TAX | QUALIFIED OPPORTUNITY ZONES

OPPORTUNITY KNOCKS: OZ 2.0

Perpetual rolling deferral, a new planning strategy under the permanent opportunity zone rules

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Introduction

The 2017 Tax Cuts and Jobs Act created new tax incentives designed to attract private investment into certain low-income communities called "qualified opportunity zones." Under what is being called OZ 1.0, a taxpayer who timely invested and elected to defer a pre-2027 eligible capital gain (which includes Section 1231 gain) in a "qualified opportunity fund" ("QOF") may achieve the following tax incentives:

1

Gain Deferral

Deferral until an inclusion event occurs or December 31, 2026.

2

Deferred Gain Reduction

A 10% or 15% reduction for investments held five or seven years, respectively, as of December 31, 2026.

3

Permanent Exclusion

No tax on appreciation gain if sold before 2048 after achieving a ten-year holding period (accomplished via an election to step up the taxpayer's basis to the investment's fair market value on the sale date).

The third incentive—electing to pay no tax on the sale after holding for ten years—appealed to prospective investors the most. The One Big Beautiful Bill Act, enacted on July 4, 2025, made OZ 1.0 permanent with enhancements (OZ 2.0), opening the door to a new strategy that may be just as appealing under the right circumstances: ***Rolling Deferral***.

The Rolling Deferral Strategy

OZ 2.0 provides rolling mechanics to ensure permanence, such as rolling ten-year zone designations and rolling five-year deferral for QOF investments made on or after January 1, 2027. Specifically, a taxpayer who timely invests may elect to defer an eligible gain for five years, at which point the deferred gain is reduced by 10% (30% for "qualified rural opportunity fund" investments). After holding for at least ten years, the taxpayer pays no tax on a sale within 30 years by making the basis-step-up election. If the taxpayer sells after holding for 30 years, then the basis-step-up election causes the basis to equal the investment's fair market value as of its 30th-year anniversary.

Although the occurrence of an "inclusion event" generally cuts off the taxpayer's ability to achieve any further tax incentives with respect to the affected QOF investment, OZ 2.0's rolling permanence offers an opportunity to re-defer the gain if it otherwise qualifies as an eligible gain. Under OZ 1.0, if an inclusion event occurs with respect to a deferred gain investment, but the gain otherwise qualifies as an eligible gain, then the taxpayer may re-defer it by investing in the same or another QOF within 180 days of the inclusion event and making a proper deferral election. These rules are unchanged for OZ 2.0, and the IRS has confirmed that they allow a taxpayer with a QOF investment under OZ 1.0 to re-defer into OZ 2.0. Specifically, the taxpayer would trigger an inclusion event generating eligible gain *before December 31, 2026* (thereby avoiding deemed gain recognition) and invest the gain amount in the same or another QOF after January 1, 2027, and within 180 days of the inclusion event and make a timely deferral election.

Accordingly, under the rolling deferral strategy, a taxpayer with an OZ 2.0 QOF investment could trigger an inclusion event that generates an eligible gain prior to the fifth anniversary of the taxpayer's QOF investment date and re-defer by investing within 180 days into the same or another QOF and making a timely deferral election. By repeating this process every four or fewer years, the taxpayer may achieve a perpetual deferral strategy that does not violate the anti-abuse rules. As a result, OZ 2.0's permanence affords the ability to achieve serial deferral analogous to the deferral available for serial exchanges of real property investments under Section 1031 (although with distinct differences, such as a higher ongoing compliance burden and holding period tacking instead of a basis step-up at death).

Weighing the Cost

Taxpayers should evaluate this strategy carefully because it comes at the cost of restarting the QOF investment's holding period. For example, a New York taxpayer with a QOF investment made prior to New York's 2021 decoupling from OZ 1.0 may want to avoid this strategy to maximize state tax incentives. In addition, the taxpayer should consult with experienced tax counsel to ensure that the inclusion event will generate gain that is eligible for re-deferral under OZ 2.0. QOFs should also seek advice on how this strategy could affect them, including but not limited to the effect on any partnership tax classification.

Next Steps

OZ 2.0 also presents other planning opportunities not discussed above. Existing QOFs and qualified opportunity zone businesses may encounter qualifying asset problems and limited ability to make improvements unless they take certain actions prior to December 31, 2026. If you have any questions or would like more information, please contact the author.

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