

United States: Notice 2026-40 Provides Interim QOZ Guidance

Notice 2026-40 bridges TCJA-era QOZ regime with transitional guidance

Notice 2026-40 previews forthcoming QOZ regulations while bridging TCJA-era regime with transitional rules.

In brief

On June 18, 2026, the IRS released Notice 2026-40 (“**Notice**”) providing long-awaited transitional guidance bridging the original qualified opportunity zone (QOZ) regime under the Tax Cuts and Jobs Act (“**TCJA**”) and such QOZ regime, “**QOZ 1.0**”) and the new permanent, “rolling” QOZ regime enacted as part of the One Big Beautiful Bill Act (OBBA) and such QOZ regime, “**QOZ 2.0**”). The Notice previews forthcoming proposed Treasury Regulations which are expected to cover (i) the mechanics of QOZ re-designation under section 1400Z-1; (ii) transition rules for investors with pre-2027 deferred gains; and (iii) transition rules for qualified opportunity funds (QOFs) and qualified opportunity zone businesses (QOZBs) operating in previously-designated QOZs.

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Key takeaways

- **Gain inclusion for December 31, 2026 cannot be re-deferred.** Taxpayers holding a QOZ 1.0 qualifying investment through year-end 2026 must include their remaining deferred gain (“**Deemed Included Gain**”) as taxable income. Such gain is not “eligible gain” for a new deferral election under QOZ 2.0. However, the taxpayer’s qualifying investment remains in place, preserving eligibility for the 10-year fair market value (FMV) basis step-up election (“**FMV Election**”) on a later disposition of its QOF investment (or, in the case of a QOF that is treated as a partnership for US federal income tax purposes, on a later disposition of qualified property by the QOF).
- **Gains realized in 2026 can be rolled into QOZ 2.0.** Eligible gains realized on or before December 31, 2026 may be invested in a QOF on or after January 1, 2027 (within the applicable 180-day window) and obtain the tax benefits under the QOZ 2.0 regime, including the five-year rolling gain deferral (measured from each investment date) and 10% basis step-up (30% for Qualified Rural Opportunity Funds (QROFs)).
- **“Inclusion event” gains remain re-deferrable.** Gain triggered by an inclusion event with respect to a QOZ 1.0 qualifying investment other than Deemed Included Gain (e.g., certain gifts, sales, partial dispositions, decertification) (“**Inclusion Event Gain**”) may itself be deferred into a QOZ 2.0 QOF investment within the applicable 180-day period, but that new investment restarts the 10-year holding period clock for the FMV Election.
- **New tangible property in a QOZ 1.0 tract after 2026.** Property acquired by a QOF or QOZB after December 31, 2026 for use in a previously-designated QOZ that is not re-designated in the 2027 cycle generally cannot be qualified opportunity zone business property (QOZBP) unless it qualifies for one of two exceptions: (i) the working capital safe harbor (WCSH) transition rule, or (ii) the ordinary-course replacement or modernization exception. Property acquired for use in a tract that is re-designated as a QOZ 2.0 tract is tested under the ordinary QOZ 2.0 QOZBP rules, measured from that tract’s new applicable start date.
- **WCSH transition relief requires meaningful pre-2027 activity.** A QOZ 1.0 project may continue acquiring QOZBP after 2026 if a written WCSH plan was adopted by December 31, 2026, at least 10% of total estimated working capital has been received by the QOZB by year-end 2026, and at least 5% of that working capital has been expended (with amounts owed under pre-2027 binding agreements treated as expended).
- **Compliance “extends” through December 31, 2047.** The Notice provides two separate safe harbors allowing QOFs and QOZBs to continue to treat expired QOZ 1.0 tracts as QOZs through December 31, 2047: one for purposes of the substantial-use element of the QOZBP definition, and one for purposes of the QOZB compliance tests.

- **2027 designation cycle is unaffected by legacy designations.** Previously-designated QOZs do not count in a State's 25% low-income community (LIC) cap for the QOZ designation period beginning January 1, 2027.
- **Unaddressed anti-abuse and reporting matters.** The Notice leaves two notable areas unaddressed. First, it does not address whether general anti-abuse principles could apply to Inclusion Event Gain, particularly where the inclusion event is intentionally triggered by the taxpayer. As a result, taxpayers should carefully evaluate potential anti-abuse risks based on the specific facts and circumstances. Second, the Notice does not provide guidance on the OBBBA's new reporting requirements. Accordingly, we expect many sponsors to remain in a holding pattern while awaiting direction as to how QOFs and QOZBs must collect, verify, and report investor and investment data to the IRS.

