



SREI Group

1031 Exchange Experts

QUALIFIED OPPORTUNITY ZONE, VS 1.0 & 2.0

THE ULTIMATE GUIDE TO QOZ/QOF

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Qualified Opportunity Zone, Background

Opportunity Zones legislation was a bipartisan effort designed to stimulate investment in economically distressed communities by offering tax incentives to investors.

The Qualified Opportunity Zone tax code was first introduced to the country as part of the 2017 Tax Cuts and Jobs Act, which allowed for certain investments in lower-income areas to receive tax advantages. The program aims to attract private capital to projects that would otherwise be overlooked due to the investor's reluctance to trigger a capital gains tax on assets. As of the end of 2024, data suggest that over \$100 billion, potentially reaching \$150 billion, has been invested in Opportunity Zones through Qualified Opportunity Funds (QOFs). Some have estimated that QOZs were responsible for a net increase of 313,000 housing units between Q3 2019 and Q3 2024.

History:

Conceived by Senators Tim Scott (R-SC) and Cory Booker (D-NJ) with the support of Representatives Ron Kind (D-WI) and Pat Tiberi (R-OH). It was drafted in 2016 and incorporated into

the 2017 Tax Cuts and Jobs Act, Sections 1400-1 and 1400-2 of the Internal Revenue Code (Title 26 of the United States Code). Opportunity Zones (8,764 land parcels countrywide) were identified as a part of the original program. The program was cautiously slow in investor acceptance until December 2019, when the legislation received the Treasury's final regulatory guidance. In addition to the overarching goal of attracting capital to low-income zones, the tax code afforded the states, as well as the five US possessions, including American Samoa, Guam, Northern Mariana Islands, Puerto Rico, and the Virgin Islands, a say in identifying their program's development zones.

Tax Benefits to the Investor

1. **Eligible investment capital** is primarily gains, recognized by the U.S. as federal taxable income, originating from domestic or foreign investment of nearly any kind, be it stocks, real estate, businesses, personal property, collectibles, etc.. Additional investor cash investment is prohibited.
2. **Investor qualifications.** A sole investor can invest in a single qualifying property, directly into a single qualifying property as part of a group, or as one of many investors into a multi-property Qualifying Opportunity Zone Fund (QOF).
3. **Taxes are deferred.** The investor's original capital gains tax payment is deferred for a term (see OZ 1.0 and OZ 2.0).
4. **Stepped-up Basis.** A 10 or 15 percent stepped-up basis provision on invested capital gains, originally part of the bill, became obsolete as of December 31, 2021 (A similar provision is reintroduced in OZ 2.0).
5. **Gains on the QOZ investment,** if held for 10 years or more, are tax-free.
6. **Depreciation Recapture.** There is no depreciation recapture upon the sale of depreciated Qualified Opportunity Zone Property.
7. **Cash-out.** A QOF Sponsor's common strategy is to attempt, through refinancing the project or other means, to secure an investor cash-out distribution from the project with sufficient timing to afford the investor a degree of liquidity as deferred taxes become payable to the investor. These distributions are not guaranteed and are dependent on the financial performance and structure of the QOF.
8. **Distributions.** Not all QOFs are structured to provide interim distributions, as the program's primary goal is long-term investment in economically distressed areas. Sponsors may prioritize reinvesting cash flows into property improvements rather than distributing them. Investors should be cautious about receiving cash during the ten-year hold period, as such might trigger a taxable event.

Popular 2025 QOZ Industry Sectors

The program's goal is to spur economic development in distressed communities

The most popular Qualified Opportunity Zone (QOZ) industry projects in 2025 primarily focus on sectors that align with the program's goal of spurring economic development in distressed communities, while leveraging tax incentives for investors.

Leading industries for QOZ projects include:

1. Real Estate Development (Commercial and Multifamily)

Real estate, particularly commercial and multifamily projects, dominates QOZ investments due to the program's structure, which favors tangible property development. These projects include office buildings, retail spaces, hotels, and apartment complexes.

