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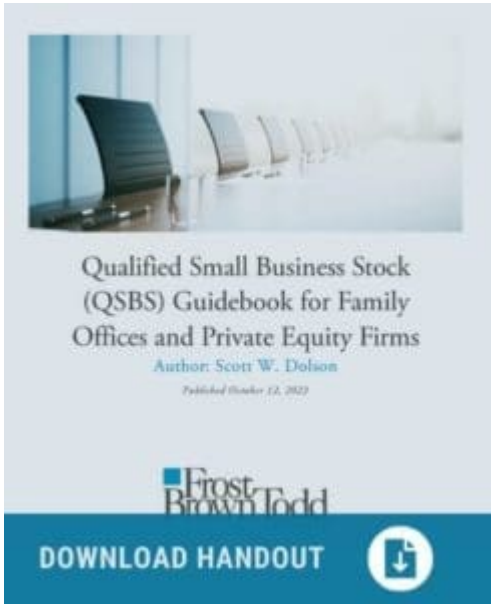
Substantiating the Right to Claim QSBS Tax Benefits | Part 2

Section 1202 provides an exclusion from capital gains when a stockholder sells qualified small business stock (**QSBS**), assuming all eligibility requirements are satisfied.[1]

Section 1045 provides for a deferral of gain arising out of a sale of QSBS if proceeds are rolled over into replacement QSBS.

The tax benefits associated with claiming Section 1202's gain exclusion or rolling over QSBS sales proceeds under Section 1045 are usually significant. Excluding $10 million of capital gain when an investment in QSBS is sold translates into $2.38 million of tax savings at the federal level.[2] The One Big Beautiful Bill Act (**OBBBA**) increased the basic per-taxpayer gain exclusion cap from $10 million to $15 million for QSBS issued after July 4, 2025.[3] Rolling proceeds from the sale of an investment in QSBS into replacement QSBS not only defers gain but also positions a taxpayer to claim Section 1202's gain exclusion when the replacement QSBS is later transferred in a taxable sale or exchange.



Previous articles have addressed the tax benefits associated with Section 1202's gain exclusion and how the statute works. For a number of articles discussing the benefits, requirements and

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planning for Sections 1202 and 1045, including the changes made by OBBBA, see the QSBS library.

Section 1202's generous gain exclusion is undoubtedly attractive and even more so after OBBBA, with its increased gain exclusion and ratcheted holding periods, has further enhanced the benefits. [4] But Section 1202's benefits, along with those of Section 1045, are available only if a score of complicated eligibility requirements are satisfied. Given the obvious benefits associated with qualifying for the gain exclusion, there is a risk that taxpayers might place too much reliance on uninformed advice or unsupported and undocumented statements regarding eligibility, none of which will help if there is a hefty tax bill associated with a failed return position. The purpose of this article is to both alert taxpayers to the challenges associated with substantiating a QSBS return position, along with discussing process and methods for accomplishing that task.

Part 1 of this article breaks down the evidence required to substantiate each QSBS-related eligibility requirement.

Part 2 addresses the following: (I) Circular 230; (II) the role of attestations and QSBS Issuer Certificates; (III) the role of tax advice and tax opinions; (IV) tax insurance; (V) relevant aspects of IRS tax forms and tax returns, including reporting by partnership and partner Schedule K-1s; (VI) tax practice and procedure; and (VII) tax penalties.

I. Circular 230 (regulations governing the practice of tax professionals before the IRS)

Circular 230 is the common name of the regulations issued by the Treasury Department that govern the practice of tax professionals before the IRS.[5] Circular 230 applies to all practitioners (attorneys, CPAs, enrolled agents, and others authorized to practice before the IRS) and, among other things, sets forth the requirements for providing written advice on federal tax matters. Tax practitioners providing written tax advice need to be familiar with Section 10.37 of Circular 230. The rules established by Section 10.37 apply to all written advice (including electronic communications such as emails and memos) concerning one or more federal tax

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matters. A "federal tax matter" is broadly defined as any matter concerning the application or interpretation of revenue provisions, any law impacting obligations under the internal revenue laws, or any other law or regulation administered by the IRS.

Circular 230's requirements for the providing of written tax advice should also be of interest to taxpayers. If the tax professional's work product does not meet the requirements of Section 10.37 of Circular 230, the tax advice is also unlikely to satisfy Treasury Regulation Section 1.6664-4(c), which outlines the requirements for taxpayers seeking penalty abatement. Section 10.37(b), along with Treasury Regulation Section 1.6694 (discussed below) address the requirements for a tax professional relying on the tax advice of other tax professionals. Taxpayers who find that their tax professionals and/or return preparers are relying on the tax advice of other tax professionals with respect to return positions should have an awareness of these requirements.

The following Circular 230 requirements apply when providing written tax advice:

Section 10.37 Requirements for written advice.

(a) ***Requirements***.

(1) A practitioner may give written advice (including by means of electronic communication) concerning one or more Federal tax matters subject to the requirements in paragraph (a)(2) of this section. Government submissions on matters of general policy are not considered written advice on a Federal tax matter for purposes of this section. Continuing education presentations provided to an audience solely for the purpose of enhancing practitioners' professional knowledge on Federal tax matters are not considered written advice on a Federal tax matter for purposes of this section. The preceding sentence does not apply to presentations marketing or promoting transactions.

(2) The practitioner must—

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(i) Base the written advice on reasonable factual and legal assumptions (including assumptions as to future events);

(ii) Reasonably consider all relevant facts and circumstances that the practitioner knows or reasonably should know;

(iii) Use reasonable efforts to identify and ascertain the facts relevant to written advice on each Federal tax matter;

(iv) Not rely upon representations, statements, findings, or agreements (including projections, financial forecasts, or appraisals) of the taxpayer or any other person if reliance on them would be unreasonable; Treasury Department Circular No. 230

(v) Relate applicable law and authorities to facts; and

(vi) Not, in evaluating a Federal tax matter, take into account the possibility that a tax return will not be audited or that a matter will not be raised on audit.

(3) Reliance on representations, statements, findings, or agreements is unreasonable if the practitioner knows or reasonably should know that one or more representations or assumptions on which any representation is based are incorrect, incomplete, or inconsistent.

(b) ***Reliance on advice of others****. A practitioner may only rely on the advice of another person if the advice was reasonable and the reliance is in good faith considering all the facts and circumstances. Reliance is not reasonable when—*

(1) The practitioner knows or reasonably should know that the opinion of the other person should not be relied on;

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(2) The practitioner knows or reasonably should know that the other person is not competent or lacks the necessary qualifications to provide the advice; or

(3) The practitioner knows or reasonably should know that the other person has a conflict of interest in violation of the rules described in this part.

(c) ***Standard of review****.*

(1) In evaluating whether a practitioner giving written advice concerning one or more Federal tax matters complied with the requirements of this section, the Commissioner, or delegate, will apply a reasonable practitioner standard, considering all facts and circumstances, including, but not limited to, the scope of the engagement and the type and specificity of the advice sought by the client.

(2) In the case of an opinion the practitioner knows or has reason to know will be used or referred to by a person other than the practitioner (or a person who is a member of, associated with, or employed by the practitioner's firm) in promoting, marketing, or recommending to one or more taxpayers a partnership or other entity, investment plan or arrangement a significant purpose of which is the avoidance or evasion of any tax imposed by the Internal Revenue Code, the Commissioner, or delegate, will apply a reasonable practitioner standard, considering all facts and circumstances, with emphasis given to the additional risk caused by the practitioner's lack of knowledge of the taxpayer's particular circumstances, when determining whether a practitioner has failed to comply with this section.

(d) ***Federal tax matter****. A Federal tax matter, as used in this section, is any matter concerning the application or interpretation of –*

(1) A revenue provision as defined in section 6110(i)(1)(B) of the Internal Revenue Code;

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(2) Any provision of law impacting a person's obligations under the internal revenue laws and regulations, including but not limited to the person's liability to pay tax or obligation to file returns; or

(3) Any other law or regulation administered by the Internal Revenue Service.

Other relevant Circular 230 sections include:

Competence (Section 10.35): Practitioners must possess the necessary competence (knowledge, skill, thoroughness, and preparation) for the matter at hand. Competence can be achieved by research or consulting with experts.

Due diligence (Section 10.22): Practitioners must exercise due diligence in preparing and filing tax returns, documents, and in determining the correctness of representations made to the IRS or to clients. The general maxim is that tax advisors are not required to audit or verify information absent a reason for doing so. Nevertheless, the failure to undertake reasonable due diligence when the situation merits it might suggest that a practitioner did not meet the competency standards established in Section 10.35.