In more detail

Background

The QOZ 1.0 regime enacted as part of the TCJA permitted deferral of capital gain invested in a QOF with a fixed December 31, 2026 gain recognition date, expiring basis step-ups, and a 10-year FMV Election available through 2047. The OBBBA established a permanent, "rolling" QOZ regime by replacing the fixed 2026 Deemed Included Gain date with a rolling five-year gain deferral, providing a single 10% basis step-up after five years (30% for QROFs), tightening census-tract eligibility, and introducing a new 10-year designation cycle beginning July 1, 2026 (effective January 1, 2027).

The high-level changes in the tax benefits between the two regimes are:

- **Tax deferral.** Eligible capital gain timely invested in a QOF (within the applicable 180-day period) is deferred until the earlier of an inclusion event or five years after the QOF investment date (replacing the fixed December 31, 2026 date under QOZ 1.0).
- **Basis step-up.** Taxpayers receive a single 10% step-up in tax basis on the original eligible gain (30% for QROFs) after holding a QOF investment for five years (compared to a potentially up to 15% step-up under QOZ 1.0 (10% at year five plus an additional 5% at year seven)).
- **10-year FMV Election.** Taxpayers holding a qualifying investment for at least 10 years may make a FMV Election on the earlier of disposition or the 30th anniversary of the investment (replacing QOZ 1.0's effective pre-2048 outer limit for the FMV Election).

Summary of Notice 2026-40

The OBBBA did not include transition rules to address the interaction between the expiring QOZ 1.0 regime and the new QOZ 2.0 regime. The Notice intends to fill in this gap, and forthcoming proposed regulations are anticipated to include proposed rules similar to the rules provided in the Notice. It is organized into three transitional categories: (1) section 1400Z-1 designations; (2) investor-level deferral mechanics; and (3) QOF/QOZB-level property qualification and ongoing compliance. We summarize each category below:

1400Z-1 designation mechanics

The Notice confirms that, for the 2027 cycle, the 25% LIC cap is applied independently to each designation period. Thus, previously-designated QOZs do not reduce the number of tracts a State governor may nominate for the period beginning January 1, 2027. For LICs certified and designated during 2026, the applicable start date is January 1, 2027 and the designation runs through December 31, 2036.

Investor-level transitional rules

Gain realized and invested by December 31, 2026. The investments remain governed by QOZ 1.0. Any remaining Deemed Included Gain is recognized on December 31, 2026, and cannot be re-deferred via a QOZ 2.0 investment. The taxpayer, however, continues to hold a "qualifying investment" and remains eligible to make a FMV Election on a later sale if other requirements are met.

Gain realized on or before December 31, 2026, and invested on or after January 1, 2027. These investments are governed by QOZ 2.0, and benefit from deferral until the earliest of an inclusion event, sale, or five years after the investment date and a 10% basis step-up after five years (30% for QROFs). Gains realized after December 31, 2026 are also governed by QOZ 2.0 if invested in a QOF.

Inclusion Event Gains. Inclusion Event Gains remain eligible for the QOZ 2.0 regime if reinvested in a QOF within 180 days of the inclusion event date, but the portion of the original qualifying investment to which the inclusion event relates is no longer a “qualifying investment,” and the FMV Election clock resets for the new investment. The Notice is silent on whether anti-abuse provisions could apply to preclude a subsequent rollover.

QOF/QOZB transitional rules

General rule. Tangible property acquired by a QOF or QOZB after December 31, 2026 cannot be QOZBP unless it is used in a QOZ designated after the OBBBA’s enactment (i.e., a 2027-cycle tract). Previously-designated QOZs lack an “applicable start date” and are thus disqualified as QOZBP unless an exception applies.

WCSH transition. Property acquired after December 31, 2026 for use in a previously-designated QOZ pursuant to a written WCSH plan may still qualify as QOZBP if: (i) the plan was adopted on or before December 31, 2026; (ii) acquisitions are made substantially consistent with the plan; (iii) the QOZB received at least 10% of the total estimated working capital by December 31, 2026; and (iv) the QOZB expended at least 5% of the total estimated working capital by December 31, 2026 (with amounts required to be expended under a pre-2027 binding agreement treated as expended). QOZ stock or partnership interests acquired pursuant to such a plan are likewise treated as acquired after the “applicable date.”

