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## New Tax Law – Equity Capital Opportunities for Small Businesses

On December 17, 2010 President Obama signed the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (2010 Tax Relief Act), which extended through the end of 2011 amendments to Section 1202 of the Internal Revenue Code that offer a tremendous opportunity for small businesses (less than \$50 million in assets) that may be seeking to raise capital, or for banks or private equity or venture funds that invest in such small businesses.

Section 1202 is of particular interest to these small businesses since it effectively gives them the ability to issue stock (either common or preferred) on which a **zero** tax rate is imposed (Tax-Free Stock) if the stock is sold at a gain. Prior to the enactment of the 2010 Tax Relief Act, such stock had to be issued during the period from September 27, 2010 through December 31, 2010. **However, the 2010 Tax Relief Act extends that period through December 31, 2011.** Any startup, emerging or middle-market business that anticipates a need to secure additional equity capital during 2011 should strongly consider utilizing Section 1202, given its incentives for investment in these businesses.

In order for stock to qualify as Tax-Free Stock, it must be issued by a C corporation whose gross assets do not exceed \$50 million (including the proceeds received from the issuance of the stock). The amount of gain eligible for the exclusion is limited to the **greater of 10** times the taxpayer's basis in the stock or \$10 million of gain from stock in that corporation. To qualify, the stock

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### Contacts:

[Robert B. Webb III](#)  
+1.703.720.7855

[Arman Pahlavan](#)  
+1.650.843.3292  
+1.212.872.9810

[Nicholas Unkovic](#)  
+1.650.843.3238  
+1.415.954.0275

[Donald W. Hughes](#)  
+1.614.365.2734

[Michael G. Meissner](#)  
+1.216.479.8593

[Helen B. Jensen](#)  
+1.216.479.8272

[Scott Monroe Coffey](#)  
+1.561.650.7137  
+1.305.577.4722

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must be issued within the window period referred to above and held for more than five years.

In addition, Tax-Free Stock must meet the following requirements:

- The shareholder must have acquired the stock at original issue – i.e., directly from the issuing corporation (or through an underwriter) and not by transfer from another shareholder.
- The stock must be stock of a C corporation (at the time of issue, at the time of sale and during substantially all of the taxpayer’s holding period for such stock).
- The shareholder must not be a corporation.
- The stock must have been issued in exchange for:
  - Cash;
  - Property (other than other stock); or
  - Services (other than services performed as an underwriter of such stock).
- The corporation must be engaged in an “active business.” This requirement is satisfied if at least 80 percent of the assets of the corporation are used in the active conduct of one or more qualified trades or businesses. A “qualified trade or business” is defined to mean any trade or business other than:
  - A trade or business involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees;
  - Any banking, insurance, financing, leasing, investing or similar business;
  - Any farming business (including the business of raising or harvesting trees);
  - Any business involving the production or extraction of products of a character with respect to which a deduction is allowable

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under Section 613 or 613A; and

- o Any hotel, motel, restaurant or similar business.

A special provision of Section 1202 effectively allows businesses engaged in certain start-up and research and development activities to qualify as businesses engaged in an active trade or business without regard to whether the corporation has any gross income from such activities at the time of the determination. In addition, the “active trade or business” requirement is waived for a “specialized small business investment company” if the SBIC is licensed to operate under Section 301(d) of the Small Business Investment Act of 1958.

Section 1202 imposes certain other requirements including rules relating to redemptions, real estate holding corporations and pass-through entities that may be relevant to particular situations.

If you would like to learn more about the possible advantages of using Section 1202 to issue or acquire Tax-Free Stock, please contact your principal Squire Sanders lawyer or one of the professionals listed in this Alert.

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The contents of this update are not intended to serve as legal advice related to individual situations or as legal opinions concerning such situations. Counsel should be consulted for legal planning and advice.

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