

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: The Pilot Compensation Profile

Pilot compensation concentrates active income in ways that differ from a standard salaried position. Four structural features create the tax planning challenge:

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.**

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.

Federally Capped Hours

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 First

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.

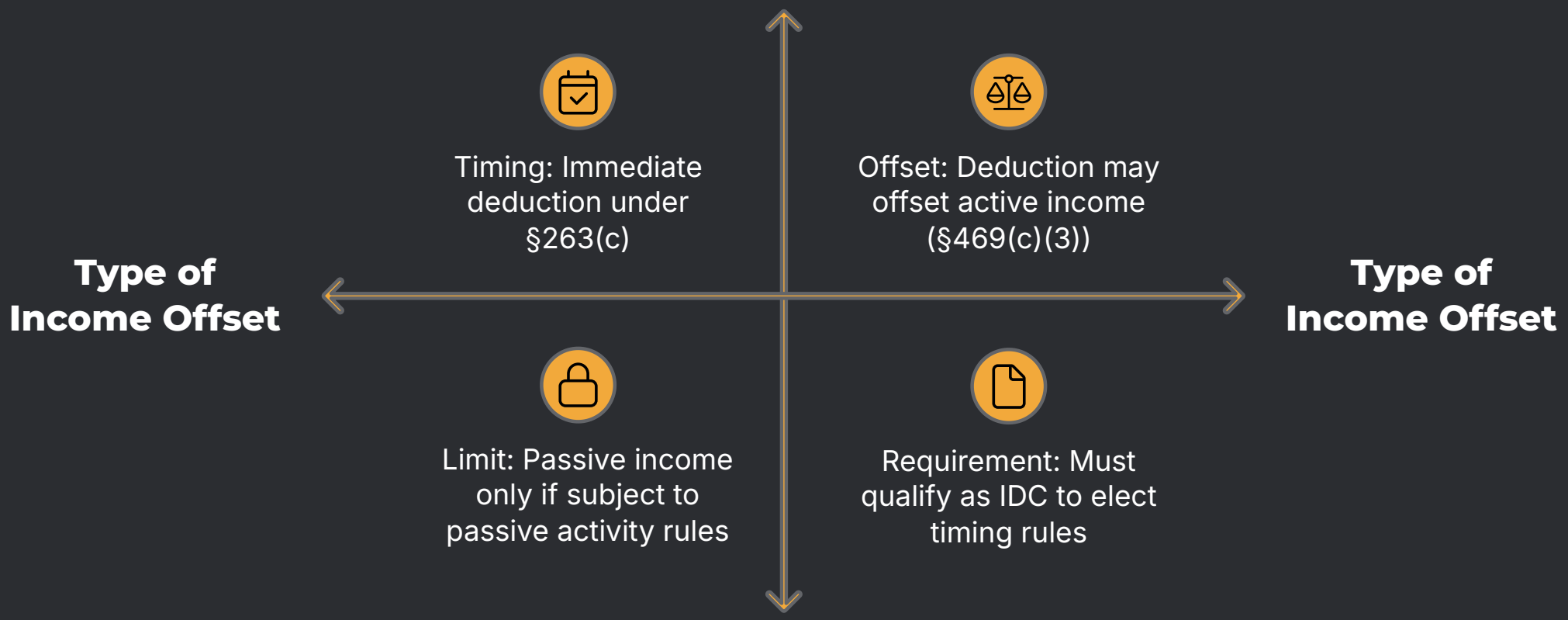
Industry reporting places IDCs at roughly **60 to 85 percent of total well cost**, though this is a range, not a guaranteed figure, and the actual percentage for any specific well is confirmed through the Authorization for Expenditure (AFE) issued for that well.

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 — IRC Section 469(c)(3)

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.

The practical consequence 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 — without requiring the pilot to satisfy any hours-based participation standard.

This stands in sharp contrast to the real estate professional exception under Section 469(c)(7), which 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.

At-Risk Limitation

IRC Section 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

IRC Section 57(a)(2)(A) treats excess IDCs as an AMT preference item, but only to the extent those costs exceed 65% of net income from oil, gas, and geothermal properties. Section 57(a)(2)(E) exempts independent producers, subject to a 40% AMTI ceiling — the 65/40/60 relationship.

Economic Performance

IRC Section 461(h) requires economic performance before a cost can be deducted, restricting 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.

Excess Business Loss Limit

IRC Section 461(l) caps aggregate business losses that can offset nonbusiness income at $256,000 for single filers and $512,000 for joint filers in 2026. Any excess is carried forward as a net operating loss rather than lost.

The Four-Layer Loss Limitation Order

Before a drilling cost deduction reaches a taxpayer's Form 1040, it passes through four sequential limitations. Understanding this order is essential for accurate tax modeling in any year with a concentrated bonus or profit-sharing payout.

Layer 1: Basis Limitation

The deduction cannot exceed the taxpayer's adjusted basis in the working interest. Direct ownership and cash contribution establish this foundation.

