this persona.

This white paper examines one such mechanism: direct participation in oil and gas working interests structured as an entrepreneurial joint venture rather than a passive investment vehicle. It explains the distinction between the timing provision that allows certain drilling costs to be deducted in the year incurred (IRC Section 263(c)) and the separate provision that determines whether that deduction may offset active, ordinary income at all (IRC Section 469(c)(3), the working interest exception to the passive activity loss rules).

This paper is educational in nature. It is not tax, legal, or investment advice, and any pilot evaluating this structure should review their specific compensation composition with a qualified CPA or tax attorney before acting.

The Core Problem

Federal duty-time regulation caps flying hours by rule — not by personal choice — eliminating hours-based tax strategies as a practical option while leaving active income fully exposed at the top marginal rate.

The Statutory Solution

IRC Section 469(c)(3) carves out a narrow and specific path for direct working interest ownership in oil and gas wells: **no hours test, no material participation requirement, no test of how the taxpayer spends their time at all.** The exception depends entirely on the legal form of ownership.

Why This Issue Matters: Pilot Compensation Structure

Pilot compensation concentrates active income in ways that differ from a standard salaried position. Understanding these unique characteristics is essential to appreciating why a statutory mechanism built for scale — rather than incremental deferral — is needed.

Base & Overtime Pay

Senior widebody captains at major carriers routinely clear **400,000 to 550,000 dollars or more per year** once base pay, overtime, and profit-sharing are combined. Pay scales with seniority and aircraft type.

Profit-Sharing & Bonuses

Annual profit-sharing payouts, signing bonuses for new-hire or type-rating commitments, and retention bonuses tied to contract cycles are paid in **concentrated amounts** that can push a pilot's taxable income sharply higher in a single tax year.

Flight-Related Liquidity Events

Pilots who hold an interest in a charter operation, flight school, or fixed-base operator and sell that interest — or who receive a deferred compensation payout upon retirement — add another layer of **active income concentrated around a specific event.**

Federal Duty-Time Regulation

FAR Part 117.23(c) caps flight duty period hours at **60 within any 168 consecutive hours** and 190 within any 672 consecutive hours. Industry practice caps flying at roughly 100 hours per 28 days and 1,000 hours per year. These limits are not discretionary.

A pilot cannot simply work more hours to qualify for a tax strategy that requires a personal-services hours threshold — a structural constraint most other high-income professionals do not face in the same regulated form.

The 2026 Tax Landscape for High-Income Pilots

For 2026, the federal income tax brackets published under IRS Revenue Procedure 2025-32 place the top marginal rate of 37 percent on taxable income above 640,600 dollars for single filers and 768,700 dollars for married filing jointly, a structure made permanent by the One Big Beautiful Bill Act. A captain with a strong profit-sharing year or a signing bonus can clear these thresholds without difficulty.

37%

Top Marginal Rate

Applies above $640,600 (single) or $768,700 (MFJ) for 2026 under IRS Rev. Proc. 2025-32

$24,500

401(k) Deferral Limit

2026 employee deferral limit; combined employee-and-employer limit of $72,000

$7,500

IRA Contribution Limit

2026 Traditional and Roth IRA limit; Roth eligibility phases out above $252,000 MAGI for joint filers

$512K

Excess Business Loss Cap

Section 461(l) cap for joint filers in 2026; $256,000 for single filers

None of these figures are sized to meaningfully offset a six-figure profit-sharing distribution or bonus, leaving pilots in need of a statutory mechanism built for the scale of the problem rather than an incremental deferral tool, and one that does not depend on hours a pilot does not control.

Foundational Concepts: IDCs and the Distinction Most Explanations Miss

What an Intangible Drilling Cost Is

When a well is drilled, costs fall into two categories. **Tangible costs** — such as casing, wellhead equipment, and storage tanks — have salvage value and are capitalized and depreciated, generally over seven years under the Modified Accelerated Cost Recovery System established in IRC Section 168.