Standards for tax return positions (Section 10.34): Practitioners may not sign a return or advise a position that lacks a reasonable basis, is an unreasonable position, or is a willful attempt to understate tax liability or is reckless or intentional disregard of rules or regulations.

Section 10.36 of Circular 230 includes procedures to ensure compliance with the IRS rules and provides that individuals who have principal authority and responsibility for overseeing a firm's tax practice may be disciplined (sanctions for violation of Circular 230 found at Section 10.50, including censure, suspension or disbarment)) if the individual "*through willfulness, recklessness, or gross incompetence does not take reasonable steps to ensure that the firm has adequate procedures to comply with [Circular 230]*" and those employed by the firm engage "*in a pattern or practice, in connection with their practice with the firm, of failing to comply*

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with [Circular 230]."

II. The role of attestations and QSBS Issuer certificates

A. What is an attestation?

An "attestation" is generally a memorandum or statement, sometimes prepared in a checklist format, confirming that Section 1202's QSBS Issuer-level eligibility requirements are satisfied as of the date of the attestation. The attestation is sometimes coupled with a general discussion of Section 1202 issues or a customized analysis taking into account the applicable facts. Unlike reasoned tax opinions, attestations rarely address contrary or conflicting tax authorities. Typically, attestations do not set forth in detail the qualifications of the attestation's author, the process undertaken to reach the conclusions set forth in the attestation, or the underlying facts, tax authorities and analysis supporting the attestation's conclusions. Attestations are generally issued by tax professionals or financial services companies. Attestations are often provided periodically as part of a package of corporate and/or valuation related services, but some attestations are issued on a one-off basis, usually in connection with events such as stock issuances or a sale process, or periodically (typically annually) as part of a package of corporate and/or valuation related services. Attestations are often commissioned by the QSBS Issuer and address only QSBS Issuer eligibility requirements. But some attestations are commissioned by individual taxpayers and address both QSBS Issuer and taxpayer level eligibility requirements.

The principal role of attestations is providing the recipient with the comfort of knowing that the author has undertaken a certain level of review of the applicable facts and tax authorities, and based on that review and the author's analysis, has concluded either that the QSBS Issuer eligibility requirements were satisfied as of the a certain date or that a particular taxpayer's stock is QSBS. Attestations are often used for internal planning purposes, although they are sometimes provided to or obtained by taxpayers as support for taking return positions and claiming QSBS-related

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benefits.

There are a growing number of tax professionals and third-party service providers issuing attestations. Potential customers should consider several factors when deciding whether to obtain an attestation or choosing among tax professionals or other purveyors of attestations.

Potential customers should consider the following when seeking an attestation:

- who will undertake the review and prepare the attestation and that individual's expertise and experience. An attestation is only as good as its author. Also, if the attestation is structured to qualify as "tax advice," potential customers should consider the statement in *Neonatology Associates, PA v. Commissioner*,[6] where the Tax Court noted that the reasonable cause reliance on tax advice requires that the taxpayer prove that *"[t]he advisor was a competent professional who had sufficient expertise to justify reliance. . . ."*

- the review process (i.e., what documents are reviewed, certification of facts obtained and analysis undertaken) undertaken by the attestation's author.

- the "quality" of the written work product (perhaps based on reviewing examples of a sample work product?).

- whether the attestation will specifically provide that it cannot be relied upon as "tax advice" in connection with taking a return position or establishing reasonable cause for seeking penalty mitigation.

- how the author's analysis (if any) and conclusions are set forth in the attestation –will the attestation consist of conclusory statements regarding QSBS status or each eligibility requirements or will the attestation include any detailed background information and analysis regarding how the conclusion was reach or why eligibility requirements were satisfied.

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- will the format and content of the attestation be useful in assisting taxpayers in their decision to take a return position or provide a useful roadmap for defending an audit or tax controversy.

- how does the issuer of the attestation handle the situation where a difficult or problematic issue is identified in the review process – will the issuer handle the issue internally, outsource the issue to another tax professional for more in-depth analysis or terminate the issuance process.

Many attestations are clear that they do not serve that function, which doesn't necessarily mean that the attestation doesn't serve a useful function.[7] Nevertheless, potential customers should understand the role of an attestation and what the attestation does and does not accomplish with respect to the customers' efforts to substantiate QSBS-related return positions and, if necessary, seek abatement of penalties. "Attestations" are often not intended or structured to meet the standards for written tax advice that serves as a basis for establishing a taxpayer's reasonable-cause defense – that the advice is based upon "*all pertinent facts and circumstances and the law as it relates to those facts and circumstances*," must not be based on "*unreasonable factual or legal assumptions*," and must not "*unreasonably rely on representations, statements, findings, or agreements of the taxpayer or any other person*" (see Treasury Regulation Section 1.6664-4(c)).

Finally, while a reasoned tax opinion from a competent tax professional addressing in great detail each Section 1202 eligibility requirement might be preferable over a short-form conclusory attestation, there is a definite cost difference. QSBS Issuers or taxpayers who elect to rely on an attestation for planning purposes might later consider obtaining a tax opinion and/or tax insurance in connection with later claiming the QSBS-related return position.

B. Timing of the attestation's issuance.

Generally, the best time to obtain an attestation is when there is an event occurring where it is meaningful to confirm that the QSBS

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Issuer remains a "qualified small business" or a taxpayer's stock qualifies as QSBS. For example, obtaining an attestation prior to the issuance of equity compensation, a capital raise from investors, or commencement of an M&A process might contribute meaningfully to the planning process.

C. Limitations on the utility of attestations and the significance of whether attestations qualify as "tax advice."

Some attestations address only QSBS Issuer level eligibility requirements. Obviously, it is important to know whether those QSBS Issuer level eligibility requirements are satisfied at a relevant point in time. Attestations can be obtained on behalf of the QSBS Issuer or taxpayers (stockholders) that address both QSBS Issuer eligibility requirements and the specific taxpayer eligibility requirements. If the attestation only addresses QSBS Issuer level eligibility requirements, the stockholder will need to take steps to substantiate satisfaction of each taxpayer-level eligibility requirement, which might include separately contracting for a taxpayer-level attestation.

Attestations do not generally address how outstanding QSBS will be affected by a planned recapitalization, stock redemption, equity rollover or other restructuring, nor whether stock issued in the next equity raise will qualify as QSBS (for example, whether the "aggregate gross asset" test will be passed in connection with the proposed capital raise). That planning advice must generally be obtained on a one-off basis from a tax professional (tax accountant or tax attorney). Most third-party attestations are not structured as a thorough reasoned written analysis of tax issues, and as a result have limited utility when preparing for a tax audit. There is no way to know in advance whether an IRS agent might accept as acceptable substantiation some or all of the conclusions reached by an attestation. An IRS revenue agent could take conclusions in the attestation at face value or possibly take the position that the attestation is not sufficient substantiation and must be discounted as evidence in the absence of supporting certificates from management and other relevant substantiation. The quality and

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thoroughness of the attestation is likely to be a significant factor in determining its value during the course of an audit.

Depending on the identity of the provider (e.g., tax professional or other), there can be certain limits as to the utility of attestations. Unless the attestation is structured to qualify as tax advice from a tax professional to a specific taxpayer (generally the taxpayer claiming Section 1202's gain exclusion) and the written advice meets the requirements of Treasury Regulation Section 1.6664-4(c) (discussed in Section III. F. below), the attestation will generally not qualify as "tax advice" for purpose of seeking penalty abatement under Sections 6662 and 6664.

D. Final thoughts regarding attestations.

Attestations can be a valuable tool for QSBS planning and substantiation if the timing of the attestation's issuance makes sense, the process followed in preparing the attestation results in the consideration of applicable facts and tax authorities, and the issuer has sufficient expertise to prepare, and makes the effort to prepare, a quality written work product.

Note that unless advised otherwise by a competent tax professional, neither the taxpayer nor a QSBS Issuer should attach an attestation to a tax return or provide a copy of the attestation to the IRS.

