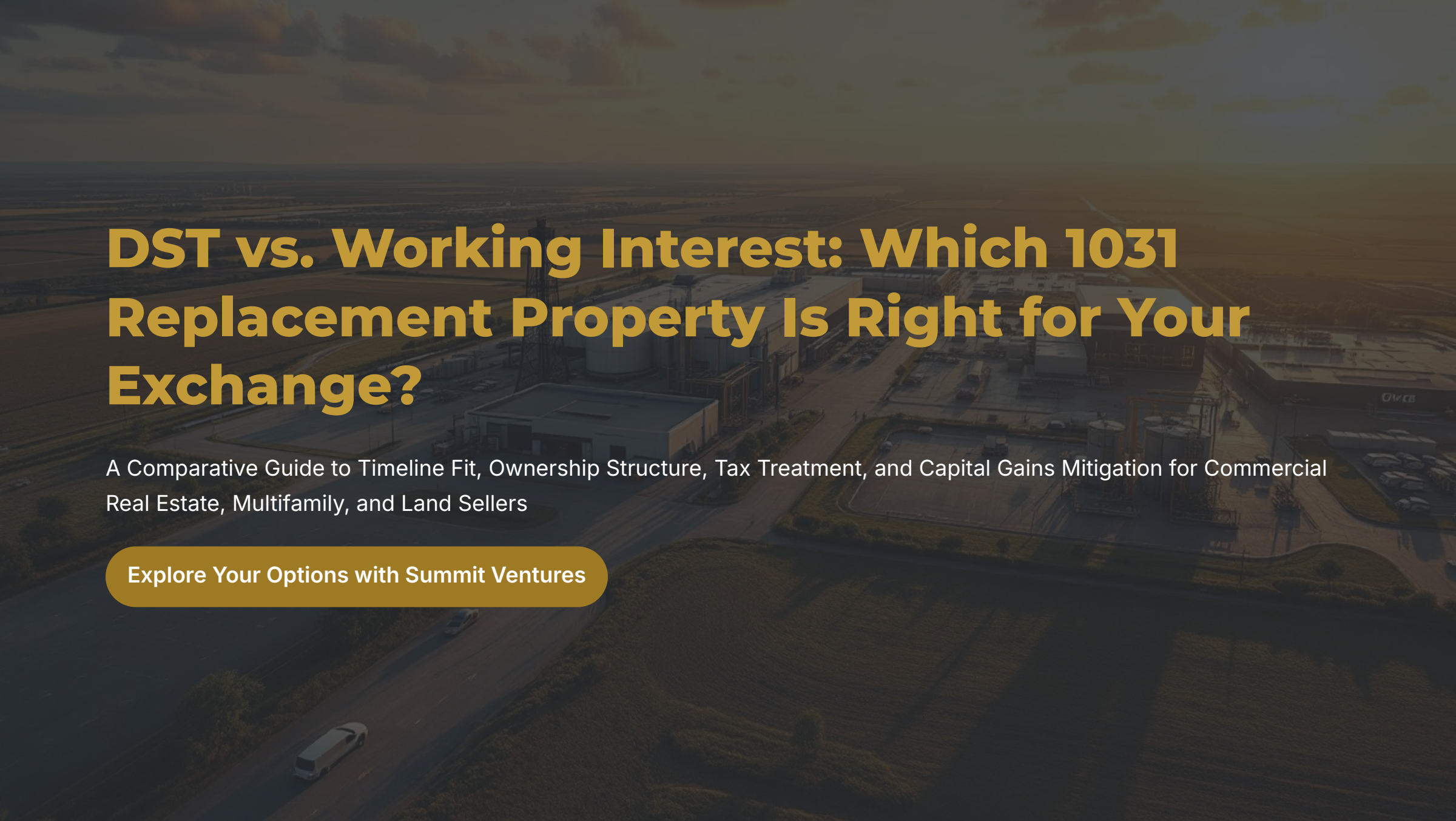




DST vs. Working Interest: Which 1031 Replacement Property Is Right for Your Exchange?

A Comparative Guide to Timeline Fit, Ownership Structure, Tax Treatment, and Capital Gains Mitigation for Commercial Real Estate, Multifamily, and Land Sellers

Explore Your Options with Summit Ventures

The Clock Is Already Running

A seller who has just closed on a commercial building, a multifamily asset, or a parcel of development land is already on the clock. Under IRC Section 1031, the identification period runs **45 calendar days** from the closing date of the relinquished property, and the full exchange must close within **180 calendar days**. Neither deadline is extended for weekends, holidays, or a slow market. Once the 45-day window lapses without a valid identification, the exchange cannot be rescued.