By 2020, over \$48 billion in QOZ equity had been invested, with a significant portion directed toward real estate, especially in urban areas such as Miami, Los Angeles, and Washington, D.C..

The 10-year tax-free appreciation benefit incentivizes long-term real estate holdings, and the "substantial improvement" requirement (investing at least the property's purchase price in upgrades within 30 months) suits large-scale development.

2. Affordable Housing

Affordable housing projects, often paired with Low-Income Housing Tax Credits (LIHTC), are a growing focus, especially in cities like Austin, where anti-displacement policies encourage such developments.

These projects address community needs while meeting QOZ goals of economic revitalization. In 2025, areas like Austin will prioritize affordable housing to combat gentrification.

Affordable housing aligns with the social impact goals of QOZs and can attract additional tax credits, enhancing returns for investors.

3. Operating Businesses in Qualified Opportunity Zones

Investments in Qualified Opportunity Zone Businesses (QOZBs) that operate within QOZs, such as manufacturing, tech startups, or service-based businesses, are gaining traction. These businesses must have at least 70% of their tangible assets in a QOZ.

While less dominant than real estate, QOZBs are popular in rural QOZs, where the new Qualified Rural Opportunity Funds (QROFs) offer enhanced tax benefits, like a 30% stepped-up basis after five years.

QOZBs enable diversification beyond real estate and support job creation, a key objective of QOZs. Rural zones benefit from a lower "substantial improvement" threshold (50% of adjusted basis vs. 100% for urban zones).

4. Historic Rehabilitation and Mixed-Use Development:

Rehabilitation of historic properties for mixed-use purposes (e.g., combining retail, office, and residential spaces) is a prominent trend in zones with historic tax credit (HTC) opportunities, such as New Orleans.

These projects are attractive in areas with historic buildings, as they combine QOZ tax benefits with HTC incentives.

The combination of tax incentives makes these projects financially viable, and they contribute to community revitalization by preserving cultural assets.

5. Infrastructure and Community Development Projects

Some QOZ funds support infrastructure improvements, such as public marketplaces or community facilities, often as part of broader revitalization efforts.

These projects are less common but significant in areas with strong local government support, such as Erie, Pennsylvania, where QOZ funds supported the development of a public marketplace.

These projects align with QOZ goals of long-term economic impact and can attract additional public or private funding.

What is the role of the “Sponsor”

A Qualified Opportunity Sponsor (QOS) is a real estate company or individual that organizes and manages a Qualified Opportunity Fund (QOF), which is a vehicle created under the U.S. Tax Cuts and Jobs Act of 2017 to invest in Qualified Opportunity Zones (QOZs). They are responsible for finding properties, acquiring them, and structuring the trust, as well as managing the property and distributing income to investors.

Key Points About a Qualified Opportunity Sponsor (QOS):

- **Role and Responsibilities:**

- A QOS is typically the manager or sponsor of a QOF, tasked with identifying, managing, and executing investments in Opportunity Zone projects.
- They ensure the fund complies with IRS regulations to maintain the tax benefits associated with Opportunity Zone investments.
- Responsibilities include selecting eligible properties or businesses, managing development projects, and ensuring the fund meets the requirement that at least 90% of its assets are invested in qualified Opportunity Zone property.

- **Qualifications:**

- There are no strict federal requirements for who can be a QOS. Still, they are typically experienced real estate developers, fund managers, or investment professionals with expertise in managing complex projects.
- They must have the ability to structure deals, secure financing, and navigate the regulatory requirements of Opportunity Zones.

What QOZ Improvements Are Required

Qualified Opportunity Zone (QOZ) projects are not explicitly required to make "basic improvements" as defined. Still, they must meet specific requirements under the Tax Cuts and Jobs Act of 2017 to qualify for tax benefits, particularly when dealing with existing property. The key requirement for existing property is substantial improvement, which applies to tangible property used in a QOZ business.