E. QSBS Issuer certificates.

Certificates provided by the QSBS Issuer generally confirm facts that help substantiate satisfaction of QSBS Issuer level eligibility requirements and/or confirm that any documents, tax returns and financial statement provided were true, correct and complete copies. Certificates are often a necessary part of substantiating eligibility to claim Section 1202's gain exclusion because certain facts may only be known to management personnel with actual knowledge of the QSBS Issuer's financial matters. There are QSBS Issuers who won't cooperate with their stockholders, and fund management who won't cooperate with their partners, both perhaps often driven by fear that cooperation will lead to claims

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that the party was providing faulty tax advice. Knowing this, stockholders and partners should pursue obtaining a QSBS Issuer certificate with supporting documents confirming QSBS status at the time of the initial stock issuance. And investors should obtain the QSBS Issuer's agreement to cooperate by confirming QSBS status and providing relevant documentation when the stock is transferred in a taxable sale or exchange.

When investing through a fund, investors should inquire about the efforts made by the fund to obtain QSBS Issuer certificates and other documentation supporting the QSBS status of the fund's investments. In terms of obtaining substantiation of QSBS Issuer level eligibility requirements, it is probably sufficient for management to provide certified statements and documents with the understanding that neither the QSBS Issuer nor management will have any liability arising out of such cooperation. Management will want to make it clear that a QSBS Issuer certificate does not represent tax advice, and that taxpayers should seek their own tax advice in connection with taking QSBS return positions and not rely on unsubstantiated statements by QSBS Issuer management or fund management.

QSBS Issuer certificates setting forth detailed statements of fact and signed by someone with actual knowledge of the business and financial affairs of the QSBS Issuer often represent the best available evidence confirming certain facts necessary to support claiming Section 1202's gain exclusion. Sometimes QSBS Issuer certificates are conclusory statements of mixed fact and law (e.g., "*we believe that the applicable stock is QSBS*" or "*each of the QSBS Issuer level eligibility requirements were satisfied as the date of the taxable transfer*"), but do not provide any back-up documentation, facts or analysis providing support for the conclusions. QSBS Issuer certificates can also represent specific facts or conclusions of law (e.g., "*the corporation satisfied Section 1202's 80% Test throughout the stockholders QSBS holding period*" or "*XYZ Corporation met Section 1202's $50 [$75] million test prior to and immediately after the issuance of the applicable stock*").

A QSBS Issuer certificate with detailed representations of fact provides the best support. QSBS Issuer certificates are of greater

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value if they are coupled with the delivery of slide decks, documents, tax returns and financial statements confirming statements of fact. A certificate might also confirm that the taxpayer or tax advisor was provided with true and correct copies of certain documents and financial statements, or in connection with the delivery of a tax opinion, confirm that the background information is accurate and documents are correct and complete copies. Taxpayers are generally put in the best position if the person signing the certificate has actual knowledge with respect to the background facts necessary to reach whatever conclusions or representations are set forth in the certificate.

It is important to note that taxpayers bear the burden of proof and witness credibility is likely to be an important consideration.[8] Hopefully, the IRS will accept a well-constructed certificate as factual evidence supporting the taxpayer's position. In Tax Court, the taxpayer would need to introduce evidence through testimony from the QSBS Issuer's management unless the IRS agrees to stipulate applicable facts.

III. The role of tax advice and tax opinions

Given the complicated tax issues and absence of clear guidance in tax authorities relating to much of Sections 1202 and 1045, and the significant tax dollars (and potential penalties) involved, many taxpayers choose to rely on tax advice and tax opinions. Informed consumers should consider the practical and technical issues associated with tax advice and tax opinions.[9]

A. Tax advice generally.

First and foremost, tax advice is only as good as the accuracy and completeness of the facts upon which that advice is based, coupled with the expertise of the tax professional and availability of tax authorities to assist in analyzing the issues. The recipient of tax advice should confirm that a tax professional has the necessary expertise and experience. Tax professionals should take reasonable steps to ensure that advice is based on all relevant facts and documents, and that any formal tax opinion included in the project is a high quality product (which is a standard commented upon by

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the Tax Court when considering whether to abate penalties).

Tax advice ranges from a conclusory statement (e.g., "*you are holding QSBS as of such and such date*") to a reasoned analysis addressing in detail the elements of each eligibility requirement, including supporting and adverse tax authorities. A short form conclusory opinion might be useful to a stockholder who values the judgment of a tax professional and is comfortable that the opinion is based on sufficient information and analysis. As a practical matter, some taxpayers do not want to pay the fees associated with obtaining a formal written tax opinion. At the other extreme, a long-form well-reasoned formal tax opinion not only satisfies the "comfort" opinion function (see below), but also should assist a taxpayer in making an independent assessment of the strengths and weaknesses of the return position, and serve as a position paper in the event of an audit. Finally, a quality formal reasoned opinion should provide better support for the argument that a taxpayer satisfied the "reasonable cause" requirement for penalty abatement addressed in Sections 6662 and 6664.[10]

B. Tax opinions.

Taxpayers generally seek tax opinions regarding QSBS related issues (e.g., whether there is "substantial authority" that a taxpayer's stock was QSBS when sold; whether there is "substantial authority" that the requirements for making a Section 1045 election were satisfied) for the following reasons:

- For the comfort associated with obtaining a well-reasoned opinion that serves both to provide the bottom-line conclusions of an experienced tax professional, along with sufficient background information and analysis to allow taxpayers to reach their own conclusions regarding the strengths and weaknesses of QSBS-related return position.
- For the benefit of obtaining a detailed analysis that will serve as an advanced guide addressing QSBS-related return positions' strengths and weaknesses in the event of a tax audit. An opinion's detailed analysis and reference to applicable facts and tax authorities should help a taxpayer

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substantiate the applicable QSBS-related return positions, and serve as a guide for dealing with the IRS.

- A well-reasoned tax opinion based on all relevant facts and documentation assists taxpayers in making the argument that accuracy-related penalties under Sections 6662 and 6664 should be abated, as well as a basis for an argument by the return preparer that preparer penalties under Section 6694 should be abated.
- A tax opinion issued at the "more likely than not" level is required by insurance underwriters in connection with the issuance of a tax insurance policy covering QSBS return positions.

The levels of comfort that can apply when a tax professional issues a formal opinion range from "reasonable basis," to "substantial authority," to "more likely than not," to "should" and to "will." A "will" opinion is consistent with the conclusion that there is no material risk of being wrong, while a "reasonable basis" opinion is defined to mean that the position is reasonably based on one or more of the authorities listed in Treasury Regulation Section 1.6662-4(d)(3)(iii). Although there are no formal percentages attached to these different comfort levels, the consensus among tax professionals appears to be that that on a percentage basis, "reasonable basis" opinions fall into the 20% to 30% estimated range for anticipated success on the merits, "substantial authority" in the 30% to 40% range, "more likely than not" in the 50.1% to 69% range, "should" in the 70% to 90% range and "will" over 90%.[11]

Most formal tax opinions addressing QSBS related issues are issued at the "substantial authority" or "reasonable basis" comfort levels, which are the levels relevant to return positions unless a tax shelter is involved, except for "more likely than not" opinions that are required in connection with obtain tax insurance.[12] The issuance of an overall opinion at the "substantial authority" level should satisfy the standard under Treasury Regulation Section 1.6664-4(d)'s for seeking reasonable cause penalty abatement, assuming the Tax Court agrees with the conclusion that substantial authority did exist for the contested return position. Disclosure on Form 8275 or 8275-R of a return position needs to be coupled with a

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"reasonable basis" opinion, as disclosure where there is not a reasonable basis for the position does not qualify for penalty abatement. If a taxpayer is looking for a higher comfort level with respect to a QSBS issue and a "more likely than not" tax opinion can be issued with respect to the issues at hand, taxpayers can seek to obtain a tax insurance policy from an insurance underwriter (see Section III below).

The most common opinion relating to QSBS is one addressed to a taxpayer claiming Section 1202's gain exclusion after having sold or exchanged QSBS in a taxable transaction. The opinion addresses each taxpayer-level and QSBS Issuer-level Section 1202 eligibility requirement and generally concludes that there is "substantial authority" for the position that the applicable stock was QSBS when it was transferred in a taxable sale or exchange. Some opinion letters are addressed to the QSBS Issuer and only address QSBS Issuer level eligibility requirements. Other opinion letters address whether stock as QSBS when transferred in a taxable sale or exchange and that all of the requirements for making a Section 1045 election were satisfied with respect to the applicable stock. Finally, some opinions not only reach the conclusions addressed in the preceding sentence, but also whether (i) all taxpayer-level and QSBS-Issuer eligibility requirements were satisfied with respect to a taxpayer's original QSBS investment, (ii) all requirements for making a Section 1045 election were satisfied, and (iii) all taxpayer-level and QSBS-Issuer level eligibility requirements were satisfied under Section 1202 in connection with taxable sale or exchange of the replacement QSBS.

