Independent FMV Appraisals Can Play a Critical Role in Substantiating QSBS Gain Exclusions

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Section 1202 provides an exclusion from capital gains when a taxpayer sells qualified small business stock ("**QSBS**"), assuming all eligibility requirements are satisfied.[1] The One Big Beautiful Bill Act ("**OBBBA**") further enhanced Section 1202's benefits for QSBS issued after July 4, 2025. Section 1045 provides for the tax-free rollover of gain from the sale of QSBS into replacement QSBS, again assuming all eligibility requirements are satisfied. See the QSBS library for articles discussing benefits, requirements and planning for Sections 1202 and 1045.

The federal income 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 QSBS is sold translates into $2.38 million (long-term capital gains rate of 20% plus net investment income tax rate of 3.8%) of tax savings at the federal level.[2] OBBBA increased the basic per-taxpayer, per QSBS issuer gain exclusion cap to $15 million from $10 million for QSBS issued after July 4, 2025. Rolling proceeds from the sale of QSBS into replacement QSBS under Section 1045 not only defers gain but also positions a taxpayer to claim Section 1202's gain exclusion if the replacement QSBS is transferred in a taxable sale or exchange, assuming all eligibility requirements are met.

A critical issue when considering whether a taxpayer should claim a QSBS tax benefit is determining whether each Section 1202 eligibility requirement can be adequately substantiated. Before a taxpayer claims a QSBS tax benefit, the conclusion should be reached that the taxpayer has a "reasonable basis" or "substantial authority" for the return position.[3] See the articles "*Substantiating the right to claim QSBS tax benefits (Part 1)*" and "*Substantiating the right to claim QSBS tax benefits (Part 2)*."

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Overview

QSBS-focused valuation work tends to arise at three distinct points: (1) **at issuance**, to support satisfaction of the "aggregate gross assets" test ceiling, if property is contributed to an issuer of QSBS ("**QSBS Issuer**"); (2) **during the QSBS holding period**, to substantiate compliance with FMV-based tests embedded in the "active business requirement"; and (3) **at disposition**, to support the shareholder's Section 1202 Tax Basis in connection with the computation of the Section 1202 gain exclusion cap. Not every taxpayer will need an appraisal to back up claiming a gain exclusion, but some taxpayers will benefit from the support of several appraisals undertaken by the QSBS Issuer.

This article provides a practical framework for understanding how valuation considerations intersect with the Section 1202 rules at each stage of the QSBS lifecycle. It begins with an overview of why fair market value plays a central role in establishing and defending QSBS eligibility, then addresses valuation issues that commonly arise when stock is first issued, including transactions involving contributed property and situations where eligibility thresholds may be in question. The article next examines value-based requirements that can become relevant during the QSBS holding period as a company's operations and asset composition evolve. It then turns to the disposition of QSBS, explaining how fair market value affects QSBS basis, the calculation of Section 1202 gain, and the application of the exclusion caps. The article concludes with practical guidance on when independent appraisals should be considered and how taxpayers and issuers can assemble and maintain documentation to support QSBS positions over time.

1. FMV of Contributed Property: Why It Matters?

1.1 QSBS eligibility: The $75 million gross assets ceiling

QSBS must be issued by a C corporation for money, property (other than stock) or services. But only QSBS Issuers whose "aggregate gross assets" have not exceeded $75 million at any time prior to and immediately after the exchange of money and/or property for

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stock are eligible to issue QSBS in exchange for the additional money and/or property.[4] The $75 million ceiling is particularly relevant when an LLC/LP taxed as a partnership converts into a C corporation in exchange for QSBS or an S corporation's operating business is dropped into a C corporation subsidiary in exchange for QSBS.

1.2 Exclusion mechanics: Section 1202 Tax Basis and the 10X Cap

Section 1202 has its own tax basis rules for QSBS issued in connection with contributions of property that differ from the stock basis rules that apply for the determination of capital gain. A taxpayer's basis in stock issued in exchange for the contribution of property (the taxpayer's "**Section 1202 Tax Basis**") equals the FMV (not historic tax basis) of the property.[5] When the QSBS is sold, that Section 1202 Tax Basis drives the calculation of the amount of Section 1202 gain that can be offset against capital gain. A taxpayer's Section 1202 Tax Basis is also relevant for the calculation of a cap on the amount of Section 1202 gain exclusion that is based on 10 times the taxpayer's basis in QSBS sold (the "**10X Cap**"), including the taxpayer's Section 1202 Tax Basis.

> **EXAMPLE 1**: If property with an aggregate tax basis of $5 million and FMV of $30 million is contributed to a C corporation in exchange for QSBS, the tax basis in the QSBS is $5 million for purposes of calculating capital gain, but the "Section 1202 Tax Basis" is $30 million. So, when the QSBS is later sold for $300 million and the taxpayer has met all of Section 1202's eligibility requirements, the taxpayer would have $295 million of realized capital gain and $270 million of excludable gain under Section 1202 ($300 million – $30 million = $270 million). The 10X Cap based on $30 million FMV of contributed property would be $300 million (i.e., more than $270 million). So, the QSBS sale would trigger $25 million of recognized (taxable) capital gain and $270 million of excluded capital gain under Section 1202.
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> **EXAMPLE 2**: If the property in Example 1 is sold for $60 million rather than $200 million and the taxpayer has met Section 1202's eligibility requirements, the taxpayer would recognize

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$25 million of capital gain, and the Section 1202 gain exclusion would be limited to $30 million ($60 million – $30 million = $30 million). In hindsight, this taxpayer would have had a better result if his contributed property was appraised at $10 million, resulting in $5 million of recognized capital gain and $50 million of excludible gain under Section 1202.

2. Other Section 1202 Requirements that hinge on FMV Computations

2.1 The 80% Test

In order for a corporation's stock to qualify as QSBS, the corporation must satisfy Section 1202's "active business requirement." Section 1202(e)(1) provides that a corporation will not satisfy Section 1202's "active business requirement" for any period during which less than 80% "by value" of a corporation's assets are used in the active conduct of a qualified activity (the "**80% Test**"). The QSBS Issuer must satisfy the "active business requirement" during "substantially all" of a taxpayer's QSBS holding period, which likely falls between 80% and 95% of the applicable period. The question taxpayers and their advisors must ask themselves is how to substantiate that the 80% Test is satisfied when the QSBS Issuer's assets include both assets used in qualified activities and other assets, which might include a mixture of assets used in excluded activities, real property not used in the qualified business, cash and other investment assets that don't qualify as working capital (collectively, "**Excluded Assets**").

There are no tax authorities that define "by value" as that term is used in Section 1202(e)(1). Presumably, "by value" means FMV. As discussed elsewhere in this article, the reference to "by value" seems to exclude short-term and long-term liabilities.

