

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

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

1031 EXCHANGE GUIDE | IRC SECTION 1031

The Question Every Seller Inside Their 45-Day Window Is Facing

If you sold a commercial property, a multifamily asset, or a parcel of land and are now inside your 45-day identification window, you are facing one question with two statutory answers. Both a Delaware Statutory Trust (DST) and a direct working interest in oil and gas real property can qualify as replacement property under Section 1031. They are not the same tool, and they do not solve the same problem in the same way.

A DST is a packaged securities offering built around Revenue Ruling 2004-86. It is designed for sellers who want to exit property management entirely and are comfortable holding a fixed, non-controlling beneficial interest in a trust-owned asset for a defined hold period.

A direct working interest in oil and gas is a real property interest recognized under Revenue Ruling 68-331. It is designed for sellers who want active ownership of a producing asset, governance rights in how that asset is operated, and, where capital gains or boot cannot be fully deferred, a current-year Intangible Drilling Cost (IDC) deduction under IRC Section 263(c) that a DST interest structurally cannot offer.

This guide places both structures side by side using the same evaluation criteria: ownership rights, participation level, governance and control, timeline fit, tax treatment, liquidity, and complexity. The goal is not to declare a universal winner. It is to give you and your qualified intermediary (QI), CPA, and attorney a clear, factual framework before day 45 arrives.

Two Structures. One Decision.

1 **Option A: DST Interest**

Beneficial ownership in a trust holding real property — packaged, pre-structured, fully passive.

2 **Option B: Working Interest**

Direct, assignable ownership in mineral and operating rights beneath producing acreage — active, governed, and IDC-eligible.

Evaluation Criteria: What "Qualifies" and What "Fits"

Before comparing the two structures, it helps to define what "qualifies" and what "fits" actually mean for a real estate seller on the clock.

Statutory Basis

What IRS guidance or case law specifically supports the structure as like-kind replacement property.

Timeline Fit

How quickly the structure can be identified within 45 days and closed within 180 days.

Ownership & Governance

Whether the exchanger holds a direct, assignable interest with operational input, or a fixed beneficial interest with no management voice.

Tax Treatment

How income, depreciation or depletion, and potential deductions flow to the exchanger, and whether the structure can offset boot if full deferral is not achieved.

Liquidity & Hold Period

How long capital is expected to remain committed, and what happens if the exchanger needs to exit early.

Cost Structure & Complexity

Sponsor fees, minimum investment size, and the administrative burden of holding the asset.

Option A: The Delaware Statutory Trust (DST)

The DST structure traces directly to Revenue Ruling 2004-86, which held that a beneficial interest in a properly structured Delaware statutory trust can be treated as a direct interest in the underlying real property for Section 1031 purposes, rather than an interest in a business entity. This ruling solved a real problem: it gave sponsors an IRS-blessed way to fractionalize institutional-grade real estate (multifamily portfolios, industrial parks, net-lease retail) into exchange-eligible units that can be sold to multiple exchangers quickly, since the sponsor already owns the underlying property before the offering opens.

That packaged-offering convenience comes with seven structural restrictions that tax professionals commonly call the **"seven deadly sins"** of DST ownership. Under Revenue Ruling 2004-86, a qualifying DST cannot deviate from these conditions without risking reclassification as a business entity — which would disqualify it for 1031 purposes entirely.

On tax reporting, DST beneficial owners typically receive a grantor trust letter rather than a partnership K-1 or a 1099, since each owner is treated as directly owning a pro-rata share of the underlying property for federal tax purposes. Depreciation is computed against each individual owner's own carried-over basis rather than reported at the trust level.

Ownership in a DST is also a securities transaction. DST interests are typically offered to accredited investors through a broker-dealer, with minimum investments commonly in the $100,000 to $250,000 range. Industry data places total fee drag across a typical DST's life in the range of **25% to 35% of invested capital**, with upfront loads alone commonly cited between 10% and 15%. Hold periods are generally structured for 5 to 10 years, and secondary sale discounts have been reported at **20% to 50% off book value**.

The Seven Deadly Sins of DST Ownership

1. No New Capital

Cannot accept new capital contributions once the offering closes.

2. No New Leases

Cannot renegotiate or enter new leases, except on the same terms as an expiring lease.

3. No New Debt

Cannot obtain refinancing or incur new debt, except in connection with tenant default or bankruptcy.

4. No Reinvestment

Cannot reinvest sale proceeds if the property is sold. Proceeds must be distributed to beneficial owners.

