

Concentrated Income, Flat Brackets: A Statutory Tax Framework for Family Law Attorneys

An Analytical White Paper Examining IRC Section 263(c), Section 469(c)(3), and Direct Working Interest Participation in Domestic Energy Production

WHITE PAPER | TAX STRATEGY | FAMILY LAW

Executive Summary

Family law practice generates a distinctive income pattern. Retainers are collected, cases are litigated or mediated over months or years, and the largest fee collections of the year often land in a single concentrated window, when a contested high-asset divorce settles, a final decree closes, or a year-end billing cycle clears an accumulated balance. For a boutique firm partner or sole practitioner, that concentration meets a federal tax code that does not adjust for how income arrives, only for how much arrives. The result is a structurally high marginal tax exposure that conventional deferral tools were never designed to address at this income scale.

This white paper examines two statutory provisions, IRC Section 263(c) and IRC Section 469(c)(3), that together govern how a direct working interest in an oil and gas well is taxed and classified. It explains the mechanics of intangible drilling cost treatment, the working interest exception to the passive activity loss rules, and the related statutory layers — at-risk limitation, alternative minimum tax preference treatment, economic performance timing, excess business loss limitation, and percentage depletion — that determine how this structure actually functions for a family law attorney evaluating year-end tax planning options with a qualified advisor.

> The purpose of this document is educational. It explains the statutory framework in detail so that family law attorneys and their CPAs can evaluate the mechanics on their own merits, not as a sales proposition.

IRC Section 263(c)

Governs timing and classification of intangible drilling costs — when and how these costs are deducted rather than capitalized.

IRC Section 469(c)(3)

The working interest exception — determines whether deductions can offset active income like W-2 wages, 1099 income, or K-1 distributive shares.

Related Statutory Layers

At-risk limitation, AMT preference treatment, economic performance timing, excess business loss limitation, and percentage depletion.

Introduction: Why This Issue Matters

Family law attorneys spend their careers translating complex financial facts — business valuations, deferred compensation schedules, retirement account division, and tax basis characterization — into outcomes their clients can act on. A contested high-net-worth divorce routinely runs $50,000 to $500,000 or more per side once business valuation, forensic accounting, and expert witness work are layered onto attorney time. In 2026, high net-worth divorce attorneys typically charge $500 to $1,500 per hour, with total costs ranging from $50,000 to over $500,000 for highly contested matters. For the attorney billing those hours, this means that litigation retainers are often sized to match, with retainers ranging from $2,500 for uncontested matters to $25,000 or more for high-asset contested cases, replenished as the lawyer bills against the balance.

That billing structure — hourly work drawn against a retainer, a complex case that settles after eighteen months of discovery, a final fee collected at closing, or a year-end sweep of aged receivables — produces lumpy, concentrated income recognition. A managing partner's compensation reflects this directly. Partners and firm owners see the widest range of income, and a managing partner of an established family law firm with a strong referral network and a reputation for handling complex marital estates can build an income well above the all-lawyer median, particularly in affluent markets. The Bureau of Labor Statistics does not track family law as a separate occupational code, so the median annual wage of $159,670 for lawyers as of May 2025 is the only verifiable federal benchmark available, a figure that is pulled up by large corporate firms while family law skews toward solo and small-firm practitioners. In practice, this means a busy divorce practice handling complex marital estates can produce partner income, and partner K-1 distributive shares, that land well above that national anchor figure in a given tax year, concentrated around case resolutions rather than spread evenly across twelve months.

Foundational Concept #1

Timing and Classification: How a cost associated with drilling a well is treated for tax purposes in the year it is incurred. Governed by IRC Section 263(c) and Treasury Regulation 1.612-4.

Foundational Concept #2

Active Income Offset: Whether a deduction generated through a working interest can offset active income — W-2 wages, 1099 income, or partnership K-1 distributive shares — rather than being quarantined to offset only passive income. Governed by IRC Section 469(c)(3).

These two statutory ideas are frequently confused with one another even among sophisticated professionals. A family law attorney evaluating this structure needs both pieces to understand why direct working interest participation functions differently than a typical passive real estate or securities position.