Intangible drilling costs (IDCs) have no salvage value. They include labor, drilling fluid and chemicals, site preparation, and hauling. Treasury guidance dating to 1916 first allowed these costs to be expensed, and the provision was codified as IRC Section 263(c) in the Internal Revenue Code of 1954. Treasury Regulation 1.612-4 permits a working interest owner to elect to deduct IDCs in the year incurred rather than capitalizing them over the life of the well. Industry reporting places IDCs at roughly **60 to 85 percent of total well cost**, though this is a range, not a guaranteed figure, and the actual percentage for any specific well is confirmed through the Authorization for Expenditure (AFE) issued for that well.

The Distinction Most Explanations Miss

Section 263(c) only governs the **timing and classification** of a deduction. It says nothing about what kind of income that deduction can offset.

The provision that determines whether an IDC deduction can offset active, ordinary income — including flight pay, profit-sharing distributions, and bonuses — is a **separate statute: IRC Section 469(c)(3)**, the working interest exception to the passive activity loss rules.

Under the general rule of IRC Section 469, losses from a passive activity can only offset passive income, not wages, business income, or portfolio income. Section 469(c)(3) carves out a narrow and specific path for direct working interest ownership in oil and gas wells.

The Statutory Framework in Detail

The Working Interest Exception

The practical consequence of IRC Section 469(c)(3) is that a properly structured direct working interest, held with unlimited liability exposure for that specific interest, is treated as nonpassive. The expensed IDC deduction generated under Section 263(c) can therefore offset active, ordinary income: flight pay, profit-sharing distributions, bonuses, and deferred compensation payouts all qualify as the category of active income this exception is designed to interact with, without requiring the pilot to satisfy any hours-based participation standard.

The statute's own language, found at 26 U.S.C. 469(c)(3)(A), excludes from the definition of passive activity *"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 with respect to such interest."* The exception depends entirely on the legal form of ownership, not on hours worked. If the same economic interest is instead held through an LLC or limited partnership that limits the owner's liability, the exception is forfeited and the activity reverts to passive treatment.

At-Risk Limitation (§465)

Limits deductibility to the amount the taxpayer has at risk — cash contributed plus any recourse debt for which the taxpayer is personally liable. Nonrecourse financing does not increase the at-risk amount.

AMT Treatment (§57(a)(2))

Excess IDCs are an AMT preference item only to the extent they exceed 65% of net income from oil, gas, and geothermal properties. Independent producers are exempt subject to a 40% AMTI ceiling — the 65/40/60 relationship.

Economic Performance (§461(h))

Requires economic performance before a cost can be deducted, restricting prepayment of drilling costs in December for a well that will not spud for months. A narrow 90-day drilling exception exists.

Percentage Depletion (§§611, 613A)

Independent producers may claim 15% of gross income from the property, continuing even after the property's cost basis has been fully recovered — unlike cost depletion.

The Four-Layer Loss Limitation Order

Before a drilling cost deduction reaches a taxpayer's Form 1040, it passes through four sequential limitations: first, basis limitation; second, the at-risk limitation under Section 465; third, the passive activity limitation under Section 469, which the working interest exception removes when the interest is held directly with unlimited liability; and fourth, the excess business loss limitation under Section 461(l). For 2026, Section 461(l) caps the amount of aggregate business losses that can offset nonbusiness income at 256,000 dollars for single filers and 512,000 dollars for joint filers, with any excess carried forward as a net operating loss rather than lost.

⚠ A pilot evaluating this structure in a year with a profit-sharing distribution or bonus should run the full AMT calculation against that specific income before assuming the regular-tax deduction flows through unaffected. For 2026, the AMT 28% rate applies above $244,500 of excess AMTI, and the AMT exemption phases out at 50 cents per dollar once AMTI reaches $500,000 (single) or $1,000,000 (joint filers).

What the Statute Does Not Shelter

A direct working interest in oil and gas is treated as an active trade or business, and the Tenth Circuit's decision in *Methvin v. Commissioner* confirms that this classification carries self-employment tax exposure, a distinct issue from income tax treatment. For a pilot already subject to self-employment tax considerations on any outside flight-related business income, this is a relevant parallel worth modeling explicitly.

K-1 Reporting

A properly structured direct working interest generates a Schedule K-1 reflecting nonpassive, active classification across Box 1, Box 12, Box 13, and Box 20, distinct from the passive-activity coding that applies to most LLC or limited partnership interests.

