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Alert | Tax/Opportunity Zone Funds

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IRS Issues Notice 2026-40, Providing Transition Guidelines to Opportunity Zone Projects

Go-To Guide
IRS Notice 2026-40 provides transition relief to qualified opportunity zone projects. The Notice: • Acknowledges the Dec. 31, 2028, QOZ 1.0 expiration date and, with the QOZ 2.0 zones becoming effective for investment in QOFs on or after Jan. 1, 2027, enables a pathway for investment in QOZ 1.0 projects by QOZ 2.0 investors. • Provides that compliance safe harbors for expired QOZ 1.0 zones continue through 2047 (limited purpose). • Allows continued and future investment in QOZ 1.0 zones if the conditions in the Notice are complied with by Dec. 31, 2026.

On June 18, 2026, the IRS issued IRS Notice 2026-40 (Notice), providing transition rules for the expiring opportunity zone census tracts certified under the Tax Cuts and Jobs Act of 2017 (QOZ 1.0). The Notice addresses how "QOZ 1.0" projects may continue to operate in a qualifying manner as the current opportunity zone program approaches key transition dates and new opportunity zone census tracts begin the designation process under the One Big Beautiful Bill Act of 2025 (QOZ 2.0), and ultimately how the QOZ 1.0 rules interact with the QOZ 2.0 framework that goes into effect Jan. 1, 2027.

Background

Investors making a capital contribution to a qualified opportunity fund (QOF) on or before Dec. 31, 2026, will be eligible for the following QOZ 1.0 federal income tax benefits: (1) deferral of recognition of eligible capital gain invested in the QOF until Dec. 31, 2026; and (2) full elimination of taxable gain upon exit of the investment after the interest in the QOF is held for 10 years (eliminating depreciation recapture), so long as the sale occurs by Dec. 31, 2047.

Investors making a capital contribution to a QOF after Dec. 31, 2026, will be eligible for the following QOZ 2.0 federal income tax benefits: (1) five-year deferral of recognition of eligible capital gain invested in the QOF; (2) tax basis step-up for the deferred eligible capital gain of 10% (30% for Qualified Rural Opportunity Funds) after such five-year period (so that only 90% of the deferred eligible capital gain must be recognized at such time); and (3) full elimination of taxable gain upon exit of the investment after the interest in the QOF is held for 10 years (eliminating depreciation recapture) (subject to a 30-year cap on the amount of such eliminated gain).

The opportunity zone census tracts certified under QOZ 1.0 are currently set to expire Dec. 31, 2028 (or Dec. 31, 2027, in the case of all Puerto Rico census tracts). Beginning July 1, 2026, the chief executive officer of each state, the District of Columbia, and any U.S. possession has from 90 to 120 days to designate 25% of the eligible census tracts in his or her jurisdiction as new opportunity zones under QOZ 2.0. Each QOZ 2.0 designation will be effective for 10 years, initially from Jan. 1, 2027, until Dec. 31, 2036, with the process for designating opportunity zones for the next decennial period repeating every 10 years. See Rev. Proc. 2026-14 for additional details relevant to the QOZ 2.0 designation and certification mechanics.

Transitional Guidance

According to the Notice, Treasury and the IRS intend to issue proposed regulations under QOZ 2.0, and those regulations are expected to be generally consistent with the rules described in the Notice, aspects of which are described below.

The Notice's transitional guidance aims to provide specific relief and safe harbors to enable QOFs and qualified opportunity zone businesses (QOZBs) to continue to satisfy the opportunity zone requirements (i) where a project or capital deployment began before Dec. 31, 2026, under the QOZ 1.0 rules, but will continue fundraising and/or development in or beyond 2027, (ii) where tangible property is acquired by a QOZB in a QOZ 1.0 census tract after 2026 and (iii) after a QOZ 1.0 census tract has expired.