This guide compares two credible paths for sellers who want to satisfy the 1031 identification requirement without re-entering the operational demands of tenants, toilets, and trash, or without taking on a loan structure and management obligation they do not want: the **Delaware Statutory Trust (DST)** and the **direct working interest in oil and gas real property**. Both are recognized forms of real property for exchange purposes, but they function on fundamentally different ownership, control, and tax mechanics.

This guide also addresses a related but distinct scenario: what happens when the identification window closes without a suitable replacement, or when a portion of the proceeds becomes taxable boot. In that circumstance, a separate tax mitigation tool — the intangible drilling cost (IDC) deduction under IRC Section 263(c) — becomes relevant even though it operates outside the 1031 exchange framework itself.

⚠ Understanding the difference between "qualifying as replacement property" and "offsetting a tax result after an exchange shortfall" is the central distinction sellers need before the clock runs out.

45

Day Identification Window

Calendar days from closing to identify replacement property

180

Day Closing Deadline

Calendar days to fully close the exchange

0

Extensions Available

No extensions for weekends, holidays, or slow markets

What Is Being Compared

Delaware Statutory Trust (DST)

A DST is a separate legal entity, recognized under Delaware law, that holds title to real estate on behalf of multiple beneficial owners. Revenue Ruling 2004-86 established that a beneficial interest in a properly structured DST is treated as a direct interest in real property for purposes of IRC Section 1031, provided the trust operates within specific IRS-imposed restrictions.

A DST sponsor acquires the property first, structures the trust, and then sells fractional beneficial interests to exchangers seeking replacement property.

Direct Working Interest in Oil and Gas Real Property

A working interest is an ownership position in the mineral estate that carries the right to extract oil and gas and the obligation to bear a proportionate share of development and operating costs. Revenue Ruling 68-331 holds that a working interest in oil and gas in place qualifies as real property for like-kind exchange purposes, and the companion Revenue Ruling 68-226 confirms that a lessee's interest in oil and gas in place is treated as an interest in real property.

Summit Ventures structures participation as a direct working interest position, held by the exchanger rather than through a fund or limited partnership unit — the structural detail that determines whether the real property classification and related tax treatment actually apply.

Both structures can serve as 1031 replacement property. They differ sharply in participation level, fee load, liquidity, and the tax mechanics available if the exchange does not go entirely as planned.

Evaluation Criteria

Sellers evaluating either path, or weighing a boot mitigation strategy, should assess each option against the following factors:

1	Timeline Fit How quickly can the asset be identified within the 45-day window and closed within 180 days?
2	Ownership Structure What legal interest does the exchanger actually hold?
3	Participation & Governance What decision-making rights, if any, come with the position?
4	Liquidity How easily, and at what cost, can the position be exited before a planned hold period ends?
5	Tax Treatment How does the structure interact with depreciation, basis carryover, and available deductions?
6	Exposure & Complexity What structural restrictions, operating exposures, and administrative burdens apply?

Option A: The Delaware Statutory Trust

A DST sponsor typically acquires an institutional-quality asset (multifamily, net-lease retail, industrial, or similar), places it into the trust, arranges non-recourse financing at the trust level, and then offers beneficial interests to exchangers. Because the sponsor already owns and has underwritten the property before the offering opens, closing on a DST interest can occur in a matter of days once subscription documents are signed — a meaningful advantage inside a 45-day identification window.

The trust structure, however, comes with seven specific operating restrictions established by Revenue Ruling 2004-86 and commonly referred to in the industry as the "**seven deadly sins**." The trustee generally cannot:

- Accept new capital contributions after the initial offering closes
- Renegotiate the terms of existing financing or place new debt on the property
- Execute new leases or materially renegotiate existing ones beyond customary renewal terms
- Reinvest sale proceeds from the property — must distribute them to beneficial owners instead
- Hold cash reserves except in short-term, passive investments
- Make capital improvements beyond routine maintenance or legally required work
- Actively manage the trust's day-to-day decisions, which remain with the trustee under a fixed operating mandate

These restrictions exist specifically so the IRS will respect the beneficial interest as a direct ownership position in real property rather than a security interest in an active business.