Among unknowns are what the Tax Court would consider sufficient evidence that a QSBS Issuer satisfied the 80% Test on an ongoing basis. Credible testimony that almost all assets were used in the qualified activities and that the corporation did not hold any Excluded Assets should be sufficient. But if a corporation has

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significant Excluded Assets, it may be necessary to obtain an appraisal of the qualified business assets and Excluded Assets in order to substantiate satisfying the 80% Test. The IRS auditor and ultimately the Tax Court will dictate what evidence is sufficient to substantiate satisfaction of the 80% Test, and whether more than one independent appraisal would be required during the QSBS holding period. QSBS Issuers that obtain periodic Section 409A valuations should be able to use the information provided in those valuation reports to make at least a rough calculation of the overall value of the corporation's assets, although the report won't provide a separate valuation of qualified and excluded activities. If a QSBS Issuer recognizes that it might have a problem substantiating satisfaction of the 80% Test, the corporation should consider getting ahead of this issue by consulting with tax advisors and valuation firms to develop a plan for substantiating satisfaction of the test throughout the applicable QSBS holding period.

2.2 Limits on excess working capital and investment assets

After a corporation has been in existence for two years, Section 1202(d)(6) limits to 50% of the corporation's assets the amount of "working capital" (cash and invested working capital) that a QSBS Issuer can count towards meeting Section 1202's "80% test".[6] Presumably, the reference to "assets of the corporation" means the FMV of those assets. After the two-year mark is reached, the application of this eligibility requirement (test) is ongoing, and for corporations with significant cash and investment assets, the same questions regarding substantiation of value as addressed in Section 2.1 above are applicable.

2.3 A QSBS Issuer's maximum holding of corporate stock and securities

Section 1202(e)(5)(B) provides a corporation will not meet the "active business requirement" during any period where more than 10% of the value of the corporation's assets (in excess of liabilities) consists of stock or securities in non-subsidiaries (other than stock and securities representing invested working capital). The phrase "the value of assets" appears to refer to the FMV of the corporation's assets. For a QSBS Issuer with substantial amounts of

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corporate stock and securities, the same questions regarding substantiation of value that are addressed in Section 2.1 above are applicable.

2.4 A QSBS Issuer's maximum real estate holdings

Section 1202(e)(7) provides that a corporation will not satisfy the active business requirement during any period in which more than 10% of the total value of its assets consists of real property that is not used in the active conduct of a qualified trade or business. The statutory text focuses on asset value, which points to fair market value, rather than book "total assets." Presumably, the IRS and the Tax Court would be satisfied if a taxpayer provided credible testimony and annual financial statements to substantiate that the value of real estate holdings did not exceed Section 1202(e)(7)'s limit. As a practical matter, corporations may monitor this limitation using financial statements, but taxpayers seeking an IRS audit-ready record should be prepared to substantiate the value of non-business real property and the total asset value used as the denominator.

3. Measuring a QSBS Issuer's "Aggregate Gross Assets"[7]

3.1 General rules and contributed property FMV

Section 1202(d)(1) provides that a QSBS Issuer cannot issue QSBS if at any time prior to or immediately after the issuance of the applicable stock, the corporation's "aggregate gross assets" have exceeded $75 million ($50 million for QSBS issued prior to July 5, 2025). Under Sections 1202(d)(3), parent corporations (including S corporations) and corporate subsidiaries must be aggregated for purposes of the "aggregate gross assets" calculation.

If no property other than cash has been contributed to a QSBS Issuer, then under Section 1202(d)(2)(A) the corporation's "aggregate gross assets" would equal the amount of cash and the aggregate adjusted bases of other property held by the corporation. But, if property has been contributed to the

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corporation, then Section 1202(d)(2)(B) provides that the basis of that property for purposes of calculation "aggregate gross assets" is determined as if the tax basis of the property was equal to its FMV as of the time of contribution. This FMV amount would also be included in the Section 1202 Tax Basis of the QSBS issued in connection with the property contribution. ***Valuation discounts are not applicable when valuing the contributed property.***

Note that there will be either an actual or deemed contribution of property in connection with a partnership conversion or a contribution of property by a sole proprietor or S corporation to a C corporation. Also, Section 1202(i)(2) provides that the tax basis of property contributed to a QSBS Issuer as a capital contribution is no less than the property's FMV on the date of contribution. The purpose of Section 1202(i) is to prevent claiming Section 1202's gain exclusion for property appreciation occurring prior to holding the property in corporate form.

3.2 The treatment of long-term and short-term liabilities

How a corporation's long-term and short-term liabilities are handled in the computation of FMV has been a subject of some debate in the world of QSBS planning. The issue is whether references in Section 1202 to "assets" means (i) gross assets with no offset for liabilities or (ii) assets net of long-term and/or short-term liabilities.

There are three points supporting the conclusion that when determining the Section 1202 Tax Basis of property contributed to a QSBS Issuer (including for purposes of the $75 million "aggregate gross assets" test), both long-term and short-term liabilities are ignored (except with respect to the computation required by Section 1202(e)(5)(B), as discussed below):

(1) The key sections of Section 1202 dealing with the $75 million "aggregate gross assets" test and the Section 1202 Tax Basis refer to the corporation's "assets," not either "net assets" or "assets net of liabilities." The plain wording of the statute supports the conclusion that neither long-term nor short-term liabilities offset the FMV of the corporation's assets. Courts generally assume that the words of a statute

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mean what an "ordinary" or "reasonable" person would understand them to mean. Moreover, some courts adhere to the principle that if the words of a statute are clear and unambiguous, the court need not inquire any further into the meaning of the statute.[8] A reasonable person would likely read "assets" to mean "assets," not "assets net of liabilities."

(2) Section 1202's legislative history supports the conclusion that the reference to "assets" is not a reference to assets net of liabilities. When Section 1202 was first introduced, the legislation offset short term liabilities against asset value for purpose of the $50 million "aggregate gross assets" test calculation. The original draft legislation provided that the gross assets test was calculated as follows:

As of the date of issuance, the excess of (1) the amount of cash and the aggregate adjusted bases of other property held by the corporation, over (2) the aggregate amount of indebtedness of the corporation that does not have an original maturity of more than one year (such as short-term payables), cannot exceed $50 million" and "*In the case of a corporation that owns at least 50% of the vote or value of a subsidiary, the parent corporation is deemed to own its ratable share of the subsidiary's assets, and to be liable for a ratable share of the subsidiary's indebtedness.*"[9]

The Conference Agreement following the House bill referenced the following modification:

Gross asset. – The conference agreement provides that the $50 million size limitation is based on the issuer's gross assets (i.e., the sum of the cash and the adjusted basis of other property held by the corporation) without subtracting the short-term indebtedness of the corporation. For purposes of this rule, the adjusted basis of property contributed to the corporation is determined as if the basis of the property immediately after the contribution were equal to its fair market value ."[10]

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The legislative history supports the conclusion that as enacted, the references to "assets" was to gross assets, not assets net of liabilities.

