

Qualified Opportunity Zone Investments in Divorce: A Practitioner's Guide to the Tax Collision No One Saw Coming

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Abstract

Qualified Opportunity Zone (QOZ) investments present one of the most complex — and least understood — tax issues in modern divorce practice. When a spouse defers capital gains by investing in a Qualified Opportunity Fund (QOF) during marriage, the resulting asset carries a hidden tax liability that can profoundly affect property division. This paper examines the statutory framework of IRC Section 1400Z-2, the critical interaction between the QOZ inclusion event rules and IRC Section 1041 (the general nonrecognition provision for divorce transfers), the December 31, 2026 mandatory recognition deadline, and the recent changes enacted by the One Big Beautiful Bill Act (OBBBA). It provides practical guidance for family law attorneys, financial neutrals, and CDFAs navigating QOZ assets in collaborative and litigated divorce settings, with particular attention to Texas community property considerations.

Key Takeaway: Transferring a QOF interest to a spouse incident to divorce is an *inclusion event* under Treasury Regulations — it triggers immediate recognition of the deferred gain. IRC Section 1041's nonrecognition rule does not save you. Every divorce practitioner with a QOZ asset on the balance sheet needs to understand this before signing a property settlement.

I. Introduction: Why Family Lawyers Need to Care About Opportunity Zones

When Congress enacted the Qualified Opportunity Zone program as part of the Tax Cuts and Jobs Act (TCJA) of 2017, it created a powerful capital gains deferral incentive designed to attract investment into economically distressed communities. The program allows taxpayers to defer — and potentially reduce or eliminate — capital gains taxes by investing those gains into designated Qualified Opportunity Funds.

What Congress almost certainly did not contemplate was what happens when the investor gets divorced.

The QOZ program's intersection with divorce law creates a series of traps for the unwary:

- **The general rule for divorce property transfers (IRC 1041) does not apply.** A transfer of a QOF interest to a spouse in divorce triggers an “inclusion event,” immediately recognizing the deferred gain.
- **The 2026 deadline is a hard wall.** All deferred gains must be recognized by December 31, 2026, regardless of when the investment was made or whether the asset is sold. For divorcing couples, this creates a tax liability that must be allocated — and it may land in the middle of settlement negotiations.
- **Investments made after 2021 receive zero basis step-up.** The 5-year and 7-year holding period benefits are now mathematically impossible to achieve before the 2026 deadline for any investment made after December 31, 2021.
- **QOF interests are inherently difficult to value.** Many QOFs invest in illiquid real estate or private businesses with no public market price.

This paper is designed to give collaborative divorce professionals — attorneys, financial neutrals, mental health professionals, and CDFAs — the working knowledge they need to identify, value, and strategically divide QOZ assets in divorce.

II. The QOZ Framework: How It Works

A. Statutory Foundation: IRC Section 1400Z-2

The Qualified Opportunity Zone program is codified at IRC Section 1400Z-2, added by Section 13823 of the Tax Cuts and Jobs Act of 2017 (P.L. 115-97). The statute creates three layers of tax incentive:

1. **Temporary Deferral of Capital Gains** (IRC 1400Z-2(a)): A taxpayer who realizes a capital gain may elect to defer recognition of that gain by investing an amount equal to the gain into a Qualified Opportunity Fund (QOF) within 180 days of the sale or exchange that generated the gain.
2. **Partial Exclusion Through Basis Step-Up** (IRC 1400Z-2(b)(2)(B)): If the QOF investment is held for specified periods, the taxpayer receives a step-up in the basis of the investment:
 - **5 years:** Basis increased by 10% of the deferred gain
 - **7 years:** Basis increased by an additional 5% (total 15%) of the deferred gain
3. **Permanent Exclusion of Appreciation** (IRC 1400Z-2(c)): If the QOF investment is held for at least 10 years, the taxpayer may elect to increase the basis of the QOF interest to its fair market value on the date of sale, effectively excluding all post-investment appreciation from taxation.

B. The \$0 Basis Rule

This is counterintuitive and critically important: **the taxpayer’s initial basis in the QOF investment is zero** — not the amount invested. IRC 1400Z-2(b)(2)(A). The invested amount

represents the deferred gain, which sits “inside” the QOF interest as a latent tax liability. Basis only increases through:

- The 5-year step-up (10% of deferred gain)
- The 7-year step-up (additional 5%)
- The 10-year FMV election
- Or recognition of the deferred gain on the earlier of an inclusion event or December 31, 2026

C. The 180-Day Investment Window

The taxpayer must invest the eligible gain amount into a QOF within 180 days of the sale or exchange that generated the gain. IRC 1400Z-2(a)(1)(A). The 180-day period generally begins on the date the gain would be recognized absent the deferral election.