QSBS Issuers sometimes obtain tax opinions addressing corporate-level Section 1202 eligibility requirements for planning purposes, especially immediately prior to a sale process or after completion of the sale. One issue that arises after the QSBS Issuer obtains a tax opinion is how the corporation should communicate with its stockholders regarding QSBS issues. QSBS Issuers are placed in a difficult position when trying to balance a desire to assist their stockholders with the equally strong desire to avoid being seen as giving tax advice or exposing the corporation to potential stockholder claims. Tax opinions issued to QSBS Issuers generally provide that they cannot be relied upon by any party other than the

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QSBS Issuer. Further, an opinion letter addressed to the QSBS Issuer is unlikely to be considered "tax advice" provided to stockholders for purposes of Sections 6662 and Section 6664. Some QSBS Issuers choose to provide copies of the tax opinion to stockholders, but that action risks the potential disclosure to the IRS during a tax controversy. Typical reasoned opinions include a discussion of both favorable and adverse tax authorities and arguments, which is not something that should end up in the hands of District Counsel. Most corporations limit access to the corporate-level opinion and instead inform stockholders that they may have a viable Section 1202 return position and should seek competent tax advice. A potential solution to this thorny problem is to provide stockholders with a statement certifying key facts known to corporation's management that might be necessary for a stockholder's tax advisor to independently conclude that both the stockholder-level and corporate-level eligibility requirements under Section 1202 were satisfied and a viable return position exists. Of course, stockholders have the option of seeking their own tax opinion addressing the relevant tax issues.

Only under extraordinary circumstances should a copy of a tax opinion be included with a tax return or otherwise disclosed to the IRS, and then only upon the advice of a tax professional. If the return position fails and the only remaining issue is penalty abatement, the opinion might be provided to the IRS and the court, but again only upon the advice of a tax professional.

C. The "substantial authority" return position standard.

Treasury Regulation Section 1.6664-4(d) provides that for items other than tax shelters, no accuracy penalty will be imposed if there is "substantial authority" for the tax treatment of an item. Taxpayers relying on a tax professional's advice and/or opinion should confirm whether the advisor has concluded that there is "substantial authority" for the position, or if not, then at least a "reasonable basis," which then must be coupled with disclosure on IRS Form 8275 or Form 8275-R.[13] Taxpayers can always mitigate risk even if the conclusion is that there is substantial authority for

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the return position by filing Form 8275 or Form 8275-R. Not surprisingly, the IRS does not comment on or publish statistics regarding whether disclosure on the form increases the risk of audit. The Tax Court will make its own determination of whether there was "substantial authority" or a "reasonable basis" for the return position.

Treasury Regulation Section 1.6664-(d)(2) provides that:

the substantial authority standard is an objective standard involving an analysis of the law and application of the law to relevant facts. The substantial authority standard is less stringent than the more likely than not standard (the standard that is met when there is a greater than 50-percent likelihood of the position being upheld), but more stringent than the reasonable basis standard as defined in §1.6662-3(b)(3). The possibility that a return will not be audited or, if audited, that an item will not be raised on audit, is not relevant in determining whether the substantial authority standard (or the reasonable basis standard) is satisfied.

Treasury Regulation Section 1.6664-(d)(3)(i) provides that:

there is substantial authority for the tax treatment of an item only if the weight of the authorities supporting the treatment is substantial in relation to the weight of authorities supporting contrary treatment. All authorities relevant to the tax treatment of an item, including the authorities contrary to the treatment, are taken into account in determining whether substantial authority exists. The weight of authorities is determined in light of the pertinent facts and circumstances in the manner prescribed by paragraph (d)(3)(ii) of this section. There may be substantial authority for more than one position with respect to the same item. Because the substantial authority standard is an objective standard, the taxpayer's belief that there is substantial authority for the tax treatment of an item is not relevant in determining whether there is substantial authority for that treatment.

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The regulations go on to address the weight to be accorded to different tax authorities. As discussed above, because of the focus on "substantial authority" as the standard for taking undisclosed return positions, most tax opinions addressing QSBS issues are issued at the "substantial authority level.

D. The "reasonable basis" return position standard.

In some cases, there might not be "substantial authority" for a return position (i.e., the weight of tax authorities favoring the return position does not exceed the weight of tax authorities supporting a contrary treatment) and the taxpayer nevertheless elects to obtain a "reasonable basis" (if applicable) opinion and then couples the return position with the filing of a Form 8275 or Form 8275-R. Treasury Regulation Section 1.6662-3(b)(3) provides that:

reasonable basis is a relatively high standard of tax reporting, that is, significantly higher than not frivolous or not patently improper. The reasonable basis standard is not satisfied by a return position that is merely arguable or that is merely a colorable claim. If a return position is reasonably based on one or more of the authorities set forth in §1.6662-4(d)(3)(iii) (taking into account the relevance and persuasiveness of the authorities, and subsequent developments), the return position will generally satisfy the reasonable basis standard even though it may not satisfy the substantial authority standard as defined in § 1.6662-4(d)(2). (See §1.6662-4(d)(3)(ii) for rules with respect to relevance, persuasiveness, subsequent developments, and use of a well-reasoned construction of an applicable statutory provision for purposes of the substantial understatement penalty.) In addition, the reasonable cause and good faith exception in §1.6664-4 may provide relief from the penalty for negligence or disregard of rules or regulations, even if a return position does not satisfy the reasonable basis standard.

A tax opinion issued at the "reasonable basis" level is most likely to include as a condition to its effectiveness the requirement that the

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taxpayer file a Form 8275 or Form 8275-R (as applicable).

E. The "more likely than not" opinion letter standard.

The "more likely than not" standard referenced in Treasury Regulation Section 1.6662-4(d)(2) is one where "*there is a greater than 50-percent likelihood of the position being upheld.*"[14] The "more likely than not" standard requires an assessment and judgement whether the taxpayer is more likely than the government to prevail if the applicable issue were litigated in court. In this respect, the standard differs from the "substantial authority" and "reasonable basis" standards, which focus on the weight of authority supporting taking a return position rather than an assessment of the likelihood of prevailing if the applicable tax issue were litigating in court. However, a taxpayer's or return preparer's objective conclusion that the taxpayer is "more likely than not" to prevail on the merits is also based on an analysis of relevant facts and an object analysis of all tax authorities. On a percentage likelihood of success benchmark, the "more likely than not" standard is more stringent than the "substantial authority" standard (comparing a 50.1% likelihood of success with a 40% to 45% likelihood of success which is often cited as the percentage applicable to the substantial authority standard.

As discussed below, the providing of a tax opinion reaching a "more likely than not" conclusion is one of the requirements for obtaining tax insurance covering QSBS issues. The "more likely than not" standard is also addressed in Sections 6662 and 6664 with respect to penalties associated with tax shelters and reportable transactions. Under Section 6662, a taxpayer most have both "substantial authority" and a reasonable belief that the position is "more likely than not" correct to avoid penalties. Also, under Section 6694, for tax shelter or reportable transaction positions, a tax preparer avoids penalties only if it is reasonable to believe that a position would "more likely than not" be sustained on its merits.

F. Tax opinions – a further in-depth look.

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The tax issues addressed in opinions involving QSBS vary, but most QSBS-related opinions involve consideration of whether there is at least "substantial authority" for the conclusion that the stock qualified as QSBS when transferred in a taxable sale or exchange (along with confirming the greater than five-year holding period requirement was met).[15] Stock issued by many domestic (US) C corporations organically satisfies many of Section 1202's eligibility requirements, but sometimes there are several difficult issues that must be addressed before the author of an opinion letter is able to reach at least a "substantial authority" conclusion.

When a Section 1045 election is involved, and a subsequent Section 1202 gain exclusion when the replacement QSBS is transferred, the determination of whether the steps taken meet the requirements of Sections 1202 and 1045 will require a look at whether the original stock was QSBS when sold, whether the requirements of Section 1045 were met, and whether the replacement stock was QSBS when transferred in a taxable sale or exchange (and whether the holding period for the original and replacement QSBS was greater than five years). If the stockholder funds a newly organized C corporation with original or rollover proceeds, and later sells the original QSBS or replacement QSBS to a third party for a meaningful profit, there should generally be little question whether the QSBS Issuer actively conducted its business or whether the overall arrangement was undertaken for bona-fide business purposes. But where the QSBS Issuer of replacement QSBS ceases operation and liquidates, the issue of "active conduct" and the potential application of judicial doctrines such as "bona-fide business purpose" will generally be a central focus of the analysis in an opinion letter.