(3) Third, Section 1202(e)(5)(B) provides the following:

*A corporation shall be treated as failing to meet the requirements of paragraph (1) [the "active business requirement"] for any period during which more than 10 percent of the value of its assets (**in excess of liabilities**) consists of stock or securities in other corporations which are not subsidiaries of such corporation (other than assets described in paragraph (6))*" (emphasis added).

Here Congress did elect to offset the FMV of a QSBS Issuer's assets by its liabilities. If the QSBS Issuer's liabilities are $100 and the FMV of its assets is $500, then the value of assets in excess of liabilities is $400, in other words, a net asset value. The fact that liabilities are explicitly deducted from the FMV value in this provision while the other provisions of Section 1202 are silent is compelling evidence that liabilities are not deducted from the FMV of assets in other sections of Section 1202.

3.3 Partnership-to-C corporation conversions (assets over vs. interests over)

When a contribution of property involves converting a business operated through a partnership (including LPs and LLCs) into a C corporation, an important issue for purposes of calculating the corporation's "aggregate gross assets" is how the incorporation is accomplished.

Revenue Ruling 84-111, 1984-2 CB 88, addresses the transfers of partnership assets and equity interests for corporate stock, and walks through the several ways of converting that fall into the category of either an "interests-over" or "assets-over" method. A further discussion of the treatment of partnership conversions under Revenue Ruling 84-111 can be found in the article "*Guide to Converting Partnerships (LLCs/LPs) into C Corporation Issuers of*

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QSBS – Part 1."

Assets Over. The "assets-over" method literally is treated as though the partnership contributed assets to the C corporation in exchange for QSBS. The "assets over" method applies if (i) the partnership actually contributes assets in exchange for QSBS, (ii) where the partnership files a "check-the-box" election on Form 8832 to be taxed as a C corporation, (iii) where the partnership converts to a corporation under state-law, (iv) where the partnership merges into a C corporation, (v) where the partnership distributes assets to its equity owners who in turn contribute them in the C corporation, and (vi) where a single-member LLC's membership interest is contributed to the corporation (treated as a deemed asset contribution under applicable law (see Section 7701). Where assets are either actually being contributed into a C corporation for QSBS or deemed to be contributed based on preceding conversion methods, it is reasonable to conclude that what is valued is the FMV of the contributed assets, without regard to any long-term or short-term debt assumed by the QSBS Issuer. ***Here the valuation report should address the FMV of the contributed assets and explicitly state that long-term and short-term liabilities are not offset against the FMV of the contributed assets***.

> **EXAMPLE 3**: A partnership contributes assets with a FMV of $20 million and aggregate tax basis of zero to a newly organized C corporation (QSBS Issuer), and also assigns $5 million of long-term and short-term debt. The Section 1202 Tax Basis of the QSBS issued in the exchange is $20 million. The partnership either holds onto the QSBS issued in exchange for its assets or distributes the stock to equity owners. If the QSBS is later sold for $150 million, the first $20 million would be taxed as capital gain and the next $130 million would be eligible for exclusion under Section 1202, applying the 10X Cap (10 times $20 million = $200 million potential gain exclusion).[11]
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> **EXAMPLE 4**: A partnership contributes assets with a FMV of $80 million and an aggregate tax basis of $20 million to a newly-organized C corporation and assigns $20 million of

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long-term debt and $20 million of short-term debt. The stock issued in the exchange is not QSBS because the corporation's "aggregate gross assets" exceeded $75 million immediately after the contribution.

Interests Over. An "interests over" contribution is a contribution of the partnership's (LP/'s/LLC's) equity interests in exchange for QSBS. The contribution of membership interests by partners/members to the C corporation is a favorite approach for bringing a business operated through a tax-partnership within the C corporation tax regime. It seems reasonable to conclude that where the property being contributed is a partnership interest for tax purposes, the assets being contributed are the partnership interests (i.e., not the partnership's assets) and the FMV of those partnership interests would indirectly include recognition of the impact on FMV of the partnership's long-term and short-term debt, at least to the extent that the valuation methods used by the appraiser take into account those liabilities. This approach would be consistent with the treatment of sellers of partnership interests under Revenue Ruling 99-6, 1999-1 CB 432 – those sellers, who hold 100% of the partnership's equity interests, are treated as selling their equity interests rather than a slice of each asset held by the partnership. This approach would also be consistent with those tax authorities that treat as partner's sale of an equity interest as a sale of an intangible asset rather than a transfer of the assets held by the partnership (the entity theory – see, e.g., *Grecian Magnesite Mining*.[12]

EXAMPLE 5: LLC members together contribute 100% of the membership interests of an LLC taxed as a partnership to a newly-organized C corporation in exchange for stock. The LLC's assets have a FMV of $70 million, and the LLC has $20 million of long-term debt and $20 million of short-term debt. An appraiser determined that the enterprise value of the LLC is $40 million, taking into account in the valuation the FMV of the partnership assets and liabilities. The stock issued by the corporation is QSBS because the QSBS Issuer's "aggregate gross assets" immediately after the exchange are $70 million. If the QSBS is later sold for $500 million, the first $70 million

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would be taxed as capital gain and the next $430 million would be eligible for exclusion under Section 1202, applying the 10X Cap (10 times $70 million = $700 million potential gain exclusion).

4. Determining Section 1202 Tax Basis for Contributed Property QSBS (Gain and 10X Cap)

Section 1202(b)(1) provides for a "standard" $15 million per-taxpayer, per-QSBS Issuer gain exclusion cap ($10 million for QSBS issued prior to July 5, 2025) and the separate but parallel 10X Cap. The 10X Cap can prove valuable to taxpayers holding QSBS with a substantial Section 1202 Tax Basis. If a taxpayer's Section 1202 Tax Basis in Corporation A's QSBS is $5 million, then the taxpayer's potential Section 1202 gain exclusion will be at least $50 million. Section 1202(b)(1) provides that the adjusted basis of QSBS for purposes of the 10X Cap is determined without regard to any addition to basis (e.g., resulting from a capital contribution) after the date on which the stock was originally issued.

If a taxpayer contributes only money to a QSBS Issuer in exchange for QSBS, the Section 1202 Tax Basis will be equal to the amount of the contributed money. Under Section 1202(i)(1)(B), if QSBS is issued for contributed property, "*the basis of such stock in the hands of the taxpayer shall in no event be less than the fair market value of the property exchanged*." So, for purposes of the 10X Cap, the fair market value of property contributed to a corporation in exchange for QSBS must be determined.

