

An aerial view of a city skyline at sunset. The sky is filled with orange and yellow clouds. In the foreground, a multi-lane highway with several cars is visible. To the right, there are several construction cranes. The city buildings are silhouetted against the bright sky.

# DST vs. Working Interest: Which 1031 Replacement Property Is Right for Your Exchange?

A Comparative Guide to Timeline Fit, Ownership Structure, Tax Treatment, and Boot Mitigation for Commercial Real Estate, Multifamily, and Land Sellers Under IRC Section 1031

Explore Your Options with Summit Ventures

# Introduction: Two Clocks, One Decision

The moment a commercial property, multifamily asset, or parcel of land closes escrow, two statutory clocks begin running at the same time. The seller has **45 calendar days** to identify replacement property in writing and **180 calendar days** to close on it. Both periods run concurrently from the relinquished property's closing date, not sequentially, and neither clock pauses for weekends, holidays, financing delays, or a seller's inability to find a suitable asset.

For sellers who understand the problem but have not yet decided on an approach, two distinct categories of replacement property consistently surface in the research phase: the **Delaware Statutory Trust (DST)** and the **direct oil and gas working interest**.

Both are structured to qualify as replacement property under Section 1031. Both can be identified and closed inside the statutory window. Both exist, in large part, because many sellers are done being landlords and do not want to trade one tenant-and-toilet problem for another. But the two structures are built on different legal foundations, carry different ownership and governance characteristics, and solve different versions of the seller's underlying problem.

A seller who has already exhausted the 45-day search, or who is staring down a partial exchange with unavoidable boot, is evaluating a related but separate question: how to offset the resulting tax liability when a full like-kind replacement is no longer possible. This guide separates those two decision points — direct like-kind replacement versus boot mitigation — and compares DST participation against direct working interest ownership across the evaluation criteria that matter most under deadline pressure.

## 45 Calendar Days

To identify replacement property in writing from the closing date of the relinquished property

## 180 Calendar Days

To close on the replacement property — both clocks run concurrently, not sequentially

## No Pauses

Neither clock stops for weekends, holidays, financing delays, or inability to find a suitable asset

# What Is Being Compared

This guide compares two categories of replacement property available to a seller running a Section 1031 exchange, and a third, related strategy available to a seller who cannot complete a full exchange.

| 1                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                      | 2                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                    | 3                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                          |
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| <p><b>Option A — Delaware Statutory Trust (DST)</b></p> <p>A passive fractional ownership vehicle. A sponsor acquires real property, places it into a Delaware statutory trust, and sells beneficial interests in that trust to multiple exchangers. <b>Revenue Ruling 2004-86</b> established that a DST beneficial interest is treated as a direct interest in the trust's underlying real property for Section 1031 purposes, provided the trust operates within a defined set of restrictions commonly referred to as the "seven deadly sins."</p> | <p><b>Option B — Direct Working Interest in Oil and Gas Real Property</b></p> <p>An operating ownership position. The exchanger acquires an actual working interest in a producing well or development project, held directly and not through a fund, limited partnership, or other pooled entity. <b>Revenue Ruling 68-331</b> held that a lessee's working interest in a producing oil and gas lease, held for productive use in a trade or business or for investment, is like-kind to a fee interest in real property under Section 1031. The IRS separately confirmed this in <b>Revenue Ruling 68-226</b>.</p> | <p><b>Option C — Tax Boot Mitigation</b></p> <p>Applies when a full like-kind exchange is not achievable — whether because the 45-day window closed without a suitable identification, the seller intentionally took cash out, or the replacement property value came in below the relinquished property value. Deploying capital directly into a working interest at that point is not a 1031 transaction. It is a separate decision to use the resulting <b>Intangible Drilling Cost (IDC) election under IRC Section 263(c)</b> to generate a current-year deduction that can be weighed against the taxable gain or boot recognized from the sale.</p> |

# Evaluation Criteria

Sellers comparing these paths under time pressure should evaluate each option against the following criteria, used consistently throughout this guide and summarized in the comparison table below:



## Ownership

What legal interest does the exchanger actually hold, and does it meet the real property standard required for 1031 treatment.



## Participation

How involved is the exchanger in decisions affecting the asset after closing.



