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Update on Qualified Opportunity Zone Investing

Qualified appraisals of Qualified Opportunity Zone investments could support paying less tax on deferred gains recognized on December 31, 2026. New rules create interesting capital raising and investment opportunities in data centers and other infrastructure projects.

For Qualified Opportunity Zone ("QOZ") funds and investors, important changes will take place at the end of the year as the original QOZ rules enacted by The Tax Cuts and Jobs Act of 2017 (the "Original QOZ Rules") are modified by the new, permanent version of the QOZ rules passed by the One Big Beautiful Bill Act of 2025 (the "Modified QOZ Rules").

On December 31, 2026, gain deferral under the Original QOZ Rules will end, and for most QOZ investors, tax will be owed on their deferred gain (generally at capital gain tax rates). In certain situations, QOZ investors will be able to include less than the entire amount of their deferred gain in income and potentially owe less tax. QOZ investors should consider how these rules apply to their QOZ investments in advance of year end.

For taxable years beginning after the enactment of the Modified QOZ Rules on July 4, 2025 (generally 2026 for calendar year taxpayers), Qualified Opportunity Funds ("QOFs") and Qualified Opportunity Zone Businesses ("QOZBs") will have new reporting obligations. The form and timing for delivering these reports is still pending guidance, but QOFs and QOZBs should begin compiling the relevant information to ensure that they are able to satisfy these reporting requirements on a timely basis.

On January 1, 2027, the Modified QOZ Rules relating to new QOZ investments will go into effect. While the Modified QOZ Rules are similar to the Original QOZ Rules in many ways, there are important differences that QOZ Funds and investors should keep in mind. In particular, enhanced benefits create interesting capital raising and investment opportunities for investments made in rural areas, like data centers and other infrastructure projects.

Gain Deferral Under Original QOZ Rules

On December 31, 2026, QOZ investors will recognize the lesser of (i) their deferred gain and (ii) the fair market value of their QOZ investment on such date (in each case, subject to a reduction of 10% for QOZ investments held for 5 years and 15% for QOZ investments held for 7 years). QOZ investors should consider whether the fair market value of their QOZ investments has declined to less than the amount of their deferred gain. A QOZ investor intending to include less than the full amount of their deferred gain in income on that basis should obtain a qualified appraisal to support that reporting position.

An important rule applies to most QOZ investors on account of holding QOZ investments in QOFs that are treated as partnerships for tax purposes. When determining their income inclusion based on fair market value, these QOZ investors are required to calculate that amount based on the gain that they would have recognized on a fully taxable disposition of their QOZ investment at fair market value. This rule could impact the amount of income that these QOZ investors recognize, especially with respect to QOFs that have recognized losses or made distributions. Under this rule, even QOZ investors whose investment has declined in value may nevertheless have to recognize the entire amount of their deferred gain if they received benefits (e.g., allocations of tax losses or cash distributions) along the way.

QOZ investors should consult with their tax return preparers to determine how these rules would apply to their QOZ investments and whether obtaining a qualified appraisal would be worthwhile.

New Reporting Requirements

Starting in the first taxable year, beginning after the enactment of the Modified QOZ Rules on July 4, 2025 (generally 2026 for calendar year taxpayers), both existing and new QOFs will be required to file an annual return that includes certain information that QOFs were not required to report under the Original QOZ Rules. Additionally, new and existing QOZBs will be required to provide information to their QOFs to support these information reporting requirements. Generally, the new information that QOFs and QOZBs will be required to furnish relates to:

- NAICS codes for the trades or businesses conducted by such QOZBs
- The approximate number of residential units (if any) for any real property held by such QOZBs
- The approximate average monthly number of full-time equivalent employees of such QOZBs
- With respect to each QOZ investor that disposed of an investment in the QOF during the year—
  - their name, address, and TIN,
  - the date or dates on which the disposed investment was acquired, and
  - the date or dates on which any such investment was disposed and the amount of the investment disposed

QOFs will also be required to issue statements to QOZ investors in connection with dispositions of their QOZ investments.

Rules for New Investments and Funds

While the Original QOZ Rules were based on fixed QOZ designations and a fixed gain deferral period, the Modified QOZ Rules implement 10-year rolling QOZ designations and 5-year rolling gain deferral periods. The Modified QOZ Rules also identify QOFs that invest primarily in rural areas as Qualified Rural Opportunity Funds ("QROFs").

For QOZ investments made on or after January 1, 2027, gain deferral will end 5 years after the investment in a QOF is made. For QOZ investments held for 5 years, 10% of the deferred gain will be excluded from income (the Modified QOZ Rules did not carry over the 15% exclusion for investments held for 7 years). For QOZ investments made in QROFs, this exclusion from income increases from 10% to 30%.

For QOZ investments held for 10 years, QOZ investors may still elect to permanently exclude from income any appreciation from the date that the QOZ investment was made. While the Original QOZ Rules required that a QOZ investment be liquidated by December 31, 2047, to benefit from this election, the Modified QOZ Rules permit this election to be made at any time but freeze the amount of appreciation that can be excluded from income after 30 years.

An additional advantage for QROFs is that the "substantial improvement" test for qualified QOZB property requires a reinvestment of only 50% of a property's adjusted tax basis (as opposed to 100% for non-QROFs).

Transition Rules

On June 18, 2026, the Treasury Department issued transitional guidance relating to the Modified QOZ Rules. This guidance clarified that, for deferred gain recognized on December 31, 2026, QOZ investors cannot make a new deferral election with respect to that gain for new QOZ investments. However, for deferred gain accelerated into income in connection with an inclusion event (such as a sale or exchange of a QOZ investment), QOZ investors may be eligible to make a new deferral election with respect to that inclusion event gain with respect to new QOZ investments. QOZ investors should consult with their tax advisors about the application of these transition rules to their investments.

This client alert does not establish an attorney-client engagement and does not constitute legal advice. Please contact counsel if you need advice in a specific situation.

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