A tax opinion should address all facts and circumstances germane to the determination of whether Section 1202's eligibility requirements were met, including consideration of whether the QSBS Issuer actively conducted its business activities and whether the overall arrangement was undertaken for bona-fide business reasons. Treasury Regulation Section 1.6664-4(c) provides that reasonable reliance on an opinion or tax advice is predicated on the requirement that the advice is based upon "*all pertinent facts and circumstances and the law as it relates to those facts and circumstances,*" must not be based on "*unreasonable factual or*

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legal assumptions," and must not "*unreasonably rely on representations, statements, findings, or agreements of the taxpayer or any other person*." In the end, a taxpayer's best defense against an IRS challenge is to have thoroughly substantiated the satisfaction of each eligibility requirement, which is best accomplished by commencing the substantiation effort when the original QSBS is first issued.[16] But it isn't uncommon for stockholders to gather the documentation necessary to substantiate their QSBS return position when they sell their shares given the fact that there are no filing requirements or other formal steps that must be taken when acquiring, holding or selling QSBS in order to claim Section 1202's gain exclusion.

Finally, it is worth noting a few additional aspects of tax opinions. A tax opinion is neither tax insurance (commercial tax insurance is generally available at a cost in M&A transactions and, as discussed below, in connection with certain QSBS positions), nor an agreement by a professional firm issuing the opinion to indemnify, defend or contribute towards the payment of any deficiency, interest, penalties or expenses arising out of any return position taken by the recipient of the tax opinion. A tax opinion is exactly what it sounds like, the "opinion" of the tax professional who authors the opinion. As such, the opinion is only as good as the effort undertaken by the author, and that author's expertise and experience with respect to the issue addressed in the opinion letter. The IRS and the courts may disagree with the conclusions reached in a tax opinion. A tax opinion is not itself a "tax authority," but the various tax authorities cited and addressed in a tax opinion can support the taxpayer's return position. Neither the recipient of a tax opinion nor the return preparer should provide a copy of a tax opinion, or any written tax advice for that matter, to the IRS without first obtaining the advice of a tax professional.

IV. Tax insurance

If a taxpayer intends to report a transfer of stock as qualifying for partial or total gain exclusion pursuant to Section 1202, a robust QSBS File and a "substantial authority" tax opinion may be sufficient to avoid the imposition of accuracy-related penalties under Section

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6662 if the taxpayer's position is successfully challenged. Taxpayers who want to hedge against the costs associated with unsuccessfully defending a return position should consider obtaining a tax insurance policy.

Underwriting of tax liabilities has evolved during the past decade to the point where today tax insurance is often available to mitigate the risk of a position being successfully challenged by a taxing authority. Tax insurance is an efficient risk mitigation strategy when there is a relatively low risk of a position being challenged by a taxing authority, but the economic cost to the taxpayer from a successful challenge would be significant. The threshold for obtaining a tax insurance policy is a position for which the worst case scenario outcome can be quantified, and for which an external tax advisor can reach a comfort level of at least "more likely than not", which is defined in Treasury Regulation Section 1.6662-4(g)(4) as a position for which "*the likelihood of being upheld on its merits is greater than 50%*" (see the discussion above).

In the context of QSBS, a tax insurance policy could potentially cover a variety the qualifications and requirements for Section 1202, including whether (1) whether the initial receipt of shares constitutes an "original issuance," (2) the QSBS Issuer conducts a qualifying business; (3) the value of the QSBS Issuer's aggregate gross assets met the "aggregate gross assets" test as of the applicable QSBS issuance date(s), (4) sufficient amounts of the gross assets of the QSBS Issuer are utilized in the qualified activities, (5) the requisite holding period has been met, (5) the quantum of gain that can be excluded, (6) shares received in exchange for QSBS also qualify as QSBS, and (7) transactions occurring before or after the original issuance or in relation to the disposition of QSBS have an impact on the application of Section 1202.

In today's tax insurance market, a tax insurance policy addressing QSBS issues will typically cost the insured a one-time premium of 3-5% of the limit on the policy, plus an underwriting fee. The duration of the underwriting period will typically range from two to six weeks, depending in part on the complexity of the issuance and disposition transactions and any material transactions occurring in

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the intervening period. Supporting documentation should be included in the QSBS File discussed in Part I of this article, including a description of the relevant facts and parties, contemporaneous appraisals, support for the gain exclusion calculation, and a "more likely than not" tax opinion addressing the relevant aspects of Sections 1202 and/or 1045. Up to the agreed-upon policy limit, the coverage would include the tax deficiency, interest, penalties and a gross-up to account for the fact that the insurance proceeds would be subject to tax at capital gains rates, given that the nature of the insurance claim arises out of the sale of a capital asset (i.e., the stock).

V. Relevant aspects of IRS tax forms and tax returns, including reporting by partnerships and partner Schedule K-1s, tax practice and procedure, and IRS penalties

A. IRS tax forms.

Depending on how QSBS is sold, taxpayers may receive a form or statement reporting a taxable sale or exchange. A redemption payment might be reported by the redeeming corporation or an intermediary on Form 1099-B, Form 1099-DIV, Form 1099-CAP or possibly on Form 1099-MISC. If a stockholder sells shares of QSBS directly to a third party, it is likely that there will be no form issued by the purchaser.

Only Form 1099-DIV has a place for reporting the amount of a taxpayer's Section 1202 gain. The instructions for "Box 2c. Section 1202 Gain" provide that the QSBS Issuer should *"[e]nter any amount included in box 2a that is section 1202 gain from certain qualified small business stock*." Presumably if asked, the IRS would state that its expectation is that if Form 1099-DIV is completed by a corporation redeeming stock, Box 2c would be completed with respect to sales of stock where the QSBS Issuer believes that all of the QSBS Issuer-level Section 1202 eligibility requirements were met. However, it seems more likely that a corporation would report the transaction on Form 1099-B, which doesn't include a box for

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reporting Section 1202 gain, and if a QSBS Issuer did for some reason use Form 1099-DIV to report a capital gains transaction instead of a dividend payment, which is the typical use of the Form, the QSBS Issuer would be unlikely to report that gain was from the sale of QSBS.[17] A return preparer might include a white paper statement with the taxpayer's return identifying that the proceeds shown on a Form 1099 are being reported as proceeds from the sale of QSBS

B. Partnership and S corporation returns; taxpayer Schedule K-1s.

Partnerships selling QSBS report the sale of stock, including QSBS, on Form 8949 (Sales and Other Dispositions of Capital Assets) and Schedule D (Form 1065 Capital Gains and Losses). Partnerships and S corporations are required to use Schedule K-1 to report each partner's or stockholder's share of income, deductions and credits. Beginning in 2023, the IRS modified the instructions to Schedule K-1 to provide that a partnership should include with Box 11 (Other Income), Code M, which would report to partners the amount of gain eligible for a Section 1045 rollover with respect to replacement QSBS purchased by the partnership or Code O, which would report to partners "*the amount of gain from the sale or exchange of QSBS (as defined in the Instructions for Schedule D (Form 1065) eligible for a Section 1202 exclusion*."

The changes to Schedule K-1 put partnerships in the awkward position of being told to provide what might be considered tax advice to partners – i.e., stating that gain from the sale of stock is eligible for Section 1202's gain exclusion (at least with respect to QSBS Issuer and partnership-level eligibility requirements). The same holds true for Section 1045 elections to roll over original QSBS proceeds into replacement QSBS. The instructions require the partnership to disclose to partners their share of gain from the sale of QSBS. Some funds have marketed investments in their equity based on the fund's focus on QSBS investments and have agreed to substantiate eligibility and pass on to partners the information necessary to support claiming Section 1202's gain exclusion. Those funds are generally sufficiently comfortable with Section 1202's

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requirements and have substantiated eligibility through obtaining documents and certificates from the QSBS Issuer and in some cases tax opinions, and as a result, are willing to advise partners that they are passing through gain eligible for Section 1202's gain exclusion. But many funds are unwilling to complete Box 11 and provide what they consider to be tax advice.