5. Cash Reserves Only

Must hold cash reserves only in short-term, low-risk instruments between distributions.

6. No Capital Improvements

Cannot make capital improvements beyond routine maintenance or legally required work.

7. No Active Trustee

Cannot have an active trustee who exercises discretionary management authority over day-to-day business decisions.

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

The working interest path rests on a different, older piece of guidance. Revenue Ruling 68-331 holds that an operating working interest in oil and gas — meaning the right to develop, produce, and receive a share of production from a well — is real property under state law tests and therefore like-kind to other real estate for Section 1031 purposes. A companion ruling, Revenue Ruling 68-226, separately confirms that a lessee's interest in oil and gas in place is itself classified as real property. Treasury Regulation 1.1031(a)-3 applies a state-law-based test for what qualifies as real property, and working interests have consistently met that test.

Structural Distinction

Unlike the DST, there is no single IRS revenue ruling that blesses a packaged, multi-owner working interest offering the way Revenue Ruling 2004-86 does for trusts. This is precisely why the structure requires more deliberate handling: to preserve its real-property classification, a working interest generally must be held directly by the exchanger, or through a structure that affirmatively elects out of partnership tax treatment under IRC Section 761(a), rather than through a standard LP, LLC, or pooled fund vehicle.

Summit Ventures structures participation as a direct working interest assignment, documented through the Authorization for Expenditure (AFE) and joint operating agreement, specifically to preserve this direct real-property character rather than converting it into a fund interest.

Active Income Exception & Governance

That direct structure is also what preserves the second major benefit available to working interest owners: the IRC Section 469(c)(3) active income exception. Income and losses from a working interest held directly, or through an entity that does not limit the owner's liability, are not automatically classified as passive under the federal tax code — in contrast to most other oil and gas fund structures and DST interests, which are securities by design.

Participation in a working interest also carries governance rights that a DST does not offer. As a working interest owner, the exchanger is a party to the joint operating agreement governing the well, with standing to review operational decisions, cost allocations, and production data, functioning as an active joint venture (JV) member in the asset rather than a fixed beneficial interest holder in someone else's trust.

Timeline fit is a critical factor for a 1031 exchanger. Because working interests in currently producing wells can be assigned directly, without the multi-week securities subscription and closing process a DST or a traditional real estate purchase requires, this structure is frequently identifiable within the 45-day window and closeable well inside the 180-day deadline, when properly coordinated with your qualified intermediary from the start of the exchange.

Tax Boot Mitigation: When the Exchange Cannot Be Fully Deferred

What Is Boot?

Boot — meaning cash or non-like-kind property received in the transaction, and any portion of the original debt not replaced on the new property — is taxable in the year of the exchange regardless of which replacement property is chosen.

The same is true if the 45-day identification period lapses without a qualifying identification, or if the 180-day closing deadline is missed entirely: the original sale is treated as a fully taxable event, triggering:

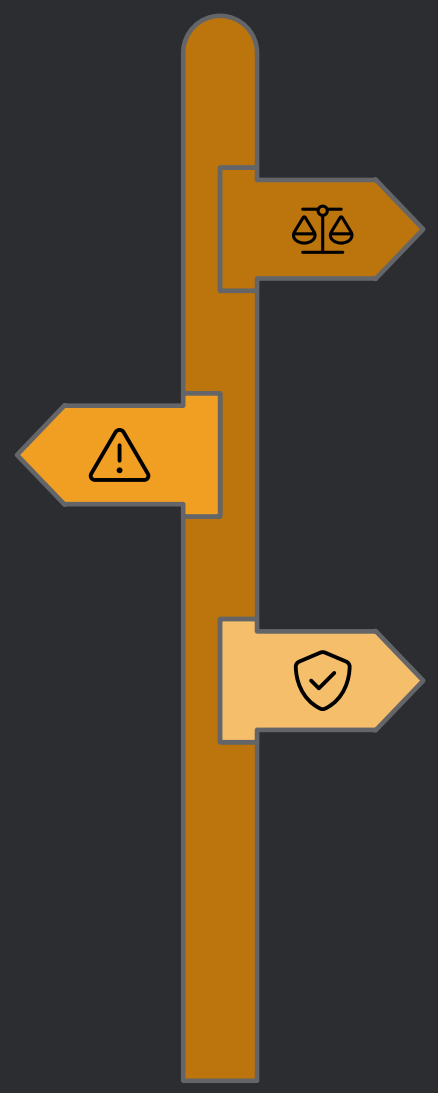
- Federal and state capital gains tax
- The 3.8% Net Investment Income Tax (NIIT) where applicable
- Depreciation recapture taxed at ordinary rates up to 25%

The IDC Advantage of Working Interests

This is the second decision path this guide is built around, and it is structurally different from the replacement-property decision. A DST interest, because it is a passive, grantor-trust-reported real estate holding, does not generate a current-year deduction that can offset boot or a failed-exchange gain in the year it is recognized. A direct working interest does.