How Direct Working Interest Participation Is Structured

Summit Ventures structures direct working interest participation as an entrepreneurial joint venture built around four elements designed to preserve the statutory treatment described above — elements particularly well suited to a schedule-constrained pilot with limited spare hours to devote to active management.

1

Direct Assignment

The business participant receives a direct assignment of a working interest in a specific well or group of wells — not a fund share, a limited partnership unit, or a security. This direct assignment is the structural foundation that keeps the interest inside the Section 469(c)(3) exception rather than defaulting to passive treatment, and it requires no ongoing hours commitment from the participant.

2

AFE-Documented Cost Allocation

Every dollar allocated to intangible and tangible drilling costs is documented through the Authorization for Expenditure for that specific well, giving the active JV member and their CPA a verifiable, well-by-well record rather than a blended fund-level estimate.

3

Governance Rights & Operational Transparency

Active JV members retain governance rights and ongoing operational transparency into drilling, completion, and production decisions, consistent with the unlimited-liability, direct-ownership structure the statute requires, without a minimum personal-involvement threshold.

4

K-1 Active Classification Reporting

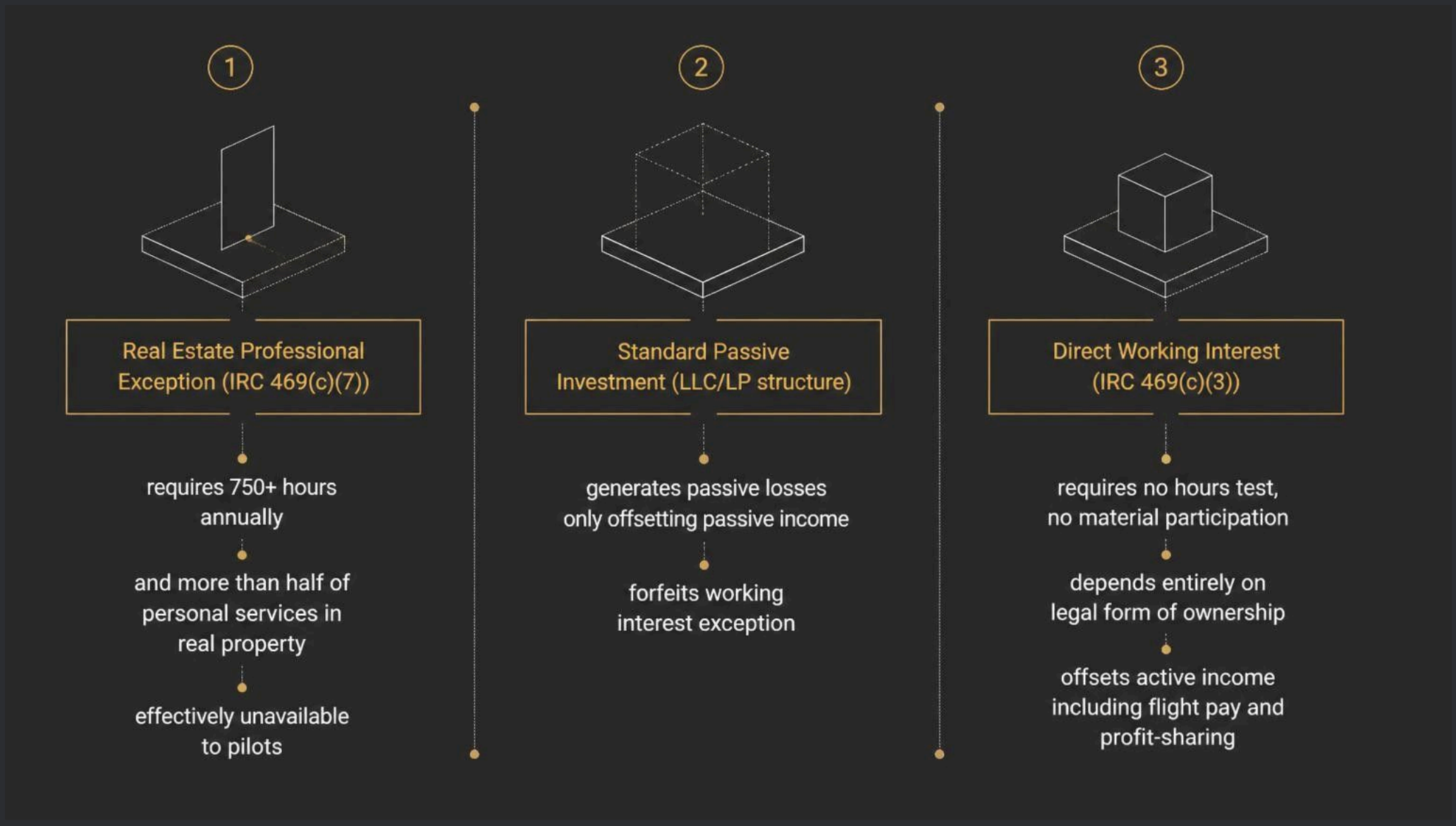
Annual K-1 reporting reflects the nonpassive classification appropriate to a direct working interest, giving the business participant and their tax preparer a documentation trail consistent with the statutory position being taken on the return.

