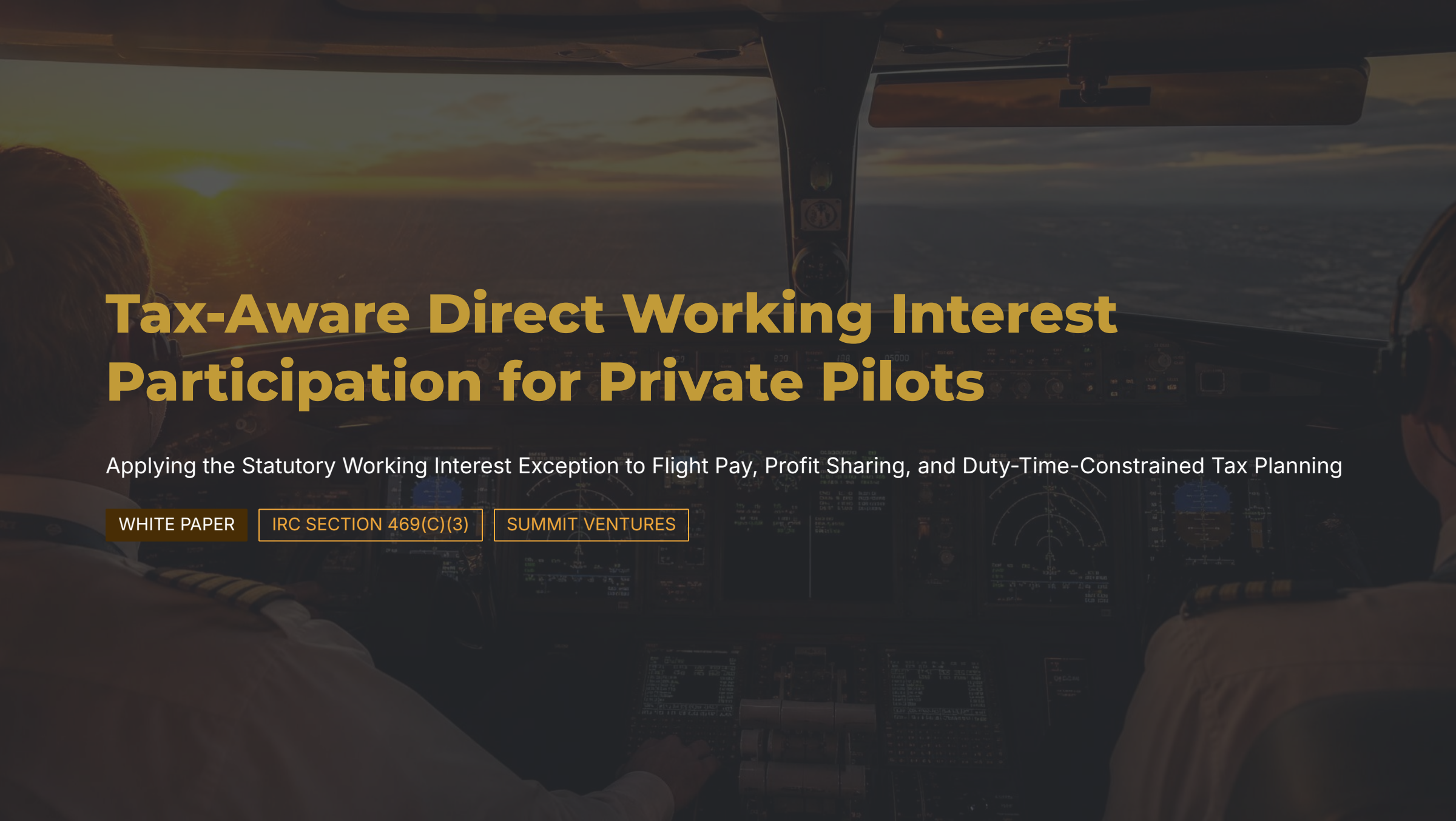


Tax-Aware Direct Working Interest Participation for Private Pilots

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.

