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In this article, the authors argue that while qualified opportunity fund investors face a December 31, 2026, deemed realization event, the statutory “lower-of” rule, paired with a qualified appraisal, can cap the inclusion at fair market value and may reduce the gain recognized.

The authors provide valuation, tax, and legal services of the type discussed in this article and may be retained by investors addressing the December 31, 2026, inclusion event. The authors have no other relationships or financial interests requiring disclosure.

I. The Approaching Cliff: December 31

For every taxpayer who elected to defer eligible capital gains by investing in a qualified opportunity fund under section 1400Z-2, a fixed and immovable deadline is rapidly approaching.¹ On December 31, subject to the “lower-of” rule discussed here, all remaining deferred gains must be recognized in gross income, regardless of whether the investor has sold the QOF interest, received any distributions, or generated a single dollar of liquidity from the investment. This inclusion event, or “deemed realization event,” creates a real tax bill.

¹Section 1400Z-2(b)(1)(B); Tax Cuts and Jobs Act of 2017, P.L. 115-97, section 13823.

Industry estimates indicate that over \$100 billion has been deployed into QOFs since the program’s inception in 2018, spread across thousands of funds and tens of thousands of individual investors. For many, the 2026 tax bill may be sneaking up on them. Investors must generally source cash from outside the fund to pay federal and state taxes on gains they have not yet monetized.² The passage of the One Big Beautiful Bill Act on July 4, 2025, permanently extended the qualified Opportunity Zone program into a new “OZ 2.0” framework but did nothing to move the December 31 recognition date for legacy investments.³

Yet amid the looming tax hit lies a genuine and potentially overlooked tax mitigation opportunity. The statute itself contains a taxpayer-protective mechanism, the lower-of rule. When the rule is paired with a rigorous independent appraisal of the value of the QOF stock or partnership interest, its application could materially reduce the gain recognized and possibly lock in significant long-term tax savings. This article examines the technical mechanics of the lower-of rule, demonstrates its application through a hypothetical case study, and provides an actionable roadmap for practitioners and investors.

II. The Technical Mechanism: Understanding the Lower-of Rule

The defining statutory provision that creates the planning opportunity is the calculation of the

²In certain circumstances, the QOF itself may complete a cash-out refinancing to fund distributions for this purpose, subject to the disguised sale principles imported into the QOF regime.

³One Big Beautiful Bill Act, section 70421 (signed July 4, 2025). The OBBA permanently extended the QOZ program but left the December 31 recognition date intact for first tranche investments.

inclusion amount itself. Under section 1400Z-2(b)(2)(A) and reg. section 1.1400Z2(b)-1(e), the amount of gain included in gross income on December 31 is determined by a two-step formula. (See Table 1.)⁴

Table 1. Inclusion Amount Formula

Section 1400Z-2(b)(2)(A); reg. section 1.1400Z2(b)-1(e)
Inclusion amount = the excess of:
(1) The <i>lesser</i> of: (a) the original (and remaining) deferred gain, or (b) the FMV of the interest in the QOF as of December 31, 2026
Over
(2) The taxpayer's adjusted basis in the QOF investment (starting at \$0, potentially increased by the 10 percent five-year and 5 percent seven-year step-ups)

The regulation uses the terminology “fair market value of the qualifying investment,” and the term “qualifying investment” is defined throughout the section 1400Z-2 regulations as the eligible taxpayer’s equity interest in the QOF, not the taxpayer’s pro rata share of QOF assets or net asset value (NAV). The IRS’s “Opportunity Zones Frequently Asked Questions” restate the statute and regulation, saying that the inclusion amount “depends on (i) the fair market value of your qualifying investment in the QOF on the date of the inclusion event and (ii) adjustments to the tax basis of that qualifying investment.”⁵