The Problem: Income Concentration Meets a Flat Top Bracket

Three structural facts define the tax exposure family law attorneys face at the high end of the income range.

1 Federal Marginal Tax Brackets Are Flat Regardless of How Income Arrives

For 2026, the top 37 percent bracket begins at $640,600 for single filers and $768,700 for married filing jointly. A contested-case settlement, a year-end collection of aged receivables, or a lump-sum partnership distribution upon a partner's retirement or a firm merger does not receive separate tax treatment because it arrived in a concentrated period rather than evenly across the year.

2 Conventional Deferral Tools Are Capped Well Below Concentrated Fee-Collection Scale

For 2026, the employee 401(k) deferral limit is $24,500, with a combined employee-and-employer limit of $72,000, and a catch-up contribution of $8,000 for attorneys age 50 and older. A boutique firm partner whose K-1 distribution in a settlement year substantially exceeds these figures finds that standard retirement deferral vehicles cannot absorb a meaningful share of the additional taxable income, regardless of how diligently they are funded.

3 Hours-Based Alternatives Are Functionally Closed to Billable-Hour Professionals

Family law attorneys track time in six-minute increments for billing purposes, which makes the point worth stating plainly: strategies that require a demonstrated hours commitment — such as real estate professional status under the passive loss rules — require 750 hours of personal service annually and more than half of the taxpayer's personal service time, a test that is difficult to satisfy for an attorney already billing a full caseload. Section 469(c)(3), examined below, does not impose a comparable hours test.

37%

Top Federal Bracket

Applies at $640,600 (single) / $768,700 (MFJ) in 2026

$72K

Max 401(k) Limit

Combined employee-employer limit for 2026, including catch-up

750

Hours Required

For real estate professional status — functionally unavailable to full-caseload attorneys