- **Substantial Improvement Requirement:** For a property to qualify as QOZ business property, it must either be "original use" (newly placed in service in the QOZ) or substantially improved. Substantial improvement means that within any 30 months after acquisition, the additions to the adjusted basis of the property (excluding land) must exceed the adjusted basis of the property at the start of that period. For example, if a QOF purchases a building for \$1 million, with \$600,000 allocated to the building value, it must invest more than \$600,000 in improvements to the building within 30 months to meet this standard.
- **Eligible Improvements:** Improvements that count toward the substantial improvement requirement include enhancements to the building itself, such as structural upgrades, renovations, or rehabilitation. However, improvements to land (e.g., parking lots, landscaping) do not count toward the building's substantial improvement requirement, though they may qualify as new property for the 90% asset test.
- **Assets Held in QOF:** The QOF must hold at least 90% of its assets in QOZ property (tested semiannually).

Key Insights

- The source of investment must come from capital gains, either short-term or long-term, from the sale or exchange of property, such as stocks, real estate, or business assets.
- Exact 2025 QOZ investment breakdowns by industry are limited, as reporting requirements are still evolving. However, real estate remains the dominant sector due to its alignment with QOZ rules. New 2025 regulations, like the "One Big Beautiful Bill Act," impose stricter reporting requirements on QOFs, emphasizing transparency in project impacts, which may favor industries with measurable community benefits (e.g., affordable housing, job-creating businesses).
- While most Qualified Opportunity Zone investments are offered as Private Offerings available only to Accredited Investors, there are very few publicly listed Qualified Opportunity Funds.
- Investors do not have to engage in a 1031 exchange; instead, they have 180 days after realizing the capital gains event to invest in a Qualified Opportunity Zone (subject to tax return filing).
- If the QOF investment is held for at least 10 years, the investor can elect to apply a stepped-up basis to the QOF investment, treating it as if it were held at its fair market value on the date of sale or exchange, thereby effectively eliminating taxes on any appreciation in the QOF investment's value.
- An investment in a QOF has specific time thresholds outlined in the IRC, whereby an early exit by the investor may not achieve the intended tax mitigation and could trigger a taxable event.
- Proper investor deferral elections made during its hold time concerning your initial investment are essential to benefit from all tax mitigation aspects of the IRC for Opportunity Zone legislation.

What is Stepped-Up Basis?

Basis, as it applies to Qualified Opportunity Zones, refers to the value, the “taxable amount”, of the original gains as they’re invested into a QOZ. It is this value, along with the stepped-up basis adjustments at key milestones within the QOC tax code, that is exceptionally beneficial to the investor’s tax burden.

This tax provision is significant in the context of U.S. tax law (Section 1400-1 and 1400-2), particularly for capital gains tax purposes, and it applies across all states; however, each state may have nuances relating to state-specific tax laws.

- **What is Tax Basis?** The tax basis of an asset, or its investment value, is typically its original taxable amount, subsequently adjusted by specific program factors. It’s used to calculate taxable amount when the deferred tax payment is due or another taxable event occurs within the QOZ program.
- **How Stepped-Up Basis Works:** Within the QOZ tax code, investors qualify for specific stepped-up basis adjustments, which generally reduce their tax assessment. The increase in basis value reduces the amount of difference (its capital gain) between original value and its current Fair Market Value (FMV).
- **Impact on Capital Gains Tax:** When an investor experiences a tax event within the QOZ program, capital gains tax is calculated based on the difference between the sale price and the stepped-up basis. Since the basis is reset to the FMV, the different program milestones often reduce or eliminate capital gains tax liability.

