The Role of the Business Purpose Doctrine in Transaction Planning Involving Qualified Small Business Stock

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This article addresses the importance of having bona fide (non-federal income tax) business and personal purposes (referred to in this article as "Non-Tax Purposes") when taking steps that have the result of enhancing the availability or magnitude of Section 1202's benefits.[1] A risk associated with undertaking transactions that are beneficial from a federal income tax standpoint is that the IRS will assert the business purpose doctrine (claiming the transaction is undertaken for the principal purpose of tax avoidance) as a reason for refusing to respect the transaction's form or claimed tax consequences.[2]

During the past several years, there has been an increase in the use of C corporations as the start-up entity of choice. Much of this interest can be attributed to the reduction in the corporate rate from 35% to 21%, but savvy founders and investors have also focused on qualifying for Section 1202's generous gain exclusion. Any future increases in capital gains rates may result in qualified small business stock (QSBS) eligible investments being even more attractive by comparison.[3]

This is one in a series of articles addressing planning issues relating to QSBS and the workings of Sections 1202 and 1045 of the Internal Revenue Code.

Does the business purpose doctrine apply to choice-of-entity planning?

Most business and tax planning involving qualified small businesses focuses on the underlying business and economic aspects of founding start-ups, attracting capital and structuring liquidity events. During this process, the choice of the C corporation is often driven by the requirements of early-stage venture investors who expect to invest in SAFE instruments[4], convertible debt or

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preferred stock. If obtaining start-up financing is not a critical factor, then initial choice-of-entity tax planning generally focuses on the relative merits of the C corporation versus LLCs or other entities qualifying for pass-through tax treatment.[5] Business owners do also consider the potential benefits of claiming Section 1202's gain exclusion, but Section 1202 usually represents only one of several reasons when the C corporation is chosen.

Against this backdrop, should there be a concern that the IRS might attempt to challenge a choice-of-entity decision by applying the business purpose doctrine? Might the IRS argue, for example, that there must be Non-Tax Purposes before business owners are permitted to rely on Section 351's nonrecognition treatment when converting a partnership to a C corporation?[6] The IRS has previously taken the position outside of the Section 1202 context that nonrecognition treatment under Section 351 isn't available if the parties lack Non-Tax Purposes.[7] Based on our review of tax authorities, we believe that the IRS would fare poorly litigating the position that taxpayers must have Non-Tax Purposes for basic choice of entity decisions. Past court decisions denying Section 351 nonrecognition treatment involve attempts to abuse Section 351 for the purpose of accomplishing an additional tax avoidance goal. A typical example is one where taxpayers attempt to contribute "loss" property to a C corporation, claiming Section 351 nonrecognition treatment, when their agenda includes immediately benefiting from the losses through a second step.[8] We expect that most choice-of-entity planning, including planning resulting in the selection of a C corporation with the intent to ultimately benefit from Section 1202's gain exclusion, will be undertaken for a number of additional Non-Tax Purposes. We also believe that choice of entity planning also falls into the category of permissible "tax avoidance," which was eloquently described by the Supreme Court as follows: "The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits."[9]

Does the business purpose doctrine apply to planning focused on maintaining a corporation's qualified small business status?

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Once QSBS is issued, management's role often includes monitoring on an on-going basis compliance with Section 1202's eligibility requirements. For most start-ups, with some notable exceptions, this monitoring requires minimal effort. One common exception to this general rule is where management intends to issue later rounds of QSBS. In those circumstances, steps may need to be taken to maintain the corporation's "aggregate gross assets" under the $50 million mark. Another exception is when the corporation is involved in recapitalizations or other capital transactions. These transactions can have an adverse effect on Section 1202 eligibility if improperly structured. Also, if the corporation undertakes a sale process or goes public in a special-purpose acquisition company (SPAC) merger, careful attention will need to be paid to ensuring that the transaction either triggers the right to claim Section 1202's gain exclusion or the QSBS status of the stockholders' shares is not adversely affected.[10] Finally, investors holding QSBS should hope that management steers clear of S elections or holding minority owned corporate subsidiaries.