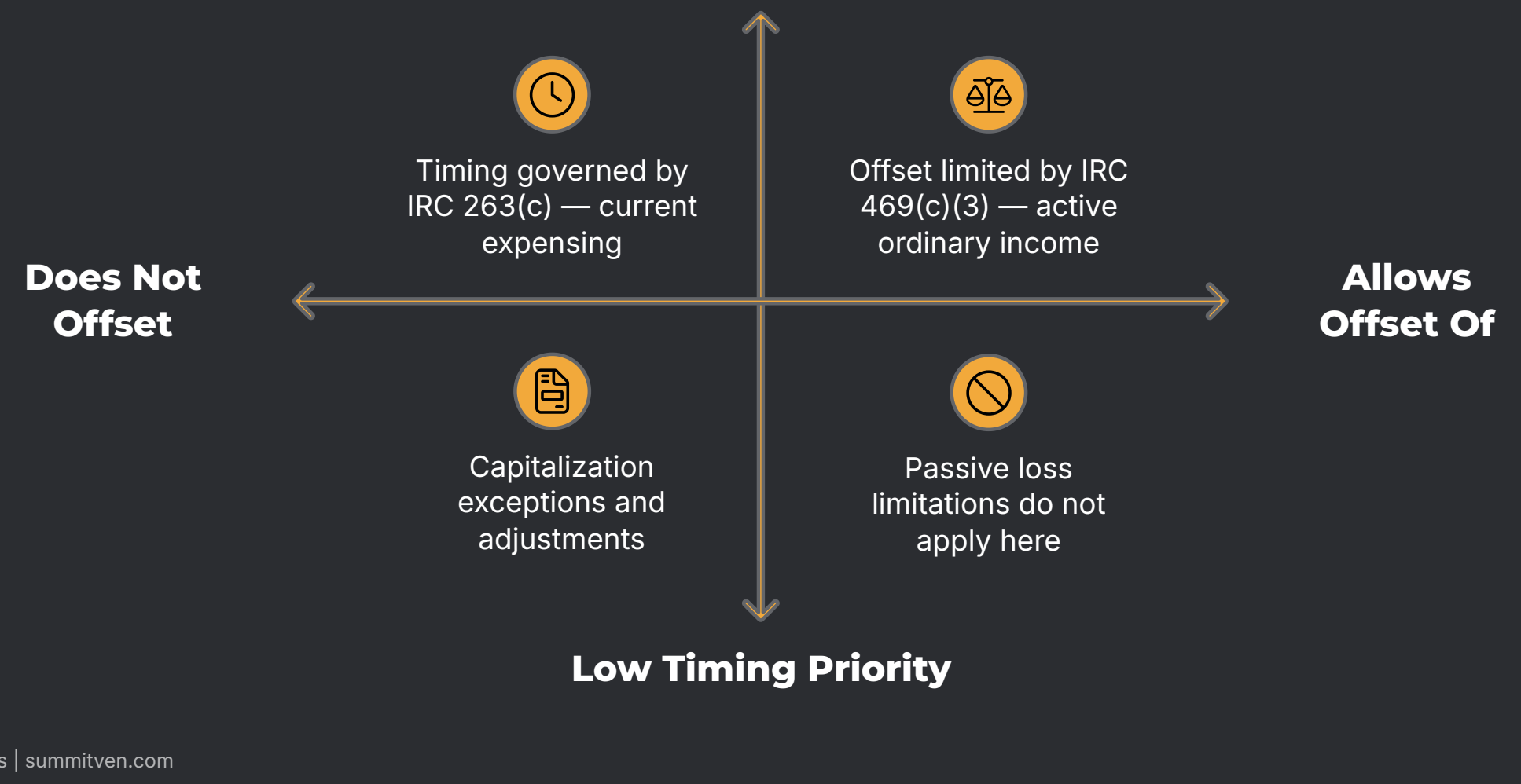
Industry reporting places IDCs at roughly **60 to 85 percent of total well cost**, though this is a range, not a guaranteed figure, and the actual percentage for any specific well is confirmed through the Authorization for Expenditure (AFE) issued for that well.