Ordinary-course replacement or modernization. Tangible property acquired after December 31, 2026, in the ordinary course of a QOF’s or QOZB’s existing trade or business to replace or modernize existing property in a previously-designated QOZ may qualify as QOZBP, but property acquired to expand the business or transition into a new line of business will not. The Notice illustrates this distinction with three examples (e.g., a warehouse expansion is disqualified, window/appliance replacements at an existing apartment building is qualified, and a restaurant kitchen modernization to maintain operations is qualified).

Compliance tests after a QOZ designation period ends. A QOF or QOZB that acquires property on or before the expiration of the applicable QOZ designation period (December 31, 2027, or December 31, 2028, as applicable), or pursuant to the WCSH transition or ordinary-course replacement exceptions described above, may continue to treat a previously-designated (now expired) QOZ as a QOZ solely for purposes of the substantial use element of the QOZBP definition through December 31, 2047. A QOZB that has begun to engage in the active conduct of a trade or business within a previously-designated QOZ on or before the expiration of its QOZ designation period (December 31, 2027, or December 31, 2028, as applicable), or that reasonably anticipates to begin doing so in accordance with a written plan that meets the requirements of the WCSH transition exception, may continue to treat a previously-designated QOZ whose designation has expired as a QOZ solely for purposes of the 50% gross income and intangible property requirements through December 31, 2047.

Frequently asked questions

Q1: A QOZ 1.0 investor holds a qualifying QOZ 1.0 QOF investment. Can the investor defer the mandatory gain recognized on December 31, 2026 by re-investing into a QOZ 2.0 QOF?

No. The Notice confirms that Deemed Included Gain recognized in the taxable year that includes December 31, 2026, is *not* eligible for a new QOZ 2.0 deferral election because the original deferral election remains in effect. Importantly, the underlying QOF investment continues to be a “qualifying investment,” and the FMV Election remains available on a future disposition.

Q2: Are there any planning opportunities for the mandatory Deemed Included Gain on December 31, 2026?

Potentially, but only for Inclusion Event Gain (not the December 31, 2026 Deemed Included Gain). A taxpayer that triggers an inclusion event (e.g., certain gifts, partial sale, distribution in excess of basis, decertification) in 2026 or later may roll the resulting Inclusion Event Gain into a new QOF investment under the QOZ 2.0 regime within 180 days. The trade-off, however, is significant because for the new QOF investment, the FMV Election 10-year holding-period restarts with respect to the portion of the investment to which the inclusion event relates. Further, the Notice is silent on whether the general anti-abuse principles could apply to such inclusion event rollover planning (particularly self-triggered inclusion events).

Q3: Under what circumstances can capital gains recognized in 2026 be invested to qualify for QOZ 2.0 treatment?

A taxpayer with eligible gain realized in 2026 whose 180-day window extends into 2027 may invest in a QOF on or after January 1, 2027, and obtain QOZ 2.0 tax benefits. The 180-day investment period generally begins on the date the relevant gain would otherwise be recognized; however, in certain circumstances (such as gains realized through

partnerships or S corporations, gains arising from late-year 2026 dispositions, or certain installment sale gains), the start of the 180-day period may be deferred, allowing taxpayers with 2026 gains whose investment window extends into 2027 to invest in a QOF on or after January 1, 2027 and access QOZ 2.0 benefits.

Q4: How can a sponsor to a multiphase QOZ 1.0 development project keep the QOZ 1.0 project active and compliant with the QOZ rules after 2026?

The Notice's most consequential planning point for sponsors is the WCSH transition rule. To preserve the ability to acquire QOZBP after 2026 in a previously-designated QOZ tract, sponsors should immediately confirm that: (i) a written WCSH plan covering the post-2026 development is in place on or before December 31, 2026; (ii) the QOZB has received at least 10% of the total estimated working capital by year-end; and (iii) the QOZB has expended (or has binding contractual commitments to expend) at least 5% of that capital by year-end. Satisfying all three requirements by December 31, 2026 is particularly important because it preserves the longest possible post-2026 period during which the project may continue to deploy working capital and acquire QOZBP under the WCSH transition rule. Sponsors should review and, if necessary, update existing WCSH plans to ensure the scope (including future phases, contingency reserves, and amenity buildouts) is broad enough to cover anticipated 2027-2028 acquisitions. Examples 4 and 5 in the Notice illustrate that mid-stream capital infusions and cost overruns of a project may qualify under the WCSH transition exception so long as the additional expenditures are made substantially consistent with, and integral to, the original pre-2027 master plan.