Beneficial owners receive a grantor trust letter rather than a Schedule K-1 or Form 1099, and each owner's depreciation is calculated from that owner's own carried-over basis rather than reported at the trust level. DST offerings are typically limited to accredited investors, with minimum investments commonly in the range of \$100,000 to \$250,000, and planned hold periods of five to ten years.

Fee structures in the DST market are an important factor for sellers focused on capital preservation. Industry sources describing typical DST offerings cite upfront organizational and offering costs in the range of **10 to 15 percent** of invested capital, with additional annual asset and property management fees, disposition fees, and promote structures that can bring total fee drag across the life of the investment to an estimated **25 to 35 percent** of the capital contributed. Because the trustee cannot reinvest proceeds or accept new capital, an exchanger who wants out before the trust's disposition event is dependent on a secondary market, where resale of a DST interest, when a buyer can be found at all, has been reported to require a discount in the range of **20 to 50 percent** against book value.

The DST market itself has grown substantially, with industry tracking showing approximately **\$5.04 billion** in DST equity raised in 2023 following more than **\$9 billion** in 2022, reflecting its position as the most widely used packaged 1031 replacement vehicle, largely because Revenue Ruling 2004-86 gives sponsors a clean, IRS-sanctioned framework for a multi-owner offering.

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

A direct working interest positions the exchanger as an actual owner of record in the mineral estate and associated equipment — not as a holder of a fund unit or a limited partnership interest. This distinction is the legal foundation of the entire structure. Treasury Regulation 1.1031(a)-3 and the underlying state-law tests used to classify an interest as real property require that the position be held directly, or through a partnership that has validly elected out of Subchapter K treatment under Section 761(a), which allows the co-owners to be treated as holding an undivided direct interest rather than a partnership interest for federal tax purposes.

If the interest is instead held through an LP or LLC that has not made this election, the real property classification required for 1031 treatment — and the active-participation treatment required for certain tax benefits — can be lost.

Summit Ventures structures participation as an entrepreneurial joint venture built around this direct ownership model. Business participants hold a working interest position with governance rights tied to the joint operating agreement, receive operational transparency into drilling, completion, and production decisions, and share proportionally in both the costs and the output of the project as an active JV member rather than as a passive unit holder in a sponsor-controlled trust.

IRC Section 263(c) — IDC Deduction

Costs allocated to intangible drilling costs (IDC) — covering items such as labor, fuel, and drilling-related services that have no salvage value — may qualify for current-year deduction. Depending on the specific IDC and TDC allocation, individual tax circumstances, and applicable tax treatment, this can allow a business participant to deduct up to 100% of eligible costs in the year the capital contribution is made.

IRC Section 469(c)(3) — Active Income Treatment

Because the position is held as a direct working interest rather than a limited partnership interest, Section 469(c)(3) excludes a working interest in an oil and gas property from the passive activity loss limitations that would otherwise restrict how the IDC deduction can be applied against other income — provided the ownership form preserves unlimited liability exposure consistent with a working interest.

- Timeline fit for a direct working interest within a 1031 exchange depends on project-specific due diligence and documentation. Sellers pursuing this path should begin the identification and documentation process as early as possible within the 45-day window and coordinate closely with their qualified intermediary and tax counsel.

Tax Boot Mitigation: When the Exchange Does Not Go as Planned

Not every exchange closes cleanly. A seller may run out of time during the 45-day identification period, may be unable to locate a replacement property that matches the relinquished property's value and debt, or may complete a partial exchange that leaves a portion of the proceeds as taxable boot — whether in the form of unreinvested cash, debt relief that was not replaced, or non-like-kind property received in the transaction. Any of these outcomes can trigger recognition of gain, exposing the seller to:



Federal Capital Gains Tax

Recognition of gain on the taxable portion of the transaction



3.8% NIIT

Net investment income tax applied where applicable



Depreciation Recapture

Taxed as ordinary income up to 25% on the recaptured amount

This is a materially different problem than selecting a replacement property, and it calls for a different tool. When capital becomes taxable because an exchange has failed in whole or in part, deploying that capital into a direct working interest outside the 1031 framework can still generate an IRC Section 263(c) IDC deduction in the year the capital is contributed.

