

# Opportunity Zones and 1031 Exchanges

October 2026

While both of these tools let an investor postpone tax on a capital gain, they differ in what they protect. A 1031 exchange keeps an existing real estate gain deferred for as long as the investor stays in real estate. An Opportunity Zone (OZ) investment defers a gain for a fixed five years, and its main benefit applies to the growth of the new investment.<sup>1</sup>

## How a 1031 exchange works

A 1031 exchange applies to real estate held for investment or business use. The owner sells one property and buys another of “like kind.” If the rules are met, the gain on the sale is not taxed at that time.<sup>2</sup>

Three requirements shape most exchanges:

- ◆ **Real estate only.** Exchanges are limited to real property. Gains from stock, a business sale, or other assets do not qualify.<sup>2</sup>
- ◆ **Full reinvestment.** To defer the entire gain, the investor generally reinvests all of the sale proceeds and replaces any debt that was paid off. Cash taken out is taxable, up to the amount of the gain.<sup>2</sup>
- ◆ **Fixed deadlines.** The investor has 45 days to identify replacement property and 180 days to close. A qualified intermediary typically holds the sale proceeds in the meantime.<sup>3</sup>

The deferral has no set end date. An investor can exchange again at each later sale. Under current law, heirs generally take the property with a tax basis equal to its market value at death, so a deferred gain may never be taxed.<sup>4</sup>

## How an Opportunity Zone investment works

An OZ investment starts with a capital gain from almost any source, including stock, a business sale, or real estate. Within 180 days, the investor places some or all of that gain in a Qualified Opportunity Fund (QOF). The fund invests in real estate or businesses located in designated census tracts.<sup>5</sup>

Only the gain needs to be invested. The rest of the sale proceeds stay with the investor.<sup>5</sup>

Three benefits follow:

- 1. Deferral.** Tax on the original gain is postponed for five years from the date of the investment, or until the investment is sold if that comes first.<sup>6</sup>
- 2. A partial reduction.** After five years, the taxable amount of the original gain is reduced by 10%. The reduction is 30% for funds that invest in rural zones.<sup>6</sup>
- 3. Tax-free growth.** If the investment is held for at least ten years, the investor can sell at the end of the holding period and owe no federal capital gains tax on its appreciation. Depreciation taken along the way is generally not recaptured on that sale.<sup>7</sup>

The tax on the original gain comes due at year five. The fund investment is usually still illiquid at that point, so investors need a plan for that payment.

OZ rules also generally require a fund to build new property or substantially improve existing property.<sup>5</sup> That brings development risk that a stabilized 1031 replacement property may not carry.

## Side by side

|                                       | 1031 exchange                                                        | Opportunity Zone investment                                                                             |
|---------------------------------------|----------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------|
| <b>Eligible gains</b>                 | Real estate held for investment or business use                      | Capital gains from most assets, including stock, a business sale, or real estate                        |
| <b>What must be reinvested</b>        | All sale proceeds, to defer the full gain                            | The gain only                                                                                           |
| <b>Debt</b>                           | Debt paid off at sale must be replaced to defer the full gain        | No debt to replace                                                                                      |
| <b>Deadlines</b>                      | 45 days to identify, 180 days to close                               | 180 days to invest                                                                                      |
| <b>What the investor owns</b>         | Replacement real estate anywhere in the U.S., usually owned directly | A passive interest in a fund that invests in designated zones                                           |
| <b>Co-owners</b>                      | The selling entity generally exchanges as a whole                    | Each partner can generally invest separately                                                            |
| <b>Deferral of the original gain</b>  | Open-ended, until a taxable sale                                     | Five years                                                                                              |
| <b>Reduction of the original gain</b> | None                                                                 | 10% after five years (30% for rural funds)                                                              |
| <b>Tax on new appreciation</b>        | Deferred again with each later exchange                              | No federal capital gains tax after a ten-year hold                                                      |
| <b>At death</b>                       | Heirs generally receive a stepped-up basis                           | Any gain still deferred stays taxable to heirs. The holding period generally carries over. <sup>8</sup> |

State tax treatment can differ from the federal rules for both tools. California, for example, does not follow the federal OZ provisions.<sup>9</sup>

## A simple example

An investor sells a rental property for \$2,000,000. The cost basis is \$1,200,000, so the gain is \$800,000. Depreciation and state taxes are left out to keep the example simple.

**With a 1031 exchange**, the investor buys replacement real estate worth at least \$2,000,000 and uses all of the proceeds to do it. The \$800,000 gain stays deferred until that property is sold in a taxable sale.

