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KPMG report: Calculating QOZ gain recognition on December 31, 2026

The qualified opportunity zone (QOZ) program was enacted as part of the P.L. 115-97, the “Tax Cuts and Jobs Act of 2017” (TCJA), to spur economic investment and job creation in distressed low-income communities across the United States. By offering tax incentives to taxpayers who reinvest capital gains into designated opportunity zones, the program aimed to encourage long-term investment in areas that have historically struggled with poverty and underinvestment.

In its original form, the QOZ program offered three primary tax incentives: (1) the ability to defer recognition of eligible capital gains until December 31, 2026, if the taxpayer timely invested an amount equal to those capital gains in a qualified opportunity fund (QOF) (the gain deferral benefit); (2) a basis step-up in the QOF investment of 10% of the deferred gain, if the taxpayer held its QOF investment for at least five years, with an additional 5% step-up in basis available for investments held at least seven years, thereby reducing the amount of deferred capital gain recognized on December 31, 2026 (the gain reduction benefit); and (3) the ability to eliminate any gain recognized on the sale or exchange of the QOF investment by electing to step up the tax basis of the investment to its fair market value (FMV) on the date of disposition, if the taxpayer held its QOF investment for at least 10 years (the gain elimination benefit) (section 1400Z-2).

A critical milestone in the QOZ program looms at the end of 2026: QOF investors’ gain deferral holiday is coming to an end, and the tax bill will soon come due. Understanding the mechanics of the required deferred gain recognition under the QOZ program is essential. This report describes certain key steps required for QOF investors to determine the proper amount of gain recognition at the end of the year.

The basics: gain deferral and recognition

A taxpayer who elected to defer eligible capital gains in the QOZ program generally must recognize the deferred gains upon the earlier of (1) the date the taxpayer sells or exchanges its QOF investment, or (2) December 31, 2026 (section 1400Z-2(b)(1)). At the time of the gain inclusion, the taxpayer generally recognizes gain equal to (1) the lesser of the amount of gain deferred or the FMV of the QOF investment on the date of disposition, over (2) the taxpayer’s basis in its QOF investment (as determined under section 1400Z-2(b)(2)).

Due to the global financial instability experienced over the last three years, many QOZ businesses have underperformed and may be currently underwater compared to the amount of the original investment (i.e., the current FMV of the entity’s equity may subceed the original investment amount). Consequently, investors in underperforming QOFs may expect that calculating their December 31, 2026, gain based on their QOF

investment's FMV would yield a lower tax liability than calculating their gain based on the amount of gain originally deferred.

Example 1: Investor A realized an eligible capital gain of \$1 million and timely invested \$1 million into a C corporation QOF during 2021. Investor A still holds her QOF investment on December 31, 2026, with no intervening gain inclusion events. On December 31, 2026, the FMV of her QOF stock is \$1.2 million.

Under section 1400Z-2(b)(2)(A) and the corresponding regulations, on December 31, 2026, Investor A must recognize \$900,000 of her deferred capital gain—the lesser of (1) the amount of gain deferred (\$1 million) or the FMV of the QOF investment on December 31, 2026 (\$1.2 million), over (2) the taxpayer's basis in its QOF investment (\$100,000) (computed as an initial basis of zero plus the 10% basis increase Investor A earned for holding the QOF investment at least five years under the gain reduction benefit).

Alternatively, if the FMV of her QOF stock on December 31, 2026, is \$750,000, Investor A must recognize only \$650,000 of the deferred capital gain—the lesser of (1) the amount of gain deferred (\$1 million) or the FMV of the QOF investment on December 31, 2026 (\$750,000) over (2) the taxpayer's basis in its QOF investment (\$100,000).

Modification of the basic rule for QOF partnerships and S corporations

For investors in QOFs organized as partnerships (or S corporations), however, an unwelcome surprise could be lying in wait because Treas. Reg. § 1.1400Z2(b)-1(e)(4) contains a different gain recognition equation for them. On December 31, 2026, investors in a QOF partnership (or QOF S corporation) must recognize gain equal to the lesser of (1) the investor's remaining deferred gain less any basis adjustments from the gain reduction benefit or (2) the gain the investor would recognize on a fully taxable disposition of their QOF interest at FMV.