COVID-19 Extensions: IRS Notice 2020-39 and Notice 2021-10 extended certain deadlines for QOZ investments. Specifically, if the last day of the 180-day investment period fell on or after April 1, 2020, and before March 31, 2021, the deadline was extended to March 31, 2021. These extensions are now historical but may be relevant for determining when specific investments were made and their holding periods.

D. What Is a Qualified Opportunity Fund?

A QOF is an investment vehicle organized as a corporation or partnership (including an LLC taxed as a partnership) that holds at least 90% of its assets in Qualified Opportunity Zone Property. IRC 1400Z-2(d)(1). The fund self-certifies by filing IRS Form 8996 with its annual tax return.

QOF investments typically take the form of: - Partnership interests (most common) - Corporate stock - LLC membership interests

This matters for divorce because the form of the investment determines the transfer mechanisms available and the applicable inclusion event rules.

III. The 2026 Deadline: A Hard Wall

A. Mandatory Recognition

IRC 1400Z-2(b)(1) provides that the deferred gain is included in gross income in the taxable year that includes **the earlier of:**

1. The date on which the QOF investment is sold or exchanged, or
2. **December 31, 2026**

This is not a sunset provision that can be worked around. It is a statutory deadline. On December 31, 2026, every dollar of deferred gain in every QOF investment in America becomes taxable — whether or not the taxpayer sells, whether or not the fund is liquidated, and whether or not the taxpayer has cash to pay the tax.

B. The Basis Step-Up Math Is Now Closed for Recent Investors

For the basis step-up to apply, the investment must have been held for the requisite number of years **before** December 31, 2026:

To Achieve	Required Holding Period	Must Have Invested By
10% basis step-up	5 years	December 31, 2021
15% basis step-up	7 years	December 31, 2019
Full FMV exclusion	10 years	December 31, 2016 (pre-TCJA)

Any investment made after December 31, 2021 receives zero basis step-up before the 2026 recognition date. The full deferred gain is taxable with no offset.

This has profound implications for divorce cases involving QOF investments made in 2022 or later — including the hypothetical in our CLE case study, where Tommy Norris invested approximately \$210,000 of RSU gain into a QOF in approximately 2022.

C. Post-OBBBA Landscape

On July 4, 2025, President Trump signed the One Big Beautiful Bill Act (OBBBA, P.L. 119-21) into law. The OBBBA made the QOZ program permanent and introduced significant modifications:

For New Investments (post-December 31, 2026): - Deferral period becomes a rolling 5-year window from the date of investment (rather than the fixed 2026 date) - 10% basis step-up after 5 years retained - The additional 5% step-up at 7 years is **eliminated** - 10-year full exclusion of appreciation retained

For Rural Qualified Opportunity Funds (QROFs): - Enhanced 30% basis step-up after 5 years for investments in rural census tracts - At least 33% of newly designated OZs must be rural

For Existing Investments (pre-December 31, 2026): - **The December 31, 2026 deadline is unchanged.** Existing investors still face mandatory recognition on that date. - Existing investments still follow the original basis step-up schedule

New Reporting Requirements: - QOFs must report asset types, residential units, total asset values, employee counts, and census tract locations - Penalties for non-compliance: up to \$10,000 per return (\$50,000 for funds with over \$10M in assets)

Bottom line for divorce practitioners: The OBBBA does not rescue existing QOF investors from the 2026 deadline. If your client invested before 2027, the original rules apply.

IV. QOZ and Divorce: The IRC 1041 / 1400Z-2 Collision

This is the heart of the matter — and the section most family law practitioners have never encountered.

A. The General Rule: IRC 1041

IRC Section 1041 provides that no gain or loss is recognized on a transfer of property from an individual to: - A spouse, or - A former spouse, if the transfer is incident to divorce

The transferee takes the transferor's adjusted basis in the property (a carryover basis), and the transfer is treated as a gift for income tax purposes. IRC 1041(b). This provision has been the bedrock of tax-free property division in divorce since its enactment in 1984.

Family law practitioners are conditioned to assume that property can be transferred between divorcing spouses without triggering tax. For most assets, this is correct.

For QOF interests, it is wrong.