The Notice states that, beginning Jan. 1, 2027, certain statutory requirements for qualified opportunity zone business property (QOZ Business Property) are tied to whether such property is acquired after the "applicable start date" for an opportunity zone certified under QOZ 2.0.[1] Because previously designated QOZ 1.0 census tracts do not have an "applicable start date" under the QOZ 2.0 rules, property acquired after Dec. 31, 2026, in a QOZ 1.0 census tract generally would not qualify as QOZ Business Property absent transitional relief or another exception. The Notice provides three principal categories of transition relief relevant to a project located in a QOZ 1.0 census tract.

[1] Please note that *tangible property acquired before Jan. 2, 2027,* for use in a qualified opportunity zone designated only under QOZ 2.0 will not have been acquired after the "applicable start date" for QOZ 2.0 purposes. Please keep this date in mind when fixing the closing date of transactions involving the purchase of tangible property that will not be effective until after the end of 2026.

1. Working capital safe harbor transition relief:

   Tangible property acquired by a QOZB after Dec. 31, 2026, in a QOZ 1.0 census tract may be treated as satisfying certain acquisition timing requirements and qualify as QOZ Business Property if the property is acquired pursuant to a written working capital safe harbor plan that (i) is adopted by Dec. 31, 2026, (ii) provides for the acquisition, construction, and/or substantial improvement of tangible property in a manner substantially consistent with the plan and schedule, and (iii) satisfies additional transition conditions.

   These additional transition conditions are that the QOZB must have *(A) received at least 10% of the total planned working capital for the project by Dec. 31, 2026, and (B) expended at least 5% of the total planned working capital for the project by Dec. 31, 2026, with amounts subject to a binding agreement entered into before Jan. 1, 2027, treated as expended for this purpose*. The Notice does not prescribe the source of the "working capital assets" used to satisfy the 10% receipt and 5% expenditure thresholds. As such, it would appear that the capital utilized for purposes of satisfaction of the 10% receipt and 5% expenditure thresholds outlined above may be sourced from QOF equity, non-QOF equity, or true debt.

2. Ordinary-course replacement/modernization property:

   Certain tangible property acquired after Dec. 31, 2026, in a QOZ 1.0 census tract may be treated as QOZ Business Property *if acquired to replace or modernize existing tangible business property in the ordinary course of the trade or business, including replacement or modernization necessary to continue current operations*. This exception does not cover property acquired to expand an existing business or to transition into a new line of business.

3. Ongoing compliance requirements following QOZ 1.0 expiration:

   Treasury and the IRS expect to issue proposed regulations that include safe harbors intended to facilitate continued compliance after a QOZ 1.0 designation expires. Certain QOZ Business Property and QOZB requirements may continue to be tested as though an expired QOZ 1.0 census tract remains a certified opportunity zone, but solely for limited purposes and generally only through Dec. 31, 2047.

   These limited-purpose safe harbors include continued treatment of the expired QOZ 1.0 census tract as a certified opportunity zone solely for purposes of (i) the "substantial use" requirement for certain QOZ Business Property and (ii) certain QOZB operational requirements (including the gross income and intangible property tests), in each case subject to conditions described in the Notice. *A QOZB may qualify for the continued treatment under clause (ii) above if it either (A) has begun to engage in the active conduct of a business in a QOZ 1.0 census tract on or before the date of such tract's expiration (i.e., generally Dec. 31, 2028), or (B) reasonably anticipates it will begin doing so in accordance with a written working capital safe harbor plan as described in section 1 above.*

The Notice also confirms that QOZ 2.0 investments made to a QOF after 2026, that are deployed into a QOZB with an underlying project in a QOZ 1.0 census tract that has met the foregoing conditions by the end of 2026, will be considered qualifying investments for purposes of qualifying for the enhanced QOZ 2.0 federal tax benefits (assuming satisfaction of all other requirements thereunder).

Notice 2026-40 is transitional guidance previewing proposed regulations that Treasury and the IRS expect to issue. Future proposed or final regulations, or other IRS guidance, may differ from or modify the transition rules described above.

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