Under **IRC Section 263(c)**, a working interest owner may elect to currently deduct intangible drilling costs — the labor, chemicals, fuel, and other consumable costs of drilling and completing a well — rather than capitalizing them. Because these costs are concentrated in the year capital is deployed, a working interest participation made in the same tax year as a taxable boot event or a failed exchange can generate a current-year deduction that directly offsets that ordinary and capital gains exposure, subject to the specific well's cost structure, the owner's individual basis and at-risk amount, and confirmation from a qualified tax professional.

This makes direct working interest participation a tool worth evaluating in two distinct scenarios: as 1031 replacement property itself, and separately, as a year-end capital deployment decision for sellers who already know they will recognize boot or a failed-exchange gain.



Path 1: Full Deferral

1031 replacement property only; no boot realized.

Path 2: Boot or Failed Exchange

1031 property plus boot or unreplaced debt; taxable gain.

IDC Deduction Offset

IRC 263(c) IDC deduction may offset taxable gain from boot.

Side-by-Side Comparison

Both structures evaluated strictly as 1031 replacement property candidates and as a tax boot mitigation tool for sellers who cannot fully defer their gain.

Category	DST Interest	Direct Working Interest
Statutory Basis	Revenue Ruling 2004-86 (beneficial trust interest treated as direct real property interest)	Revenue Ruling 68-331 and 68-226; Treasury Regulation 1.1031(a)-3 state-law test
Ownership Structure	Fixed beneficial interest in a trust; securities offering, typically limited to accredited investors	Direct, assignable real property interest; structured to preserve direct ownership rather than a fund or LP/LLC interest
Participation Level	Fully passive; no capital calls, no operational input	Active joint venture participation; party to the joint operating agreement
Governance & Control	None; trustee authority is deliberately restricted under the seven DST conditions	Governance rights tied to the operating agreement; access to AFE and production data
Timeline Fit	Identifiable quickly since sponsor already owns the property; typical closing in 3 to 5 days once subscribed	Can be identified and closed within standard 45/180-day windows when coordinated early with your QI
Tax Reporting	Grantor trust letter; depreciation computed on owner's own carried-over basis	Reporting reflects direct ownership; income and costs tied to the specific well and ownership share
Boot Mitigation	Not applicable; no current-year deduction mechanism against boot	IRC Section 263(c) IDC election available as a current-year deduction tool, subject to individual facts and professional confirmation
Cost Structure	Industry-cited total fee drag of approximately 25% to 35% of capital; common 10% to 15% upfront load	Costs documented through the AFE at the well level; no third-party sponsor promote layered on top of a securities offering structure
Liquidity & Hold	Illiquid; typical 5 to 10 year planned hold; secondary resale commonly discounted 20% to 50% off book value	Hold period tied to the producing life of the well and the owner's own objectives; not a publicly traded security
Minimum Participation	Commonly $100,000 to $250,000	Varies by well and allocation; structured as a direct assignment rather than a fixed securities minimum
Eligibility	Typically limited to accredited investors under Rule 501 of Regulation D	Open to exchangers and business participants who complete Summit's standard participation and suitability process
Complexity	Low complexity for the exchanger after subscription; high structural complexity for the sponsor to maintain the seven conditions	Moderate complexity; requires direct holding documentation and coordination with your QI and tax advisor

Advantages and Limitations of Each Structure

DST INTEREST

Advantages

- A clean, long-settled IRS framework with no ambiguity about qualification
- Fast closing once subscribed, since the sponsor already owns the asset
- Genuinely passive ownership with zero management responsibility
- Well suited to exchangers who are fully done with active property decisions

Limitations

- No owner governance or operational input under any circumstance
- No mechanism to offset boot or a failed-exchange gain
- Cumulative fee drag meaningfully higher than a direct holding structure
- Illiquidity with steep reported discounts on early secondary sale
- Accredited-investor and suitability gating that excludes some sellers outright