Most of the actions described in the preceding paragraph should fall into the category of permissible tax planning. For example, business owners should be permitted to structure an exit as a stock sale rather than asset sale for the sole purpose of triggering the stockholders' right to claim Section 1202's gain exclusion. Less clear but still something that we believe should fall into the scope of permissible tax planning would be a corporate restructuring that could be undertaken in one step but instead is undertaken in two steps for the purpose of preserving the QSBS status of outstanding stock. Never the less, given the potential that the IRS might attempt to expand the scope of the business purpose doctrine, we believe that business owners and professionals should routinely identify and memorialize Non-Tax Purposes in connection with undertaking any action that has the effect of enhancing (obtaining, expanding or preserving) Section 1202's benefits.

When identifying and documenting Non-Tax Purposes should play a critical role in the planning process.

We believe that it is prudent to consider, when undertaking certain actions resulting in enhanced Section 1202 benefits, that the IRS

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might first assume and then assert that the action was undertaken for the principal purpose of securing federal income benefits (i.e., for tax avoidance purposes). For instance, the IRS might challenge the tax treatment of a corporate restructuring where there are several paths to achieving the intended end-result and the form selected is the only path that enhances Section 1202's benefits. The IRS might also challenge gifting QSBS to multiple trusts undertaken in connection with wealth transfer and asset protection planning, if one result is the expansion of Section 1202's benefits. Any corporate transaction or other action involving QSBS could be a potential target for IRS scrutiny.

As discussed above, we believe that the thrust of any IRS challenge would be the argument that the transaction enhancing Section 1202's benefits was undertaken for the principal purpose of tax avoidance (i.e., lacks principal Non-Tax Purposes). The IRS would likely argue (or at least operate from the premise) that there should be a presumption of tax avoidance purpose given the magnitude of Section 1202's potential benefits. In support of its position, the IRS would cite Section 269, Section 643(f), or one or more of several judicially created anti-tax avoidance doctrines (e.g., the sham transaction or economic substance doctrines).

We believe that the taxpayer's best counter to this potential IRS attack is to establish at the outset of the planning process that a transaction is being undertaken for the principal purpose of achieving one or more Non-Tax Purposes. The reality is that, in many cases, there are several significant Non-Tax Purposes driving transactions that also have the collateral effect of enhancing Section 1202's benefits. But given the fact that the IRS's assertion of the business purpose doctrine ultimately ends up as a facts and circumstances battle, we believe a key to success in an audit or in court is to demonstrate by producing convincing contemporaneous documentation that Non-Tax Purposes were the principal reason for undertaking the transaction. Put another way, we believe that regardless of whether a transaction was, in fact, undertaken for Non-Tax Purposes, taxpayers risk losing valuable credibility by waiting until an audit is looming before making the effort to articulate and memorialize the transaction's Non-Tax Purposes.

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Parting thoughts.

Business owners and tax advisors should look beyond whether the mere form of a transaction "works" based on their literal reading of the Internal Revenue Code and consider whether there are sufficient Non-Tax Purposes for the transaction to withstand the assertion of the business purpose doctrine. Business owners and tax advisors should consider the potential negative consequences of undertaking a transaction that lacks meaningful Non-Tax Purposes. The failure of business owners to fully develop and contemporaneously document the principal Non-Tax Purposes for undertaking a transaction could encourage the IRS to first presume tax avoidance and then assert the business purpose doctrine. Finally, tax advisors should be familiar with the Non-Tax Purposes for undertaking various transactions and the workings of the business purpose doctrine.

In spite of the potential for extraordinary tax savings, many experienced tax advisors are not familiar with Code Section 1202 and Code Section 1045 planning. Venture capitalists, founders and investors who want to learn more about Code Section 1202 and Code Section 1045 planning opportunities are directed to several articles on the Frost Brown Todd website.