How Schedule K-1 reporting is handled differs from fund to fund, but a typical approach is to leave Box 11 blank and instead including a "white paper statement" with the Form 1065 return indicating that the partnership has reason to believe that the stock sold may qualify as QSBS and/or may have met the QSBS Issuer-level and partnership-level eligibility requirements for claiming Section 1202's gain exclusion. The partnership then generally provides this whitepaper statement to partners, and often provides additional information and documents helpful to partners in substantiating their return position. In that situation, given that the potential for claiming Section 1202's gain exclusion was disclosed with the Form 1065 partnership return, it appears that many funds and investors do not believe that a Form 8082 (Notice of Inconsistent Treatment or Administrative Adjustment Request) would be required to be filed with the partners' returns, based on the conclusion that partners claiming the benefits of selling QSBS would not be taking an inconsistent position.

Given the reluctance on the part of funds to make definitive statements to partners regarding QSBS, partners should consider obtaining solid assurances when they invest that the fund will cooperate with the partners' efforts to substantiate eligibility to claim the benefits of QSBS.

Recent changes to the instructions to Schedule K-1 require additional reporting in connection with making a Section 1045 election when the original QSBS is sold by partnership.[18] It seems likely that in future years the IRS will extend these additional reporting requirements to direct transfers of QSBS by taxpayers.

C. Reporting the sale of QSBS on a tax return; making a Section 1045 election.

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Taxable gain arising out of the sale of capital assets is reported on the taxpayer's Form 8949 and Schedule D, including QSBS, when the stock is a capital asset in the hands of the stockholder. The 2024 Form 8949 and its instructions require a taxpayer to include the description of the QSBS, the proceeds and tax basis of the QSBS, adjustment codes in column (f) (including Section 1202 gain exclusion and the Section 1045 election) and the amount of the adjustment relating to the adjustment codes in column (g), and the net gain in column (h), after subtracting the adjustments indicated in columns (f) and (g). Capital gain is then reported on Schedule D, which includes instructions regarding how to report installment sales of QSBS. If less than 100% of the gain is excludable under Sections 1202 and/or 1045, taxpayers would also need to complete Form 8960 (Net Investment Income Tax – Individuals, Estates and Trusts) and Form 6251 (Alternative Minimum Tax – Individuals) if less than a 100% gain exclusion applies. The discussion of reporting requirements in this article is qualified in its entirety by the requirements set forth in current IRS forms and instructions.

A Section 1045 election is generally made on the tax return filed for the year during which a taxpayer's original QSBS was transferred in a taxable sale or exchange, except as provided in Treasury Regulation Section 1.1045-1. Treasury Regulation Section 1.1045-1 includes extensive rules addressing Section 1045 elections to reinvest original QSBS proceeds in replacement QSBS by funds or investors. Revenue Procedure 98-48 addresses the procedure for making a Section 1045 election.[19] As noted in the preceding section, the 2024 instructions to Schedule K-1 provide for certain actions and disclosures on the Schedule K-1 when a partnership transfers QSBS in a taxable sale or exchange and recent changes to the instructions to Schedule K-1 requires reporting in connection with making a Section 1045 election when the original QSBS is sold by partnership.[20]

VI. A brief introduction to tax practice and procedure.

Taxpayers generally have a duty to file tax returns on the proper form that includes sufficient information for the IRS to determine

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the correctness of the self-assessed tax. A person making a return is required to sign the return and verify it by a written declaration that the return is made under penalties of perjury. Taxpayers and return preparers who sign and verify returns establish the liability for the tax due on the return and establish the basis for the potential imposition of civil or criminal penalties.

The Department of the Treasury has the authority under Section 7801 to establish the IRS to administer and enforce the internal revenue laws. If the IRS disputes a taxpayer's return position and the dispute isn't resolved at the administrative level, the IRS will issue a notice of deficiency that matures into a taxpayer debt to the Government unless the matter is resolved favorably for the taxpayer. During the IRS examination and appeals process, the taxpayer generally has the burden of convincing the IRS that a return position complies with the tax law. If a tax dispute is litigated, the burden is also generally on the taxpayer to demonstrate by a preponderance of the evidence that the IRS's determination is in error.[21] A taxpayer also generally has the burden of persuasion with respect to liability for asserted penalties.

VII. Tax penalties.

A. Accuracy-related penalties

When a taxpayer takes a return position involving QSBS (e.g., claiming Section 1202's gain exclusion or electing to reinvest proceeds under Section 1045), the deficiency and interest amounts are typically significant. The IRS will generally assert Section 6662's accuracy-related penalty, which amounts if imposed to 20% of the portion of the understatement attributable to any substantial understatement of income tax.[22] Section 6664(c)(1) provides that an accuracy-related penalty will not be imposed "*with respect to any portion of an underpayment if it is shown that there was a reasonable cause for such portion and that the taxpayer acted in good faith with respect to such portion*." The Supreme Court has stated that "reasonable cause" requires a taxpayer to exercise "*ordinary business care and prudence*" as to the disputed item.[23] That determination is made on a case-by-case basis, taking into account all pertinent facts and circumstances, including the

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taxpayer's knowledge and experience and "*the extent of the taxpayer's effort to assess the taxpayer's proper tax liability*."[24]

A taxpayer may demonstrate "reasonable cause" through good faith reliance on the advice of an independent competent tax advisor, even if the taxpayer's position proves to be wrong.[25] The taxpayer is required to show that he selected a competent advisor with sufficient expertise to justify reliance, supplied the advisor with all necessary and accurate information, and actually relied in good faith on the advisor's judgment.[26] The advice must "*be based upon all pertinent facts and circumstances and the law as it relates to those facts and circumstances*." It must "*take into account the taxpayer's purposes (and the relative weight of such purposes) for entering into a transaction and for structuring a transaction in a particular manner*." Treasury Regulation Section 1.6664-4(c)(1) provided that a taxpayer may not unreasonably rely on advice *"based upon a representation or assumption which the taxpayer knows, or has reason to know, is unlikely to be true, such as an inaccurate representation or assumption as to the taxpayer's purposes for entering into a transaction or for structuring a transaction in a particular manner*." Further, reliance on advice "*based on unreasonable factual or legal assumptions (including assumptions as to future events)*" cannot be reasonable, and the tax advisor may "*not unreasonably rely on the representations, statements, findings, or agreements of the taxpayer or any other person*." Finally, the taxpayer must show that he or she relied on professional advice and that the advice was given before taking the applicable return position.

The Tax Court has held that there may be reasonable cause to abate penalties where a taxpayer takes a debatable position in a case of "first impression" or where the interpretation of the law is unclear.[27] Tax authorities weighing against imposing accuracy-related penalties where taxpayers take erroneous return positions in good faith in connection with unresolved tax issues may be particularly relevant given abundance of unresolved planning issues and sparsity of tax authorities addressing QSBS-related issues.

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B. Increased penalties for "nondisclosed" transactions that lack economic substance.

Section 6664(c)(2) provides that the reasonable cause exception does not apply to any portion of a payment attributable to a transaction lacking economic substance. Section 6662(i) provides that an understatement based on a return position attributable to a "*nondisclosed noneconomic substance transaction*" (i.e., one not disclosed on Form 8275) is subject to a 40% penalty. Governed by Sections 6662(b)(6), 6662(i) and 7701(o), the codified economic substance doctrine applies where there is a determination that a taxpayer's transaction did not change a taxpayer's economic position in a material way and the taxpayer did not have a substantial non-tax purpose for entering into the transaction. The term "transaction" generally includes all the factual elements relevant to the expected tax treatment of any investment, entity, plan, or arrangement, and any or all of the steps that are carried out as part of a plan. Whether the economic substance doctrine is relevant will depend on the facts and circumstances of a particular transaction.

The 20% accuracy-related penalty is imposed on the portion of an underpayment of tax based on a transaction that is found to lack economic substance and the penalty is increased from 20% to 40% if adequate disclosure is not made on a properly completed Form 8275 or 8275–R and filed with the applicable return. The argument that a corporation's activities lack economic substance should not be based merely on the grounds that the corporation failed or the activities failed to produce a profit. The IRS might assert a lack of economic substance if it believes that the QSBS Issuer did not have a reasonable chance of producing acceptable profits if tax benefits are not taken into account. Taxpayers might respond to this potential IRS argument by pointing out that imposing an economic substance requirement in connection with reinvestment of QSBS sales proceeds under Section 1045 effectively takes away the tax benefits bestowed by Congress on taxpayers who successful invest in a ultimately sell their original QSBS investment.[28] Guidance issued to IRS agents suggests that promoted arrangements or plans

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are more likely to attract economic substance review.