B. The Exception: QOF Transfers Are Inclusion Events

Treasury Regulation Section 1.1400Z2(b)-1(c) defines "inclusion events" — transactions that trigger recognition of the deferred gain before December 31, 2026. The regulation provides that:

A transfer of a qualifying investment in a QOF to a spouse pursuant to a divorce decree **is an inclusion event**, which ends the deferral period.

This is explicitly confirmed in the IRS Opportunity Zone FAQ (Q&A #38 and related guidance), which states that when the investor transfers a QOF interest to a spouse in divorce:

1. The deferral period ends
2. The investor must report the deferred gain on their tax return for the year of transfer
3. The transferee spouse receives a **non-qualifying investment** in the QOF

Read that last point again. The transferee spouse does not receive a QOF interest with deferred gain characteristics. They receive a non-qualifying investment. This means:

- The transferee spouse cannot benefit from any remaining basis step-ups
- The transferee spouse cannot elect the 10-year FMV exclusion
- The original investor bears the full tax burden of the deferred gain recognition
- The transferee's basis in the received interest equals its fair market value at the time of transfer (since the gain has been recognized)

C. Why IRC 1041 Doesn't Override 1400Z-2

The Treasury Regulations specifically carved out QOF transfers incident to divorce as inclusion events. This is not an oversight — it reflects a deliberate policy determination, one that was actively challenged and ultimately upheld.

The ACTEC Challenge

During the notice-and-comment period for the final QOZ regulations, the American College of Trust and Estate Counsel (ACTEC) submitted a formal Comment Letter to Treasury arguing that divorce transfers should *not* be treated as inclusion events. ACTEC's position:

- The conference report to the TCJA does not indicate Congressional intent to give “sale or exchange” a meaning contrary to its plain statutory language
- IRC 1041 transfers are not “sales or exchanges” — they are treated as gifts
- Treasury should adopt a rule *preventing* Section 1041 transfers from triggering inclusion events

Treasury declined to adopt ACTEC’s position. In the preamble to the final regulations (85 FR 1866, January 13, 2020), Treasury justified its broad reading of disposition events by pointing to the legislative history and the conference report. The divorce-as-inclusion-event rule was finalized as proposed.

ACTEC’s legal arguments were substantive, and some tax practitioners believe Treasury overreached. However, no taxpayer has litigated this issue, and the approaching 2026 sunset diminishes the practical significance of a challenge.

The Death vs. Divorce Asymmetry

Treasury’s treatment of death and divorce transfers reveals a striking asymmetry:

Transfer Type	Inclusion Event?	What Happens
Death	No	Deferred gain is recognized on the decedent’s final return; beneficiary does NOT inherit the deferral but receives the asset at stepped-up basis
Divorce	Yes	Transferor immediately recognizes deferred gain; transferee receives non-qualifying investment
Gift	Yes	Same as divorce — transferor recognizes deferred gain

The rationale for the asymmetry: at death, IRC 691 (income in respect of a decedent) provides an enforcement mechanism — the deferred gain is captured on the final return. For divorce and gift transfers, Treasury saw no analogous mechanism to ensure the gain would eventually be taxed, so it chose immediate recognition.

Policy Justifications (Treasury’s reasoning):

1. **Specificity:** IRC 1400Z-2 is a specific, later-enacted provision with its own inclusion event framework. Where a specific provision conflicts with a general provision (IRC 1041), the specific provision controls.
2. **Deferral vs. Exclusion:** IRC 1041 provides nonrecognition treatment — it doesn’t eliminate the gain, it defers it to the transferee. But QOZ deferral already involves a

deferral mechanism. Allowing 1041 to apply would create a “double deferral” that the statute doesn’t contemplate.

3. **Congressional Intent:** The QOZ incentive is designed to encourage investment in distressed communities. The tax benefit is tied to the investment, not to the investor’s marital status. Allowing tax-free transfers would enable gain-shifting strategies that undermine the program’s purpose.

D. Practical Implications

If You...	Then...
Transfer QOF interest to spouse in divorce	Inclusion event — transferor recognizes deferred gain immediately
Sell QOF interest to fund settlement	Inclusion event — seller recognizes deferred gain
Hold QOF interest through divorce, keep it	No inclusion event — gain still deferred until 12/31/2026
Both spouses keep their own QOF interests	No inclusion event for either
Court orders liquidation of QOF	Inclusion event — gain recognized on liquidation

V. Community Property Considerations: A Texas Focus

A. Characterization of the QOF Interest

Under Texas Family Code Sections 3.001-3.003, property acquired during marriage is presumed community property. Separate property is property owned before marriage, acquired during marriage by gift or inheritance, or recovered for personal injuries.