Market Context

This structure sits against a market backdrop of continued domestic production growth. The U.S. Energy Information Administration's most recent short-term outlook reports that 2025 annual production reached a finalized record of 13.7 million barrels per day, with 2026 forecast to set a new record at 13.8 million barrels per day. Production in the first half of 2026 averaged 13.7 million barrels per day, a 2 percent increase of roughly 0.3 million barrels per day over the same period in 2025, with growth concentrated in the Permian Basin of Texas and New Mexico and the Federal Gulf of America. This is relevant market context for a pilot evaluating where to allocate a portion of a profit-sharing distribution — not a projection of any specific return, since well-level production and economics vary by project and are not guaranteed.

Comparing the Working Interest Exception to Other Strategies

Understanding how IRC Section 469(c)(3) differs from other high-income tax strategies clarifies why it is uniquely suited to pilots constrained by federal duty-time regulation.



The real estate professional exception under Section 469(c)(7) requires more than 750 hours of personal services annually and more than half of the taxpayer's personal services performed in real property trades — a test that is effectively unavailable to a pilot whose flying hours are federally capped and whose remaining time is further constrained by rest requirements. The working interest exception under Section 469(c)(3) stands in sharp contrast: no hours test, no material participation requirement, no test of how the taxpayer spends their time at all.

Recommendations and Questions for Your Advisor

Five Key Recommendations

1 Model Early

Pilots anticipating a year with a large profit-sharing distribution, signing bonus, or retention bonus should model that year's marginal and alternative minimum tax exposure well before the payout date, not after.

2 Verify Ownership Structure

Any direct working interest participation intended to offset active income under IRC Section 469(c)(3) must be structured as direct, unlimited-liability ownership. An interest held through an LLC or limited partnership that limits liability forfeits the exception — no amount of flying hours can substitute for this structural requirement.

3 Model At-Risk Basis

The at-risk limitation under IRC Section 465 should be modeled against the pilot's actual cash contribution and any recourse debt.

4 Run the Full Tax-Year Model

The AMT interaction under IRC Section 57(a)(2) and the excess business loss limitation under IRC Section 461(l) should both be run as part of the same tax-year model, particularly in a year with a concentrated bonus or profit-sharing payout.

5 Address SE Tax Separately

The self-employment tax exposure confirmed in *Methvin v. Commissioner* should be addressed directly with a tax advisor as a distinct line item, separate from the income tax analysis, particularly for pilots who also hold an interest in a flight-related business.

