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Treasury Provides Transition Roadmap for Opportunity Zones 2.0

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Key Takeaways

- Notice 2026-40 gives taxpayers the first practical roadmap for transitioning from OZ 1.0 to OZ 2.0, including rules for existing investments, 2026 gains, new tract designations and the new rolling five-year deferral period.
- Timing will drive eligibility and tax outcomes. OZ 1.0 deferred gains generally come due Dec. 31 and cannot be rolled into OZ 2.0, while certain 2026 gains may qualify if invested during a 2027 window.
- Investors should review OZ 1.0 positions, pending projects and 2026 capital gains before year-end, with particular attention to working capital safe harbors, new tract designations and whether Rural QOF benefits may support future investment planning.

The Treasury Department recently released Notice 2026-40, which provides taxpayers with the first practical transition roadmap for moving from the original Opportunity Zone tax incentive program (OZ 1.0) into the new, extended Opportunity Zone program (OZ 2.0). Notice 2026-40 is not the final word. Treasury intends to issue regulations consistent with the rules in the notice. In this alert, we explain the key transition rules, timing considerations and planning opportunities for taxpayers evaluating OZ 2.0 investments.

How the Opportunity Zone Incentive Works

Opportunity Zones are a tax incentive program created by the Tax Cuts and Jobs Act of 2017 to encourage long-term investment in lower-income communities designated as "Qualified Opportunity Zones."

To receive OZ tax incentives, investors must realize capital gains from the sale of any property and, within certain specific time frames — generally 180 days from the sale — invest those gains into a Qualified Opportunity Fund (QOF). Generally, investments are made through a two-tiered structure. The taxpayer invests in a QOF, which in turn invests in a Qualified Opportunity Zone Business (QOZB). A QOZB purchases and/or develops Qualified Opportunity Zone Property in a designated Qualified Opportunity Zone.

By making such investments starting Jan. 1, 2027, taxpayers can (i) defer paying tax on the capital gains invest in a QOF, (ii) eliminate the tax on 10% or 30% of such deferred gain and (iii) avoid all federal income tax on any appreciation (and depreciation recapture) with respect to their new investment if it is held for 10 years or more. Many, but not all, states offer corresponding state income tax incentives.

Key Takeaways from the Notice

Notice 2026-40 addresses several transition issues for taxpayers with existing OZ 1.0 investments, 2026 capital gains or projects in current OZ tracts. The following points are most relevant for investors evaluating eligibility, timing and planning considerations for OZ 2.0:

1. OZ 1.0 deferred gains come due on Dec. 31.

For investors who made OZ 1.0 investments and are still holding them, any remaining deferred gain must be recognized on Dec. 31. This recognized gain cannot be rolled into OZ 2.0 for a new deferral. However, if a taxpayer sells its investment or causes an "inclusion event" with respect to their OZ 1.0 investment prior to Dec. 31, the taxpayer can timely reinvest in OZ 2.0 and continue to defer the realized gains. Unfortunately, this would restart the holding period for purposes of the 10-year appreciation exclusion benefit.

2. Some 2026 capital gains can qualify for OZ 2.0.

A taxpayer with capital gain realized in 2026 can make an OZ 2.0 investment during the portion of the applicable 180-day investment window that falls in 2027. The 180-day window commences on the date of sale with respect to any assets directly held by a taxpayer. However, if a taxpayer realizes gains through a passthrough entity, the taxpayer may elect to start the 180-day window as late as the unextended due date of the passthrough entity's income tax return for the year in which it realized the gain.

In other words, (i) capital gains directly realized by a taxpayer in the second half of 2026, and (ii) capital gains realized through a passthrough entity at any time in 2026, may be eligible for OZ 2.0. Investors can invest K-1 gains recognized in 2026 as late as early September, 2027 and receive OZ 2.0 benefits.

3. New Opportunity Zones will be designated soon, to be effective Jan. 1, 2027.

New Opportunity Zone census tracts should be designated by the individual states by Oct. 28 and are expected to be approved shortly thereafter, effective Jan. 1, 2027. These opportunity zones will continue as designated tracts through Dec. 31, 2036.

4. Transition Rules for OZ 1.0

For old OZ 1.0 designated tracts, the designation period generally ends on Dec. 31, 2028. However, additional property within OZ 1.0 tracts that are not redesignated as OZ 2.0 tracts may only be acquired after Jan. 1, 2027 if one of two exceptions applies.

The first exception applies if: (i) property is acquired pursuant to a written Working Capital Plan adopted before Dec. 31, (ii) at least 10% of the total working capital anticipated by the Working Capital Plan has been received by Dec. 31 and (iii) at least 5% of the total anticipated working capital has been expended by Dec. 31.

The second exception applies to property acquired to replace or modernize an existing business. Property may be acquired in an OZ 1.0 zone in 2027 or later if the property replaces or modernizes existing business property and is needed to continue the existing business. This exception does *not* allow taxpayers to buy property to expand a business.

OZ 1.0 QOFs can continue to hold existing OZ 1.0 property through 2047. Taxpayers can liquidate their OZ 1.0 investments at any time through Dec. 31, 2047 and avoid federal income tax. We are awaiting guidance that would allow OZ 1.0 investments a basis step-up to fair market value on Dec. 31, 2047 if they have not yet been sold.

The transition guidance is more restrictive on expanding OZ 1.0 businesses than we expected, and it leaves open issues. It will be important for OZ 1.0 projects that are in progress to carefully plan and document working capital safe harbors and related issues. The notice also at least implies that an existing OZ 1.0 QOF can accept OZ 2.0 investments after Dec. 31 and invest those funds into OZ 1.0 designated zones during a valid working capital safe harbor period. If so, these new QOF investors would receive OZ 2.0 benefits regardless of whether they invest in a new or existing QOF.

5. New OZ 2.0 investments get a rolling five-year deferral period.

Tax on any capital gains reinvested into OZ 2.0 are deferred for a five-year period from the investment date. This is considered a rolling period because each investment has its own five-year period (unlike OZ 1.0 where investors' gain was deferred until Dec. 31, regardless of when the investment was made).

If the investment is held for five years, the taxpayer can eliminate 10% or, in the case of an investment in a Rural QOF, 30% of the deferred gain (see below regarding rural investments).

6. Rural Qualified Opportunity Funds receive additional benefits.

OZ 2.0 provides enhanced benefits for Rural QOFs. A QOF is a Rural QOF if at least 90% of its assets are in rural areas — any area other than a city or town with more than 50,000 people and any urbanized areas contiguous with such cities or towns.

Investors in a Rural QOF may eliminate 30% of their deferred gains if they hold their investments for five years, compared to 10% for non-rural QOFs.

Additionally, in cases where previously used OZ property is acquired, taxpayers must substantially improve the property. Outside of a rural area, this means that the taxpayer must spend an amount equal to its adjusted basis with respect to such property on improvements. However, used property located in a rural area only requires expenditures equal to 50% of the taxpayer's adjusted basis in the property. For example, an investor which purchases an existing building in a Rural OZ for $100,000 must only spend $50,000 towards improvements or renovations for the building to qualify as OZ property. The same building in a city of greater than 50,000 residents would require improvements of $100,000 to qualify.

What's Next for Opportunity Zone 2.0 Guidance

The notice states that proposed final regulations will be issued and, once final, will be effective from the date of the notice. The notice provides welcome guidance to OZ investors but is subject to change by the regulations. Regardless, we anticipate more detailed guidance in the coming months.

For more information on Opportunity Zones and OZ 2.0 transition planning, contact the alert authors or your preferred Polsinelli attorney.