

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 regulations cap flying hours by rule — not by personal choice — eliminating hours-based tax strategies that other high-income professionals can access.

The Statutory Solution

IRC Section 469(c)(3) provides a working interest exception built entirely around ownership structure, not hours worked — making it uniquely suited to the pilot's regulatory reality.

Why This Issue Matters: Pilot Compensation Structure

Pilot compensation concentrates active income in ways that differ from a standard salaried position:

Base & Overtime Pay

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

Lump-Sum Distributions

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 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.

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.

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** for single filers and **$768,700** 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.

The 2026 401(k) employee deferral limit is $24,500, with a combined employee-and-employer limit of $72,000; the 2026 Traditional and Roth IRA contribution limit is $7,500; and Roth IRA eligibility phases out above $252,000 of modified adjusted gross income for joint 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: What You Need to Know

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.

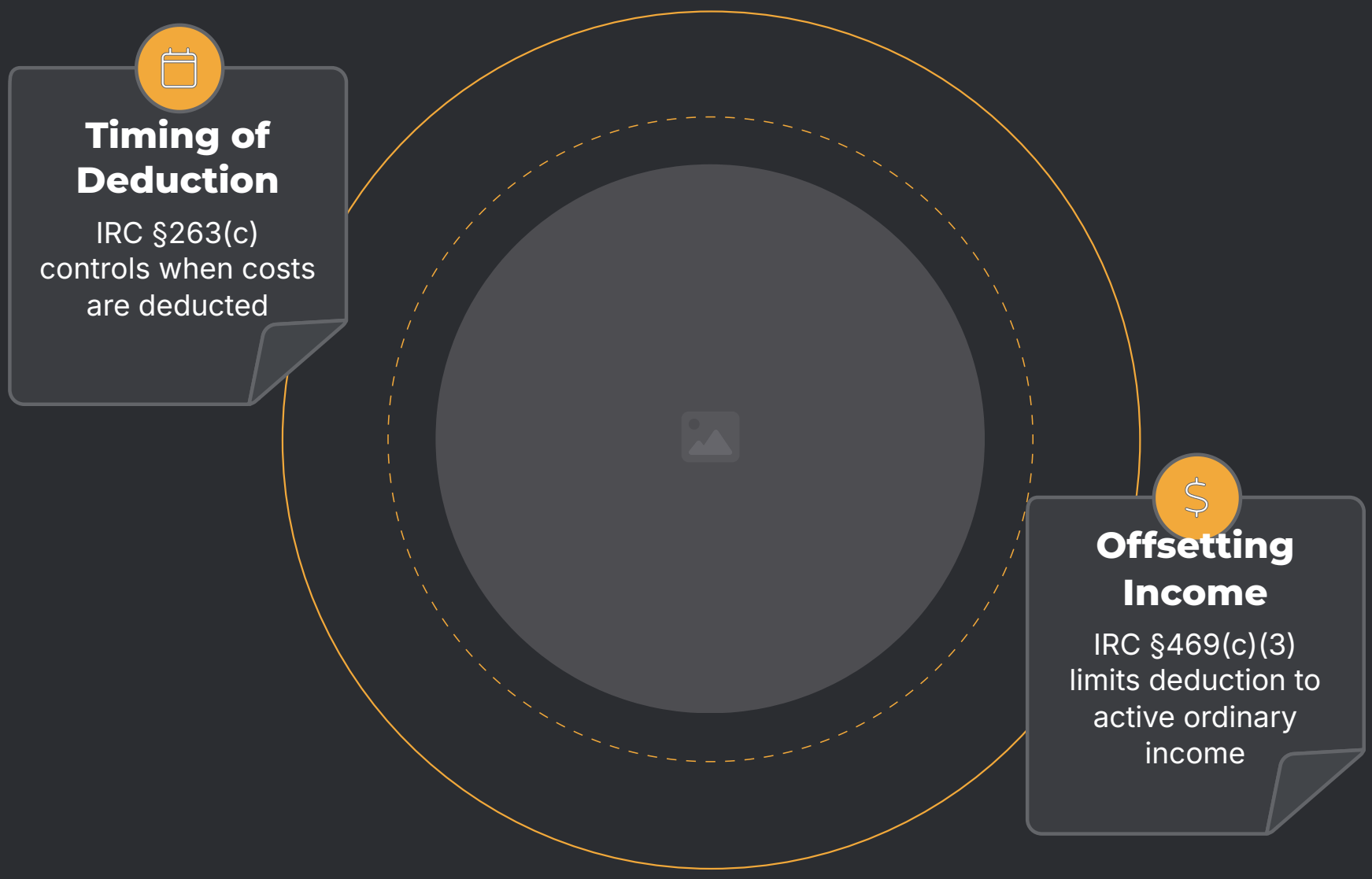
Industry reporting places IDCs at roughly **60 to 85 percent of total well cost**, though this is a range, not a guaranteed figure, and the actual percentage for any specific well is confirmed through the Authorization for Expenditure (AFE) issued for that well.