The determination of the Section 1202 Tax Basis for QSBS issued in exchange for property not only affects the calculation of the 10X Cap but also is relevant when determining how much Section 1202 gain is applicable when QSBS is sold. Since Section 1202(i)(1)(B) provides that the basis of QSBS is no less than the FMV of contributed property, there will be a difference between the amount of capital gain and Section 1202 gain arising out of the sale of QSBS issued in exchange for appreciated property. Section 1202(i)(1)(B) is intended to prevent taxpayers from claiming Section 1202's gain exclusion for property appreciation occurring prior to the contribution of the property to the corporation. For example, if

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property with a zero basis and FMV of $5 million is contributed for QSBS and the QSBS later sells for $40 million, then the capital gain is $40 million. The Section 1202 gain exclusion, however, would be limited to $35 million because the Section 1202 Tax Basis in the QSBS sold would be $5 million (the FMV at the time of contribution) rather than zero.

The typical business converting a C corporation with an eye towards taking advantage of Section 1202's gain exclusion is making the conversion with the expectation that the QSBS issued in the conversion will substantially appreciate. For example, a business whose assets are worth $25 million would be converted with the expectation that five years later, the resulting QSBS might be sold for $300 million. Under those circumstances, the hope is generally that the appraisal of the FMV of the tangible and intangible assets contributed to the C corporation will be high enough to support a significant Section 1202 gain exclusion. However, there is another potential side to a high valuation. If the tax basis of the contributed assets is $5 million and the FMV is $25 million at the time of contribution, then the first $20 million of capital gain will not be eligible for offsetting with Section 1202's gain exclusion, because that appreciation occurred prior to those assets being held by the C corporation. So, in the rare instance where the expectation is that the amount of appreciation between incorporation and sale of the QSBS will be more modest (e.g., $25 million FMV increases to $50 million over five years), then the hope might be that the appraisal of the contributed assets would be substantially below $25 million.

5. When to Obtain an Independent Appraisal

Section 1202 does not require or mention an independent appraisal of contributed property, but the Tax Court has noted that it is customary in valuation cases for both the taxpayer and the IRS to offer expert evidence to support their opposing valuation positions. [13] Although dueling independent appraisal reports are often part of the evidence submitted in a Tax Court proceeding, taxpayers should consider the circumstances where it would make sense to obtain an appraisal as part of the initial planning process or prior to taking a return position claiming Section 1202's gain exclusion.

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If property with material value is being exchanged for QSBS and there is a possibility that the corporation's "aggregate gross assets" will exceed the $75 million ceiling, business owners should certainly consider obtaining an independent valuation in advance of converting an LLC/LP or restructuring an S corporation so that its assets are held by a C corporation. If the transaction is completed and it is later determined that the corporation's "aggregate gross assets" exceeded $75 million, there is likely no way to put the genie back into the bottle and the stock held by the contributors will not meet Section 1202's eligibility requirements.

There isn't the same degree of urgency at issuance for obtaining a valuation if failing the $75 million "aggregate gross assets" test is not an issue. But given Section 351 reporting requirements[14] and the general perception that contemporaneous documentation is more accurate and reliable, business owners should certainly consider obtaining an appraisal either prior to or shortly after completion of a property contribution for purposes of establishing the Section 1202 Tax Basis of QSBS issued in the Section 351 exchange.

5.1 Obtaining an appraisal of assets during the planning process

Prior to accepting contributions of property in exchange for QSBS, QSBS Issuers should consider obtaining an independent appraisal for the purpose of determining the FMV of contributed assets, particularly when incorporating a partnership or otherwise issuing QSBS in exchange for property (including circumstances where an S corporation either directly contributes property to a C corporation in exchange for QSBS or contributes property after first undertaking a Type F reorganization). If the appraisal results in the determination that the corporation's "aggregate gross assets" would exceed Section 1202's $75 million ceiling, the parties would have the opportunity to restructure the contribution so that the QSBS Issuer's "aggregate gross assets" remain below the $75 million ceiling.

5.2 Obtaining an appraisal of assets prior to taking a return position

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If an appraisal was not obtained when property was contributed to a QSBS Issuer, taxpayers should consider obtaining an independent appraisal if any material amount of property was contributed to the corporation prior to claiming Section 1202's gain exclusion. The purpose of the appraisal would be to substantiate that the QSBS Issuer's "aggregate gross assets" were below the applicable $75 million or $50 million ceiling when the QSBS was originally issued. The appraisal would also establish the Section 1202 Tax Basis of the QSBS sold or exchanged for purposes of calculating the Section 1202 gain and determining the applicable 10X Cap amount.

A recurring theme in QSBS controversies is that taxpayers often lose not because the business was necessarily ineligible, but because the taxpayer cannot produce credible, contemporaneous evidence covering the relevant time period. Courts have emphasized that a taxpayer must prove each element of Section 1202 eligibility before claiming its benefits; incomplete historical records can be fatal even when later-period financials appear favorable.

A recent case highlights how a taxpayer's failure to adequately substantiate satisfaction of an element of a single eligibility requirement can result in a failed QSBS-related return position. The taxpayer in *JU v. Commissioner* acquired stock in 2003 but introduced into evidence at his trial only financial information for the 2009-2011 period.[15] The IRS successfully argued that the financial records from 2009 to 2011 were not "credible evidence" of the corporation's aggregate gross assets six years earlier. The court noted that "*as a threshold matter [a] plaintiff has the burden of proving that a section of the Internal Revenue Code applies to him, before he is able to benefit from its provisions*."[16] In spite of the fact that the "aggregate gross assets" of the QSBS Issuer were only $2.15 million in 2009, the court concluded that the taxpayer had failed to provide sufficient evidence that the corporation's aggregate gross assets were less than $50 million in 2003. What can be inferred from the *JU* decision is that it only takes the failure to substantiate one element of a single eligibility requirement for a court to reject a taxpayer's QSBS return position. It is possible to infer from the court's view in *JU* that a failure to adequately

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substantiate the FMV of contributed property would be sufficient to result in denial of the claimed Section 1202 gain exclusion.