## Governance and Control

What voting, consent, or management rights exist, and who exercises day-to-day authority.



## Timeline Fit

How quickly can the interest realistically be identified and closed inside the 45-day and 180-day windows.



## Liquidity

How readily the position can be transferred, resold, or exited before a planned hold period ends.



## Tax Treatment

How the position is reported, and what deductions, depreciation, or recapture considerations apply.



## Exposure and Limitations

What structural or operational constraints come with the position.



## Complexity

What is required of the exchanger, the qualified intermediary, and outside advisors to execute the transaction correctly.

# Option A: Delaware Statutory Trust (DST)

A DST sponsor pre-packages the real property before any exchanger is involved. The sponsor identifies and acquires an asset — often a multifamily portfolio, net-lease retail property, or industrial facility — places it in trust, and arranges financing and a property manager in advance. Because the sponsor already owns and operates the property, a seller's subscription can close in a matter of days once funds are in place, which makes the DST a workable option for a seller who is close to the 45-day deadline with no other identified replacement.

The trade-off for that speed is structural rigidity. Revenue Ruling 2004-86 permits the DST to be treated as direct real property ownership only if the trust avoids seven specific actions for the life of the investment:

|                                                                                                                                                                                                              |                                                                                                                                                                                                               |                                                                                                                                                                                                                              |                                                                                                                                                                                                                         |
|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
|  <p><b>No Additional Capital</b></p> <p>No additional capital contributions from beneficiaries once the offering closes</p> |  <p><b>No Refinancing</b></p> <p>No renegotiation or refinancing of existing debt except in tenant-default distress</p>      |  <p><b>No New Leases</b></p> <p>No new leases or material lease renegotiation beyond same-terms renewals</p>                              |  <p><b>No Reinvestment</b></p> <p>No reinvestment of sale or refinancing proceeds; proceeds must be distributed to beneficiaries</p> |
|  <p><b>Limited Reserves</b></p> <p>Reserves held only in short-term, low-risk instruments</p>                             |  <p><b>No Capital Improvements</b></p> <p>No capital improvements beyond required maintenance or legally mandated work</p> |  <p><b>No Active Management</b></p> <p>No active, discretionary trustee management of the kind an operating business would exercise</p> |                                                                                                                                                                                                                         |

These restrictions exist because the IRS will reclassify the trust as a business entity taxed under Subchapter K, rather than a direct real property interest, if the trustee steps outside them. That reclassification would unwind the 1031 treatment entirely, which is why DST sponsors manage the structure conservatively and why beneficiaries have no vote on operating decisions.

A DST beneficiary receives a grantor trust letter rather than a Schedule K-1 or Form 1099, and each beneficiary computes depreciation individually against their own carried-over basis from the relinquished property, since the trust itself is not a separate tax-reporting entity. Participation is limited to accredited investors in most offerings, and total fee drag across the life of a typical DST — combining upfront load, ongoing asset and property management fees, a disposition fee, and a sponsor promote above a preferred return hurdle — commonly runs in the range of roughly a quarter to a third of invested capital over a five-to-ten-year hold, based on third-party fee breakdowns published by DST industry analysts. Secondary market liquidity before the planned hold period ends is limited: when a buyer can be found at all, resale has been reported to require a discount to book value in the range of 20 to 50 percent, reflecting the illiquid, non-traded nature of the interest. Ownership is also capped at the practical ceiling of whatever fractional interest the sponsor sells, unlike a tenant-in-common structure, which Revenue Procedure 2002-22 caps at 35 co-owners; the DST has no such numeric ownership cap, which is part of why it has become the more commonly used passive 1031 vehicle among the two.

# Option B: Direct Working Interest in Oil and Gas Real Property

A working interest is acquired directly by the exchanger — a legal and tax distinction that matters more than it may first appear. Unlike a DST, which is a pre-packaged security sold to multiple passive beneficiaries, a working interest can be structured so that the exchanger holds title to the actual interest in the oil and gas lease, consistent with the direct-holding requirement that preserves both its real property classification for Section 1031 and the related tax treatment available under the Internal Revenue Code. Several sources on partnership taxation confirm that an interest in a partnership, LLC, or corporate entity that itself owns qualifying real property does not qualify as like-kind replacement property; the exchanger must hold title to the interest itself, which is why Summit Ventures structures participation as a direct working interest position rather than units in a pooled fund.

