Guidance for Investors and Qualified Opportunity Funds Moving from OZ 1.0 to OZ 2.0

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In Notice 2026-40, the U.S. Department of the Treasury and the Internal Revenue Service announced their intent to issue proposed regulations under the latest iteration of the Qualified Opportunity Zone ("QOZ") program, known as OZ 2.0, which takes effect after Dec. 31, 2026. The Notice includes transitional guidance for investors, as well as Qualified Opportunity Funds ("QOFs") and Qualified Opportunity Zone Businesses ("QOZBs") that exist under the current iteration of the QOZ program, known as OZ 1.0.

Investors

The rules of OZ 1.0 continue to apply to an investor that realizes capital gains and invests those gains in a QOF on or before Dec. 31, 2026. Under OZ 1.0, an investor will be required to recognize previously deferred capital gains on Dec. 31, 2026, except to the extent the investor has already recognized such gains, or a portion thereof, as a result of an earlier inclusion event. An investor that recognizes such deferred capital gains on Dec. 31, 2026, will not be permitted to elect to defer those capital gains further by investing in another QOF under OZ 2.0 but will be treated as continuing to hold a qualifying investment in the QOF in which it invested such gain and will remain eligible to elect to eliminate gain (including recapture income) on an exit event with respect to the applicable QOZ investment that has been held for at least 10 years ("OZ 1.0 10-Year Exclusion").

The rules of OZ 2.0 will apply to an investor that realizes capital gains and timely invests such gains in a QOF on or after Jan. 1, 2027. As noted in our previously issued Client Alert, dated Nov. 9, 2026, OZ 2.0 provides investors with three tax benefits, including (i) potential five-year deferral of eligible invested capital gains, (ii) a permanent exemption/elimination of the taxes on 10 percent (30 percent in the case of capital gains invested in a qualified opportunity fund that holds at least 90 percent of its assets in qualified rural opportunity zone property) of invested capital gains that remain invested for five years, and (iii) a potential 100 percent permanent exemption/elimination of any gain (including any recapture income) resulting from an exit event with respect to the applicable QOZ investment that has been held for at least 10 years.

QOFs and QOZBs

After the QOZ designations under OZ 1.0 expire on Dec. 31, 2028 (Dec. 31, 2027 in the case of Puerto Rico), it was unclear how QOFs and QOZBs would continue to satisfy the many requirements that their property, and their trade or business, be located in a QOZ. The Notice announces that proposed regulations will include helpful safe harbors to allow property and activities located in an area previously designated as a QOZ to continue to qualify as located in a QOZ for these purposes.

Surprisingly, this flexibility does not extend to additional property that a QOF or QOZB purchases in a previously designated QOZ after Dec. 31, 2026 (which is significantly earlier than the OZ 1.0 designation expiration date). Such property will not qualify as Qualified Opportunity Zone Business

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Property unless (1) the applicable QOZ is redesignated under OZ 2.0, (2) the property is acquired pursuant to a working capital plan adopted on or before Dec. 31, 2026, the acquisition is made in a manner substantially consistent with the plan, the applicable QOZB has received at least 10 percent of the total estimated working capital assets designated in writing under the plan by Dec. 31, 2026 and the QOZB has spent at least 5 percent of the total estimated working capital assets by Dec. 31, 2026, or (3) the property is tangible property acquired by a QOF or QOZB for use in the ordinary course of its trade or business in a previously designated QOZ that is intended to replace or modernize existing tangible business property in order to continue the operations of the applicable trade or business.

If you would like to discuss how a prospective QOZ investment may be eligible for the benefits of OZ 2.0, or how your current OZ 1.0 investment may be affected by OZ 2.0, please reach out to the Haynes Boone attorneys listed below.

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[1] Interestingly, if an investor includes gain deferred under OZ 1.0 due to an inclusion event, the investor may be eligible to defer that gain further by investing in a QOF after Dec. 31, 2026, under OZ 2.0. The new investment would need to satisfy all of the OZ 2.0 requirements, including the 180-day investment period, but assuming those requirements can be satisfied, the investor would be entitled to the benefits of OZ 2.0. Because OZ 1.0 would no longer apply to the investment, the investor would no longer be eligible for the OZ 1.0 10-Year Exclusion, and the investor's holding period would restart for purposes of the similar exclusion for QOZ investments held for at least 10 years under OZ 2.0.

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