More QSBS Resources:

- Section 1202 Qualification Checklist and Planning Pointers
- A Roadmap for Obtaining (and not Losing) the Benefits of Section 1202 Stock
- Maximizing the Section 1202 Gain Exclusion Amount
- Advanced Section 1045 Planning
- Recapitalizations Involving Qualified Small Business Stock
- Section 1202 and S Corporations
- The 21% Corporate Rate Breathes New Life into IRC § 1202

Contact Scott Dolson if you want to discuss any Code Sections 1202 or 1045 issues by telephone or video conference. You can also visit our **QSBS & Tax Planning Services page** to get our latest insights and analysis.

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[1] References in this article to "Section" are to sections of the Internal Revenue Code, as amended. Section 1202 makes available to eligible stockholders a gain exclusion when selling qualified small business stock (QSBS). The available gain exclusion is generally capped at a $10 million per stockholder per-issuer exclusion, although the exclusion can exceed that amount under certain circumstances. Section 1045 allows the proceeds from the sale of QSBS to be rolled over on a tax-free basis into replacement QSBS.

[2]*Gregory v. Helvering*, 293 U.S. 485 (1935). Treasury Regulation Section 1.368(b) and (c) summarize the "business purpose doctrine" as requiring that a reorganization must be (a) required by the exigencies of business, (b) an ordinary and necessary incident to the conduct of the business, and (c) not a device for tax avoidance.

[3] Although it is likely that the corporate tax rate will increase from the current 21% rate, it is also likely that the capital gains rate for high-income individuals will increase dramatically, potentially making seeking the Section 1202 gain exclusion an even more compelling planning option.

[4]Simple agreement for future equity (a "SAFE").

[5] E.g., S corporation or limited liability company or limited partnership taxed as a partnership for federal income tax purposes. Business owners should think twice before selecting the S corporation at the outset as stock issued by the S corporation will not qualify for Section 1202's gain exclusion, which often means that founder stock won't qualify while investors' preferred stock issued after the corporation converts from S to C corporation will qualify.

[6] Business purposes, for example, beyond positioning a business to take advantage of favorable corporate income tax rates and the potential benefits of the Section 1202 gain exclusion.

[7] See FSA 200135001. Notwithstanding the IRS occasional position, the Section 351 regulations don't require that the parties have a business purpose.

[8] In Technical Advice Memorandum 200204002, the IRS took the position that it can rely on Section 269 to disallow what was characterized as an abusive misuse of the nonrecognition treatment

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of Section 351. In the TAM, the IRS acknowledged that courts have held that the scope of Section 269 does not extend to nonrecognition concepts (which could include Section 351). The IRS indicated in the TAM that it disagrees with those authorities. See *Cherry v. United States*, 264 F.Supp. 969 (C.D. Cal. 1967) and *Bijou Park Properties, Inc. v. Commissioner*, 47 T.C. 207 (1966).

[9] *Gregory v. Helvering*, 293 U.S. 465 (1935). Former Supreme Court Justice Louis D. Brandeis is quoted as saying: "I live in Alexandria, Virginia. Near the Supreme Court chambers is a toll bridge across the Potomac. When in a rush, I pay the dollar toll and get home early. However, I usually drive outside the downtown section of the city and cross the Potomac on a free bridge. This bridge was placed outside the downtown Washington, DC area to serve a useful social service, getting drivers to drive the extra mile and help alleviate congestion during the rush hour. If I went over the toll bridge and through the barrier without paying the toll, I would be committing tax evasion … If, however, I drive the extra mile and drive outside the city of Washington to the free bridge, I am using a legitimate, logical and suitable method of tax avoidance, and am performing a useful social service by doing so. For my tax evasion, I should be punished. For my tax avoidance, I should be commended. The tragedy of life today is that so few people know that the free bridge even exists."

[10] When a target stockholders holds QSBS, the focus will often be on triggering a stock sale to claim Section 1202'g gain exclusion unless the stockholders' holding period is less than five years. If that is the case, then the focus might shift to rolling over target stock into buyer stock or structuring the purchase of replacement QSBS under Section 1045.

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