This deduction does not retroactively cure a failed exchange or substitute for like-kind treatment. It operates independently, as a direct offset against the taxable gain and boot recognized from the sale, by generating a current-year deduction against ordinary or business income depending on the participant's specific tax position. For a seller who has already accepted that some portion of the transaction will be taxed, this provides a way to actively reduce that tax exposure through a current deduction rather than absorbing the full liability with no offsetting mechanism.

- ① The amount and character of any benefit depend entirely on the specific IDC and TDC allocation of the project, the participant's individual tax situation, and confirmation from a qualified tax professional. This strategy should be evaluated as a distinct decision from the 1031 replacement property decision itself.

Side-by-Side Comparison

Category	Delaware Statutory Trust (DST)	Direct Working Interest
Ownership	Beneficial interest in a trust holding title to real estate	Direct ownership of record in the mineral estate and associated equipment
Participation	No active role; trustee controls all decisions under a fixed mandate	Active JV member with governance rights under the joint operating agreement
Governance & Control	Centralized with the trustee; the seven restrictions of Rev. Rul. 2004-86 bar new leases, debt, capital contributions, or active management	Shared governance tied to the operating agreement, with operational transparency into project decisions
Timeline Fit	Closing can occur within days once the sponsor's offering is underwritten — favorable to the 45-day window	Requires early identification and documentation; no single packaged-offering ruling equivalent to Rev. Rul. 2004-86 exists
Liquidity	Illiquid before the trust's disposition event; secondary resale, when available, reported at a discount to book value	Illiquid and project-dependent; exit generally tied to the life and disposition of the underlying asset
Tax Treatment	Qualifies as 1031 replacement property under Rev. Rul. 2004-86; depreciation based on each owner's carried-over basis; grantor trust letter issued, not a K-1	Qualifies as 1031 replacement property under Rev. Rul. 68-331 when held directly; IDC deduction available under Section 263(c); excluded from passive loss limits under Section 469(c)(3)
Exposure & Limitations	Sponsor-level restrictions eliminate new capital contributions or reinvestment of proceeds; fee load can reduce capital over the hold period	Direct holding carries proportional responsibility for development and operating costs under the joint operating agreement
Complexity	Lower ongoing administrative burden for the exchanger; sponsor manages all operational reporting	Requires direct-ownership documentation and coordination with tax counsel to preserve real property and active-income treatment

Advantages, Limitations & Best-Fit Scenarios

Delaware Statutory Trust — Advantages

- Closing process can move quickly enough to fit comfortably inside the 45-day identification window
- Long-settled IRS framework under Revenue Ruling 2004-86 that sponsors and qualified intermediaries recognize readily
- No requirement for the exchanger to participate in property-level decisions

Delaware Statutory Trust — Limitations

- Fixed, sponsor-controlled structure that cannot adapt to changing circumstances once the offering closes
- Reported total fee drag across the life of the investment that can run from 25 to 35 percent of contributed capital
- Limited liquidity should the exchanger need to exit before the planned disposition event

Direct Working Interest — Advantages

- Governance rights and operational transparency as an active JV member
- Tax mechanic under Section 263(c) that is not available through the DST structure
- A mitigation tool through the same IDC mechanic for sellers who face a failed exchange or taxable boot, independent of whether 1031 treatment is ultimately achieved

Direct Working Interest — Limitations

- Absence of a single packaged-offering ruling equivalent to Revenue Ruling 2004-86 — each project's documentation must be reviewed individually to confirm like-kind treatment
- Proportional responsibility for development and operating costs that comes with direct ownership



Three best-fit scenarios:

Scenario 1 - DST fits a seller who wants to fully exit day-to-day property decisions, is comfortable with a sponsor-controlled operating mandate for a five- to ten-year hold, and needs a replacement property that can close within days given a tight remaining identification window.



Scenario 2 - Direct Working Interest fits a seller who wants governance rights and operational transparency, is seeking diversification away from real estate operating risk, and may also be facing a partial or failed exchange wanting a tax mitigation lever through Section 263(c) IDC deduction.



Scenario 3 - Combined Approach uses a DST for the portion of proceeds that must satisfy strict like-kind replacement on a compressed timeline, and a direct working interest allocation inside or outside the exchange to address diversification goals and any anticipated boot exposure.

