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Deferring Taxes Through a 1031 Exchange vs. Qualified Opportunity Funds

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Section 1031 of the Internal Revenue Code, as amended by the Tax Cuts and Jobs Act ("TCJA") in December 2017, now allows for the deferral of tax arising from gains solely on the sale of real property. This limitation to real property was a significant change from rules that applied prior to 2018. On the other hand, Qualified Opportunity Funds, a product of the TCJA, allow for the deferral of tax due on capital gains from any source that generates eligible gains.

Although further regulations are needed to fully implement Qualified Opportunity Funds, taxpayers who have recently recognized capital gains, or plan to do so imminently, need to carefully analyze the requirements, benefits, and limitations of both Section 1031 like-kind exchanges and Qualified Opportunity Funds. The following tables provide a comparison of the various attributes of each alternative.

Relinquished Property and Replacement Property Requirements

	1031 Exchange	Qualified Opportunity Fund
Property Type Eligible	Effective 1/1/18, only real property.	Any property that generates capital gain.
Location Requirements	Replacement property can be located anywhere in the U.S.	Property must be located in a Qualified Opportunity Zone.
Required Reinvestment	Entire proceeds from sale (i.e., net equity plus debt replacement).	Only net capital gain must be reinvested.
Replacement Property Usage Restrictions	Cannot be held primarily for sale. Must be held for productive use in a trade or business or held for investment.	Cannot be used for golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack, gambling facility, or certain stores with a principal business of selling alcoholic beverages for off-premises consumption.

Ownership and Timing Requirements

	1031 Exchange	Qualified Opportunity Fund
Ownership	Owner of new property must be same as owner of sold property.	Owner of new property must be Qualified Opportunity Fund (any entity that is a corporation or partnership for tax purposes).
Deadline to Identify Replacement Property	45 days after sale.	Not applicable.
Deadline to Acquire Replacement Property	180 days after sale.	Capital gain must be invested into Qualified Opportunity Fund within 180 days of recognition of capital gain.
Reverse Reinvestments	Replacement property can be acquired first, after which relinquished property is sold.	Capital gain event must occur prior to investment into Qualified Opportunity Fund.
Applicability to Partnerships	Partnership itself must enter into 1031 exchange. Partners cannot separately defer gain.	Either partnership itself or the partners, individually, are able to defer gain into Qualified Opportunity Fund.
* Special rule for gains generated by partnerships	Not applicable.	For 180-day test, partners that defer gain individually use December 31 of the taxable year as the start date for the test or can elect to use the partnership's actual gain recognition date.

Special planning note: If a partnership attempts, but fails, a 1031 exchange due to the 180-day replacement period, individual partners still have additional time after December 31 to defer gain by investing into Qualified Opportunity Funds.

Tax Benefits and Reporting Requirements

	1031 Exchange	Qualified Opportunity Fund
Deferral Period	Gain deferred until new property sold. However, permanent deferral is possible if owner of new property dies, and owner's estate receives basis step-up.	Gain deferred until earlier of the date on which the investment in a Qualified Opportunity Fund is sold or exchanged, or December 31, 2026. If taxpayer dies before December 31, 2026, the gain must be recognized. There is no step-up at death.
Tax Reporting	Form 8824.	Form 8996 for fund self-certification and Form 8949 for deferral reporting. Awaiting other reporting guidance.
State Conformity	Most states conform, but certain states have clawback provisions.	Awaiting guidance from states on conformity.