Layer 2: At-Risk Limitation (IRC §465)

Deductibility is limited to cash contributed plus recourse debt for which the taxpayer is personally liable. Nonrecourse financing does not count.

Layer 3: Passive Activity Limitation (IRC §469)

Under the general rule, losses can only offset passive income. The working interest exception under §469(c)(3) **removes this layer entirely** when the interest is held directly with unlimited liability — no hours test required.

Layer 4: Excess Business Loss Limitation (IRC §461(l))

For 2026, caps aggregate business losses offsetting nonbusiness income at $256,000 (single) / $512,000 (joint). Excess carries forward as a net operating loss.

Additional Provisions: Percentage Depletion & Self-Employment Tax

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.

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.

⚠ 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.

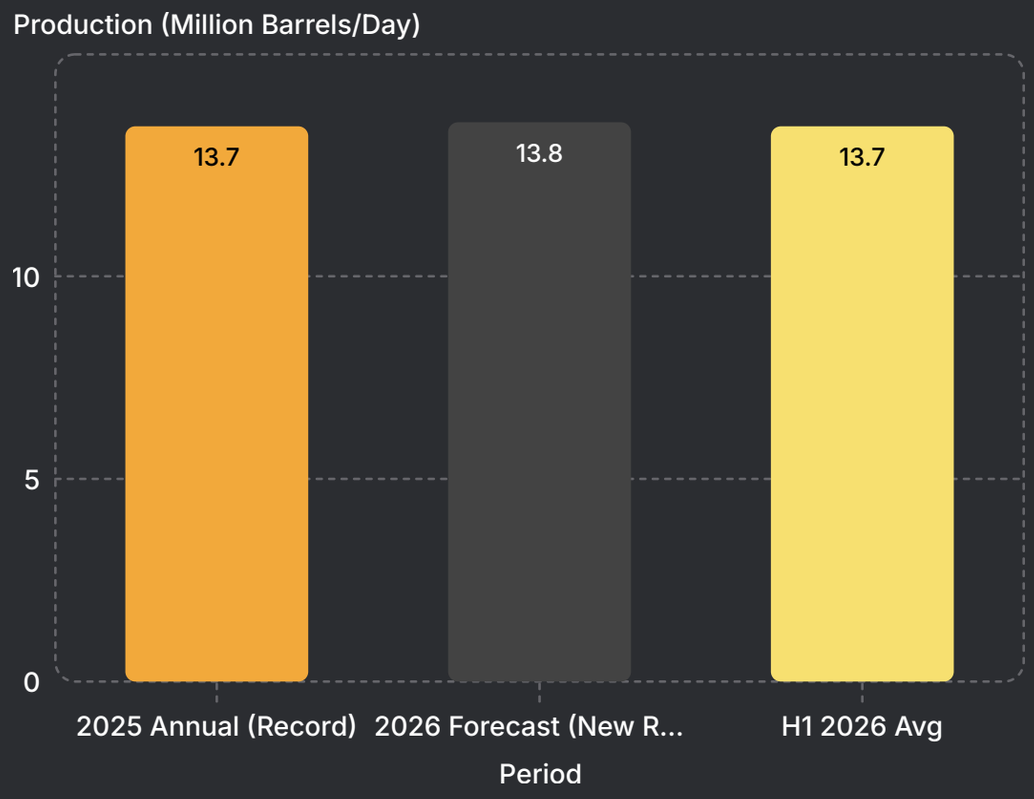
4

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: U.S. Domestic Production

This structure sits against a market backdrop of continued domestic production growth. The following data 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.



Source: U.S. Energy Information Administration, Short-Term Energy Outlook, eia.gov/todayinenergy

Key Production Highlights

- 2025 annual production reached a finalized record of **13.7 million barrels per day**
- 2026 forecast to set a new record at **13.8 million barrels per day**
- H1 2026 averaged 13.7 million barrels per day — a **2 percent increase** (~0.3 million bpd) over the same period in 2025
- Growth concentrated in the **Permian Basin** of Texas and New Mexico and the **Federal Gulf of America**

Recommendations & 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 Structure 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 — 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 AMT 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

> 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.

IRC §263(c) Timing: Deduct IDCs in the year incurred rather than capitalizing over well life	**IRC §469(c)(3)** Scope: Offset active, ordinary income — no hours test, ownership structure controls
IRC §465 + §461(l) Limits: At-risk basis and excess business loss caps apply in the same tax year	**AMT §57(a)(2)** Floor: The 65/40/60 relationship generally prevents AMTI from falling below ~60% of pre-deduction income

Ready to Explore Whether a Direct Working Interest Has a Role in Your Tax Year?

Summit Ventures structures direct working interest participation as an entrepreneurial joint venture designed for schedule-constrained pilots. Speak with our team to evaluate whether this statutory mechanism fits your specific compensation profile.

Speak With Summit Ventures | Learn More About Our Structure

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; Internal Revenue Service 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.