That direct-holding structure does double duty. First, it is what allows the working interest to be identified and closed as 1031 replacement property under Revenue Ruling 68-331, since the ruling's like-kind holding applies to an actual lessee's interest in the producing lease, not to an indirect security interest in an entity that owns one. Second, it is what preserves eligibility for the **IRC Section 469(c)(3) exception** to the passive activity loss rules, which allows a working interest holder who holds the interest directly — or through an entity that does not limit the holder's liability — to treat associated losses as active rather than passive, regardless of whether the holder materially participates in operations. A working interest held through a limited partnership or limited liability company that caps the holder's liability forfeits this exception, which is a central reason the direct ownership structure matters for both the 1031 eligibility question and the tax treatment question.

Because a working interest acquisition does not require a securities registration, a sponsor-controlled trust structure, or a multi-week subscription and suitability process in the way a DST offering does, a direct working interest position can often be structured, identified by lease name, well name, API number, and county and state, and closed within a compressed window — which matters to a seller who is already well into the 45-day period. The exchanger assumes an operating, non-passive ownership position with governance rights tied to the working interest, rather than a purely passive beneficial interest, and the position is not subject to the seven restrictions that bind a DST trustee, since there is no trust structure or Rev Rul 2004-86 framework involved.

The tax treatment also diverges meaningfully from the DST. **IRC Section 263(c)** permits a working interest holder to elect to currently deduct Intangible Drilling Costs — the labor, chemicals, mud, and other non-salvageable costs of drilling and completing a well — rather than capitalizing them. The exact share of total project costs that qualify as intangible, and the resulting deduction, depends on the specific well's cost structure, the holder's individual tax position, and professional tax guidance, since the Code does not guarantee a fixed percentage outcome for any given project. This deduction mechanism is what makes the working interest useful in the separate boot-mitigation scenario described below, independent of whether the position is also being used as 1031 replacement property.

## Rev. Rul. 68-331

A lessee's working interest in a producing oil and gas lease is like-kind to a fee interest in real property under Section 1031 — the foundational ruling for working interest exchanges.

## IRC § 469(c)(3)

Exception to passive activity loss rules for working interests held directly or through an entity that does not limit the holder's liability — preserving active income treatment.

## IRC § 263(c)

Election to currently deduct Intangible Drilling Costs rather than capitalize them — the mechanism that makes the working interest valuable in boot-mitigation scenarios.

# Tax Boot Mitigation: When the Exchange Clock Cannot Be Met

Not every exchange closes cleanly. A seller may reach Day 45 without a suitable identification, may receive a cash-out that creates boot, or may intentionally decide that a full-value replacement is not available on terms that make sense. In each of these situations, some portion of the deferred gain becomes currently taxable, alongside applicable depreciation recapture and, where applicable, net investment income tax exposure.

Deploying capital into a direct working interest at that point is a distinct decision from a 1031 identification. It is a current-year capital contribution into an operating asset, made in the same tax year the gain or boot is recognized, with the IDC election under Section 263(c) available to generate a deduction that can be evaluated against the taxable gain. This path does not require 45-day identification language, a qualified intermediary, or Form 8824 reporting, since no exchange is being claimed; it is evaluated independently by the seller's tax advisor as an offset strategy.

For a seller who already knows the exchange will not be completed in full, this is the point at which the working interest conversation shifts from "is this valid replacement property" to "does this deduction mechanism help offset what I am already going to owe."

## Boot Mitigation at a Glance

- No 45-day identification language required
- No qualified intermediary needed
- No Form 8824 reporting — no exchange is being claimed
- Current-year capital contribution into an operating asset
- IDC election under § 263(c) generates a current-year deduction
- Evaluated independently by seller's CPA or tax attorney
- Applies in the same tax year the gain or boot is recognized

### Exchange Fails

Day 45 passes or boot received



### IDC Election

Elect §263(c) for current-year deduction



### Deploy Capital

Invest in direct working interest



# Side-by-Side Comparison

The table below compares the Delaware Statutory Trust and the Direct Working Interest across all eight evaluation criteria used in this guide.