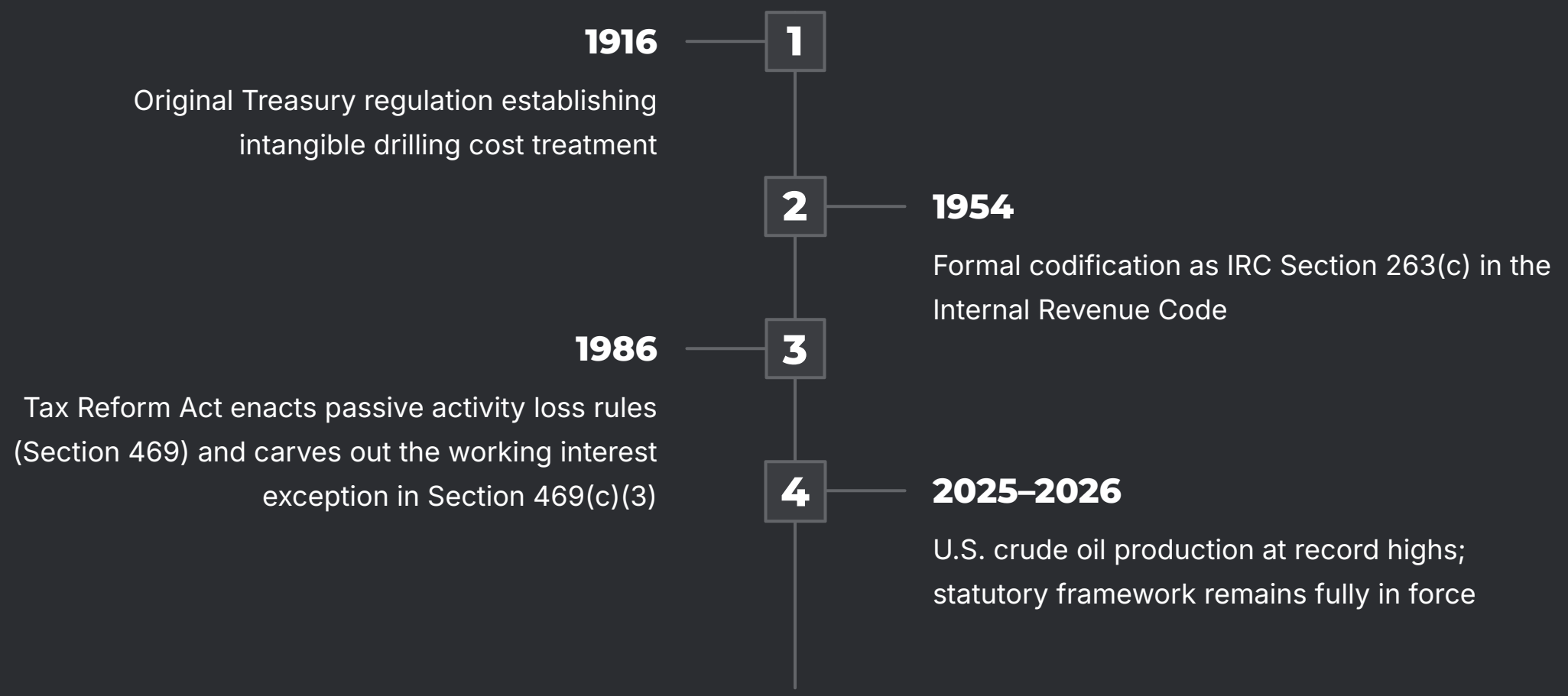
Background and Context

The intangible drilling cost deduction traces to a 1916 Treasury regulation and was formally codified as IRC Section 263(c) in the Internal Revenue Code of 1954. The provision was designed to encourage domestic drilling by allowing the operator or working interest holder to elect current deductibility of the non-salvageable costs of drilling, rather than capitalizing them over the life of the well.

The working interest exception found in Section 469(c)(3) has a separate and more recent origin. It was enacted as part of the Tax Reform Act of 1986, the same legislation that created the passive activity loss rules in Section 469 generally. Congress limited the ability of taxpayers to use passive losses — largely from tax shelter structures popular at the time — to offset W-2 and business income. In the same legislation, Congress carved out a specific exception for direct working interest holders in oil and gas properties, provided the interest is held directly or through an entity that does not limit the holder's liability. That structural requirement, examined in detail in the Analysis section below, is the single fact that determines whether a working interest holder's share of deductions can offset active income or is instead quarantined under the general passive activity rules.

> Domestic production context is relevant to why this statutory framework remains active policy today rather than a historical artifact. U.S. crude oil production reached a record 13.7 million barrels per day in 2025, with 2026 forecast to reach a new record of approximately 13.8 million barrels per day, and Permian Basin output alone forecast at 6.8 million barrels per day in 2026, an increase of roughly 3 percent.

The statutory framework encouraging direct participation in domestic wells has not been repealed or narrowed alongside this production growth; it remains part of the active Internal Revenue Code.



Analysis: The Statutory Mechanics

Section 263(c): Timing, Not an Income Offset

IRC Section 263(c), implemented through Treasury Regulation 1.612-4, allows a working interest holder to elect to currently deduct intangible drilling costs — meaning the non-salvageable costs of drilling such as labor, drilling fluids, site preparation, and hauling — rather than capitalizing them. Tangible costs, including casing, wellhead equipment, and tanks, are instead capitalized and recovered through depreciation under Section 168. Published industry sources commonly cite intangible drilling costs as representing a range, frequently described as 60 percent to 85 percent of total well cost, though the specific allocation for any well is confirmed only through its authorization-for-expenditure documentation and depends on well design, formation, and completion method. **Section 263(c) by itself only governs when and how this cost is deducted. It does not, standing alone, determine whether that deduction can offset a family law attorney's active K-1 distributive share or 1099 income.**

Section 469(c)(3): The Provision That Actually Offsets Active Income

The provision that performs that function is IRC Section 469(c)(3)(A), which states that the term passive activity "shall not include 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." Two structural conditions follow directly from this statutory text. The interest must be held directly, or through an entity structure — such as a general partnership — that does not shield the holder from liability. An interest held through a limited liability company or limited partnership that caps the holder's exposure does not qualify, and deductions generated through that structure revert to ordinary passive activity treatment, meaning they can generally only offset income the tax code separately classifies as passive. Unlike real estate professional status, Section 469(c)(3) imposes no material participation or minimum-hours test. A family law attorney billing a full litigation calendar with no spare hours to dedicate to a second activity is not disqualified from this exception on that basis.