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: **no hours test, no material participation requirement, no test of how the taxpayer spends their time at all.**



The Statutory Framework in Detail

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.

Working Interest Exception

A properly structured direct working interest, held with unlimited liability exposure, is treated as nonpassive. IDC deductions can offset flight pay, profit-sharing, bonuses, and deferred compensation — with no hours-based participation standard.

At-Risk Limitation (§465)

Deductibility is limited 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 ceiling: the reduction to AMTI cannot exceed 40% of pre-reduction AMTI — the 65/40/60 relationship.

Economic Performance (§461(h))

Economic performance must occur before a cost can be deducted, restricting the practice of prepaying drilling costs in December for a well that will not spud for months. A narrow 90-day drilling exception exists.

The Four-Layer Loss Limitation Order

Before a drilling cost deduction reaches a taxpayer's Form 1040, it passes through four sequential limitations:

1

1. Basis Limitation

First gate: deduction cannot exceed taxpayer's basis in the interest

2

2. At-Risk (§465)

Second gate: limited to cash contributed plus recourse debt

3

3. Passive Activity (§469)

Third gate: **removed** by the working interest exception when held directly with unlimited liability

4

4. Excess Business Loss (§461(l))

Fourth gate: caps aggregate business losses offsetting nonbusiness income at $256,000 (single) / $512,000 (MFJ) for 2026

Additional Statutory Provisions

Percentage Depletion (§§611 & 613A)

IRC Sections 611 and 613A permit independent producers to claim percentage depletion, generally **15 percent of gross income from the property**, which continues even after the property's cost basis has been fully recovered, unlike cost depletion. This provision is tied to the policy objective of building long-term domestic energy production revenue by rewarding continued production from a working interest after the initial capital has been recovered through depreciation and depletion.

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.

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.

⚠ 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.

2026 AMT Key Thresholds

For 2026, the AMT 28 percent rate applies above **$244,500** of excess AMTI, and the AMT exemption itself phases out at 50 cents per dollar once AMTI reaches **$500,000** for single filers or **$1,000,000** for joint filers — a reversion to a pre-2018-style phaseout structure under the One Big Beautiful Bill Act. 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.

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: U.S. Domestic Production

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.

Recommendations & Implications

1 Model Tax Exposure 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 Structure Ownership Correctly

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 and reverts to passive treatment, and no amount of flying hours can substitute for this structural requirement.

3 Model the At-Risk Limitation

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 AMT & EBL Calculation

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 Self-Employment 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

The following questions are designed to structure a productive conversation with a qualified CPA or tax attorney when evaluating this strategy for a specific compensation year:

Active Income Interaction

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?

At-Risk Basis

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?

AMT Position

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?

Ownership Documentation

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?

Excess Business Loss Exposure

What is my projected exposure under the excess business loss limitation of IRC Section 461(l) for the tax year in question?

No-Hours-Test Advantage

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?

Self-Employment Tax Modeling

How should self-employment tax exposure under the Methvin precedent be modeled alongside any income I receive from an outside flight-related business interest?

Required Documentation

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 under IRC Section 469(c)(3) is one of the few statutory mechanisms in the Internal Revenue Code that is structurally indifferent to how many hours a taxpayer works — making it uniquely relevant to a profession where hours are federally capped for safety, not by choice.

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). [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. [12] Federal Aviation Administration flight time and duty time scheduling practice. [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. [15] Internal Revenue Service Revenue Procedure 2025-32, 2026 federal income tax brackets and AMT 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. [17] One Big Beautiful Bill Act, permanent extension of 2017 individual tax rate structure and related provisions.

Ready to evaluate whether a direct working interest participation has a role to play in your specific compensation year?

Connect with Summit Ventures | Learn More About Our Structure