Opportunity Zone 1.0

The program's goal is to spur economic development in distressed communities

Opportunity Zone 1.0:

- Opportunity Zone Code, initially included in the 2017 Tax Cuts and Jobs Act (now also known as version OZ 1.0), laid a framework for what has proven to be a very popular bipartisan economic development engine that has benefited multitudes across the entirety of the country and its territories. It has proven to be a substantial platform that has been refined and made permanent in the One Big Beautiful Bill Act of July 4th, 2025 (also known as OZ 2.0).
- Capital gains invested in a QOF are deferred until the earlier of the QOF investment's sale or December 31, 2026, at which time, assessed taxes become due and must be paid in full. Many (but not all) of the early QOF sponsors have cash-out distributions planned, providing a level of liquidity that allows investors' funds to pay their tax obligations.
- To qualify for the stepped-up basis investor benefit provision linked to the December 31, 2026 deferral date, the QOF investment needed to be made by December 31, 2021 at the latest (for the 10% stepped-up basis) or December 31, 2019 (for the additional 5%).
- The inventory of eligible census tracts that qualify for QOZ treatment is known and will remain in effect until the following designated list becomes available on January 1, 2027. With its renewed focus as part of the OBBBA of July 4, 2025, the new list is expected to have fewer eligible census tracts.
- An aspect of making investments in Oz 1.0 is that, based on the stage of the construction, investor payable tax obligations are predicated on the then FMV of the OZ project. A potential "J Curve" in valuation may make the QOF investment especially compelling.
- New OZ properties purchased now could also benefit from their lower acquisition price due to the market correction currently being experienced.

Opportunity Zone 2.0

Opportunity Zone 2.0:

- The One Big Beautiful Bill Act (OBBBA) legislation, signed into law on July 4, 2025, makes the Opportunity Zone Tax Code permanent and resets some (but not all) of the OZ 1.0 provisions.
- Investments made after December 31, 2026, receive a 10% stepped-up basis after 5 years. A new category of “Qualified Rural Opportunity Funds” (QROF) offers enhanced tax benefits for investments in QOZs. QROF investors will receive a 30% basis increase after a five-year holding period.
- Taxable gains deferred through QOF investments will be recognized on the fifth anniversary of the investment date.
- OZ 2.0 establishes a system for permanent, rolling 10-year Opportunity Zone designations. States will nominate new zones every 10 years, with the first round becoming effective on January 1, 2027.
- The OBBBA tightens the requirements for Opportunity Zone designation, focusing on areas with a greater need for investment and development. The new definition refines eligibility by excluding census tracts where median family income exceeds 125% of the state or metropolitan median, depending on whether the tract is rural or urban. This aims to focus the designations more strictly on genuinely underserved communities and ensure the benefits are not directed to areas already experiencing prosperity.
- The OBBBA introduces more stringent reporting requirements for both Qualified Opportunity Funds (QOFs) and the businesses operating within Opportunity Zones. This is intended to increase accountability, track the program's economic and social impact, and prevent potential abuse.

Opportunity Zone Investing

Important Considerations:

- Recent legislative changes, particularly the “One Big Beautiful Bill Act” (OZ 2.0), aim to modify and enhance the QOZ program, potentially including provisions for rolling gain deferral and increased transparency. However, most of these changes are expected to take effect after December 31, 2026.
- The OBBBA introduces additional benefits for investments in Qualified Rural Opportunity Funds (QROFs). A QROF is defined as a QOF that holds at least 90% of its assets in qualified opportunity zone property (QOZP) that is located in a rural OZ. These benefits include a 30% basis increase for QROF investments held for at least five years. Additionally, the "substantial improvement" requirement for existing structures in rural areas is reduced from 100% on an adjusted basis to 50%.
- QOZ investments are recognized for their significant tax provisions, which may benefit some investors more than others. Investors may consider the asset to be illiquid during an anticipated 10-year holding period, during which much of its intrinsic tax value is realized. Selling or redeeming (if available within the fund) within the minimum holding period negates much of the investor's tax mitigation. Without the tax benefit, the reduced value, especially in the thinly traded secondary market, would be apparent.
- To realize the full benefit of the QOF investment, the holding term needs to meet all IRC milestones, which may not align with estate planning strategies.