The characterization question for QOF interests has multiple layers:

Layer 1: The Original Capital Gain What asset generated the capital gain that was rolled into the QOF? If the gain came from: - **Separate property** (e.g., pre-marital stock, inherited property): The gain itself retains the separate property character - **Community property** (e.g., assets acquired during marriage): The gain is community

Layer 2: The QOF Investment Under Texas’s “inception of title” doctrine, the character of property is determined at the time the right to acquire it arises. When a spouse invests capital gains into a QOF during marriage: - If the gains were separate property, the QOF interest arguably retains separate character (as traceable proceeds of separate property) - If the gains were community property, the QOF interest is clearly community

Layer 3: The Commingling Problem In practice, QOF investments often involve commingling: - Were community funds used to pay management fees or capital calls? - Was community effort involved in selecting or managing the QOF investment? - Have distributions been made to a community account?

Any of these may create a community interest through the doctrines of reimbursement or constructive trust, even if the original investment was separate property.

B. The Norris Hypothetical

In our CLE case study, Tommy Norris sold vested ExxonMobil RSUs approximately four years ago, generating roughly \$210,000 in capital gains. He rolled those gains into a QOF. The RSUs themselves vested partly during marriage (community) and partly before marriage (separate, subject to the coverture fraction analysis). The characterization of the QOF interest therefore depends on:

1. Whether the RSUs that were sold were community or separate property tranches
2. Whether the QOF investment was funded entirely from RSU sale proceeds or was supplemented with community funds
3. Whether any community effort was involved in managing the QOF investment

Angela does not know the QOF exists — it is undisclosed. Under Texas Family Code Section 7.009, the court may grant a disproportionate division of the community estate if one spouse has committed fraud on the community, which includes concealing community assets.

C. The “Just and Right” Division

Texas Family Code Section 7.001 directs the court to divide the community estate in a manner that is “just and right, having due regard for the rights of each party and any children of the marriage.”

For QOF interests, a “just and right” division must account for:

1. **The embedded tax liability:** The deferred gain is a real liability that will crystallize no later than December 31, 2026. It must be treated as a liability on the property division balance sheet.
 2. **The illiquidity premium:** QOF interests in private funds cannot be readily sold. The party receiving the QOF interest bears liquidity risk.
 3. **The inclusion event trap:** If the decree transfers the QOF interest to the non-investing spouse, it triggers immediate gain recognition for the investing spouse. The decree must account for who bears this tax cost.
 4. **Future appreciation potential:** If the investment is held for 10+ years, future appreciation may be excluded from tax. This upside potential should be considered in valuation.
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VI. Valuation Challenges

A. No Public Market

Most QOF interests are partnership interests in private funds investing in real estate development or private businesses. There is no ticker symbol, no daily price, and no market maker. Valuation typically requires:

- **Net Asset Value (NAV):** The fund's assets minus liabilities, allocated to the investor's interest
- **Independent appraisal:** For underlying real estate or business assets
- **K-1 reporting:** The fund's annual Schedule K-1 will report the investor's share of income, loss, and capital account balance
- **Subscription/redemption agreements:** May contain valuation provisions or transfer restrictions

B. Tax-Affecting the Value

The fair market value of a QOF interest on the property division balance sheet is **not** the same as its economic value to the holder. The embedded deferred gain creates a "tax overhang" that reduces the net value:

Formula:

Net Value = Fair Market Value of QOF Interest
- Deferred Gain Tax Liability (gain × applicable tax rate)
+ Present Value of Remaining Tax Benefits (if any)

Example (Norris hypothetical): - QOF interest FMV: \$285,000 - Original deferred gain: \$210,000 - Applicable capital gains rate: ~23.8% (20% federal + 3.8% NIIT) - Deferred gain tax liability: $\$210,000 \times 23.8\% = \$49,980$ - Basis step-up benefit: \$0 (investment made after 2021) - **Net value: \$285,000 - \$49,980 = \$235,020**

If the net value of the QOF interest is placed on the balance sheet at \$285,000 without accounting for the \$49,980 tax liability, the receiving spouse appears to get more than they actually receive.

C. Discount Considerations

Additional discounts may apply:

- **Lack of marketability discount** (typically 15-35%): No ready market for private fund interests
- **Minority interest discount** (if applicable): If the investor holds a small percentage of the fund
- **Transfer restriction discount:** Many QOF operating agreements restrict or prohibit transfers

These discounts are negotiable in collaborative settings and may be contested in litigation.