**With an OZ investment**, the investor places \$800,000 in a QOF. The remaining \$1,200,000 is available for any other use. Five years later, federal tax comes due on \$720,000, which is the original gain less the 10% reduction.<sup>10</sup> If the fund interest is held for ten years and then sold for more than \$800,000, the growth above \$800,000 is not subject to federal capital gains tax.

*These figures are hypothetical. They illustrate the partial tax mechanics only and do not represent the expected results of any investment.*

## Where each tends to fit

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A 1031 exchange tends to suit an investor who:

- ◆ has a gain from real estate and wants to keep owning property directly
- ◆ wants to choose and own a specific property
- ◆ wants current income in the near term, often from a stabilized property or a Delaware Statutory Trust (DST)
- ◆ values open-ended deferral and plans to pass property to heirs

An OZ investment tends to suit an investor who:

- ◆ has a gain from real estate, stock, a business sale, or another asset
- ◆ wants to keep the non-gain portion of the proceeds available
- ◆ can commit capital for ten years or more
- ◆ is focused on long-term appreciation and total after-tax return, and does not need current income in the early years
- ◆ prefers a fund to direct ownership and management

A real estate sale can fit either tool. Three practical differences often matter to real estate sellers:

- ◆ **Co-owners can go separate ways with OZ investments.** In a 1031 exchange, the taxpayer that sells generally must be the one that buys the replacement property. When an LLC or partnership sells, the entity usually completes the exchange as a whole.<sup>11</sup> With an OZ investment, when the entity passes the gain through to its owners, each partner can decide separately whether to invest a share of that gain, and in which fund.<sup>12</sup> This can help families and partners who want to separate their holdings.
- ◆ **No debt to replace.** A full 1031 deferral generally requires new debt, or added cash, equal to the debt paid off at sale.<sup>2</sup> An OZ investment has no such requirement. The investor contributes cash to a fund and generally takes on no property debt personally.
- ◆ **A move from active to passive ownership.** A 1031 exchange usually keeps the investor in direct ownership, along with the management it requires. An OZ investor holds an interest in a fund, and the fund's manager handles development, leasing, and operations.

The two can also be used together. A real estate seller who exchanges only part of the proceeds may be able to invest the remaining taxable gain in a QOF within 180 days.<sup>5</sup>

The choice usually depends on the source of the gain, the need for liquidity, and the time horizon. A tax advisor should review the details before either tool is used.

Pinnacle Partners invests exclusively in Opportunity Zone real estate. We are glad to walk through how these rules could apply to a specific sale or gain scenario.

## Notes

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1. Internal Revenue Code §§1400Z-1 and 1400Z-2, as amended by the One Big Beautiful Bill Act (P.L. 119-21, signed July 4, 2025). The OZ rules described here are those for investments made on or after January 1, 2027. IRS Notice 2026-40 (June 18, 2026) provides transition guidance. Investments made on or before December 31, 2026 follow the earlier rules, under which deferred gain is recognized on December 31, 2026. See ArentFox Schiff, [IRS Releases Notice 2026-40: Transitional Guidance on Qualified Opportunity Zones](#) (July 24, 2026).
2. IRS, [Like-kind exchanges - Real estate tax tips](#) (last reviewed May 1, 2026). See also IRC §1031(a) and (b).
3. IRC §1031(a)(3); Treas. Reg. §1.1031(k)-1.

4. IRC §1014.
5. IRS, [Opportunity zones frequently asked questions](#), Q&As 10, 11, 13, 22, 43, and 49 (last reviewed September 14, 2026). As of that date the page still showed the pre-2027 deferral dates.
6. IRC §1400Z-2(b), as amended. See the ArentFox Schiff alert in note 1 for the five-year deferral and the 10% and 30% basis increases.
7. IRC §1400Z-2(c), as amended; Treas. Reg. §1.1400Z2(c)-1; IRS FAQ in note 5, Q&As 5, 25, and 26. For investments made after December 31, 2026 and held 30 years or longer, basis is fixed at fair market value on the 30th anniversary, so later appreciation is taxable.
8. IRC §1400Z-2(e)(3); Treas. Reg. §1.1400Z2(b)-1.
9. California Franchise Tax Board, [2025 Instructions for California Schedule D \(540\)](#).
10. Assumes the QOF investment is worth at least \$800,000 at year five. If it is worth less, the taxable amount is based on the lower value. IRC §1400Z-2(b)(2).
11. IPX1031, [1031 Exchange Partnership Issues](#) (last modified June 28, 2024). Partnership interests are not eligible for exchange, and the same taxpayer must start and complete the exchange. Structures that let partners separate before a sale exist and carry tax risk.
12. IRS FAQ in note 5, Q&A 23.

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