Due Diligence FAQ

Oil & Gas Working Interests

(IDC)

Tax Purpose:

Not Recommended for the target client profile. The IDC deduction is not improper or legally fragile — it is a genuine, decades-old statutory benefit, and the working-interest passive-loss exception under §469(c)(3) has no close analog elsewhere in retail tax planning.

Mechanics & Key Considerations:

- A working interest is a direct ownership interest in the mineral lease that carries both the right to a proportionate share of production revenue and the obligation to bear a proportionate share of drilling, development, and operating costs — fundamentally different from a royalty interest, which entitles the holder to gross revenue free of any cost burden but also carries no associated deductions
- Well costs are divided into tangible costs (equipment with salvage value, which must be capitalized and depreciated) and intangible drilling costs (IDCs) — labor, fuel, hauling, drilling rig time, site preparation, chemicals, and similar items with no salvage value
- The second pillar is IRC §469(c)(3), a genuine and unusual statutory carve-out from the passive activity loss rules
- Third, percentage depletion under IRC §613A allows independent producers and royalty owners to deduct a flat 15% of gross income from the property each year, without regard to actual cost basis, continuing even after basis is fully recovered, subject to a production-quantity limit (1,000 barrels of oil equivalent/day) and a 65%-of-taxable-income cap under §613A(d)(1)
- Finally, IRC §57(a)(2) treats "excess intangible drilling costs" as an AMT preference item added back in computing AMTI

Structure:

Oil and gas working interests marketed to retail investors for their intangible drilling cost ("IDC") deduction present a case where the underlying tax mechanics are legitimate, longstanding, and well-established in the Internal Revenue Code, but the investment vehicles through which retail investors typically access them carry disproportionate promoter, fee-load, and outright fraud risk. Under IRC §263(c) and Treas. Reg. §1.

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Dimension	Score	Why
Legal Risk	**6/10**	The core tax provisions (§263(c), §469(c)(3), §613A) are longstanding, well-litigated, and not the subject of meaningful IRS challenge when properly documented; the residual legal risk is concentrated in securities-law and liability exposure rather than in tax doctrine.
Economic Substance	**5/10**	The deduction reflects real, economically substantive expenditures tied to an actual productive asset, not a circular or paper transaction, but realized value is frequently eroded well below advertised levels by fee loads, dry-hole risk, and commodity price exposure documented in SEC enforcement records.
Realistic ROI	**2/10**	Regulatory data on retail program fee loads (49–74% of proceeds to fees/commissions in documented cases), combined with dry-hole risk and commodity volatility, indicate realistic net investor returns in the retail segment of this market are frequently negative or far below what offering materials project.
Liquidity	**2/10**	No secondary market exists for working interests; positions are effectively illiquid for the life of the well (often years to decades) absent a negotiated private sale, typically executed at a steep discount.
Client Fit	**2/10**	A high-W2-income tech employee lacks the industry-specific underwriting expertise to vet operators and geology, is unaccustomed to unlimited joint-and-several liability exposure, and has no practical need to accept fraud-prone, illiquid, high-fee retail vehicles.

Key Risks:

- Investment/fraud risk is the dominant risk in this strategy, and it is disproportionate relative to the strategy's tax-technical soundness
- Liability exposure is the second major structural risk, and it is specific to this strategy's tax mechanics
- Beyond fraud and liability:
  - **Illiquidity** - no public secondary market, no standardized valuation, transfer typically requires operator/partner consent
  - **Commodity Price Volatility** - operator/promoter conflicts of interest (compensation frequently structured around drilling/completion activity rather than aligned with investor returns)
  - **Geological/Production Risk** - difficult for a retail investor to independently verify

Recommendation:

Not Recommended for the target client profile. The IDC deduction is not improper or legally fragile — it is a genuine, decades-old statutory benefit, and the working-interest passive-loss exception under §469(c)(3) has no close analog elsewhere in retail tax planning. The problem is entirely on the investment-vehicle side: the retail drilling-program market most individual investors can actually access is the same market the SEC has repeatedly and specifically flagged for high fee loads and a sustained, decades-long pattern of fraud, and the ownership form required to preserve the tax benefit is precisely the form that exposes the investor to unlimited personal liability rather than the capped, LLC-shielded structure a prudent retail investor would otherwise choose.