“Sleep Comfortably with QOZs”

All investments have some degree of risk, and advisory services should be sought to measure your acceptance of those personal investment risks before making any investments. However, QOZ passive investment characteristics should be considered.

Potential Upsides that Might Contribute to *"Sleep Well at Night"*

- **Passive Income Potential:** QOFs do not inherently include regular income distributions, but whether they make such distributions depends on the fund's structure, investment strategy, and governing documents. The primary investment gain benefit is realizing the appreciation upon exit, accentuated by the long-term tax mitigation.
- **Diversification:** Investing in QOFs enables you to diversify your real estate holdings across various sponsors, property types, and geographic locations, thereby helping to mitigate risk.
- **Professional Developed and Managed:** QOFs are primarily a development project that, once completed, becomes a stabilized project requiring professional management.

However, it's crucial to be aware of the risks that could potentially cause sleepless nights:

- **Lack of Control:** You relinquish control over your investment development and ongoing property management decisions when you invest in a QOF, relying heavily on the sponsor's expertise.
- **Illiquidity:** QOF investments are considered illiquid, meaning you may not be able to easily sell your interest if you need to access your funds due to the limited resale market and negative tax implications.
- **Market Risk:** Real estate values are subject to market fluctuations, which can impact the value of your QOF investment.
- **Sponsor Risk:** The success of your QOF investment depends heavily on the sponsor's experience and competence.
- **Fees:** QOFs often come with various fees that can reduce your overall returns.

In conclusion, QOF investments can offer potential passive income, long-term appreciation, and substantial tax benefits. Still, they also carry risks, such as a lack of control and illiquidity, that need to be carefully evaluated.

Qualified Opportunity Fund Summary Benefits

1

Minimum Investment

While IRC has no minimum investment amount, Sponsors set minimums ranging \$50,000 to \$250,000. Some Sponsors require \$1,000,000.

2

Stepped-Up Basis

The 2017 Tax Cuts and Jobs Act, and now the One Big Beautiful Bill Act, attract investor investment offering tax mitigation in large part using stepped-up basis at specific program milestones.

3

Defer Taxes

QOFs offer temporary deferral of capital gains taxes. Oz 1.0 initially offered two different step-up basis, Oz 2.0 includes a new rolling 5 yr partial step-up. Both Oz 1.0 & Oz 2.0 have a full step-up basis on investment gain after 10 yrs.

4

Passive Income

Not all QOFs are structured to provide interim distributions, as the program's primary goal is long-term investment in economically distressed areas. Sponsors may prioritize reinvesting cash flows into property improvements rather than distributing them.

5

Limited Liability and Non-Recourse Debt

An investment in a QOF transfers all risk of debt recourse, if any, and general liability to the Sponsor.

6

Long-Term, Stable Income

An investment in QOF, by the design of the tax code, incentivizes a long-term, ten year or more investment.

States' Cooperation with OZ Legislation

Not all states fully cooperate with Qualified Opportunity Zone (QOZ) non-tax provisions, as state conformity to federal Opportunity Zone (OZ) tax incentives varies. The federal QOZ program, established under the 2017 Tax Cuts and Jobs Act, offers tax benefits, including capital gains deferral and potential exclusion, for investments in designated Opportunity Zones. However, states have their tax codes and policies, and their alignment with federal OZ benefits, including non-tax provisions such as administrative support or additional incentives, differs.

Key Points on State Cooperation - Tax Conformity with Federal OZ Benefits:

- Most states (and D.C.) conform to some extent with federal OZ tax provisions, particularly the deferral of capital gains, because their tax codes are tied to federal taxable income calculations. For example, states such as **California**, **Texas**, and **New York** generally permit deferral of capital gains for QOZ investments by federal rules.
- However, some states, such as **California**, **Massachusetts**, and **Pennsylvania**, do not fully conform to all federal OZ tax benefits. For instance:
 - **California** does not offer a state-level capital gains exclusion for QOZ investments held for 10 years or more; however, it does allow for deferral.
 - **Massachusetts** has its own rules and does not conform to the federal exclusion of gains for long-term QOZ investments.
 - **Pennsylvania** conforms to federal deferral but has limited additional state-specific OZ incentives.