C. Tax shelters.

Section 6662(d)(2)(C) provides that Section 6662(d)(2)(B), which provides for mitigation of the substantial understatement penalty when a taxpayer either has substantial authority for a return position or a reasonable basis for a return position and the relevant facts were adequately disclosed on the return (Form 8275), does not apply if the "plan or arrangement" is a "tax shelter." A "tax shelter" is defined as a plan or arrangement if a principal purpose of such plan or arrangement is the avoidance or evasion of federal income tax.[29] In most instances, there should not be significant risk that the IRS would successfully argue that a return position involving QSBS was a tax shelter. But the risk might increase if a return position involves a tax product promoted by investment professionals, for example, a poorly conceived Section 1045 tax product might be susceptible to both an economic substance attack and the assertion that the packaged rollover opportunity is a tax shelter "plan or arrangement."

D. Fraud additions to tax.

Section 6663 provides that if any part of an underpayment of tax required to be shown on a return is due to civil fraud, there shall be added to the tax an amount equal to 75% of the underpayment which is attributable to fraud. The IRS has the burden of proving fraud by clear and convincing evidence. Civil fraud exists if any part of an underpayment was due to fraud. But the fraud penalty doesn't apply to any portion of an underpayment for which reasonable cause and the taxpayer's good faith are shown, although in practice it is difficult to see how such a defense would apply assuming the IRS meets its burden of showing by clear and convincing evidence that the penalty applies in the first instance.[30] The Tax Court's *Holmes v. Commissioner*,[31] decision provides a good discussion of the elements and issues associated with the assertion by the IRS of a civil fraud penalty in a QSBS-related case and should be a cautionary note for taxpayers who might consider claiming the benefits of Sections 1202 or 1045 without sufficient

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substantiation. While the Tax Court did not ultimately impose the 75% civil fraud penalty on the taxpayer in *Holmes*, he was found liable for a 20% substantial understatement penalty.[32]

E. Section 6694 return preparer penalties.

Section 6694 provides that if a tax return preparer prepares a return that results in an understatement due to an "unreasonable position," and the preparer knew or should have known of the position, the preparer is subject to penalties under Section 6694. Generally, a position is "unreasonable" unless there is or was substantial authority for the position, or the position taken has a reasonable basis and is adequately disclosed Form 8275. Substantial authority and reasonable basis have the same definitions as discussed above with respect to taxpayer penalties. [33]

Advisors who provide advice with respect to QSBS issues but are not the client's tax return preparer can fall into the category of a "*nonsigning tax return preparer*." Treasury Regulation Section 301.7701-15 provides that "*examples of nonsigning tax return preparers are tax return preparers who provide advice (written or oral) to a taxpayer (or to another tax return preparer) when that advice leads to a position or entry that constitutes a substantial portion of the return*." A return position regarding QSBS could easily qualify on most individual's returns as a substantial portion of the return. Generally, if there is a reasonable basis for the return position, a non-signing tax return preparer can avoid the Section 6694 penalties if the taxpayer is advised of the opportunity to avoid penalties through disclosure and adequate disclosure is made on Form 8275 or 8275-R.

Treasury Regulation Section 1.6694-1 establishes requirements for a tax professional's right to rely on the tax advice of another tax professional:

for purposes of sections 6694(a) and (b) (including demonstrating that a position complied with relevant standards under section 6694(a) and demonstrating reasonable cause and good faith under §1.6694-2(e)), the tax

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return preparer generally may rely in good faith without verification upon information furnished by the taxpayer. A tax return preparer also may rely in good faith and without verification upon information and advice furnished by another advisor, another tax return preparer or other party (including another advisor or tax return preparer at the tax return preparer's firm). The tax return preparer is not required to audit, examine or review books and records, business operations, documents, or other evidence to verify independently information provided by the taxpayer, advisor, other tax return preparer, or other party. The tax return preparer, however, may not ignore the implications of information furnished to the tax return preparer or actually known by the tax return preparer. The tax return preparer must make reasonable inquiries if the information as furnished appears to be incorrect or incomplete.

Treasury Regulation Section 1.6694-1 suggests that a return preparer could assert that Section 6694's preparer penalty should not be imposed where the preparer reasonably relied on tax advice furnished to the taxpayer by another tax professional. An example might be where the taxpayer obtains a tax opinion concluding there is substantial authority supporting the position that the taxpayer's stock was QSBS when sold in connection with a cash-out merger transaction, and that the greater than five year holding period requirement was satisfied.

F. The use of Forms 8275 or 8275-R in connection with QSBS return positions.

A taxpayer is not required to include a disclosure statement to seek mitigation of penalties if the taxpayer has at least "substantial authority" for a return position, but the taxpayer certainly has the option of including the applicable disclosure form. If a taxpayer obtains written tax advice or an opinion concluding that there is merely a "reasonable basis" for a return position, then if the taxpayer intends to claim reliance on tax advice for purposes of penalty mitigation, Treasury Regulations require the filing of a Form 8275 or Form 8275-R (Disclosure Statement) with the return. These

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forms identify for the IRS taxpayer return positions for which the taxpayer does not have "substantial authority."[34]

Please contact Scott Dolson if you want to discuss any Section 1202 or Section 1045 issues by video or telephone conference. You can also visit our QSBS & Tax Planning Services page for more QSBS-related analysis curated by topic, from the choice of entity decision and Section 1202's gain exclusion to Section 1045 rollover transactions.

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[1] References to "Section" are to sections of the Internal Revenue Code of 1986, as amended. There are a number of articles on the Frost Brown Todd website addressing the benefits of Section 1202's gain exclusion and the various eligibility requirements and planning issues associated with seeking and obtaining Section 1202's benefits. The website also includes several articles focused on the workings of Section 1045. See *Frost Brown Todd's QSBS library.*

[2] Section 1202 has a gain exclusion cap that generally functions to limit a stockholder gain exclusion from a single issuer of QSBS to the greater of $10 million or 10 times the stockholder's aggregate basis in QSBS sold during the taxable year. Once the taxpayer has taken an aggregate $10 million gain exclusion with respect to a particular QSBS Issuer, any additional gain exclusion would depend on whether the taxpayer has sufficient tax basis in his QSBS. For QSBS issued after July 4, 2025, the $10 million gain exclusion cap is increased to $15 million. Many states follow the federal treatment of QSBS. California, Pennsylvania, Alabama, Mississippi, and New Jersey (until January 1, 2026) do not follow federal treatment.

[3] A discussion of the OBBBA can be found in the article by Scott Dolson and Brian Masterson at "*One Big Beautiful Bill Act Doubles Down on QSBS Benefits for Startup Investors*." The amendments to Section 1202 include a reference to Section 1223 which has the effect of blocking the conversion of pre-OBBBA QSBS into post-July 4, 2025, QSBS through stock-for-stock exchanges or in connection with the reinvestment of pre-OBBBA sale proceeds into replacement QSBS under Section 1045.

[4] See the article "*One Big Beautiful Bill Act Doubles Down on QSBS Benefits for Startup Investors*."

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[5] On June 12, 2014, the Treasury Department issued final regulations amending Circular 230 – Regulations Governing Practice Before the Internal Revenue Service (31 C.F.R. Part 10).

[6] 115 T.C. 43 (2000).

[7] Among other functions, an attestation or tax memorandum can provide useful contemporaneous documentation that helps support a tax opinion or tax insurance policy obtained by a taxpayer.

[8] See *Joseph W. Sherman*, T.C. Memo 2023-63 (5/17/2023). In *Sherman*, the Tax Court noted that "*Generally, we found Dr. Sherman's testimony to be self-serving, and, at times, lacking in credibility and candor. His testimony failed to corroborate the alleged business activities of Songswell or the reported business expenses associated with his medical practice.*" If a taxpayer's QSBS return position is challenged by the IRS, whether the testimony of the taxpayer or others testifying on the taxpayer's behalf is credible will be a key factor in determining whether the return position will be sustained.

[9] "Tax advice" is defined in Treasury Regulation Section 1.6664-1(c)(2) as being "*any communication, including the opinion of a professional tax advisor, setting forth the analysis or conclusion of a person, other than the taxpayer, provided to (or for the benefit of) the taxpayer and on which the taxpayer relies, directly or indirectly, with respect to the imposition of the section 6662 accuracy-related penalty. Advice does not have to be in any particular form.*"

[10] See the Treasury Regulations for Sections 6662 and 6664.

[11] See, for example, the discussion in Robert Rothman, "*Tax Opinion Practice*" published at 64 *The Tax Lawyer* 301 (Winter 2011).

[12] In the case of opinions issued at the "reasonable basis" comfort level, the opinion should be coupled with disclosure through the inclusion of a Form 8275 or Form 8275-R on the applicable return.

