



The Real Estate Roundtable

Analysis of Opportunity Zones Transition Challenges and Request for Expedited IRS Guidance

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Background

Sections 1400Z-1 and -2 were enacted on December 22, 2017 (the “TCJA QOZ” program). Many complex issues arise related to the QOZ program having requirements that generally apply at multiple levels: (i) at the investor level, where an investor’s eligible gains must be invested into a QOF within specified timeframes (generally, 180 days from a capital-gain-realization event), (ii) at the QOF level, where the QOF has certain tests and requirements that must be met in order to self-certify as a QOF and avoid penalties, and (iii) at the QOZB level, most often where property is acquired/business conducted, with its own separate requirements. There is often a lag between contribution of investor gain dollars to a QOF, the contribution of cash into a QOZB, and investment by a QOZB into the QOZ trade or business, adding to the complexity.

At least 90% of a QOF’s assets must be qualified opportunity zone property (“QOZP”). The QOZP definitions have three parts, considering: (1) acquisition after the relevant start date, (2) that the entity was a good QOZB at the time of acquisition¹ and (3) that “during substantially all of the QOF’s holding period” in the property the entity qualified as a QOZB (Treas. Reg. § 1.1400Z2(a)-1(b)(5) provides guidance defining the “substantially all” holding period in the third prong of the QOZP definitions to mean 90%).²

Prior to the OB3 Act, it was clear that eligible gains recognized after December 31, 2026 could not be invested into TCJA QOZs under Section 1400Z-2(a)(2)(B), which limited gain deferral elections (effectively the “gate” to the program) to gains from sales/exchanges on or before December 31, 2026. Given that subsection (B) of Section 1400Z-2(a)(2) was stricken as part of OB3’s making the QOZ program permanent, an investor’s 180-day period to invest a gain recognized in 2026 into a QOF can be as late as September 10, 2027 (for gains that are reported on a 2026 Schedule K-1).

¹ Or meets the substantial improvement or original use requirement, for business property held directly by a QOF (though it is uncommon for QOFs to directly hold qualified opportunity zone business property (“QOZBP”).

² For QOZ stock and QOZ partnership interests the entity “qualified as a qualified opportunity zone business” and for QOZBP “substantially all of the use of such property was in a qualified opportunity zone.”)

Section 1400Z-1(e) (previously Section 1400Z-1(f) prior to OB3) provides that the “period for which the [TCJA QOZ] designation is in effect” ends Dec. 31, 2028. Although it is not 100% clear what it means to have the designation period end, QOZ designations appear relevant to QOZB level testing including the 70% tangible property, 50% gross income and 40% intangible property tests, as well as the 90% QOZP investment standard at the QOF level.

Treas. Reg. § 1.1400Z2(c)-1(c) allows investors to make a basis step up election even after the QOZ designation is no longer in effect, and specifically through the end of 2047 (which effectively could have been viewed as the “outside date” for the TCJA QOZ program). The OB3 Act codified and expanded the “outside date” concept by adding a special rule to Section 1400Z-2(c), limiting the investor’s basis step up to FMV on the 30-year anniversary of the investor’s investment.³

It is not clear how a QOF might satisfy its 90% test or avoid penalties after QOZ designations are no longer in effect. Example 1 of Treas. Reg. § 1.1400Z2(c)-1(d)(1) notes “[b]ut for the expiration of the designated zones in [s]ection 1400Z-1(f), QOF S and A’s conduct is consistent with continued eligibility to make the election under [s]ection 1400Z-2(c)” and concludes that “the expiration of the zone’s designation does not, without more, invalidate A’s ability to make an election under [s]ection 1400Z-2(c).”

If the period for which the QOZ designation is in effect has ended, and the QOZ is not re-designated, it is unclear how QOZP will satisfy the 90% holding period test. Two bookend cases should be considered: (1) a QOZB that was fully funded and engaged in a trade or business in a QOZ before January 1, 2029, and (2) a QOZB that makes an investment into a TCJA QOZ prior to December 31, 2028, using eligible gain dollars that an investor invests in a QOF during 2027 or 2028.