The lower-of rule acts as a statutory cap on the taxpayer’s liability. If (1) the QOF investment has declined in value or underperformed, or (2) the FMV of the investor’s specific partnership interest (as opposed to a pro rata share of underlying assets or NAV) is below the original (and remaining) deferred gain, the taxpayer is protected from recognizing an unduly high amount of deferred gain. In other words, if the taxpayer has an unrealized loss on the QOF ownership interest during the holding period leading up to December 31, the taxpayer can

effectively use that loss to decrease the amount of deferred gain they must recognize. The statute’s plain language provides that the recognized gain is not to exceed the current FMV of the interest, less any income tax basis. The rule is intuitive: Taxpayers should not pay tax on the previously deferred amount if the value of their QOF investment on the deemed realization date is lower than that previously deferred amount.

But this protection is not automatically activated. Instead, the taxpayer’s calculations require substantiation through a qualified, independent appraisal that derives FMV as that term is widely recognized and defined throughout the Internal Revenue Code and Treasury regulations.⁶

III. The Valuation Strategy: Why Partnership Interest FMV Is Often Below Invested Capital

A. The Critical Distinction: Interest vs. Underlying Assets

The vast majority of QOFs are structured as tax partnerships. Under established federal tax law and decades of Tax Court precedent, the FMV of a partnership interest is not the same as the investor’s pro rata share of the fund’s NAV.⁷ The partnership, not the individual partner, owns the tax partnership’s property. The investor holds an equity interest in the entity, which is subject to the typical governance limitations, illiquidity, and transfer restrictions common to partial interests in private investment funds. The fund assets and liabilities may have changed through the life cycle of the vehicle. A hypothetical willing buyer of a partnership interest would certainly seek to identify NAV, but as with many other private investment funds without withdrawal rights, that buyer would likely transact at a price less than the pro rata share of NAV.

⁶ Statute-driven basis adjustments further reduce the recognized gain. Investors who held QOF interests for at least five years before December 31, 2026, receive a 10 percent basis step-up; those who held for seven years receive an additional 5 percent (total 15 percent). Due to the fixed deadline, the seven-year step-up is available only to investors who entered by December 31, 2019, and the five-year step-up is available only to those who entered by December 31, 2021. Investors who entered in 2022 or later receive no basis step-up whatsoever, making the FMV cap their only statutory protection against a full-gain inclusion.

⁷ Rev. Rul. 59-60, 1959-1 C.B. 237; see also *Mandelbaum v. Commissioner*, T.C. Memo. 1995-255 (nine-factor discount for lack of marketability framework).

⁴ Section 1400Z-2(b)(2)(A); reg. section 1.1400Z2(b)-1(e).

⁵ IRS, “Opportunity Zones Frequently Asked Questions” (last updated Sept. 13, 2025). The IRS’s “Opportunity Zones Frequently Asked Questions” do not constitute substantial authority within the meaning of reg. section 1.6662-4(d)(3) and may be offered only in an attempt to mitigate penalties under section 6662, not to uphold the validity of the taxpayer’s return position.

B. Valuation Discounts: DLOC and DLOM

Two well-established categories of discount commonly apply to noncontrolling, nonmarketable partnership interests. First, the discount for lack of control (DLOC) reflects the limited partner's inability to compel distributions, direct asset dispositions, refinance debt, or force liquidation. Tax Court decisions consistently recognize DLOCs in the range of 10 to 30 percent. Second, the discount for lack of marketability (DLOM) reflects the difficulty, cost, and uncertainty of converting a private, restricted partnership interest into cash. Empirical studies, including restricted stock studies, indicate DLOMs of 20 to 40 percent for noncontrolling interests with illiquidity. These discounts are multiplicative, not additive.⁸

Those experienced with private investment funds may be curious whether there is a secondary market for QOF interests and what pricing data indicates. As best we can tell, the secondary market for QOFs is quite thin. Unlike standard private equity, selling a QOF interest alters the asset's very tax DNA; an early disposition constitutes an inclusion event that accelerates deferred gains, triggers immediate taxation, and forfeits the selling investor's remaining 10-year tax-free appreciation benefit. An interest can nonetheless be sold on the secondary market; the selling investor simply forfeits the associated tax benefits, and the buyer's 10-year holding period begins anew as of the purchase date. Voluntary secondary trading nonetheless appears limited, and no central repository tracks those transactions, so some secondary trading has likely occurred without public record.