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

1 The Working Interest Exception — IRC Section 469(c)(3)

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 — without requiring any hours-based participation standard. The statute's own language 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 held through an LLC or limited partnership that limits the owner's liability, the exception is forfeited and the activity reverts to passive treatment.

2 At-Risk Limitation — IRC Section 465

IRC Section 465 limits deductibility to the amount the taxpayer has at risk, meaning cash contributed plus any recourse debt for which the taxpayer is personally liable. Nonrecourse financing does not increase the at-risk amount.

3 Alternative Minimum Tax Treatment — IRC Section 57(a)(2)

IRC Section 57(a)(2)(A) treats excess intangible drilling costs as an AMT preference item, but only to the extent those costs exceed 65 percent of the taxpayer's net income from oil, gas, and geothermal properties for the year. IRC Section 57(a)(2)(E) exempts independent producers from this preference item entirely, subject to a separate ceiling: the resulting reduction to alternative minimum taxable income cannot exceed 40 percent of AMTI computed without that reduction. The combined effect — sometimes summarized as the **65/40/60 relationship** — is that drilling cost deductions generally cannot reduce AMTI below roughly 60 percent of pre-deduction income. 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 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.

4 Economic Performance and Timing — IRC Section 461(h)

IRC Section 461(h) requires economic performance before a cost can be deducted, which restricts the common 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:

Basis Limitation

First layer — the deduction cannot exceed the taxpayer's basis in the interest.

At-Risk Limitation — Section 465

Second layer — limited to cash contributed plus recourse debt for which the taxpayer is personally liable.

Passive Activity Limitation — Section 469

Third layer — the working interest exception removes this limitation when the interest is held directly with unlimited liability. This is the critical gate for pilots.

Excess Business Loss Limitation — Section 461(l)

Fourth layer — for 2026, caps aggregate business losses that can offset nonbusiness income at **$256,000 for single filers** and **$512,000 for joint filers**. Any excess is carried forward as a net operating loss rather than lost.

Percentage Depletion — IRC Sections 611 and 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.

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.

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 and Implications

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.

Structure Matters Above All Else

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.

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.

Run the Full AMT and 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.

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

Before engaging in any direct working interest participation, pilots should bring the following questions to their CPA or tax attorney:

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.

IRC § 263(c)

Timing mechanism — IDCs deducted in the year incurred rather than capitalized over well life.

IRC § 469(c)(3)

Active-income mechanism — working interest exception requires no hours test, only direct unlimited-liability ownership.

IRC § 465 / § 57 / § 461(l)

Limitation framework — at-risk, AMT, and excess business loss rules must all be modeled in the same tax year.

Sources and References

[1] U.S. Energy Information Administration, Short-Term Energy Outlook, eia.gov/todayinenergy. [2] IRC Section 263(c); Treasury Regulation 1.612-4. [3] IRC Section 168, MACRS. [4] IRC Section 469(c)(3); 26 U.S.C. 469(c)(3)(A). [5] IRC Section 469(c)(7), real estate professional exception. [6] IRC Section 465, at-risk limitations. [7] IRC Section 57(a)(2), AMT treatment of IDCs. [8] IRC Section 461(h), economic performance. [9] IRC Section 461(l), excess business loss limitation. [10] IRC Sections 611 and 613A, percentage depletion. [11] 14 CFR Part 117.23(c), flight duty period cumulative limitations. [12] FAA flight time and duty time scheduling practice. [13] Industry pilot compensation reporting, senior widebody captain ranges. [14] *Methvin v. Commissioner*, Tenth Circuit, self-employment tax treatment. [15] IRS Revenue Procedure 2025-32; IRS IR-2025-111, 2026 retirement plan limits. [16] Tax Reform Act of 1986, IRC Section 469 and working interest exception. [17] One Big Beautiful Bill Act, permanent extension of 2017 individual tax rate structure.

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

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