| Category                 | DST (Delaware Statutory Trust)                                                                                                                                                                                                     | Direct Working Interest                                                                                                                                                                                |
|--------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Ownership                | Beneficial interest in a trust holding title to real property; treated as a direct real property interest under Revenue Ruling 2004-86                                                                                             | Direct title to a working interest in an oil and gas lease; real property treatment under Revenue Ruling 68-331 and 68-226                                                                             |
| Participation            | Passive; beneficiary has no operating role by design                                                                                                                                                                               | Active working interest position with governance rights tied to joint operating agreement terms                                                                                                        |
| Governance and Control   | None; trustee authority is restricted to the seven permitted actions, no beneficiary vote                                                                                                                                          | Working interest owner participates in defined governance and decision rights under the operating structure                                                                                            |
| Timeline Fit             | Fast close once subscription funds are available, since sponsor already owns the asset; identification is typically a fractional-interest purchase                                                                                 | Can be identified by lease, well, and API number and structured for closing within the statutory window                                                                                                |
| Liquidity                | Limited before planned exit; secondary resale, when available, has been reported at a meaningful discount to book value                                                                                                            | Hold period and transferability depend on the specific working interest and operating agreement terms                                                                                                  |
| Tax Treatment            | Grantor trust letter, not a K-1 or 1099; depreciation computed individually on carried-over basis; no current deduction mechanism beyond standard depreciation                                                                     | Section 263(c) IDC election available for current-year deduction treatment; Section 469(c)(3) active-income exception available when held directly                                                     |
| Exposure and Limitations | Bound by the seven restrictions (no new contributions, no refinancing outside distress, no new leases beyond renewals, no reinvestment of proceeds, limited reserves, no discretionary improvements, no active trustee management) | Direct operating exposure tied to the specific lease and well performance; no dedicated packaged-offering revenue ruling comparable to Rev Rul 2004-86, relies on case law and Treas. Reg. 1.1031(a)-3 |
| Complexity               | Standardized sponsor offering process; typically limited to accredited investors; suitability and subscription paperwork through a broker-dealer                                                                                   | Requires direct title structuring and qualified intermediary familiarity with identifying a working interest as replacement property; fewer QIs have direct experience with resource-based exchanges   |

# Advantages, Limitations & Best-Fit Scenarios

## DST — Advantages

DST advantages center on **speed of close**, since the sponsor has already completed acquisition and operational setup, and on the **complete absence of a management role**, which directly answers a seller's fatigue with tenants, toilets, and trash.

## DST — Limitations

DST limitations center on the **seven restrictions** that bind the trustee, the **fee drag** that accumulates across sponsor, asset management, and disposition layers over the hold period, and the **illiquidity** of the position if a seller needs to exit before the planned disposition.

## DST Best Fits a Seller Who:

- Wants a fully passive fractional interest in a familiar asset class such as multifamily or net-lease retail
- Is comfortable with accredited-investor suitability requirements
- Does not need governance input on the underlying property
- Is planning for a defined five-to-ten-year hold without an early-exit requirement

## Working Interest — Advantages

Working interest advantages center on the **direct, non-fund ownership structure** that supports both 1031 eligibility and the separate 263(c) IDC deduction mechanism, the **elimination of real estate's physical management burden** entirely in favor of an energy asset, and a **timeline that can be structured for a compressed identification and closing window** when title is clearly described.

## Working Interest — Limitations

Working interest limitations center on the **absence of a single packaged-offering revenue ruling** with the breadth of Rev Rul 2004-86, meaning the exchanger and qualified intermediary must rely on a more fact-specific application of Rev Rul 68-331, Rev Rul 68-226, and Treas. Reg. 1.1031(a)-3, and on the importance of selecting a **qualified intermediary and tax advisor** who have direct experience with resource-based exchanges.

## Working Interest Best Fits a Seller Who:

- Wants to diversify out of traditional real estate entirely and into an energy real property interest
- Wants defined governance participation rather than a purely passive beneficial interest
- Is working against a compressed identification window and needs a QI and advisor team that can structure direct title quickly
- Wants a structure that also supports the Section 263(c) IDC deduction mechanism if some portion of the exchange ultimately falls short

❏ The boot-mitigation path fits a seller who has already determined, with their advisor, that a full exchange will not be completed — whether due to the 45-day window closing without suitable identification or a deliberate decision to take proceeds out of real estate — and who wants to evaluate a direct working interest capital contribution specifically for its current-year deduction characteristics rather than as replacement property.