6. What a QSBS-Focused Valuation Report Should Include

6.1 What the Tax Court has to say about valuation issues

The Tax Court has noted that approximately 243 sections of the Internal Revenue Code require FMV estimates in order to assess tax liability, and that 15 million tax returns are filed each year on which taxpayers report an event involving a valuation-related issue.[17] Understandably, the Tax Court has a lot to say about appraisals and appraisers. For instance, the Tax Court has noted that:

*We evaluate an expert's opinion in the light of his or her qualifications and all the evidence in the record. See Helvering v. Nat'l Grocery Co., 304 U.S. 282, 295 [20 AFTR 1269] (1938); Estate of Mellinger v. Commissioner, 112 T.C. 26, 39 (1999). "The persuasiveness of an expert's opinion depends largely upon the disclosed facts on which it is based." Estate of Davis v. Commissioner, 110 T.C. 530, 538 (1998). We are not bound to follow any expert witness's opinion where it is contrary to our own judgment. Helvering v. Nat'l Grocery Co., 304 U.S. at 295; Estate of Hall, 92 T.C. at 338. We may adopt or reject an expert's opinion in whole or in part. Estate of Davis, 110 T.C. at 538.**[18]***

and

the determination of the fair market value of property is a question of fact. Hamm v. Commissioner, 325 F.2d 934, 938 (8th Cir. 1963), affg. a Memorandum Opinion of this Court. At trial, we received opinion evidence testimony from many expert witnesses, and we weigh that testimony in light of the expert's qualifications as well as all the other credible evidence. Estate of Christ v. Commissioner, 480 F.2d 171, 174 (9th Cir. 1973), affg. 54 T.C. 493 (1970); Estate of Gilford v. Commissioner,88 T.C. 38, 56 (1987). Nonetheless, we are not

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bound by the opinion of any expert witness and will accept or reject expert testimony in the exercise of sound judgment. Helvering v. National Grocery Co., 304 U.S. 282, 295 Estate of Hall v. Commissioner, 92 T.C. 312, 338 (1989).

*Respondent's Revenue Ruling 59-60, 1959-1 C.B. 237, has been widely accepted as setting forth the appropriate criteria to consider in determining fair market value;**[19]***

It is important to note that while Revenue Ruling 59-60 referenced in the preceding quote does not impose qualification requirements for appraisers, other sections of the Internal Revenue Code, such as Section 170(f)(11)(E) (regarding charitable contributions), do define a "qualified appraiser" and a "qualified appraisal" for certain tax purposes. Section 170(f)(11)(E) requires a "qualified appraiser" to be an independent, experienced, and educated professional who meets specific regulatory requirements, one not excluded by relationship or fee structure, and one who provides a declaration of their qualifications and understanding of the penalties for misstatements. Section 170(f)(11)(E) further requires that the appraiser's qualifications be documented in the appraisal report, and the appraiser must not have been barred from IRS practice in the prior three years. Although the concept of a "qualified appraiser" and "qualified appraisal" does not apply explicitly to QSBS-related appraisals, those requirements provide useful guidance regarding what the IRS would generally expect to see from taxpayers using appraisals to substantiate Section 1202 eligibility requirements.

Courts have defined FMV as the price property would bring if offered by a willing seller to a willing buyer, with neither being obligated to buyer or sell, and where the buyer and seller are fully informed of the facts.[20] Experienced and qualified appraisers are familiar with the standards set by Revenue Ruling 59-60 and the various judicial decisions cited in this article. One personal observation from reviewing Tax Court decisions that look at dueling appraisal reports is that the Tax Court judges often go heavily into the weeds when considering the applicable facts and the valuation methodologies used by the parties' experts. A takeaway from reviewing these Tax Court decisions is that a taxpayer should

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greatly benefit from hiring an appraiser who has a significant amount of expertise and experience valuing the type of property contributed to the corporation, or closely-held corporation stock, as applicable, and one who is experienced handling tax-related appraisals. The appraisal report should address all relevant facts and be sufficiently detailed to meet the requirements of a Section 170 "qualified appraisal," along with providing sufficient analysis to support the report's conclusions. A critical responsibility of QSBS Issuers and taxpayers is to ensure that appraisers are provided with all relevant background facts and documentation when undertaking the valuation project, particularly when appraisers are asked to determine the FMV of contributed business goodwill or the FMV of QSBS issued by closely-held corporations.

There may be circumstances where disclosure of certain facts to the IRS by an appraiser might be damaging to a taxpayer. Section 8 below addresses whether creating a *Kovel* arrangement will help maintain the confidentiality of information and documents provided to the appraiser.

6.2 What should be included in a QSBS-focused appraisal report

A QSBS-focused appraisal report should be drafted with an eye toward audit and litigation defensibility and should, as applicable, include the following:

- purpose and use statement (i.e., prepared to support Section 1202 substantiation and related reporting), including the specific statutory touchpoints the report is intended to address (e.g., Section 1202(d)(2)(B) "aggregate gross assets," Section 1202(i)(1)(B) "Section 1202 Tax Basis," and the Section 1202(b)(1) 10X cap, as applicable);
- clear statement of the final concluded FMV of the assets;
- identification of the property valued (assets vs. equity interests; tangible vs. intangible; goodwill/IP components) with sufficient detail to tie the valuation to the transaction documents;
- valuation date(s) and confirmation that the report reflects information known or knowable as of the relevant date(s);

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- standard of value (FMV/willing buyer–willing seller) and any premise of value assumptions (going concern vs. liquidation);
- scope of work and limitations, including the documents reviewed, management interviews conducted, and data sources relied upon;
- statement of appraiser qualifications and independence, including credentials, relevant experience valuing the specific asset type or closely held stock, and confirmation of compliance with professional standards;
- summary of the business and relevant facts (capitalization, ownership, business model, historical and projected financials, key agreements, contingent liabilities/litigation, pending financings or sale processes);
- valuation methodologies applied (income/market/asset approaches), key inputs (discount rates, projections, guideline companies/transactions, multiples), and a clear explanation of why each method was selected or rejected;
- explicit treatment of liabilities and working capital—particularly where the valuation is being used for tests that measure "assets," "assets in excess of liabilities," or value-based ratios under Section 1202;
- classification of assets for QSBS purposes, where relevant, including identification of assets used in the qualified trade or business versus potentially Excluded Assets (e.g., excess cash/investments, portfolio securities, non-business real estate), and any supporting schedules that allow the reader to replicate the computation;
- discounts and premiums (and whether discounts are or are not applied based on the purpose of the report), with supporting empirical data and a reconciliation narrative; and
- appendices/exhibits (transaction documents list, financial statements, cap table, key assumptions, and any management representation letter) sufficient to allow a third party to understand and test the report's conclusions and to support related reporting (e.g., Section 351 statements that require FMV and basis reporting).

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The reason why these specific Section 1202 section references are important is to make it clear to the IRS and Tax Court that the appraiser preparing the report was specifically addressing FMV as required by the specific language of Section 1202. This approach should put taxpayers and their professional advisers in a much better position in the event that they need to later defend a tax audit or Tax Court proceeding than the situation where a Section 409A valuation or gift tax valuation must be "translated" or "repurposed" to provide support QSBS-related return positions. Having up-front language specifically addressing numbers associated with specific Section 1202 provisions is much more powerful than pointing to a line-item on page 47 of the report as substantiation support. Obviously, if the appraisal is, in fact, for gift or estate tax purposes, the requirements for such appraisal and the associated appraisal report should be followed.

