

United States: "QOZ 2.0" – qualified opportunity zones are now permanent

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In brief

The One Big Beautiful Bill Act (the "**Act**") includes substantial changes to the "qualified opportunity zone" ("**QOZ**") rules. The QOZ regime and tax benefits are now made permanent on a "rolling" basis, allowing taxpayers to: defer capital gains for five years by making a qualifying investment in a "qualified opportunity fund" ("**QOF**"), receive a 10% basis step-up if a taxpayer holds its qualifying investment in a QOF for five years, and completely eliminate tax on gains from appreciation if the taxpayer held the qualifying QOF investment for more than 10 years. Further, "qualified rural opportunity funds" ("**QROFs**") were created to encourage investments in rural areas. These permanent QOZ tax benefits could provide tremendous opportunities for communities, developers, sponsors, and investors.

Key takeaways

- The QOZ regime and tax benefits are now made permanent on a "rolling" basis.
- Taxpayers may defer capital gain by making a qualified investment in a QOF and such gain is not recognized until the earlier of an Inclusion Event (as defined below) or five years after the QOF investment date.
- Once a taxpayer holds its qualifying investment in a QOF for five years, the taxpayer receives a 10% basis step-up (i.e., only 90% of the deferred gain is taxed).
- Taxpayers are allowed to completely eliminate tax on appreciation in the QOF investment if the taxpayer holds the QOF investment for more than 10 years. If the qualifying QOF investment is held for more than 30 years, the tax basis of such investment is adjusted to fair market value at the end of such 30-year period.
- New QOZ designations go into effect every 10 years starting January 1, 2027. A census tract's eligibility to qualify as a QOZ was tightened with more stringent income requirements.
- QROFs were created to encourage investments in rural areas and provide enhanced tax benefits for investments therein.
- New and additional information return requirements are created for QOFs, QOZ businesses, and QOF investors.

Background

The 2017 Tax Cuts and Jobs Act (TCJA) established temporary tax incentives for investments in QOZs to encourage investments in low-income communities. Any capital gain invested in a QOF which, in turn, invested in qualifying QOZ assets or businesses, allowed taxpayers to:

- defer such capital gain until the earlier of the disposition of the QOF investment or December 31, 2026,

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- permanently eliminate 10 or 15% of that deferred capital gain if the taxpayer held the QOF investment for five to seven years, respectively, before December 31, 2026, and
- completely eliminate tax on gains from appreciation in the QOF investment through 2047 if the taxpayer held the QOF investment for more than 10 years.

Some of these tax incentives already expired or were due to expire after 2026. We refer to the QOZ rules under the TCJA as "**QOZ 1.0**."

The One Big Beautiful Bill Act and QOZ 2.0

The Act includes substantial changes to the QOZ rules. In short, the Act made the QOZ regime and tax benefits permanent on a "rolling" basis, increased the tax benefits for investments in rural areas, tightened the eligibility criteria for census tracts to qualify as QOZs, and added new reporting requirements. We refer to the QOZ rules under the Act as "**QOZ 2.0**." This client alert aims to provide an overview of some of the material provisions of QOZ 2.0.

Tax deferral: consistent and permanent

QOZ 1.0 allowed investors to defer capital gain by making a qualifying investment in a QOF. Such deferred capital gain was recognized the earlier of (1) an "**Inclusion Event**" (defined in the Treasury Regulations as an event that reduces or terminates a qualifying investment in a QOF such as, among others, the taxpayer selling the QOF investment), or (2) December 31, 2026. In practice, the December 31, 2026 deadline imposed time pressure on taxpayers by shortening the value of tax deferral over time and investments in QOFs dropped drastically as the December 31, 2026 deadline approached.

Under QOZ 2.0, however, taxpayers may defer capital gain by the amount of their qualifying investment in a QOF until the earlier of (1) an Inclusion Event, or (2) the date which is five years after the date the investment in the QOF was made. This is a welcome change as taxpayers under QOZ 2.0 will have greater freedom to time their QOF investments and the underlying transactions which give rise to capital gain they wish to defer. Gain deferral is now set to a consistent "rolling" five year period from the taxpayer's qualifying investment in the QOF. Put differently, there is no longer a fixed gain recognition date (e.g., December 31, 2026 as under QOZ 1.0 or December 31, 2033 as was originally proposed for QOZ 2.0 under the House version of the Act) that devalues the benefits of tax deferral over time.