Suggested Approach/Rationale

For the first case, guidance is needed that is straight-forward and uncontroversial to provide, invoking a similar rationale to that used for Treas. Reg. § 1.1400Z2(c)-1(c). Note, although the 90% holding period test would allow for compliance if the holding period continued after the expiration of a QOZ designation, this generally would by itself be insufficient relief to allow many QOFs to remain invested for a full 10 years after receiving investor contributions, let alone through the “outside date”, without incurring penalties. Not providing the ability for existing QOFs and QOZBs to continue to qualify after zone designations lapse would negate the rationale for Treas. Reg. § 1.1400Z2(c)-1(c), and thus the ability of many investors to qualify for the basis step up election incentive after holding their investment for at least 10 years. This is particularly an issue for investors that cannot simply move their trade or business into another qualifying zone, such as QOFs and QOZBs investing in real estate.

³ In the NPRM IRS/Treasury noted that “[t]he incentive provided by this benefit is integral to the primary purpose of the provision (see H.R. Rept. 115-466, 537, which describes the intent to attract an influx of capital to designated low-income communities). For this reason, the proposed regulations permit taxpayers to make the basis step-up election under[s]ection 1400Z-2(c) after a qualified opportunity zone designation expires.”

The second case introduces additional issues – among them, to what extent eligible gain dollars invested in a QOF during 2027 or 2028 should be eligible for investment into TCJA QOZ projects and whether it makes a difference if the project is funded with a mix of eligible gains invested into a QOF prior to 2027 and eligible gains invested into a QOF after 2026. The second case could include a wide range of scenarios, some of which should be acceptable while others may require a bit more consideration.

The OB3 Act changed the landscape in two key ways: (1) eligible gain dollars invested in a QOF during 2027 or 2028 can potentially be invested into TCJA QOZs, and (2) there will be a new set of QOZs for those dollars to go into based on more recent census data. There is no published legislative history for OB3 as yet and therefore we do not know precisely what was intended in this situation. **We have accordingly proposed a safe harbor that we believe should be both uncontroversial and administrable, aimed at providing comfort to investors in projects started in good faith while existing zone designations were in effect and prior to the occurrence of an event that effectively excludes the old census tract from being redesignated as a QOZ.**

Our recommendation builds on the existing framework of the Working Capital Safe Harbor (“WCSH”) plan, which QOZBs generally use to track compliance with relevant timelines (e.g., 31-month period within which a capital infusion must be spent and the outside date by which a trade or business must be started) and which includes a contemporaneous written description of the trade or business and timeline on which it is expected to be developed.

We strongly suggest that in each case guardrails be introduced to avoid abusive situations (e.g., “grandfathering” a QOZ with the effect that a new trade or business is started at a future point in the expired QOZ, achieving unintended QOZ tax benefits); for this purpose we suggest that grandfather status be lost if there is significant deviation from the trade or business or timeline described in the initial WCSH plan that is not otherwise supported by reasonable cause.

Proposed Guidance

We recommend establishing a concept of “grandfathered QOZ”, which would allow the third prong of the QOZP tests in Sections 1400Z-2(d)(2)(B)(i)(III), (C)(iii), and (D)(i)(III) to be deemed satisfied. For example, Treas. Reg. § 1.1400Z2(d)-1(c)(3) (relating to whether a partnership interest is QOZP in the hands of a QOF) would still require per subsection (B) that a partnership interest is a QOZB as of the date the partnership interest is acquired (effectively requiring that the interest be acquired before the relevant QOZ designation expires)⁴ but would allow a QOZ to be “grandfathered” for purposes of determining whether the partnership is a QOZB for 90% of the QOF’s holding period for the partnership interest (effectively suspending the expiration of the QOZ designation for all testing purposes, under the below “safe harbored” circumstances).

⁴ This opens up the possibility of multiple tranches of partnership interests, some good and some bad depending on when acquired (e.g., QOZB interests acquired before the TCJA QOZ zone expiration would be good QOZP but interests acquired after TCJA QOZ zone expiration would not be good QOZP even if the QOZ were otherwise grandfathered).

A census tract would be a “grandfathered QOZ” with respect to a particular eligible entity if it meets both clauses (1) and (2) below. Specifically:

(1) the eligible entity’s written plan meeting the requirements of Treas. Reg. §1.1400Z2(d)-1(d)(3)(v)(A) though (C):

- (a) indicated the entity’s trade or business in the QOZ would commence before expiration of the census tract’s QOZ designation, or
- (b) was adopted at a time when (i) the QOZ designation had not expired and (ii) before the date upon which any “new zone event” had occurred; and

(2) capital has been used by the eligible entity in a manner that is substantially consistent with its written plan (taking into account any permissible “tolling” under Treas. Reg. §1.1400Z2(d)-1(d)(3)(v)(C), or Treas. Reg. §1.1400Z2(d)-1(d)(3)(v)(D)),⁵ and the eligible entity has not substantially changed the scope of its trade or business as described in its written plan, except as otherwise allowed by the Secretary.