A notable exception is Belpointe PREP LLC (NYSE American: Opportunity Zone), the first and only publicly traded QOF listed on a national securities exchange.⁹ There is otherwise no stand-alone QOF transaction reporting by major institutional secondary advisory desks such as Jefferies and Lazard. Discrete statutory restrictions penalize transferability, and a

secondary buyer obtains QOF tax benefits only to the extent the buyer has eligible deferred capital gains to invest. Accordingly, QOF investors are effectively locked into their investments in these entities: Sponsors will not liquidate for tax reasons, and the secondary market is thin at best. These conditions could suggest that steep discounts are applicable. On the other hand, the FMV standard presumes the existence of a transaction, placing the onus on the qualified appraiser to determine the price that would be reflective of FMV if a transaction were to occur.

C. The Hidden Opportunity: Even Performing Funds May Trigger the FMV Cap

This is an insight that many investors and their advisers may be missing. The lower-of rule does not require that the fund have failed. Even a QOF with a NAV of 1.1x or 1.2x the original investment may produce a partnership-interest FMV that falls below the 1.0x cost threshold once lack of control and lack of marketability are properly considered. Imagine a fund showing a NAV of \$1.15 for every \$1 invested where a qualified appraiser develops a combined DLOC and DLOM of 25 percent. This would result in an FMV of approximately 86 cents per dollar of original investment. The FMV cap is operative, and the inclusion amount is reduced below the full deferred gain, net of any tax basis.

For those funds formed and deployed shortly after the 2017 Tax Cuts and Jobs Act, real estate market conditions may have shifted materially since that capital was placed. Higher interest rates have put pressure on property valuations across multiple sectors, the COVID-19 pandemic impaired the office market and other segments of commercial real estate, and geopolitical instability has weighed on capital markets. These forces have largely pushed in the same direction, and many parts of the real estate market have experienced valuation declines. For many funds, the practical consequence is that NAV already sits at or below the capital originally invested, before any valuation discounts are taken into account. We have observed this directly: A number of QOFs have failed or unwound, and others now hold assets worth less than their original cost. In addition, once lack of control and lack of marketability are applied to a noncontrolling,

⁸ Combined Discount = $1 - (1 - \text{DLOC}) * (1 - \text{DLOM})$. A 10 percent DLOC and 25 percent DLOM = 32.5 percent combined, not 35 percent.

⁹ As of this writing, the stock price has declined approximately 50 percent from the outset of trading in 2021.

nonmarketable interest, the resulting FMV can fall well below the 1.0x cost threshold.

For recently funded QOFs, conditions may also be favorable. These funds may still be marked at cost on an asset basis, meaning the pro rata NAV approximates the original investment. But the FMV of a noncontrolling, nonmarketable interest in such a fund may be lower than cost, for the same reason that prices for limited partner stakes in real estate private equity funds trade below NAV in secondary markets.

IV. The Math in Action: Hypothetical Case Study

Consider an investor who deferred \$5 million in long-term capital gains by investing in a QOF partnership on January 15, 2020. By December 31 the investor has held the position for over five years (qualifying for the 10 percent basis step-up, adding \$500,000 to basis) but has not reached the seven-year mark.¹⁰ The fund's underlying real estate has appreciated modestly: The investor's pro rata NAV is \$5.75 million. A qualified appraiser determines that the FMV of the limited partnership interest, after applying a total discount of 30 percent, is \$4.025 million. (See Table 2.)