Qualifies Under 469(c)(3)

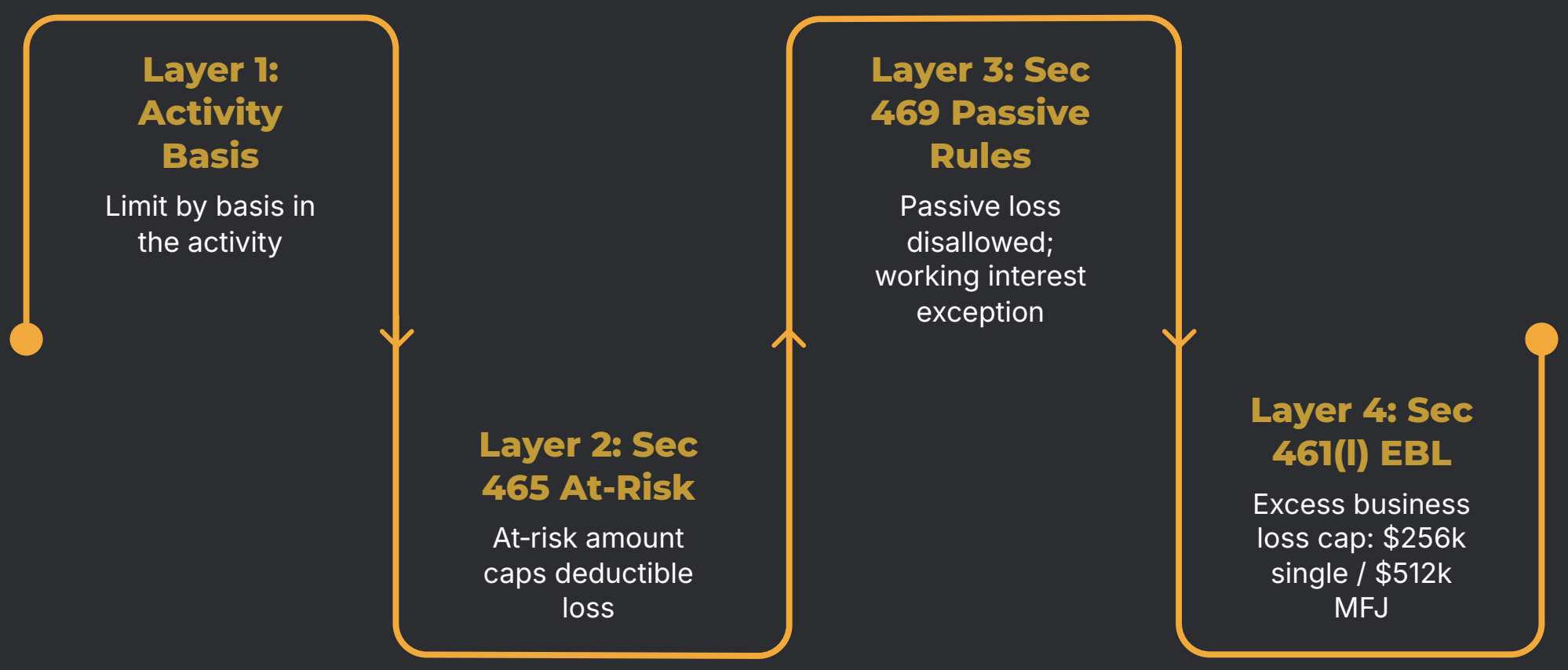
- Interest held directly by the taxpayer
- Interest held through a general partnership
- Entity that does NOT limit the holder's liability
- No minimum hours test required
- Deductions offset active W-2, 1099, or K-1 income

Does NOT Qualify Under 469(c)(3)

- Interest held through a limited liability company (LLC)
- Interest held through a limited partnership (LP)
- Any entity that caps the holder's liability exposure
- Pooled fund or passive product structures
- Deductions revert to passive activity treatment only

The Four-Layer Loss Order and Additional Statutory Provisions

Deductions generated through a working interest pass through four sequential limitations before they can offset active income. A family law attorney or advisor modeling a specific tax year should apply all four layers in sequence rather than assuming the working interest exception alone determines the final deductible amount.