VII. Tax Liability Allocation Strategies

The deferred gain tax liability must be allocated between the spouses in the property division. There are several approaches:

A. Assign Both Asset and Liability to One Spouse

The simplest approach: the spouse who holds the QOF interest keeps it and bears the tax liability. The property division balance sheet shows:

- **Asset:** QOF interest at FMV (credited to that spouse)
- **Liability:** Deferred gain tax (debited to that spouse)

The net is credited to that spouse's column. The other spouse receives offsetting assets of equivalent net value.

Advantage: Clean. No transfer, no inclusion event. **Disadvantage:** The investing spouse may not have sufficient other assets to offset, creating an imbalanced division.

B. Offset with Other Assets

If the investing spouse keeps the QOF interest, the non-investing spouse receives additional assets (or a larger share of other community assets) to compensate for: - The tax liability the investing spouse will bear in 2026 - The illiquidity premium - Any discount applied to the QOF interest

This is the most common approach in collaborative settings.

C. Indemnification Provisions

The decree should include robust indemnification language:

- The investing spouse indemnifies the non-investing spouse against any tax liability arising from the QOF investment
- If the QOF generates unexpected income or loss, the investing spouse bears the consequence
- If the 2026 recognition event creates a larger-than-expected tax bill, the non-investing spouse is held harmless

D. Present Value Discounting

The 2026 tax liability is a future obligation. Some practitioners discount it to present value as of the divorce date. Using a discount rate of 3-5%:

- Tax liability due December 31, 2026: \$49,980
- If divorce is finalized June 2026: ~6 months → negligible discount
- If divorce is finalized January 2025: ~24 months → PV at 4% ≈ \$46,200

In practice, the discount is modest given the short timeframe to the 2026 deadline.

E. Joint Filing Strategy

If the divorce is finalized in 2026 (the year of mandatory gain recognition), the parties may benefit from filing jointly for that tax year if: - The divorce is finalized late in 2026 (they were married for part of the year) - Filing jointly produces a lower tax rate on the recognized gain - Both parties agree (which requires cooperation)

Caution: Joint filing creates joint and several liability for the entire return. This must be carefully evaluated and may require an indemnification agreement.

VIII. Strategic Planning: Timing the Divorce Around QOZ Deadlines

A. The Timing Matrix

Divorce Finalized	QOZ Consequence	Planning Consideration
Before 12/31/2026 (no QOF transfer)	Gain recognized 12/31/2026 by investing spouse	Clean — investing spouse bears tax, offset in division
Before 12/31/2026 (with QOF transfer)	Inclusion event at transfer — gain recognized immediately by investing spouse	TRAP — triggers immediate tax + transferee gets non-qualifying interest
After 12/31/2026	Gain already recognized; QOF interest is now a regular investment	Simplest tax picture — but requires delaying divorce
During 2026	Gain recognized 12/31/2026; filing status affects rate	Consider joint filing if still married on 12/31/2026

B. Should You Delay the Divorce?

In some cases, it may be strategically advantageous to finalize the divorce *after* December 31, 2026:

Advantages: - The deferred gain will have been recognized and taxed already - The QOF interest becomes a regular investment (no longer “qualifying”) - IRC 1041 applies normally to transfers of regular investments - No inclusion event trap - The tax liability is known (not estimated)

Disadvantages: - Delays finalization, which may be unacceptable to one or both parties - Requires cooperation on 2026 tax filing (if filing jointly) - The recognized gain increases 2026 AGI, potentially affecting other deductions and credits

C. The Collaborative Advantage

In collaborative divorce, the team has the flexibility to:

1. **Time the agreement:** Structure the Marital Settlement Agreement to avoid transferring the QOF interest, keeping it with the investing spouse and offsetting with other assets
 2. **Coordinate tax planning:** Work with both parties' tax advisors to optimize the 2026 filing
 3. **Manage disclosure:** Ensure the QOF investment is fully disclosed early in the process (unlike our hypothetical, where Tommy concealed it)
 4. **Build in contingencies:** Draft settlement terms that account for the 2026 recognition event, including tax true-up provisions if the actual liability differs from estimates
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IX. Practical Guidance for the Collaborative Team

A. For Family Law Attorneys

Discovery/Disclosure Checklist — Identifying QOZ Investments:

- Request all IRS Forms 8949 and Schedule D for the last 7 years (identify deferred gains)
- Request IRS Form 8997 (Initial and Annual Statement of QOF Investments) for all years filed
- Request Schedule K-1s from any partnership, S-corp, or trust (look for QOZ-related entries)
- Request QOF subscription agreements, operating agreements, and side letters
- Request all brokerage and investment account statements (look for QOF investments)
- Ask directly: "Have you invested in any Qualified Opportunity Zone fund or similar tax deferral investment?"
- Search tax returns for Form 8949 entries showing deferred gain elections (Code "Z" in column (f))
- Review capital gains and losses from prior years — large gains with no corresponding tax may indicate QOZ deferral

Red Flags That a QOF Investment May Exist:

- Large capital gains realized in a prior year with lower-than-expected tax liability
- References to "opportunity zone," "QOF," or "qualified opportunity fund" in financial records
- Investments in LLCs or LPs that you cannot identify by name
- K-1s from entities you don't recognize
- Correspondence from QOF managers or administrators
- IRS Form 8997 filed with any tax return

Settlement Drafting — Key Provisions:

1. **QOZ Asset Allocation:** Specify who retains the QOF interest; do NOT transfer it unless you intend to trigger the inclusion event
2. **Tax Indemnification:** Investing spouse indemnifies non-investing spouse against all QOZ-related tax liability
3. **2026 Tax True-Up:** If the actual tax liability upon 2026 recognition differs materially from the estimate used in the division, include a true-up mechanism
4. **Cooperation Clause:** Require both parties to cooperate on 2026 tax filing, including potential joint filing if beneficial
5. **QOF Reporting:** Investing spouse agrees to provide copies of Form 8997, K-1s, and any QOF communications to the other party through 2027 filing

B. For Financial Neutrals / CDFAs

Valuation Framework:

1. **Determine the QOF's NAV:** Request the most recent fund valuation, audited financial statements, or capital account statement
2. **Identify the deferred gain amount:** This is the original capital gain that was invested, not the current value of the QOF interest
3. **Calculate the embedded tax liability:** Deferred gain \times applicable capital gains rate (federal + state + NIIT)
4. **Assess basis step-up eligibility:** Is the investment old enough to qualify for any step-up before 12/31/2026?
5. **Apply appropriate discounts:** Lack of marketability, minority interest, transfer restrictions
6. **Present the net value:** FMV minus tax liability minus discounts = net value for property division

Balance Sheet Presentation:

Item	H	W	Character	Notes
QOF Interest (FMV)	\$285,000	—	Disputed	Undisclosed; valuation per fund NAV
QOZ Deferred Tax Liability	(\$49,980)	—	Community	HARD DEADLINE: Dec 31, 2026
QOF Net Value	\$235,020	—		

Communication Tips:

- Explain the QOZ concept in plain language: “Tommy deferred a large tax bill by investing the money in a special fund. That tax bill comes due December 31, 2026 no matter what.”
- Use the phrase “tax bomb” — it’s vivid and accurate

- Show the impact on both sides: the QOF interest has value, but it carries a liability that will hit on a specific date
- Emphasize that transferring the QOF interest to Angela would immediately trigger the tax for Tommy — this is not a neutral action

C. For Mental Health Professionals

The QOZ issue is likely to be emotionally charged because:

1. **It may involve concealment:** If one spouse invested without the other’s knowledge, disclosure triggers betrayal and trust issues
2. **It involves a deadline:** The 2026 date creates urgency that may conflict with the emotional timeline of the divorce
3. **It involves technical complexity:** One spouse (typically the investor) understands the QOZ; the other may feel at a disadvantage
4. **It forces a decision:** The divorce team must allocate the QOF interest and the tax liability — there is no option to “deal with it later”

MHP Facilitation Strategies:

- Normalize the complexity: “This is genuinely complicated. Even tax professionals find this challenging.”
 - Validate the non-investing spouse’s confusion and frustration
 - Reframe concealment as a problem to solve, not a character indictment
 - Help both parties understand that the tax liability is a shared problem, regardless of who “caused” it
 - Monitor for decision fatigue — QOZ issues often arise after hours of other financial discussions
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X. Case Illustration: The Norris QOZ Problem

Based on the CDT Advanced Training Case Study

Facts

Tommy Norris left ExxonMobil approximately four years ago. Upon departure, he sold vested Restricted Stock Units (RSUs), generating approximately \$210,000 in capital gains. Rather than paying the tax, Tommy invested the full gain amount into a Qualified Opportunity Fund — a real estate development fund investing in a designated Opportunity Zone in the Permian Basin.