**Table 2. Hypothetical Case Study:
Tax Impact With and Without a
Qualified Appraisal**

	Without Appraisal	With Appraisal
Original (and remaining) deferred gain	\$5,000,000	\$5,000,000
Pro rata NAV at Dec. 31, 2026	\$5,750,000	\$5,750,000
FMV used for inclusion	\$5,000,000	\$4,025,000
5-year basis step-up (10 percent)	(\$500,000)	(\$500,000)
Inclusion amount	\$4,500,000	\$3,525,000
Federal tax at 23.8 percent	\$1,071,000	\$838,950
Tax savings from appraisal	—	\$232,050

¹⁰ To qualify for the additional seven-year 5 percent basis increase before the December 31 inclusion date, the taxpayer must generally have made the qualifying QOF investment on or before December 31, 2019. The five-year 10 percent basis increase generally required investment on or before December 31, 2021.

In this scenario, the appraisal reduces the federal tax liability by \$232,050 — a permanent savings, not merely a deferral. Presuming the 10-year hold is later achieved, the gain that is excluded from the 2026 recognition event is never recaptured under the statute, because the lower-of rule permanently caps the inclusion amount. When the investor eventually sells the QOF interest after 2030, all post-2026 appreciation is permanently excluded from income.¹¹

V. Why a 'Qualified Appraisal' Is Nonnegotiable

Although section 1400Z-2 does not explicitly mandate a formal appraisal for the 2026 inclusion event, the practical and legal case for obtaining one is overwhelming. First, there is an established body of rules and regulations defining what constitutes a qualified appraisal, most notably under section 170(f)(11)(E) and reg. section 1.170A-17. Without an independent appraisal, the taxpayer may have no evidentiary basis to support an FMV lower than the previously deferred amount, and the burden of proof in any proceeding is on the taxpayer.¹² Internal fund valuations prepared by the general partner for investor reporting purposes do not incorporate entity-level adjustments for lack of control and lack of marketability; they reflect liquidation or NAV metrics, not the FMV of a minority interest. Defaulting to the general partner's NAV computation could effectively result in tax overpayment.

Second, penalty protection is paramount. Under section 6662, substantial and gross valuation misstatement penalties of 20 to 40 percent may apply to understatements attributable to incorrect valuations. A qualified appraisal by a qualified appraiser provides the reasonable cause defense under section 6664(c)(3).¹³ Third, the IRS may devote significant examination resources to 2026 QOF-related returns. Billions of dollars in deferred gains will be reported simultaneously; returns claiming FMV significantly below the deferred gain

¹¹ Section 1400Z-2(c); the 10-year basis step-up to FMV permanently excludes all post-acquisition appreciation from income.

¹² See, e.g., Tax Court Rule 142; but see section 7491(a).

¹³ Section 6662 (accuracy-related penalties); section 6664(c)(3) (reasonable cause defense for qualified appraisals).

amount may attract heightened scrutiny. Obtaining an appraisal that complies with the Uniform Standards of Professional Appraisal Practice, prepared by a credentialed professional meeting the “qualified appraiser” standards under section 170, is the best way to proceed.¹⁴

VI. Actionable Roadmap: A Practitioner Checklist for 2026

Practitioners and investors should be executing the following steps now:

1. *Engage an independent appraiser early.* The valuation industry may face capacity constraints as the tax filing deadline approaches. Initiating the engagement early allows adequate time for due diligence, data collection, and analysis.
2. *Coordinate with fund managers for transparency.* Request audited financial statements, partnership agreements, rent rolls, capital account schedules, and distribution histories. If the sponsor is not already engaging in a mark-to-market process, the appraiser needs comprehensive data to support the asset-level valuation (stage 1) before addressing entity-level discounts (stage 2).
3. *Document the December 31 value contemporaneously.* The appraisal must reflect the FMV as of December 31, the exact statutory measurement date. Retrospective appraisals prepared years later for audit defense are less credible. Contemporaneous preparation maximizes evidentiary weight.
4. *Model liquidity needs before year-end.* Even with a reduced inclusion amount, the tax liability creates cash needs. Taxpayers and their advisers should model estimated tax payments and identify funding sources.