Many valuation reports that we review in connection with our QSBS practice either estimate a corporation's "total equity value" or "enterprise value." Neither of these numbers directly addresses what the corporation's "aggregate gross assets" are for purposes of Section 1202. Valuation reports that determine "enterprise value" or "total equity value" do generally include a balance sheet as of the applicable date. If the report determines the corporation's "enterprise value" and includes the balance sheet, our understanding is that the corporation's aggregate gross assets for purposes of Section 1202 should equal "enterprise value," plus balance sheet "cash & equivalents," plus balance sheet "total liabilities." If the report determines the corporation's "total equity value," our understanding is that the corporation's aggregate gross assets for purposes of Section 1202 should equal "total equity value" plus balance sheet "total liabilities."

Our preference would be for valuation reports to expressly state a number for the corporation's "aggregate gross assets for purposes of Section 1202" as of the applicable date instead of focusing on a corporation's "total equity value," "invested capital" or "enterprise value," Our reason for preferring this approach is that it avoids having to explain to an IRS agent or the Tax Court how a corporation's "aggregate gross assets for purposes of Section 1202" can be determined when the report only addresses the

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determination of "total equity value," "invested capital" or "enterprise value."

We typically would not recommend that a corporation rely on an annual Section 409A valuation when determining a corporations aggregate gross assets for Section 1202 purposes, as 409A valuations are prepared specifically for tax planning and financial reporting purposes in conformity with the specific requirements of Section 409A and FASB Accounting Standards Codification Topic 718 – Stock Compensation, and for that reason explicitly state that the reports should not be used for other purposes. Section 409A reports focus on the determination of the value of a share of common stock for purposes of establishing the exercise price for nonqualified options, which is far removed from determining a corporation's aggregate gross assets for purposes of Section 1202. That said, the typical Section 409A report does determine aggregate equity value before discounting, which can be used to calculate "aggregate gross assets for Section 1202 purposes" by adding back balance sheet "total liabilities." But there are tax authorities that suggest the IRS may challenge the use of Section 409A reports to substantiate value for other purposes.

6.3. Timing of appraisal work and other details

As noted above, business owners who are converting their LLC/LP to a C corporation or S corporation owners who are restructuring the company to create a C corporation subsidiary should obviously obtain an appraisal prior to the conversion if there is any question whether the "aggregate gross assets" might exceed $75 million, resulting in the C corporation's disqualification to issue QSBS in the conversion. If "aggregate gross assets" do exceed $75 million, business owners might be able to exclude sufficient assets from the contribution to bring the corporation's assets below the $75 million mark. Excluded assets can then be licensed or leased to the QSBS Issuer. If business owners are confident that the number will fall below the $75 million mark, then obtaining a valuation of the contributed property for purposes of substantiating the "aggregate gross assets" number, and for purposes of establishing the Section 1202 Tax Basis of assets for purposes of the 10X Cap and for

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establishing the pre-conversion gain amount that won't qualify for offsetting by Section 1202's gain exclusion should probably be undertaken either before the conversion or within a reasonable time (months, not years) after completion of the conversion. Certainly, where property is contributed to a C corporation in exchange for QSBS, valuing the contribute property is a necessary element for substantiating that the stock issued in the exchange qualifies as QSBS and establishing the Section 1202 Tax Basis. Whether it is possible to avoid a formal independent valuation by relying on internally determined numbers likely depends on the nature of the contributed assets – i.e., valuing real and tangible personal property might be one thing but determining the enterprise value on an ongoing business is an entirely different challenge.

In addition to determining the FMV of contributed property for purposes of establishing the Section 1202 Tax Basis for the property, Treasury Regulation Section 1.351-3(a) requires the filing of a statement with a "significant transferor's" tax return and the transferee C corporation's tax return in connection with a Section 351 transaction. This statement requires reporting the FMV and tax basis of the contributed property.

A typical QSBS-related appraisal project might take between two and four weeks for the valuation firm to provide preliminary numbers and the completed appraisal report. Fees generally range between $7,500 and $20,000 for QSBS-related appraisal projects. In many instances, valuation firms will split the project into two parts, with 50% of the fee payable up front, and 50% of the fee payable in connection with the written valuation report. Obviously, the report won't be issued if the determination is made that the FMV of the contributed property exceeds the $75 million "aggregate gross assets" ceiling and the decision is made not to move forward with the issuance of stock qualifying as QSBS.

Taxpayers should be cautious about relying on stale or repurposed valuation work (e.g., an older Section 409A report) when facts and circumstances have materially changed. IRS guidance has criticized valuation approaches that fail to incorporate information that is known or knowable as of the relevant valuation date—particularly where the business is being shopped or other transaction indicators

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exist. A QSBS appraisal that is intended to substantiate Section 1202 eligibility should therefore be contemporaneous and purpose-built to address the specific statutory measurement point at issue.

7. Transfer of QSBS by Gift or At Death: Valuation and Reporting Considerations

For QSBS issued after July 4, 2025, each taxpayer generally has a separate "standard" per-QSBS Issuer $15 million gain exclusion cap. Section 1202 also has favorable rules regarding the gifting of QSBS which can be used to multiply the standard cap amount. A common strategy is to increase the number of taxpayers holding shares through transfers qualifying as gifts for federal income tax purposes. If Individual A transfers shares of Corporation A QSBS to a non-grantor trust as a gift, both Individual A and the non-grantor trust will generally enjoy separate $15 million gain exclusion caps with respect to Corporation A's QSBS (i.e., a $15 million gain exclusion is increased to a $30 million gain exclusion).

Section 2512(a) provides that the FMV of property as of the date of a gift is considered the amount of the gift. Treasury Regulation Section 25.2512-1 provides that FMV is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell, and both having reasonable knowledge of relevant facts. Revenue Ruling 59-60 requires consideration of all relevant factors and lists several factors that are typically considered when valuing closely-held stock. None of these authorities require the donor to obtain an appraisal of closely-held stock (QSBS) transferred as a gift, but the donor is responsible for reporting the FMV of the gifted QSBS on Form 709, and the donor must be prepared to substantiate the FMV if the value placed on the stock by the donor is challenged by the IRS. The gift tax return (Form 709) does require a detailed description of the property transferred and the method used to determine value, and any discounts claimed in order to meet the "adequate disclosure" requirements.[21] Of course, the IRS could also challenge the value placed on stock transferred as a gift even if the FMV is established through an independent appraisal. Section 6662(a) imposes a penalty equal to 20% of the portion of an

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underpayment attributable to a substantial misstatement of the value of gifted stock if the portion of the underpayment attributable to the misstatement exceeds $5,000. The 20% penalty is increased to 40% for a gross misstatement.[22] If the gifted stock has significant value, obtaining a contemporaneous independent "qualified" appraisal is a prudent choice given the potential penalties involved and the difficulty of substantiating FMV for closely-held stock without the appraisal.[23]

If QSBS is transferred as a gift to a charity, a qualified appraisal of the transferred QSBS will be required if the value exceeds $5,000, and a Form 8283 must be attached to the taxpayer's return. If the claimed deduction is more than $500,000, a qualified appraisal must be attached to the taxpayer's return. A "qualified appraisal" is one prepared, signed, and dated by a "qualified appraiser" in accordance with Treasury Regulation Section 1.170A-17(a) and the Uniform Standards of Professional Appraisal Practice.[24] The appraiser must have verifiable education and experience in valuing the type of property being appraised and must not be the donor, donee, or a related party.