Basis step-up: also consistent and permanent

QOZ 1.0 also allowed investors to eliminate a portion of the capital gain they deferred through a "basis step-up" where the taxpayer's tax basis was increased by a specified percentage based on how long the taxpayer has held the QOF investment relative to December 31, 2026. If the taxpayer held the QOF investment for at least five years, it increased its basis by 10%. If the taxpayer held the investment for at least seven years, it further increased its basis by another 5% (for a total of 15%). Under QOZ 1.0, these benefits effectively expired after 2021 because deferred gain needs to be recognized by December 31, 2026.

The "basis step-up" still exists in QOZ 2.0 but does not have a sunset. Once a taxpayer holds its investment in a QOF for five years, the taxpayer receives a 10% basis step-up (meaning that only 90% of the deferred gain is taxed if the QOF is held for at least five years). Like the tax deferral discussed above, basis step-up is now a consistent "rolling" five-year 10% basis step-up. This too is a welcome change as taxpayers will receive consistent tax benefits regardless of the when they made their initial QOF investment.

Tax exemption on appreciation: same but clarified

Under QOZ 1.0, taxpayers were allowed to completely eliminate tax on gains from appreciation in the QOF investment through 2047 if the taxpayer held the QOF investment for more than 10 years. QOZ 2.0

retains this tax benefit for qualifying QOF investments that are held for more than 10 years, but removes the 2047 deadline by providing that if the qualifying QOF investment is held for more than 30 years, the tax basis of such investment is adjusted to fair market value at the end of such 30-year period (thus, any appreciation in the qualifying QOF investment is excluded from tax). Note, by forcing the taxpayer's fair market value step-up on the 30th anniversary of the QOF investment, taxpayers will no longer enjoy tax-free appreciation on the QOF investments after the 30th year.

QOZ eligible census tracts: permanent but restricted

Under QOZ 1.0, certain low-income census tracts were nominated to be a QOZ by the chief executive officer of each state. Once a census tract was nominated, Treasury certified such nomination and such QOZ designation was effective for 10 years (coinciding with the sunset of QOZ 1.0).

QOZ 2.0 tightens a census tract's eligibility to qualify as a QOZ to: (1) tracts whose median family income does not exceed 70% of statewide/area median family income (current law requires 80%), or (2) tracts with poverty levels of at least 20% and median family income below 125% of the statewide/area median family income. The Act no longer requires a minimum number of rural census tracts to be designated (which the House version of the Act contained). Further, census tracts that are contiguous to low-income tracts will lose their automatic eligibility and Puerto Rico will lose its special status under current law (which allowed the entirety of Puerto Rico to be designated as a QOZ). As a result of these changes, we expect fewer census tracts will qualify as "low-income communities" and thus as QOZs.

Consistent with the "rolling" permanency in the QOZ tax benefits as discussed above, QOZ 2.0 requires QOZ designation to occur every 10 years. Specifically, the chief executive officers of each state must designate new QOZs by July 1, 2026 and every 10th year thereafter. These designations then go into effective January 1, 2027 and every 10th year thereafter.

Qualified Rural Opportunity Funds: same QOF but better

To encourage investment and development in rural areas, QOZ 2.0 creates a new type of QOF—QROFs. A QROF is generally defined to mean a QOF that holds at least 90% of its assets in QOZ property located within a "rural area" QOZ. For this purpose, a "rural area" is defined as any area *except* a city or town with a population greater than 50,000 and contiguous urbanized areas.

Certain tax benefits under QOZ 2.0 are amplified for QROFs. Mainly, qualifying investments in QROFs are eligible to receive a 30% basis step-up after five years (tripling the 10% basis step-up of regular QOF investments) meaning that only 70% of the deferred gain is taxed if the QROF is held for at least five years. Further, the "substantial improvement test" (requiring the QOF to "substantially improve" the property in a QOZ) is relaxed for QROFs, requiring the additional investment in the rural area property to be at least 50% of the cost of the property (100% for non-rural areas).