Angela Norris does not know this investment exists.

The QOF interest has appreciated to an estimated fair market value of \$285,000. Tommy’s holding period is approximately four years (investment made circa 2022).

Analysis

Basis Step-Up: Zero. The investment was made after December 31, 2021. Tommy cannot achieve even the 5-year/10% step-up before December 31, 2026. The full \$210,000 deferred gain will be recognized with no basis offset.

Tax Liability: $\$210,000 \times 23.8\%$ (20% federal capital gains + 3.8% NIIT) = **\$49,980**. This liability crystallizes on December 31, 2026 regardless of the divorce.

Characterization: The RSUs sold were a mix of separate and community property (subject to coverture fraction analysis). The QOF investment was funded from RSU sale proceeds during marriage. Under Texas's inception-of-title doctrine, the QOF interest's character follows the character of the proceeds used to fund it — which itself depends on which RSU tranches were sold.

Disclosure: Tommy has not disclosed the QOF investment. Under Texas Family Code Section 7.009, failure to disclose community assets may support a disproportionate division. In a collaborative setting, this non-disclosure violates the participation agreement and, if discovered, threatens the entire process.

Division Strategy: The recommended approach:

1. Tommy retains the QOF interest (avoids the inclusion event trap)
2. The \$49,980 tax liability is shown on the balance sheet as a liability against Tommy
3. The net QOF value (\$235,020) is credited to Tommy's column
4. Angela receives offsetting community assets of equivalent value
5. The decree includes tax indemnification and a 2026 true-up provision
6. If the parties are still married on December 31, 2026, they may benefit from a joint return for that year

What Could Go Wrong

- If the settlement transfers the QOF interest to Angela → inclusion event → Tommy immediately owes tax on \$210,000 gain
 - If the QOF interest is liquidated to fund the settlement → inclusion event → same result
 - If the tax liability is ignored on the balance sheet → Angela appears to receive less value than she actually does
 - If the parties divorce before 2026 without addressing the tax → Tommy gets surprised by a \$50K tax bill
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XI. The One Big Beautiful Bill Act: What Changed and What Didn't

As noted in Section III.C above, the OBBBA (signed July 4, 2025) significantly modified the QOZ program going forward. For divorce practitioners, the key distinctions are:

What Changed (Post-2026 Investments)

- Rolling 5-year deferral period (instead of fixed 2026 date)

- Program made permanent
- New rural opportunity zone incentives (30% basis step-up)
- Enhanced reporting requirements
- Elimination of the 7-year additional step-up

What Did NOT Change (Existing Investments)

- **December 31, 2026 deadline:** Unchanged for all existing investments
- **Inclusion event rules:** Transfer in divorce still triggers recognition
- **Basis step-up schedule:** Still 10% at 5 years (if achievable), 15% at 7 years
- **10-year exclusion:** Still available for investments held long enough

Implications for Divorce Cases Filed After OBBBA

If a post-2026 QOF investment is involved in a divorce, the analysis is largely the same: - Transfer to a spouse will likely still be an inclusion event (the OBBBA did not change this provision) - The rolling 5-year deferral means the recognition date is investment-specific, not universal - The enhanced reporting requirements may make QOF investments easier to discover during disclosure

XII. Open Questions and Areas of Uncertainty

Several issues at the intersection of QOZ and divorce law remain unsettled:

1. **Can parties agree to allocate the 2026 tax liability differently than the property division?** The IRS is not bound by divorce decrees for purposes of determining who owes tax. The investing spouse will owe the tax regardless of what the decree says. Indemnification shifts the economic burden but not the legal liability.
 2. **What if both spouses hold QOF interests?** If both invested separately, each faces their own inclusion event / 2026 deadline analysis. The property division must account for both.
 3. **How do state tax implications interact?** Texas has no state income tax, simplifying the analysis. But in states with income tax, the state treatment of QOZ gains may differ from federal.
 4. **Can a QOF interest be divided without transferring it?** Potentially, if the fund's operating agreement allows the creation of a new interest or a partition of the existing one. This is fund-specific and requires review of the governing documents.
 5. **What happens if the QOF fails the 90% asset test?** If the fund ceases to qualify as a QOF, the tax consequences change. The investment may still be held, but the favorable QOZ treatment may be lost.
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XIII. Conclusion

Qualified Opportunity Zone investments in divorce represent a genuine collision between two areas of tax law that were never designed to work together. The family law practitioner’s instinct — “property transfers in divorce are tax-free under IRC 1041” — is flatly wrong for QOF interests.