If the holder of QSBS dies, then all property, including closely held stock, is generally included in the taxpayer's gross estate at its FMV as of the date of death. The valuation process and methodologies described in Revenue Ruling 59-60 and Treasury Regulation Section 20.2031-2 apply. Although an appraisal is not explicitly required, the common practice to attach a "qualified appraisal" as a supporting schedule to the estate tax return (Form 706) for the purpose of (i) meeting the "adequate disclosure" requirements (as a practical matter, it may not be reasonably possible to meet Treasury Regulation Section 301.6501-1(f)(3)'s disclosure requirements without attaching a qualified appraisal), and (ii) substantiating the FMV of the QSBS included in the estate.

8. Privilege and Engagement Structuring

In most circumstances involving valuation work undertaken in conjunction with QSBS return positions, taxpayers would seem likely to voluntarily disclose the results of valuation work and associated reports in connection with an IRS audit or controversy to further

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substantiate their positions regarding the satisfaction of the "aggregate gross assets" ceiling test or the amount of available gain exclusion. Once the appraiser's work product is disclosed voluntarily by the taxpayer, the confidentiality of such information is waived. But there may be circumstances where a taxpayer might instead desire to protect valuation information and associated appraiser documentation from disclosure to the IRS.

Section 7602 generally gives the IRS the power to subpoena appraisers to appear and provide testimony, documents, books, records and information relating to the appraiser's valuation work. But the powers vested in the IRS under Section 7602 must yield to a taxpayer's attorney-client privilege rights. The privilege right shields communications between an attorney and the taxpayer if the communications are for the purpose of obtaining legal advice, so long as the communications are intended to be kept confidential.[25] The scope of the privilege covers communications between taxpayer and counsel but can also extend to communications with accountants and appraisers, and under certain circumstances their workpapers if third party's role is to assist the attorney in providing legal advice to the taxpayer.[26] The privilege right does not generally extend to valuation work undertaken in connection with the preparation of tax returns or in connection with valuation reports that are required to be filed with tax returns.[27]

The fact that taxpayers might be reluctant to disclose all relevant facts to appraisers if they thought that the information would end up in the hands of the IRS has fueled the use of "*Kovel* letters," which contemplate running valuation projects through the attorney in an effort to bring communications with the appraiser and the appraiser's workpapers, etc. within the scope of attorney-client privilege.[28] There are a couple of observations to be made regarding the use of *Kovel* letters and structuring valuation projects through the attorney rather than directly with the taxpayer. First, the issue of whether the valuation work described above in connection with QSBS planning and return positions would be considered as being undertaken in connection with the providing of tax advice rather than tax return preparation work has not been addressed in tax authorities. It does appear that obtaining a valuation of contributed property is necessary for an attorney to

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advise a taxpayer whether stock meets Section 1202's eligibility requirements or the amount of the available gain exclusion, in both cases based on determining the value of contributed property. On the other hand, providing valuation reports to the IRS may be necessary to successfully substantiate satisfaction of the "aggregate gross assets" test and the amount of available gain exclusion applying the 10X Cap. Privilege is certain broken once the report has been provided to the IRS. Further, structuring an appraisal project through the attorney may be unnecessary if the taxpayer is reasonably confident that the valuation work and results will not be damaging to the taxpayer if disclosed to the IRS. Nevertheless, structuring a *Kovel* arrangement gives the taxpayer's representative the flexibility to assert privilege where it doesn't make sense to hand over to the IRS a valuation report and/or appraiser workpapers.

A "*Kovel* letter" establishes the arrangement between the appraiser and the taxpayer's attorney. To be effective, the "*Kovel* letter" should emphasize that the purpose of the appraisal work is to assist an attorney in providing legal advice (e.g., QSBS planning). Based on legal authorities addressing the reach of the *Kovel* privilege, it is important that communications among the attorney, taxpayer and appraiser are identified as confidential attorney-client privileged communications and billing should be run through the attorney, even where the client is responsible for payment.[29]

The *Kovel* letter should provide that fees for the appraisal work should run through the attorney. The attorney can avoid running into payment issues by requiring the taxpayer to deposit the required amounts with the attorney in advance of the appraiser commencing work or preparing the report, as applicable. If the valuation firm expects additional contractual rights such as indemnification, those can be established directly between the valuation firm and the taxpayer, but only after the *Kovel* arrangement with the attorney is first established.[30]

It may prove difficult from a practical standpoint to implement a process that adheres fully to the recommended process for maintaining attorney-client privilege, but the phrase "don't let perfection be the enemy of the good" should be kept in mind when

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considering efforts to protect the confidentiality of valuation work. Where appraisal work relating to QSBS tax benefits is undertaken through a properly administered *Kovel* arrangement, the IRS may not routinely pursue access to an appraiser's testimony, documents and other information with the same vigor and results seen in the Ninth Circuit's decision in *United States v. Richey*, 632 F.3d 559 (9th Cir., 2011), which dealt with a taxpayer seeking a substantial conservation easement deduction.

9. Practical Wrap-Up: Build a QSBS Valuation File

Taxpayers and issuers should consider maintaining a dedicated "QSBS valuation file" that includes (as applicable):

- appraisal reports and underlying data provided to the valuation firm;
- contemporaneous financial statements and capitalization tables;
- transaction documents for property contributions and stock issuances; and
- Section 351 reporting statements reflecting FMV and basis.

This file can be critical years later if the IRS challenges eligibility and the taxpayer must produce credible evidence covering the applicable period.

Please contact the authors, Scott Dolson or Brian Masterson, if you want to discuss any Section 1202 and Section 1045 issues by video or teleconference. You can also visit the **QSBS & Tax Planning Services page** to learn more about our team and read our latest insights and analysis.

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[1] 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 Section 1045's tax-free rollover or original QSBS sales proceeds into replacement QSBS. See *Frost Brown Todd's QSBS library.* For a discussion of OBBBA, see the article authored by Scott Dolson and Brian Masterson "*One Big*

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Beautiful Bill Act Doubles Down on QSBS Benefits for Startup Investors."

Section 1202 has gain exclusion caps 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 for stock issued prior to July 5, 2025, and $15 million or 10 times the stockholder's aggregate basis in QSBS sold during the taxable year for stock issued after July 4, 2025.

This article focuses on federal income taxes. Many states follow the federal treatment of QSBS. California, Pennsylvania, Mississippi and Alabama do not have a corresponding gain exclusion.

[2] See endnote 1.