Section 465: The At-Risk Limitation

IRC Section 465 caps deductibility at the holder's actual economic exposure, meaning cash contributed plus recourse debt for which the holder is personally liable. Nonrecourse financing does not increase the at-risk amount for this purpose. This is a meaningful structural distinction from some real estate financing structures, where nonrecourse debt can increase a taxpayer's basis for certain purposes.

Section 57(a)(2): Alternative Minimum Tax Preference Treatment

Excess intangible drilling costs can constitute a tax preference item for AMT purposes under IRC Section 57(a)(2)(A), but only to the extent the excess exceeds 65 percent of the taxpayer's net income from oil, gas, and geothermal properties for the taxable year. Section 57(a)(2)(E) provides a further exception commonly available to independent producers, subject to its own separate cap limiting the AMTI reduction to 40 percent of alternative minimum taxable income. The combined effect of these two thresholds means a family law attorney's advisor should model both the 65 percent net-income threshold and the 40 percent AMTI cap specifically. For 2026, the AMT rate itself is 28 percent above $244,500 of excess alternative minimum taxable income, with the exemption amount phasing out starting at $500,000 for single filers and $1,000,000 for married filing jointly filers.

Section 461(h): Timing and the Economic Performance Rule

IRC Section 461(h) generally requires economic performance before a liability can be deducted, which matters for year-end timing. A specific exception allows prepaid intangible drilling costs to be deducted in the year paid if drilling commences within 90 days after the close of the taxable year. This detail is directly relevant to a family law attorney evaluating a capital contribution in connection with a concentrated fee-collection year that falls late in the fourth quarter, since the exception governs whether a contribution made near year-end can still be deducted for that tax year.

Section 611/613A: Percentage Depletion

Once a well reaches production, IRC Sections 611 and 613A generally allow independent producers a percentage depletion deduction of 15 percent of gross income from the property, available on an ongoing basis as production continues and generally without the same cost-basis exhaustion limit that applies to cost depletion. This is a separate, longer-horizon statutory benefit distinct from the first-year intangible drilling cost deduction discussed above.

⚠ Two caveats deserve direct statement. First, the liability-structure requirement in Section 469(c)(3) is binding and specific: a working interest held through a liability-limiting entity, including most limited liability companies and limited partnerships, loses the active-income offset and reverts to passive treatment. Second, courts have addressed related questions about the character of working interest income and expenses for other tax purposes, including the self-employment tax treatment examined in *Methvin v. Commissioner* (10th Cir. 2016). These nuances underscore why the statutory mechanics summarized here require review with a qualified CPA or tax attorney.

Framework: How Direct Working Interest Participation Is Structured

Summit Ventures operates as an entrepreneurial joint venture platform built specifically around the structural requirements described above, rather than as a pooled fund or passive product that would forfeit the Section 469(c)(3) exception. The model rests on four elements.



Direct Working Interest Assignment

Direct assignment of a working interest position, held either individually or through an entity that does not limit liability, preserving the structural condition the statute requires rather than defaulting to the liability-limited entity structure common to pooled energy programs.



Authorization-for-Expenditure Documentation

Authorization-for-expenditure documentation that itemizes the intangible and tangible cost allocation for each well, giving the business participant and their CPA a specific, well-level record rather than a generalized percentage assumption.



Governance Rights and Operational Transparency

Governance rights and operational transparency consistent with active participation, including reporting on drilling, completion, and production status, reflecting the entrepreneurial joint venture structure rather than an arrangement with no active-member involvement.



Schedule K-1 Reporting

Schedule K-1 reporting that reflects the active, non-passive classification appropriate to a directly held working interest, supporting the business participant's own tax return preparation and professional advisor review.

This structure is positioned for evaluation alongside a family law attorney's existing tax and financial planning, not as a replacement for professional advice. Every element above should be reviewed independently by the participant's own CPA or tax counsel before a capital contribution decision is made.

Recommendations, Implications & Questions for Professional Advisor Discussion

Family law attorneys and their advisors evaluating this statutory framework should consider the following steps.

01

Model a Specific Tax Year

Particularly one in which a contested high-asset case is expected to settle, a final decree is expected to close, or a year-end receivables collection is anticipated, rather than evaluating the strategy in the abstract.