The key principles to remember:

1. **Transferring a QOF interest in divorce = inclusion event = immediate tax hit to the investing spouse**
2. **December 31, 2026 is a hard deadline** for all existing investments — the gain will be recognized
3. **Post-2021 investments get zero basis step-up** before the 2026 deadline
4. **The QOF interest should generally stay with the investing spouse** to avoid triggering the inclusion event
5. **The embedded tax liability must appear on the property division balance sheet**
6. **Robust indemnification and tax true-up provisions are essential**

For collaborative divorce teams, QOZ issues reward early identification, transparent disclosure, and creative problem-solving. The financial neutral who can explain a QOZ tax bomb in plain language, and the attorney who can draft settlement terms that navigate the inclusion event rules, will serve their clients far better than those who discover the issue after the decree is signed.

Appendix A: Key Statutory and Regulatory Citations

Citation	Subject
IRC § 1400Z-2	QOZ statutory framework (TCJA 2017)
IRC § 1400Z-2(a)	Deferral election
IRC § 1400Z-2(b)(1)	Recognition deadline (earlier of sale or 12/31/2026)
IRC § 1400Z-2(b)(2)(A)	\$0 initial basis rule
IRC § 1400Z-2(b)(2)(B)	Basis step-up schedule (5yr/7yr)
IRC § 1400Z-2(c)	10-year exclusion of appreciation
IRC § 1400Z-2(d)(1)	QOF definition and 90% asset test
IRC § 1041	Nonrecognition on transfers between spouses/incident to divorce
Treas. Reg. § 1.1400Z2(a)-1	Deferral rules
Treas. Reg. § 1.1400Z2(b)-1	Inclusion of deferred gains
Treas. Reg. § 1.1400Z2(b)-1(c)	Definition of inclusion events
Treas. Reg. § 1.1400Z2(c)-1	10-year election rules
TD 9889 (Jan. 13, 2020)	Final QOZ regulations

Citation	Subject
IRS Notice 2020-39	COVID-19 deadline extensions
IRS Notice 2021-10	Additional COVID-19 relief
IRS Form 8949	Capital gains/losses reporting (Code “Z” for QOZ deferrals)
IRS Form 8997	QOF investment annual statement
P.L. 119-21 (July 4, 2025)	One Big Beautiful Bill Act — QOZ program made permanent
Texas Family Code § 3.001-3.003	Community/separate property definitions
Texas Family Code § 7.001	“Just and right” division standard
Texas Family Code § 7.009	Fraud on the community

Appendix B: QOZ Divorce Checklist

Phase 1: Discovery and Identification - Request Forms 8949, Schedule D, and Form 8997 for all relevant tax years - Request K-1s from all partnerships, S-corps, and trusts - Request all investment account statements - Ask directly about QOZ investments in sworn inventory - Review prior-year returns for deferred gain elections (Code “Z”) - Search for QOF subscription agreements, operating agreements, and correspondence

Phase 2: Valuation - Obtain most recent QOF NAV or capital account statement - Request independent appraisal of underlying fund assets if needed - Calculate embedded tax liability (deferred gain × tax rate) - Assess eligibility for any basis step-up before 12/31/2026 - Apply appropriate valuation discounts (marketability, minority, transfer restrictions) - Determine net value for balance sheet (FMV - tax - discounts)

Phase 3: Characterization - Trace source of funds used to make QOF investment - Determine character of original capital gain (community vs. separate) - Analyze whether community funds contributed to QOF (fees, capital calls) - Apply inception-of-title doctrine (Texas) or applicable state law - Document any commingling or community effort claims

Phase 4: Division Strategy - Determine whether QOF interest will remain with investing spouse (preferred) - If transfer is contemplated, understand that it IS an inclusion event - Calculate offsetting assets needed to balance the division - Draft indemnification language for tax liability - Draft 2026 tax true-up provision - Consider joint filing strategy for 2026 if parties are still married - Include QOF reporting/disclosure obligations in decree

Phase 5: Post-Decree Monitoring - Ensure investing spouse files Form 8997 for the year of divorce - Monitor 2026 tax filing and gain recognition - Execute true-up if actual tax differs from estimate - Verify indemnification compliance

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This white paper is prepared for educational purposes as part of the CDT Advanced Training CLE program. It does not constitute legal or tax advice. The tax treatment of QOZ investments is

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