A “*new zone event*” includes:

- (i) the chief executive officer of the State in which the QOZ is located has nominated census tracts for designation as qualified opportunity zones under Section 1400Z-1(b) of the Code for the next round of QOZ designations and the census tract is not nominated under Section 1400Z-1(b)(1)(A); or
- (ii) the Secretary has designated QOZs under Section 1400Z-1(b)(1)(B) for the next round of QOZ designations and has not certified the census tract.

Example. Grandfathered QOZ—(1) Facts. On Date 1, (a) QOF A creates a QOZB partnership, P, to develop a new real estate project in census tract T, (b) QOF A acquires equity of P solely in exchange for cash, and (c) P writes a plan with a 31-month schedule for the use of the cash. The plan describes use of the cash to partially develop a residential housing project in census tract T, which is expected to be placed in service on Date 3. Census tract T’s QOZ designation has not expired on Dates 1 and 3. Other than the residential housing project described in P’s written plan, P does not own other property or conduct another trade or business in census tract T. Approximately 18 months after Date 1, on Date 2, QOF A acquires additional equity in P solely in exchange for cash, and P writes a second plan with a 25-month schedule to complete the residential housing project. Each of the two written plans describes the same trade or business to be developed in census tract T commencing before Date 3. P’s residential housing project is overbudget. On Date 3, P places the residential housing project in service, but P identifies a need

⁵ Providing “[i]f consumption of the working capital assets is delayed by waiting for governmental action the application for which is complete, that delay does not cause a failure of this paragraph (d)(3)(v)(C)” and “[i]f the qualified opportunity zone business is located in a qualified opportunity zone impacted by a federally declared disaster (as defined in [s]ection 165(i)(5)(A)), the qualified opportunity zone business may receive not more than an additional 24 months to expend its working capital assets, as long as it otherwise meets the requirements of paragraph (d)(3)(v).”

for additional capital. On Date 4, QOF B acquires equity of P solely in exchange for cash. Among the planned uses for the cash received by P from QOF B on Date 4 are completion of a swimming pool with a clubhouse for use by apartment residents, and landscaping. The additions of the swimming pool, clubhouse, and landscaping form an integral part of the initial development plan established by P on Date 1.

Analysis. Completion of the swimming pool, clubhouse and landscaping after Date 3 does not substantially change the scope of the trade or business described in P's written plans or indicate that capital has been used by P in a manner that is not substantially consistent with its written plans. Because each of P's written plans contemplates the commencement of P's trade or business with respect to its residential housing project before the expiration of census tract T 's QOZ designation, census tract T is grandfathered with respect to P's residential housing project and shall accordingly be treated as a QOZ solely for purposes of determining whether P is QOZ property. In addition, all tangible property acquired by P as it expends the proceeds received from QOF B on Date 4, to complete the swimming pool, clubhouse, and landscaping within a total of 62 months from Date 1, is treated as QOZ business property under Treas. Reg. §1.1400Z2(d)-1(d)(3)(vi)(D)(2).

We recommend that guidance (such as a Notice or Revenue Procedure) include a clear statement that it is intended to create a safe harbor. Therefore, no inference is intended or implied with respect to the U.S. federal income tax treatment of QOZ investments that do not satisfy the terms of the safe harbor, whether entered into prior to or after the effective date of this revenue procedure.

Additional Safe Harbors. The above immediate safe harbor is not intended to be the exclusive rule relating to transition rules but in our view is the most urgent. Other safe harbors to consider include:

- (a) whether the new zone event list above should include that the Secretary has issued guidance regarding which census tracts are eligible for designation as a QOZ during the next Determination Period as defined in Section 1.1400Z-1(c)(2)(B), and the census tract is not eligible under the guidance; and
- (b) a "beginning of construction" grandfathering concept where any TCJA QOZ project may be grandfathered if a certain amount of progress towards completion of a project (including substantial investment) has occurred prior to expiration of the QOZ designation.