# Decision Guidance & Questions for Your Advisory Team

Four questions typically clarify which path applies to a given seller's exchange:

- 1

**How many days remain in the identification window?**

A seller inside the first two to three weeks after closing has more flexibility to evaluate a direct working interest's title and lease details alongside a DST subscription. A seller inside the final week before Day 45 should prioritize whichever option can realistically be identified in writing and delivered to the qualified intermediary before midnight on Day 45, regardless of which structure is ultimately preferred.
- 2

**Is a fully passive position or an active governance role preferred?**

Sellers who want zero involvement after closing should weigh the DST's restrictions and fee structure against the working interest's governance participation and direct-title requirements.
- 3

**Is the seller an accredited investor, and does that matter for the specific offerings under consideration?**

DST offerings are generally limited to accredited investors; working interest structuring should be confirmed with the specific offering's own eligibility terms.
- 4

**Is a full like-kind exchange still achievable, or is the seller already planning around some level of boot?**

If a full exchange is no longer realistic, the conversation should shift from replacement-property identification to evaluating the Section 263(c) IDC deduction as an offset strategy — a decision made with a CPA or tax attorney independent of the 1031 timeline itself.

## Questions for Your Advisory Team

- How many days remain in my 45-day identification window, and what is the latest date I can deliver a written identification to my qualified intermediary?
- Has my qualified intermediary previously identified a working interest — by lease name, well name, API number, and county and state — as replacement property, or would this be a first for their practice?
- What is the full fee structure — including upfront load, ongoing management, disposition fee, and any promote above a preferred return hurdle — for any DST offering I am evaluating?
- Does my anticipated hold period match the DST's typical five-to-ten-year structure, or do I need flexibility to exit sooner?
- If I hold a working interest, is it structured as direct ownership, or through an entity that would limit my liability and forfeit the Section 469(c)(3) active-income exception?
- If my exchange will not be completed in full, what specific IDC deduction treatment applies to my individual tax position under Section 263(c), and how does my CPA model that against my expected boot or gain recognition?
- What state-level tax treatment applies to any boot or gain I recognize, in addition to federal capital gains tax, net investment income tax, and depreciation recapture?

Sellers facing the 45-day and 180-day clocks are rarely choosing between a perfect option and a flawed one. They are choosing between two legitimate, IRS-recognized paths to replacement property that solve different problems: the DST offers a fast, fully passive close for a seller done with operational responsibility, while the direct working interest offers an active ownership position in a different asset class entirely, paired with a tax deduction mechanism that remains available even if the exchange itself falls short. The right choice depends on how much of the calendar remains, how much governance participation is wanted, and whether the goal is a clean like-kind replacement or an offset against gain that has already become unavoidable. Either path should be evaluated with a qualified intermediary experienced in the specific structure under consideration and a CPA or tax attorney who can model the individual tax outcome before any identification is filed.

## Sources and References

- **Revenue Ruling 68-331:** Establishes that a lessee's working interest in a producing oil and gas lease, held for productive use in a trade or business or for investment, is like-kind to a fee interest in real property under Section 1031.
- **Revenue Ruling 68-226:** Confirms that a lessee's interest in oil and gas in place is real property for federal tax purposes, the classification underlying Rev Rul 68-331's exchange holding.
- **Revenue Ruling 2004-86:** Establishes that a Delaware Statutory Trust beneficial interest is treated as a direct interest in the trust's real property for Section 1031 purposes, subject to the seven restrictions on trustee activity.
- **IRC Section 263(c):** Permits the election to currently deduct intangible drilling and development costs rather than capitalize them.
- **IRC Section 469(c)(3):** Exception to passive activity loss treatment for working interests held directly or through an entity that does not limit the holder's liability.
- **Treas. Reg. 1.1031(a)-3 and Revenue Procedure 2002-22:** Govern the real property classification test for like-kind exchange purposes and the 35 co-owner cap applicable to tenant-in-common structures, respectively.
- Third-party industry sources on DST fee structures, hold periods, secondary market discounts, and fundraising volume, reviewed for factual, non-projected market context on the DST structure as the contrast option in this comparison.