

Qualified Opportunity Zones- Some Clarity?

Take-Away: There are many technical rules associated with a qualified opportunity zone investment or fund. Those technical rules were amended with the One Big Beautiful Bill Act (OB3) last year, seemingly making opportunity fund investments even more mysterious. A couple of the OB3 amendments were 'clarified' (if you believe the IRS) in a recent Notice.

Background: Current estate planning focuses more on saving income taxes than it does avoiding federal transfer taxes due in large part to a \$15 million applicable exemption amount available to each individual. Stepping up the basis on the death of the asset owner has taken on a new planning prominence, e.g., upstream basis planning by giving grandma a testamentary general power of appointment. Lifetime basis adjustments are also being studied and exploited, such as assuring eligibility of qualified small business "C" stock sales under IRC 1202. As such, there is renewed interest by investors for ways to increase their tax basis in assets. The attention of many investors may have turned to qualified opportunity funds.

Qualified Opportunity Zone Investments: The 2017 Tax Act provided a new way to defer capital gain tax recognition- the *qualified opportunity zone investment*. (QOZ.) QOZ's are intended by Congress to incent long-term investments in low-income urban and rural communities. The incentive allows the QOZ investor to defer, and potentially reduce, his/her tax on capital gains if the investor invests his/her gains in a *qualified opportunity fund* (QOF) which is the vehicle that, in turn, invests in an eligible QOZ property. [IRC 1400A-1 and IRC 1400A-2.] The original QOZ rules were amended by the One Big Beautiful Bill Act (OB3) of 2025. We now have some clarity (maybe) regarding the OB3 amendments to QOZ's and QOFs with a new IRS Notice.

IRS Notice 2026-40 (June 18, 2026); It has taken just about a year for the IRS to finally get around providing minimal guidance to the OB3 amendments to QOZs and QOFs.

Transition Rules: The OB3 amendments created some confusion regarding transitional rules, when it switched from the 'old' QOZ regime to the 'new' QOZ regime, which transition is addressed in the Notice. The Notice confirms that the rules to defer capital gain recognition now differ on *when* an QOZ investment was made.

Pre-2027 QOZ Investments: For investors who deferred their capital gains by making a qualifying investment in a QOF on or before **December 31, 2026, that deferred gain must be included in the investor's gross income** in the tax year that **includes December 31, 2026**. As such, the deferral ends this calendar year.

Post-2026 QOZ Investments: The OB3 created a new rule for investments made on or after **January 1, 2027**. For QOZ investments made after this date, the tax year for the investor's gain inclusion is no longer a fixed date as it was under the 2017 Tax Act. Instead, the tax year that includes the deferred gain is the date **five years after the 'new' QOF investment was made in which the investor must now report the gain**. Thus, the deferral of the gain will be five years. In addition, these 'new' QOF investments allow the investor's tax basis in their QOF investment to be **increased by 10%** if the investment is held for at least **five** years, which is yet another tax incentive for long-term QOZ investors.

Acquiring QOZ Investments: The Notice seeks to clarify the rules for what constitutes a *qualified opportunity zone business property*. (Sadly, yet another acronym, QOZBP.) With the OB3, tangible property that is acquired *after* December 31, 2026, as a generalization, cannot qualify as QOZBP if it is located in a previously designated QOZ, i.e., one that was created prior to the OB3. The Notice identifies **two exceptions** to this general rule: (i) Property can still qualify if it is acquired pursuant to a written working capital 'safe harbor plan' that was adopted on or before December 31, 2026. However, to be eligible, the business must have received at least 10% of the estimated working capital assets and expended at least 5% of them by the end of 2026. (ii) A QOF or QOZBP is allowed to acquire property after 2026 to replace or modernize existing tangible property in the ordinary course of business. However, this second exception does not apply to any new property that is acquired to expand the business or go into a new trade or new product line.

'Safe Harbors:' The original QOZ designation are in effect for 10-year periods, with most set to expire on December 31, 2028 (or December 31, 2027, if the QOZ is located in Puerto Rico.) The Notice identifies 'safe harbors' that provide long-term clarity to a business that is operated in these zones. After a zone designation expires, a business can continue to treat the location as a QOZ for some compliance tests through December 31, 2027. This 'safe harbor' applies to the 'substantial use' test under the QOZ rules for tangible property and the 'compliance' test for a QOZB, like the requirement to derive at least 50% of its gross income from the active conduct of a trade or business within the zone. The Notice's interpretation of these 'safe harbors' will allow

existing investments and businesses to continue operating under the QOZ rules long after their official designation period has ended.

Conclusion: The QOZ and QOZBP rules are highly technical, and this missive obviously glosses over (or completely ignores) those rules. The intent behind the OB3 amendments to the QOZ rules is to encourage more investors who face a large gain recognition event, like the sale of their business, or who need to diversify their investment portfolio, to divert those gains into QOZ and QOZBP to (i) defer some, or all, of the gain recognition for up to five years; and (ii) acquire a 10% tax basis adjustment if that QOZ investment held for at least five years. As investors explore ways to avoid reporting their gains, they might want to at least take a look at QOZs and QOFs as vehicles to defer taxes.