The revised passthrough formula deviates from the statutory language that focuses on the QOF investment's FMV and instead focuses on the hypothetical gain that would be allocated to the investor if the QOF investment were sold at FMV. The regulatory change was intended to prevent investors from avoiding the recognition of deferred gain by reducing the FMV of the investment through debt-financed distributions or the allocation of debt-financed losses or deductions (preamble to final regulations, T.D. 9889, 85 *Fed. Reg.* 1866 (2020)). Under the modified passthrough equation, even if the net FMV of an investor's QOF investment has fallen to zero (i.e., the investor would receive no proceeds from the sale of its QOF investment), the investor could still recognize some or all of the investor's deferred gain on December 31, 2026, if the investor's basis in its QOF interest includes a share of the QOF's debt that has supported prior distributions or loss allocations.

Example 2: In 2021, Investor A realized an eligible capital gain of \$1 million and invested \$1 million in a partnership QOF. Investor A still holds her QOF investment on December 31, 2026, with no intervening gain inclusion events. In 2026, the QOF borrows \$5 million from a third-party lender and distributes the proceeds to its investors. Investor A's allocable share of the debt under Sec. 752 is \$2.5 million, and Investor A receives a debt-financed distribution from the QOF in 2026 of \$2.5 million. On December 31, 2026, the net FMV of Investor A's QOF investment is \$250,000.

Under the modified formula for computing her 2026 gain inclusion, Investor A does not compare her deferred gain with the net FMV of the QOF investment. Instead, Investor A must recognize the lesser of (1) her remaining deferred gain (adjusted for any applicable basis step-ups from the gain reduction benefit), and (2) the gain Investor A would recognize on the hypothetical sale of the QOF investment at FMV. These amounts are computed as follows:

(A) Remaining deferred gain calculation:
The original amount of deferred gain (\$1,000,000),
Less any prior gain inclusions (\$0),
Less any gain reduction benefit basis increase (\$100,000)
= **\$900,000**;

(B) Hypothetical sale gain calculation:

The amount realized on a hypothetical sale of \$2,750,000 (i.e., the net FMV of Investor A's QOF interest (\$250,000), plus the decrease in Investor A's share of the QOF's liabilities (\$2,500,000)),
Less the adjusted basis of Investor A's QOF interest of \$100,000 (i.e., Investor A's initial basis (\$0), plus Investor A's debt basis (\$2,500,000), less Investor A's distribution (\$2,500,000), plus any gain reduction benefit basis increase (\$100,000))
= \$2,650,000

Thus, under the modified passthrough formula, despite the decline in the net FMV of Investor A's QOF investment, Investor A still must recognize her remaining deferred gain of \$900,000 on December 31, 2026.

Key considerations

Whether an investor has invested in a QOF partnership or a QOF corporation, the FMV of the investor's QOF investment on December 31, 2026, is a key factor in determining the amount of deferred gain that the investor must recognize. The QOF investment's FMV ought to equal the price at which the QOF investment would change hands between a willing buyer and a willing seller, both having reasonable knowledge of the relevant facts and neither being under any compulsion to buy or sell. A QOF investor should be able to substantiate the value used and maintain appropriate documentation and evidence supporting the methodologies, assumptions, and inputs, including any appropriate valuation discounts, used in the valuation process.

Consideration should be given, especially when the investor is relying on a lower FMV to reduce the amount of deferred gain recognized in 2026, to obtaining a third-party valuation study to establish the QOF interest's FMV on December 31, 2026. The valuation can be adjusted downward to reflect common discounts such as lack of marketability and minority interest when appropriate and supported by market data. However, investors should be cautioned that the valuation's validity could be undermined if the investor enjoys a significant gain elimination benefit in relatively close proximity to the date of the valuation, suggesting a miraculous recovery of the business that may be too good to be true. Finally, extra care should be taken with these calculations for passthrough QOFs, especially those that have used leverage, to enable their investors to receive tax-free distributions or benefit from the allocation of partnership losses or deductions during the deferral period.

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