[13] Wherever Form 8275 is referenced in this article, the reference would instead be to Form 8275-R if the applicable return position conflicts with a Treasury Regulation.

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[14] See also Treasury Regulation Section 1.6694-2(b)(1) ("*position has a greater than 50 percent likelihood of being sustained on its merits*.").

[15] And/or, if applicable, exchanged for non-QSBS in a Section 351 nonrecognition exchange or Section 368 tax-free reorganization.

[16] The possible role of pervasive judicial doctrines in connection with corporations issuing replacement QSBS was discussed in some detail in the article "*Finding Suitable Replacement Qualified Small Business Stock (QSBS) – A Section 1045 Primer*."

[17] This discussion is subject to the qualification that the author is a tax lawyer whose practice doesn't include addressing the reporting of taxable income, including capital gains, dividends and/or Section 1202 gain on the various IRS Form 1099s.

[18] The 2024 instructions to Schedule K-1 provide the following:

> ***Making the section 1045 election.***
>
> *You make a section 1045 election on a timely filed return for the tax year during which the partnership's tax year ends. See the Instructions for Form 8949 and the Instructions for Schedule D (Form 1040) for more information. Attach to your Schedule D (Form 1040) a statement that includes the following information for each amount of gain that you don't recognize under section 1045.*
>
> - *The name of the corporation that issued the QSB stock.*
> - *The name and EIN of the selling partnership.*
> - *The dates the QSB stock was purchased and sold.*
> - *The amount of gain that isn't recognized under section 1045.*
> - *If a partner purchases QSB stock, the name of the corporation that issued the replacement QSB stock, the date the stock was purchased, and the cost of the stock.*
> - *If a partner treats the partner's interest in QSB stock that's purchased by a purchasing partnership as the partner's replacement QSB stock, the name and EIN of*

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the purchasing partnership, the name of the corporation that issued the replacement QSB stock, the partner's share of the cost of the QSB stock that was purchased by the partnership, the computation of the partner's adjustment to basis with respect to that QSB stock, and the date the stock was purchased by the partnership.

[19] Revenue Procedure 98-48, 1998-2 CB 367.

[20] See endnote xi above.

[21] Tax Court Rule 142 provides that "*the burden of proof shall be upon the petitioner [taxpayer], except as otherwise provided by statute or determined by the Court.*"

[22] Section 6662 also addresses negligence, but given the typical deficiency amount associated with QSBS, this article focuses on aspects of Sectio 6662 associated with the substantial understatements of income. An understatement is deemed "substantial" if the amount of the understatement for the taxable year exceeds the greater of 10% of the tax required to be shown on the return for the taxable year or $5,000.

[23] *United States v. Boyle*, 469 U.S. 241, 246 (1985).

[24] Treasury Regulation Section 1.6664-4(b)(1). Treasury Regulation Section 1.6664-4(c) addresses reliance on tax advice or opinions. The regulation provides that "*advice must be based on all pertinent facts and circumstances and the law as it relates to those facts and circumstances*" and that "*the advice must take into account the taxpayer's purposes (and the relative weight of such purposes) for entering into a transaction and for structuring a transaction in a particular manner.*"

[25] "Advice" is defined as "*any communication, including the opinion of a professional tax advisor, setting forth the analysis or conclusion of a person, other than the taxpayer, provided to (or for the benefit of) the taxpayer and on which the taxpayer relies, directly or indirectly, with respect to the imposition of the section 6662 accuracy-related penalty. Advice does not have to be in any particular form.*" Treasury Regulation Section 1.6664-4(c)(2). The

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Tax Court in *John P. Owen v. Commissioner*, TC Memo 2012-21 noted that "*reliance on the advice of a tax professional may, but does not necessarily, establish reasonable cause and good faith for purposes of avoiding a section 6662(a) penalty . . . Such reliance does not serve as an 'absolute defense'; it is merely a 'factor to be considered. Freytag v. commissioner, 89 T.C. 849 (1987).*"

[26] See *Ralph E. Holmes v. Commissioner*, T.C. Memo 2012-251. In *106 Ltd. v. Commissioner*, 684 F3d 84 (D. DC 20212), the court upheld a Tax Court holding of no good faith reliance on an advisor's opinion because the taxpayer was sophisticated and well educated, the opinion was poorly written, and the advisor acted as a "promoter" of the transaction. In *Neonatology Associates, PA v. Commissioner*, 115 T.C. 43 (2000), the Tax Court held that the reasonable cause reliance on tax advice requires that the taxpayer prove that *"(1) [t]he advisor was a competent professional who had sufficient expertise to justify reliance, (2) the taxpayer provided necessary and accurate information to the advisor, and (3) the taxpayer actually relied in good faith on the advisor's judgment.*"

[27] See *Williams v. Commissioner*, 123 T.C. 144 (2004); *Bunney v. Commissioner*, 114 T.C. 259 (2000).

[28] See *Historic Boardwalk Hall LLC v. Commissioner,* 136 T.C. 1 (2011) *rev'd and remanded* 694 F.3d 425 (3d Cir. 2012).

[29] Treasury Regulation Section 1.6662-4(g)(2) provides that "*the principal purpose of an entity, plan or arrangement is to avoid or evade Federal income tax if that purpose exceeds any other purpose*" and that "*the principal purpose of an entity, plan or arrangement is not to avoid or evade Federal income tax if the entity, plan or arrangement has as its purpose the claiming of exclusions from income, accelerated deductions or other tax benefits in a manner consistent with the statute and Congressional purpose.*"

[30] The Internal Revenue Manual defines "tax fraud" as "an intentional wrongdoing on the part of the taxpayer, with the specific purpose of evading a tax known or believed to be owed." The United States Supreme Court offered the following nonexclusive list in *Spies v. United States*, 317 US 492 (1943) as conduct from which

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fraud may be inferred: (i) keeping a double set of books; (ii) making false entries or alterations, false invoices, or false documents; (iii) destroying books or records; (iv) concealing assets or covering up sources of income; and (v) handling one's affairs to avoid making records usual in transactions of the kind. The Internal Revenue Manual also provides a non-exhaustive list of "badges of fraud": (1) understatement of income; (2) fictitious or improper deductions; (3) accounting irregularities; including maintaining multiple sets of books; (4) acts of the taxpayer evidencing an intent to evade tax; (5) consistent pattern of underreporting taxable income over several years; (6) implausible or inconsistent explanations of behavior; (7) failure to cooperate with tax examiners; (8) concealment of assets; (9) engaging in illegal activities or attempting to conceal illegal activities; (10) inadequate records; (11) dealing in cash; (12) failure to file returns; and (13) education and experience of the taxpayer.

[31] TC Memo 2012-251.

[32] See the discussion of the *Holmes* decision in Part 1 of this article.

[33] Treasury Regulation Section 1.6694-1(e) provides that for purposes of determining whether the tax return preparer has a reasonable basis for a position,

a tax return preparer also may rely in good faith and without verification upon information and advice furnished by another advisor, another tax return preparer or other party (including another advisor or tax return preparer at the tax return preparer's firm). The tax return preparer is not required to audit, examine or review books and records, business operations, documents, or other evidence to verify independently information provided by the taxpayer, advisor, other tax return preparer, or other party. The tax return preparer, however, may not ignore the implications of information furnished to the tax return preparer or actually known by the tax return preparer. The tax return preparer must make reasonable inquiries if the information as furnished appears to be incorrect or incomplete.

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[34] Treasury Regulation Section 1.6662-3(b)(3) defines "reasonable basis" as follows:

Reasonable basis is a relatively high standard of tax reporting, that is, significantly higher than not frivolous or not patently improper. The reasonable basis standard is not satisfied by a return position that is merely arguable or that is merely a colorable claim. If a return position is reasonably based on one or more of the authorities set forth in §1.6662-4(d)(3)(iii) (taking into account the relevance and persuasiveness of the authorities, and subsequent developments), the return position will generally satisfy the reasonable basis standard even though it may not satisfy the substantial authority standard as defined in § 1.6662-4(d)(2). (See §1.6662-4(d)(3)(ii) for rules with respect to relevance, persuasiveness, subsequent developments, and use of a well-reasoned construction of an applicable statutory provision for purposes of the substantial understatement penalty.) In addition, the reasonable cause and good faith exception in §1.6664-4 may provide relief from the penalty for negligence or disregard of rules or regulations, even if a return position does not satisfy the reasonable basis standard.

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