[3] If the taxpayer only has a "reasonable basis" for the return position, the taxpayer should consider filing a Form 8275 disclosing the return position.

[4] The "aggregate gross assets" ceiling is $50 million for QSBS issued prior to July 5, 2026.

[5] See Section 1202(i)(1)(B).

[6] The "80% Test" is the determination that at least 80% by value of a corporation's assets are used in the active conduct of a qualified activity.

[7]For QSBS issued prior to July 5, 2025, the "aggregate gross assets" ceiling is $50 million instead of $75 million.

[8] *Desert Palace, Inc. v. Costa*, 539 U.S. 90 (2003).

[9] COMREP ¶ 12,021.098 ('93 Revenue Reconciliation Act. P> 103-66, 8/10/93).

[10] H.R. Conf. Rep. 103-213, H.R. Conf. Rep 103-213 (1993).

[11] All of the partnership examples assume that there are no "hot assets" under Section 751 that would be taxed at ordinary income rates rather than as capital gain.

[12] 149 T.C. 3 (2017). See also Chapter 1.02 of McKee, Nelson Whitmire & Brodie: *Federal Taxation of Partnerships and Partners*.

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Also, the exclusion of liabilities in connection with an asset contribution finds support in the fact that the initial house bill introduced in 1003 (H.R. 902) actually defined "aggregate gross assets" to include an offset for a corporation's short-term indebtedness. The legislative history notes that Representative Matsui's provision regarding short term indebtedness was removed, which suggests that the intention was to remove liabilities from the calculation of "aggregate gross assets."

[13]*The Ringgold Telephone Company*, TC Memo 2010-103.

[14] Section 351 statement requirements refer to information statements filed pursuant to Treasury Regulation § 1.351-3(b) attached to IRS Form 1120 when engaging in Section 351 nonrecognition exchanges. These statements typically include the aggregate fair market value of assets contributed to the corporation in the Section 351 exchange.

[15] *JU v. U.S.*, 170 Fed. Cl. 266 (Ct. Fed Cl. 3/18/2024).

[16] *Free-Pacheco. v. United States*, 114 AFTR 2d 2014-5272 (2014).

[17] *Estate of Edon L. Auker*, T.C. Memo 1998-185.

[18] *Kaleb J. Pierce*, T.C. Memo 2025-29.

[19]*Estate of Newhouse v. Commissioner*, 94 T.C. 193 (1973).

[20]*Elmhurst Cemetery Co. v. Commissioner*, 300 U.S. 37 (1937); *Boltar, L.L.C. v. Commissioner*, 136 T.C. 326 (2011).

[21] See Treasury Regulation Section 301.6501(c)-1(f)(2) and the instructions to Form 709. Chief Council Advice 2202211010 emphasizes the need for sufficient detail to apprise the IRS of the nature and value of the gift in order for the time period for assessment under Section 6501 to commence running. Perhaps the best way to satisfy Section 6501's adequate disclosure requirements for discounted closely-held stock is to attach a valuation report, but note that attaching the report will waive any attorney-client privilege associated with the appraiser's work.

[22] A substantial valuation misstatement occurs if the value claimed is 65% or less of the correct value. A gross valuation misstatement occurs if the value claimed is 40% or less of the

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correct value. No penalty is imposed if the taxpayer shows there was reasonable cause for the underpayment and the taxpayer acted in good faith. However, for substantial or gross valuation misstatements involving charitable deduction property, the reasonable cause exception is generally not available unless the value was based on a qualified appraisal by a qualified appraiser and the taxpayer made a good faith investigation of the value.

[23] In Chief Counsel Advice memorandum 202152018, the IRS concluded that an outdated appraisal that did not consider a pending sale was not sufficient for gift tax valuation purposes.

[24] See IRS Publication 561 (12/2024).

[25] See *United States v. Mejia*, 655 F.3d 126 (2d Cir. 2011).

[26] See *United States v. Kovel*, 296 F.2d 918 (2d Cir. 1961), the court extended attorney-client privilege to include "*all persons who act as the attorneys' agent*" where that communication was "*made in confidence for the purpose of obtaining legal advice from the lawyer*.

[27] See *United States v. Bornstein*, 977 F.2d 112 (4th Cir. 1992), *United States v. Davis*, 636 F.2d 1028 (5th Cir. 1981) and *United States v. Rickey*, 632 F.3d 559 (9th Cir. 2011).

[28] See footnote 17 and *United States v. Adlman*, 68 F.3d 1495 (3d Cir. 1995).

[29] An article published on the American College of Trust and Estate Counsel (ACTEC) discussing a Ninth Circuit Court of Appeals decision goes further still recommending that client should not contact the appraiser at any time before the appraiser is engaged by the attorney and that all communications between or among the client, the appraiser and the attorney must be identified as "confidential."[29] This may prove difficult where the taxpayer wants input in selecting the appraiser. The article further notes that the *Kovel* letter should state that the purpose of the valuation work is to assist the attorney in providing legal services and rendering legal advice. The article provides additional advice on structuring arrangements with third party professionals such as appraisers when the work is undertaken in anticipation of litigation. See Sarah

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O'Keefe & Andrew Soresen, "Protecting Privilege After Richey" found at Protecting-Privilege-After-Richey.pdf on The American College of Trust and Estate Counsel (ACTEC Foundation) website located at www.actecfoundation.org.

[30] Obviously, the attorney is unlikely to be willing to indemnify the valuation firm or otherwise be contractually obligated beyond making payment of the appraiser's fees out of funds paid for that purpose by the taxpayer to the attorney.

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- Revisiting the Choice of Entity Decision After OBBBA's 2025 Tax Law Changes | Part 1
- Exploring Section 1202's Active Business Requirement
- Substantiating the Right to Claim QSBS Tax Benefits | Part 2
- Substantiating the Right to Claim QSBS Tax Benefits | Part 1
- To Be Clear…LLCs Can Issue Qualified Small Business Stock (QSBS)
- Advanced Section 1202 (QSBS) Planning for S Corporations
- Finding Suitable Replacement QSBS – A Section 1045 Primer
- Guide to Converting Partnerships (LLCs/LPs) into C Corporation Issuers of QSBS – Part 1
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- Section 1202 (QSBS) Planning for Sales, Redemptions and Liquidations
- Can Stockholders of Employee Staffing Companies Claim Section 1202's Gain Exclusion?
- QSBS Guidebook for Family Offices and Private Equity Firms
- Conversions, Reorganizations, Recapitalizations, and Stock Splits Involving QSBS
- Navigating Section 1202's Redemption (Anti-churning) Rules
- A Section 1202 Walkthrough: The QSBS Gain Exclusion
- A SPAC Merger Primer for Holders of Qualified Small Business Stock
- Determining the Applicable Section 1202 Exclusion Percentage When Selling QSBS
- Selling QSBS Before Satisfying Section 1202's Five-Year Holding Period Requirement?
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