Non-Tax Provisions:

- Non-tax provisions include state-level administrative support, zoning flexibility, permitting assistance, or additional incentives (e.g., grants, loans, or local tax abatements) to encourage QOZ development.
- Some states actively support QOZ projects with non-tax benefits:
 - **Ohio** offers programs like the Opportunity Zone Tax Credit, which provides additional state-level incentives for QOZ investments.
 - **Maryland** has implemented local government coordination to streamline permitting and zoning for QOZ projects.
 - **New Jersey** offers complementary economic development programs to support QOZ investments, including grants and low-interest loans.

States' Cooperation

... continued.

- Other states may not offer specific non-tax provisions or actively promote QOZ development, effectively limiting cooperation. For example:
 - States like **Mississippi** and **North Carolina** may follow federal tax rules but lack robust state-level programs or administrative support for QOZ projects.
 - States with no personal income tax, such as **Florida**, **Nevada**, or **Washington**, inherently offer no state-level capital gains tax benefits. Consequently, QOZ investments may rely solely on federal incentives and local non-tax support, which varies by locality.

Variability in Local Cooperation:

- Even within conforming states, local governments (cities, counties) play a significant role in non-tax provisions like zoning, permitting, or infrastructure support. Cooperation at the local level can vary widely.

States with No Income Tax:

- States without income taxes (e.g., **Alaska**, **Florida**, **Nevada**, **South Dakota**, **Texas**, **Washington**, and **Wyoming**) do not offer state-level capital gains tax benefits. Hence, QOZ investments in these states rely on federal tax benefits and any local non-tax provisions, such as zoning incentives or economic development programs. Cooperation on non-tax provisions depends heavily on local government initiatives.

States' Cooperation Summary:

While most states conform to federal QOZ tax provisions to some degree, cooperation with non-tax provisions (e.g., administrative support, zoning, or additional incentives) is inconsistent. States like **Ohio**, **Maryland**, and **New Jersey** actively support QOZ projects with non-tax benefits. In contrast, others, particularly those with limited state income tax structures or minimal economic development programs, may offer little to no additional support. Local government policies further influence the extent of cooperation.

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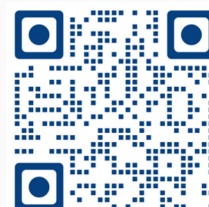
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IMPORTANT DISCLAIMER

Seek Professional Advice: The rules and regulations surrounding Qualified Opportunity Zones can be complex. It's recommended to consult with a qualified tax advisor or financial planner to determine the best strategy for your specific situation. The purchase of a QOF is restricted to accredited investors, who are individuals or entities with the financial capacity and experience to invest in private securities. Individuals with a net worth of \$1 million (excluding primary residence) or income of \$200,000 individually, or \$300,000 jointly. Entities are required to have a net worth of \$5 million, with all equity owners qualifying as accredited investors. (Securities and Exchange Commission, SEC)

This material does not constitute an offer to sell or a solicitation of an offer to buy any security.

There are material risks associated with investing in real estate, Qualified Opportunity Zones, and Qualified Opportunity Funds. These include, but are not limited to, tenant vacancies; declining market values; potential loss of entire investment principal; that past performance is not a guarantee of future results; that potential cash flow, potential returns, and potential appreciation are not guaranteed in any way; adverse tax consequences and that real estate is typically an illiquid investment. IRC Section 1400-1 and 1400-2 of the Internal Revenue Code (Title 26 of the United States Code) are complex tax codes; therefore, you should consult your tax and legal professional for details regarding your situation.

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