5. *Verify state conformity.* State treatment of the 2026 inclusion event varies significantly.¹⁵ Multistate investors face added complexity. State-level analysis is essential.
6. *Ensure consistency with prior filings.* The deferred gain amounts reported on prior Forms 8997, “Initial and Annual Statement of Qualified Opportunity Fund (QOF) Investments,” should be consistent with the deferred gain figure used in the 2026 inclusion calculation (avoid the careless mistake of claiming you deferred \$4 million when prior forms say \$4.5 million).
7. *Preserve the 10-year exclusion.* The 2026 inclusion event does not terminate the QOF investment or defeat the 10-year hold exclusion. Investors who entered in 2018 to 2019 may be eligible for the tax-free exit as early as 2028 to 2029. Absent unique circumstances, advisers should consider counseling clients to continue holding the interest through the 10-year anniversary.
8. *Monitor regulatory guidance.* There may be issues addressed via regulation between now and year-end that have varying ramifications on taxpayers.

Notably, when investing in a QOF, taxpayers were not restricted to solely investing deferred capital gains. Under section 1400Z-2, investors could legally combine eligible deferred gains with fresh, nondeferred capital to form what the tax code defines as a “mixed-fund investment.” Crucially, the IRS treats a mixed-fund commitment as two entirely separate investments. The portion funded by original (and remaining) deferred gains receives all preferential QOF tax treatments. This is the exact portion of the taxpayer’s investment subject to the 10-year tax-free growth, the potential basis step-ups, and the mandatory December 31 deemed realization event. It is also the only portion to be reviewed for application of the lower-of rule. Conversely, the

¹⁴ Section 170(f)(11) defines “qualified appraiser” and “qualified appraisal”; these definitions are the de facto benchmark across federal tax practice. Uniform Standards of Professional Appraisal Practice Standards 9 and 10 apply to business appraisal development and reporting.

¹⁵ State and local income taxation is a separate matter that turns on whether each jurisdiction conforms to the federal regime, and a state’s treatment does not alter the federal result. The topics discussed here are fully relevant to investors everywhere for federal purposes. In jurisdictions that do not conform, however, there is no state-level deferral to unwind, so the strategy produces no comparable state or local benefit. California and New York are the leading examples, by different mechanisms.

portion funded with fresh capital operates as a standard investment. It receives no special Opportunity Zone tax benefits, retains its standard cost basis, and is completely immune from the 2026 phantom income tax hit.

VII. Conclusion: Proactive Valuation as Tax Strategy

The December 31 deemed realization event need not be the tax hit that many QOF investors fear. The statute itself provides a taxpayer-favorable mechanism (the lower-of rule) that allows the inclusion amount to be capped at the appraised FMV of the partnership interest, which may be lower than the original (and remaining) deferred gain due to historical investment performance and/or after application of standard valuation adjustments.

For underperforming funds, this may reduce the 2026 tax bill to a fraction of the expected amount. For newly funded QOFs still marked at cost, discounts from pro rata NAV could lead to

meaningful savings. And for performing funds at modest multiples of invested capital, the combination of entity-level discounts and basis step-ups can drive the recognized gain well below initial expectations.

But none of this happens without action. The FMV cap is activated only by evidence — a qualified appraisal prepared by a credentialed and independent appraiser, documented contemporaneously as of the statutory measurement date. The cost of such an appraisal is likely a small fraction of the tax savings it enables. In the 2026 QOF context, proactive valuation is not merely a compliance exercise. It is, quite literally, a tax mitigation strategy.¹⁶ ■

¹⁶This article is for informational and educational purposes only and does not constitute legal or tax advice. The analysis reflects the law as of June 2026 and is subject to change based on IRS guidance, Treasury regulations, judicial decisions, and/or legislative amendments. All dollar amounts, discount rates, and tax calculations are illustrative. Readers should consult with qualified tax and legal counsel regarding the application of these rules to their specific circumstances.