Questions for Professional Advisor Discussion

- Given my specific mix of base pay, profit-sharing distributions, and any signing or retention bonuses for this tax year, how would a direct working interest participation structured under IRC Section 469(c)(3) interact with that active income?
- What is my projected at-risk basis under IRC Section 465 given my specific cash contribution, and does any portion of my financing structure limit that basis?
- How would this participation affect my alternative minimum tax position under IRC Section 57(a)(2), given a year with a concentrated bonus or distribution?
- Does the specific assignment documentation for this working interest confirm direct, unlimited-liability ownership consistent with the Section 469(c)(3) exception, as opposed to an LLC or limited partnership interest?
- What is my projected exposure under the excess business loss limitation of IRC Section 461(l) for the tax year in question?
- Given that I cannot satisfy an hours-based test like the real estate professional exception due to federal duty-time regulation, how does the no-hours-test design of Section 469(c)(3) change the range of statutory strategies available to me compared to other high-income professionals?
- How should self-employment tax exposure under the *Methvin* precedent be modeled alongside any income I receive from an outside flight-related business interest?
- What documentation — including the Authorization for Expenditure and K-1 reporting — should I require before participating to support the nonpassive classification on my return?

Conclusion & Next Steps

Pilots operate under a federal regulatory structure that caps their flying hours for safety reasons — a constraint that quietly eliminates several hours-based tax strategies as a practical option while leaving active income from base pay, profit-sharing, and bonuses fully exposed at the top marginal rate. Understanding the distinction between the timing mechanism in IRC Section 263(c) and the active-income mechanism in IRC Section 469(c)(3) — a provision built around ownership structure rather than hours worked — along with the at-risk, alternative minimum tax, and excess business loss limitations that apply alongside it, gives a pilot and their tax advisor the statutory vocabulary needed to evaluate whether a direct working interest participation has a role to play in a specific compensation year.

> The working interest exception is not a loophole — it is a statutory provision built around ownership structure, not hours worked. For pilots whose hours are federally capped, this distinction is the difference between a strategy that is available and one that is not.

IRC §263(c)

Governs **timing** of IDC deduction — allows expensing in the year incurred rather than capitalizing over well life

IRC §469(c)(3)

Governs **what income** the deduction offsets — no hours test, depends entirely on direct, unlimited-liability ownership structure

IRC §465 + §461(l)

At-risk and excess business loss limitations — must be modeled in the same tax-year analysis, especially in bonus or distribution years

IRC §57(a)(2)

AMT preference item treatment — the 65/40/60 relationship means drilling deductions generally cannot reduce AMTI below ~60% of pre-deduction income

Sources and References

- [1] U.S. Energy Information Administration, Short-Term Energy Outlook and Today in Energy, "U.S. crude oil production forecast to reach new record in 2026," eia.gov/todayinenergy.
- [2] Internal Revenue Code Section 263(c); Treasury Regulation 1.612-4, intangible drilling and development costs.
- [3] Internal Revenue Code Section 168, Modified Accelerated Cost Recovery System.
- [4] Internal Revenue Code Section 469(c)(3), working interest exception to passive activity loss rules; 26 U.S.C. 469(c)(3)(A), Cornell Legal Information Institute.
- [5] Internal Revenue Code Section 469(c)(7), real estate professional exception requirements.
- [6] Internal Revenue Code Section 465, at-risk limitations.
- [7] Internal Revenue Code Section 57(a)(2), alternative minimum tax treatment of intangible drilling costs for independent producers.
- [8] Internal Revenue Code Section 461(h), economic performance requirement.
- [9] Internal Revenue Code Section 461(l), excess business loss limitation.
- [10] Internal Revenue Code Sections 611 and 613A, percentage depletion for independent producers.
- [11] 14 CFR Part 117.23(c), electronic Code of Federal Regulations, flight duty period cumulative limitations for flight crewmembers.
- [12] Federal Aviation Administration flight time and duty time scheduling practice, approximately 100 flight hours per 28 days and 1,000 flight hours per year.
- [13] Industry pilot compensation reporting, senior widebody captain total compensation ranges at major U.S. carriers.
- [14] Methvin v. Commissioner, United States Court of Appeals for the Tenth Circuit, self-employment tax treatment of working interest income.
- [15] Internal Revenue Service Revenue Procedure 2025-32, 2026 federal income tax brackets and alternative minimum tax exemption amounts; IRS IR-2025-111, 2026 retirement plan contribution limits.
- [16] Tax Reform Act of 1986, legislative origin of current passive activity loss rules under IRC Section 469 and the working interest exception.
- [17] One Big Beautiful Bill Act, permanent extension of 2017 individual tax rate structure and related provisions.

Explore Direct Working Interest Participation with Summit Ventures