Q5: A QOF or QOZB operating in a QOZ 1.0 tract needs to acquire new tangible property after December 31, 2026. Can that property still qualify as QOZBP, and if so, under what conditions?

The ordinary-course replacement or modernization exception is broader than many practitioners anticipated but does not permit business expansion. Property acquired to (a) replace existing tangible property as it wears out or (b) modernize existing operations (e.g., new HVAC, point-of-sale, energy-efficiency upgrades) will qualify as QOZBP. Property acquired to expand capacity, enter a new product line, or pivot the trade or business will not qualify. Sponsors should document the rationale and tie capex to existing-property maintenance/modernization, not strategic expansion.

Q6: What is the effect of the expiration of a QOZ 1.0 designation on the continued qualification of QOFs and QOZBs?

The Notice extends "phantom QOZ" treatment through December 31, 2047, via two separate safe harbors. A QOF or QOZB that acquired property on or before the QOZ tract's expiration date (or pursuant to the WCSH transition or ordinary-course replacement exceptions) may continue to treat the expired tract as a QOZ for purposes of the substantial-use element of the QOZBP definition through 2047. Separately, a QOZB that has commenced, or reasonably anticipates commencing in accordance with a written plan that satisfies the WCSH requirements, the active conduct of a trade or business within the expired tract by the expiration date may continue to treat it as a QOZ for purposes of the 50% gross income and intangibles tests through 2047. Together, these safe harbors allow QOFs and QOZBs that have established a qualifying footprint within the applicable window to continue to satisfy certain ongoing QOZ requirements, and to operate and ultimately exit, without failing those requirements solely because of the QOZ tract's de-designation.

Q7: Does my State's 2027 designation slate get crowded out by legacy QOZ 1.0 tracts?

No. The Notice clarifies that the 25% LIC cap is applied separately for each designation period. State governors may nominate a new 25% slate for the cycle beginning January 1, 2027, regardless of how many tracts were designated under QOZ 1.0. This is a meaningful win for States with concentrated low-income census-tract footprints. Notably, following repeal of the prior deemed-designation rule by the OBBBA, Puerto Rico is no longer constrained by legacy designations under the 25% LIC cap.

Q8: An investor expects to realize a large capital gain on a non-QOZ asset sale (e.g., sale of a business or asset) in 2026. Should the investor invest this gain in a QOF before or after January 1, 2027?

From the investor's perspective, investing on or after January 1, 2027 is generally preferable. Pre-2027 investment locks the taxpayer into the QOZ 1.0 regime, while post-2027 investment delivers full QOZ 2.0 treatment, including a new five-year deferral period, the 10%/30% basis step-up, and the FMV Election. From the sponsor's perspective, there may be limited circumstances in which a pre-2027 investment may be operationally necessary. For example, a QOF or QOZB may need capital before year-end to take advantage of the WCSH transition relief discussed above. Accordingly, while the investor-level analysis will often favor waiting until 2027, the preferred timing may differ depending on the QOF's operational needs. In captive or affiliated QOF structures, these competing considerations may be less pronounced, thus allow the parties to weigh the QOZ 2.0 tax benefits against QOF's near-term capital deployment needs.

Q9: We have an existing QOZ 1.0 QOF that has not yet identified a project. Is it too late to reposition that QOF into a viable QOZ 2.0 QOF?

Generally, yes, unless the WCSH transition requirements can be met by December 31, 2026. The Notice requires (i) a written WCSH plan adopted by December 31, 2026; (ii) receipt by the QOZB of at least 10% of total estimated working capital actually by year-end; and (iii) expenditure (or binding commitment to expend) at least 5% of such working capital by year-end. A QOF holding cash that has not been deployed to a QOZB by December 31, 2026 may find it difficult to avail itself of this transition relief. As an alternative, the sponsor could consider (a) winding down the QOZ 1.0 QOF, (b) triggering Inclusion Event Gain, and (c) reinvesting in a newly formed QOZ 2.0 QOF in 2027. However, this approach would reset all holding periods, and may risk anti-abuse scrutiny depending on the facts and circumstances.

Sarah Eshera, Maxwell Holleman, Kelly H. T. Chan and Russell Lawson, Associates, have contributed to this legal update.

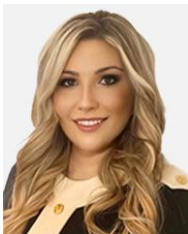
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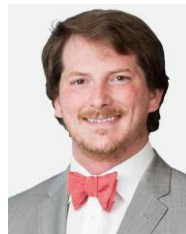
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