DIRECT WORKING INTEREST

Advantages

- Direct real property classification under a well-established revenue ruling
- Active governance rights through the joint operating agreement
- The only structure that can also serve as a current-year boot or failed-exchange tax mitigation tool through the IRC Section 263(c) IDC election
- No securities-style layered sponsor promote

Limitations

- Requires more deliberate structuring than a pre-packaged trust offering to preserve favorable tax character
- Less standardized across the industry than the DST framework
- Outcomes tied to the performance and cost structure of the specific well, which your advisory team should review well by well

Best-Fit Scenarios & Decision Guidance

When a DST Is the Better Fit

A DST is generally the better fit when the exchanger has fully completed their active ownership journey, wants zero governance responsibility of any kind, is comfortable with accredited-investor securities eligibility requirements, and does not have a boot or failed-exchange tax exposure that needs a current-year offset.

When a Direct Working Interest Is the Better Fit

A direct working interest is generally the better fit when the exchanger wants to remain an active participant in a real asset rather than a passive security holder, values governance rights and operational transparency, is working against a tight identification or closing deadline that favors a direct-assignment structure, or, separately, has already determined that some portion of the exchange will generate boot, NIIT exposure, or depreciation recapture that a current-year IDC election could help offset.

Many sellers — particularly those who have already missed a portion of their deferral or are carrying boot forward — use the working interest path specifically for its dual function: it can serve as qualifying replacement property and, independently, as a capital deployment decision that generates a current-year deduction against taxable gain.

Four Questions to Drive Your Decision Before Day 45

1

Is full deferral achievable?

If boot is unavoidable, the DST's passivity offers no offsetting tool. A working interest's IDC election does.

2

How much governance do you want?

If none, the DST's structural passivity is a feature. If you want standing in operational decisions, the working interest's JOA structure is the better match.

3

How many days remain?

Both structures can be identified quickly, but direct working interest assignments are built to move at the pace of a 45-day clock without the multi-step securities subscription process.

4

What does your CPA say?

Neither structure should be selected without a professional running the actual numbers against your individual basis, at-risk amount, and NIIT exposure.

Questions for Your Advisory Team

> Does our timeline realistically support a DST subscription process, or does a directly assignable working interest better fit our remaining identification days?

> If we expect boot or a partial failed exchange, what is our estimated federal and state capital gains exposure, NIIT exposure, and depreciation recapture, and how would an IRC Section 263(c) IDC election change that calculation?

> What specific governance rights, if any, do we want to retain in our replacement property, and does that change which structure fits?

> Has our structure been reviewed to confirm it preserves both 1031 real property classification and, if applicable, the IRC Section 469(c)(3) active income treatment?

> What is the realistic cost drag over the full hold period for each option, and how does that affect our after-tax outcome?

Ready to Confirm Which Structure Fits Your Exchange?

Both paths are legitimate, IRS-recognized tools for a real estate seller facing the 1031 clock, and neither should be chosen on urgency alone. The right structure depends on how much governance you want to retain, whether your exchange will generate boot, and how many days you have left to act.

Summit Ventures structures direct working interest participation specifically for exchangers who want to remain active business participants in a producing asset rather than passive holders of a security, and our team works alongside your qualified intermediary, CPA, and attorney to confirm fit before you commit capital.

If your identification window is closing, the conversation to have with your advisors today is **which structure, not just which property**, actually matches your remaining time and your tax position.

Talk to Summit Ventures Today

Sources & References

- IRS Revenue Ruling 2004-86 — DST beneficial interests as Section 1031 replacement property
- IRS Revenue Ruling 68-331 — Operating working interest classified as real property
- IRS Revenue Ruling 68-226 — Lessee's interest in oil and gas classified as real property
- Treasury Regulation 1.1031(a)-3 — State-law test for real property classification
- Treasury Regulation 301.7701-4(c) — Trust versus business entity classification risk
- IRC Section 1031(a)(2) and Section 761(a) — Election out of partnership tax treatment
- IRC Section 263(c) — Election to currently deduct intangible drilling costs
- IRC Section 469(c)(3) — Working interest exception to passive activity classification
- Revenue Procedure 2002-22 — 35 co-owner limit applicable to tenant-in-common structures

This guide is for informational purposes only and does not constitute legal, tax, or investment advice. Consult your qualified intermediary, CPA, and attorney before making any 1031 exchange or investment decision.