We expect QROFs to spur additional investments in non-urban QOZs, addressing a criticism of QOZ 1.0 that the investments were skewed to urban areas. Further, the relaxed substantial improvements test is expected to allow more projects/properties to qualify in these rural areas.

New QOZ reporting requirements

QOZ 1.0 required QOFs to self-certify their QOZ compliance under IRS Form 8996, which included information on the actual QOZ where the property is located as well as the EIN for the QOZ businesses held by the QOF. However, QOZ 1.0 faced criticism for lacking requirements for QOFs and QOF investors to report the impact of their QOZ investments, making it difficult to assess the QOZ program's true effectiveness in driving the desired policy benefits to communities.

To address this criticism, QOZ 2.0 requires annual informational returns to be submitted electronically by QOFs and QOZ businesses under section 6039K and section 6039L, respectively. Section 6039K requires the same information as IRS Form 8996, but additional information on industry codes of businesses, residential units created, employment impact, etc. QOFs also are required to disclose all persons who disposed of an investment in the QOF during the year, including their EIN, date(s) and amount of

investment, and date(s) and amount of disposal. QOFs must also issue a statement with the same information to each person who disposes of an investment. Section 6039L requires QOZ businesses who are owned by QOFs to issue statements to their shareholders to assist in their section 6039K preparation, with the exact contents to be prescribed by Treasury.

Penalties are also laid out for incomplete or late reporting, with enhancements for intentional disregard under section 6726. A fine of \$500 is issued for each day that a return under section 6039K is late, incomplete, or incorrect. The maximum penalty is \$10,000, or \$50,000 in the case of a QOF with more than \$10 million in assets. These penalties quintuple for intentional violations.

Effective dates: no transition rules

The current QOZ designations under QOZ 1.0 are effective until December 31, 2028. The new QOZ designations under QOZ 2.0 begin on July 1, 2026 and once certified by Treasury, go into effect on January 1, 2027. This new designation-then-certification cycle would occur every 10 years on July 1 then the following January 1. For example, on or before July 1, 2036, governors of each state will designate new QOZs which will go into effect January 1, 2037 (after being certified by Treasury) until December 31, 2046.

Under QOZ 2.0, deferral, basis step-up, and tax exemption on appreciation discussed above apply to "*amounts invested in [QOFs] after December 31, 2026.*" Unfortunately, this effective date means that QOF investors who recognize capital gain in 2025-2026 are not afforded meaningful deferral compared to those who invest in 2027 (because gain recognition must occur by December 31, 2026 under QOZ 1.0). We expect a "dead zone" for QOF capital raising in 2025-2026 because taxpayers are incentivized to defer capital gain recognition events until 2027 when the full tax benefits under QOZ 2.0 are available.

Conclusions

QOZ 2.0 gives taxpayers a second opportunity to participate in the QOZ program with more certainty because it is now permanent on a "rolling" basis. The current framework provides a powerful tax incentive for taxpayers with realized capital gains with the potential to defer and reduce tax on capital gain as well as the ability to eliminate tax on QOZ investment gain. Enhanced tax incentives for rural QOZs, such as the 30% basis step-up and relaxed improvement thresholds, could also make certain rural investments more viable. However, QOZ 2.0 does not provide any transition rules for existing QOFs or QOZ investments under QOZ 1.0. This effectively creates an artificial 18 month "dead zone" of QOZ investments because taxpayers are incentivized to defer capital gain recognition events until 2027 when the full tax benefits of QOZ 2.0 are available.

Given the bullish run of the US stock market in recent years that has created tremendous unrealized capital gain, QOFs should be able to attract much-needed capital for community development while at the same time providing significant tax benefits to investors if they are structured and executed properly under QOZ 2.0. Because QOZ 2.0 creates increased complexity and compliance requirements, QOF sponsors and investors should start evaluating their investment pipeline and engage in strategic tax planning with their tax counsel.

Contact Usⁱ



Daniel F. Cullen

Partner

daniel.cullen@bakermckenzie.com



Peter Matejcek

Partner

peter.matejcek@bakermckenzie.com



Sukbae David Gong

Partner

david.gong@bakermckenzie.com

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