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IRS Proposes Transitional QOZ Guidance

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In June, the IRS published Notice 2026-40, concerning certain transitional guidance relating to "qualified opportunity zones" ("QOZs"). The notice provides safe harbors pursuant to which existing "qualifying investments" in QOZs will continue to qualify, and pursuant to which new qualifying investments can be made into existing QOZs (even after the designation of those QOZs expire).

Although the notice is a "proposal to propose" regulations (on which taxpayers technically cannot rely), taxpayers may want to take action before the end of 2026.

In 2017, the Tax Cuts and Jobs Act (the "TCJA") created the QOZ program. Generally, if a taxpayer makes a qualifying investment in a QOZ (generally, a designated low-income census tract) that taxpayer receives certain federal income tax benefits. One of those tax benefits is the effective tax-free disposition of a qualifying investment, if that investment is held for at least 10 years (until as late as 2048).

In 2025, the One Big Beautiful Bill Act ("OBBBA") made the QOZ program permanent but tweaked the tax benefits received. Among other things, the 10-year tax benefit no longer expires in 2048, but, rather, has a rolling 30-year limit.

However, OBBBA generally did not change any of the structuring or testing requirements for QOZ investments.

Most QOZ investments today are held through what is referred to as a "two-tier" structure. In this structure, a taxpayer makes a qualifying investment in a "qualified opportunity fund" ("QOF"), which then invests in a "QOZ business" ("QOZB").

The QOZB holds and develops real property (or operates a business) in a QOZ. There are numerous requirements for a business entity to qualify as a QOZB, including that it can hold only a "reasonable amount" of working capital.

In regulations, Treasury created a safe harbor pursuant to which a QOZB's working capital would be considered reasonable (the "working capital safe harbor") if, generally, (A) "amounts are designated in writing for the development of a trade or business in a [QOZ]," (B) "[t]here is a written schedule… for the expenditure of the working capital… within 31 months of the receipt by the [QOZB]," and (C) "the working capital assets are actually used in a manner that is substantially consistent with" the designation and schedule. Multiple applications of the safe harbor are permitted for a total safe harbor period of up to 62 months.

The regulations also include safe harbors to satisfy the other quantitative QOZB requirements. However, rather than those safe harbors operating independently, Treasury hitched those other safe harbors to compliance with the working capital safe harbor. Basically, during the "start-up" period, a QOZB can comply with all its quantitative requirements by meeting the working capital safe harbor. For this reason, most well-advised QOZBs utilize the working capital safe harbor.

Due to the nature of the OBBBA changes, for most practical purposes, there are now two QOZ programs: an "old program" under the TCJA, and a "new program" under OBBBA. This new program includes the designation of new QOZs, which will be in effect as of Jan. 1, 2027, and which will expire on Dec. 31, 2036.

The "old" QOZs generally do not expire until the end of 2028, meaning that there will be a two-year overlap between the old and new programs. (This issue will not arise in the future, as QOZ designation periods will be consecutive decade-long periods moving forward.)

In addition to the one-time designation overlap, (likely due to a drafting oversight) OBBBA modified the text of the statute so that as of Jan. 1, 2027, property in an old QOZ is no longer meets the definition of "QOZ property." (The specific issue is that the term "applicable start date" does not include Dec. 31, 2017.) This "glitch," if taken literally, would cause all existing QOZ investments to eventually cease to qualify. Notice 2026-40 addresses the overlap and the glitch.

In general, the notice permits the acquisition of tangible property in an old QOZ after Dec. 31, 2026 (even after the old QOZ's expiration date), if acquired in the manner described below.

Additionally, the notice provides safe harbors that cause property in an old QOZ to continue to qualify for purposes of other QOZ quantitative tests if there is the "active conduct of a trade or business" prior to the old QOZ's expiration date, or if the transitional safe harbor below is met.

The notice permits certain acquisition of additional tangible property in an old QOZ in the "ordinary course of [a QOZB's] trade or business," meaning that the QOZB must already be in a trade or business (e.g., operating an apartment building). Permitted acquisition in this case includes property that is for "replacement or modernization," but not "the expansion…or the transition of a trade or business into a new trade or business." In examples, a QOZB that owns an apartment building is permitted to replace "window[s]… appliances, fixtures, cabinetry, [and] flooring" (replacement).

Similarly, a QOZB that runs a restaurant is permitted to update that restaurant's point of sale system (modernization). However, a QOZB that owns an industrial manufacturing facility is not permitted to acquire an adjacent parcel to build a new warehouse (expansion).

For QOZBs that are not yet in the "ordinary course of [a] trade or business," the notice provides a "transitional safe harbor." Under the transitional safe harbor, a QOZB (i) must have adopted a working capital plan (in accordance with existing the regulations describing above) by Dec. 31, 2026; (ii) acquire property in a manner that is "substantially consistent" with that plan; (iii) have received at least 10% of the estimated capital required by that plan by Dec. 31, 2026; and (iv) spent at least 5% of the estimated capital required by that plan by Dec. 31, 2026. (A binding agreement can suffice in lieu of actual expenditure by that date.)

Under the transitional safe harbor, a QOZB that intends to develop real property, could in theory, not acquire land in an old QOZ until after Jan. 1, 2027. Unlike the "ordinary course" rules above, under the transitional safe harbor, there are no limitations on the acquisition of tangible property for "replacement" or "modernization" (or prohibition on "expansion"). If a QOZB complies with the transitional safe harbor, it could, for example, acquire an adjoining parcel.

As for new qualifying investments in old QOZs, the notice gives mixed messages. Under the transitional safe harbor, a QOF can make additional investments into a QOZB in accordance with a working capital plan. However, there is no (proposed) analogous rule in the case of an ordinary-course-of-a-trade-or-business QOZB. This means that even though QOZBs that own property in old QOZs can continue to replace, etc., property, those QOZBs will need to fund those costs with operating income, debt, or n on-qualifying investments (the last of which dilute the 10-year tax benefit).

Managers of real estate QOZBs should take this time to review their working capital plans. For those QOZBs that are in the development process of real estate projects, it is more essential that ever to be operating in compliance with a working capital plan. Additionally, with the further requirements added by the transitional safe harbor, managers should plan accordingly for the end of the year to ensure that sufficient capital will be raised and spent (or contracted for) to get the benefit of the notice.

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