02

Confirm the Holding Structure with a CPA

Confirm how a specific working interest position would be held — individually or through a liability-non-limiting entity — since this single structural fact determines eligibility for the Section 469(c)(3) exception.

03

Request Authorization-for-Expenditure Documentation

For any specific well under consideration rather than relying on an industry-wide percentage range as a substitute for well-specific figures.

04

Apply the Four-Layer Loss Order

Basis, at-risk, passive activity, and excess business loss limitation — to the specific contribution amount and tax year under consideration, rather than assuming the full deduction will apply without limitation.

05

Review Partnership Agreement Provisions

Many law firm partnership agreements include disclosure or consent requirements for outside business participation that should be addressed before any capital contribution is finalized.

06

Discuss AMT and Economic Performance Timing with a CPA

The alternative minimum tax preference calculation under Section 57(a)(2) and the economic performance timing rule under Section 461(h) are directly relevant to late-year capital contribution timing.

Questions for Professional Advisor Discussion

1. How would a specific working interest position be held for purposes of the Section 469(c)(3) liability test, and does that structure match what my CPA would need to classify the deduction as active rather than passive on my return?
2. Given my firm's income pattern this year, including any anticipated case settlements or year-end collections, what tax year would a capital contribution need to occur in to be most relevant to my current income position?
3. What does the authorization-for-expenditure documentation show for the specific intangible-to-tangible cost allocation on a well under consideration?
4. How does the Section 465 at-risk limitation apply to my specific capital contribution, including whether any portion involves recourse or nonrecourse financing?
5. Does my partnership agreement or firm policy require disclosure or consent for outside business participation of this kind?
6. How would the Section 57(a)(2) alternative minimum tax preference calculation apply to my specific income position this year?
7. What ongoing reporting — including Schedule K-1 classification and production updates — will I receive as a business participant, and how does that reporting integrate with my existing tax preparation process?
8. How does the Section 461(h) economic performance rule and its 90-day drilling exception affect the timing of a contribution made late in the calendar year?

Closing Perspective

The statutory framework examined in this paper — IRC Section 263(c) governing the timing and classification of intangible drilling costs and IRC Section 469(c)(3) governing whether that deduction can offset active income — was written into the Internal Revenue Code decades ago and remains fully in force today. For family law attorneys, whose income often arrives in concentrated bursts tied to case resolutions rather than evenly across the calendar year, understanding how these provisions interact with the at-risk rules, the alternative minimum tax preference calculation, the economic performance timing rule, and the excess business loss limitation provides a more complete picture than any single statistic or deduction percentage could offer on its own.

> The next step for any attorney evaluating this framework is the same step recommended throughout this paper: bring the specific mechanics to a qualified CPA or tax attorney, apply them to a specific tax year and a specific well, and make an informed decision grounded in the statute itself rather than in a general description of the opportunity.

Sources and References

[1] Tax Foundation, 2026 Federal Income Tax Brackets, Rev. Proc. 2025-32.
[2] IRS IR-2025-111, 2026 retirement plan contribution limits.
[3] Kleinman Center for Energy Policy (UPenn); GAO report RCED-00-301R.
[4] U.S. EIA, "United States on track for record crude oil production in 2026."
[5] Tax Foundation, 2026 AMT parameters under the One Big Beautiful Bill Act.
[6] IRC Section 461(l), 2026 excess business loss thresholds.
[7] 26 U.S.C. Section 469(c)(3)(A), Cornell Legal Information Institute.
[8] 26 U.S.C. Section 57(a)(2)(A) and (E), AMT preference for intangible drilling costs.
[9] 26 U.S.C. Section 465, at-risk limitation.
[10] 26 U.S.C. Section 461(h), economic performance.
[11] 26 U.S.C. Sections 611 and 613A, percentage depletion.
[12] *Methvin v. Commissioner*, 10th Cir. 2016.
[13] Treasury Regulation 1.612-4, election to expense intangible drilling and development costs.

Ready to Evaluate This Framework for Your Practice?

Summit Ventures is built specifically around the structural requirements of IRC Section 469(c)(3). Speak with our team to review how direct working interest participation may apply to your specific tax year and income position.

Connect with Summit Ventures | **Learn More About Our Structure**