Decision Guidance & Next Steps

Begin by calendaring the exact 45-day identification deadline and 180-day closing deadline from the closing date of the relinquished property, since both run concurrently and neither is extended. Confirm accredited investor eligibility and suitability requirements with the sponsor or project operator for whichever structure is under consideration, since both DST and direct working interest offerings commonly carry eligibility requirements.

- 1

Calendar Both Deadlines Immediately

The 45-day identification window and 180-day closing deadline run concurrently from the closing date of the relinquished property. Neither is extended for any reason.
- 2

Review the Specific Document — Not Just the Structure Type

Real property classification and the availability of tax mechanics such as Section 263(c) and Section 469(c)(3) depend on the specific legal form of the interest held, not the general category.
- 3

Engage a Qualified Intermediary Before Receiving Any Funds

Constructive receipt of proceeds outside a qualified intermediary structure disqualifies the exchange entirely. This step must happen before closing on the relinquished property.
- 4

Discuss IDC Mechanics Before Year-End If Boot Is Possible

If there is any possibility of a partial boot or a missed identification deadline, discuss the IDC deduction mechanics with a qualified tax professional so that any capital deployment is timed to align with the tax year in which the gain or boot will be recognized.

Questions for Professional Advisor Discussions

- How many days remain in the 45-day identification window, and does the chosen replacement structure's closing timeline realistically fit inside the remaining 180-day period?
- Does the specific DST trust document or working interest operating agreement meet the direct real property classification required for 1031 treatment, and has this been confirmed by qualified intermediary or tax counsel review?
- What is the total projected fee load, including upfront, ongoing, and disposition costs, for the DST option under consideration, and how does that compare to the direct cost structure of a working interest position?
- If the exchange results in a partial boot or fails to close within 180 days, what is the specific IDC and TDC allocation available in a direct working interest project, and what would that mean for this individual's tax position in the current year?
- Is the working interest held directly, or through an entity that has made a valid Section 761(a) election, and has this been verified in writing?
- What governance rights and operational reporting does the joint operating agreement provide to a business participant in a direct working interest position, compared to the fixed trustee mandate in a DST?

Sellers facing the 45-day and 180-day clock do not have unlimited time to weigh every detail of these two structures, but the core distinction is a clear one. A DST offers a fast-closing, sponsor-managed path to like-kind replacement with a long-settled IRS framework and a corresponding fee and liquidity profile that comes with full delegation of control. A direct working interest offers an active ownership position with governance rights, a distinct tax mechanic under Section 263(c) that extends beyond the exchange itself, and a mitigation option for sellers who may not complete the exchange exactly as planned. Reviewing both paths against the evaluation criteria above — in coordination with a qualified intermediary and tax professional — before the identification window closes is the discipline that protects both the exchange and the underlying capital.

Sources and References

- **Revenue Ruling 2004-86 (IRS):** Establishes that a beneficial interest in a properly structured Delaware Statutory Trust is treated as a direct interest in real property for IRC Section 1031 purposes, subject to specific restrictions on trustee activity.
- **Revenue Ruling 68-331 (IRS):** Holds that a working interest in oil and gas in place qualifies as an interest in real property for like-kind exchange purposes.
- **Revenue Ruling 68-226 (IRS):** Confirms that a lessee's interest in oil and gas in place is treated as an interest in real property.
- **IRC Section 1031:** Statutory basis for like-kind exchange treatment, including the 45-day identification period and 180-day closing requirement.
- **IRC Section 263(c):** Statutory basis for the current-year deduction election for intangible drilling and development costs.
- **IRC Section 469(c)(3):** Statutory exclusion of a working interest in an oil or gas property from passive activity loss limitations when held in a form that does not limit the owner's liability.
- **IRC Section 761(a):** Statutory basis allowing qualifying co-ownership arrangements to elect out of partnership (Subchapter K) treatment, preserving direct ownership classification.
- **Treasury Regulation 1.1031(a)-3:** Regulatory framework addressing the real property classification required for like-kind exchange treatment.
- **Industry sources on DST structure and fee data:** Including published analyses of DST fee drag (approximately 10 to 15 percent upfront, 25 to 35 percent total across the holding period), typical minimum investments (\$100,000 to \$250,000), accredited investor requirements, and secondary market resale discounts (reported in the range of 20 to 50 percent of book value).
- **Industry tracking of DST capital markets activity:** Reflecting approximately \$5.04 billion in DST equity raised in 2023 and more than \$9 billion in 2022.