

OKLAHOMA TAX COMMISSION

TAX POLICY AND RESEARCH DIVISION
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December 22, 2005

Re: Our file number LR 05-156; Income Tax - Small Business Capital Formation Incentive Act and the Rural Venture Capital Formation Incentive Act

Dear

This is in response to your inquiry of September 20, 2005 (with supplemental material submitted December 21, 2005) wherein you requested a letter ruling or determination regarding the credits provided by the Small Business Capital Formation Incentive Act, 68 O.S. § 2357.60 et seq., and the Rural Venture Capital Formation Incentive Act, 68 O.S. § 2357.71 et seq. Following is a restatement of the facts outlined in your letter, the rulings requested and our responses thereto.

Facts

(the "Management Company") intends to form an Oklahoma limited liability company called (the "Fund"). The Fund will raise capital from accredited investors for the purpose of making venture capital investments in "Oklahoma small business ventures" and "Oklahoma rural small business ventures" (the "Venture Company" or "Venture Companies") as defined in the Business Incentive Acts. Investments will be made through a designated series of another Oklahoma limited liability company called (the "Capital Company"). Neither the Fund nor the Capital Company will elect to be treated as corporations for Federal income tax purposes. Therefore, they will both be treated as partnerships for Federal and Oklahoma income tax purposes.

68 O.S. § 2357.61 requires that not more than twenty percent (20%) of the funds of the Capital Company be invested in any one Oklahoma small business venture. 68 O.S. § 2357.72 requires that not more than twenty-five percent (25%) of the funds of the Capital Company be invested in any one Oklahoma rural small business venture. In order to ensure that the amount invested in each Venture Company does not exceed the applicable statutory percentage, the Capital Company will review the sum of amounts invested in each Venture Company plus cash on hand. To the extent necessary, cash on hand may be enhanced by funds borrowed from lending institutions and invested in certificates of deposit or government securities.

To raise capital, the Fund intends to issue its "Common Units" and obtain loan(s) (the "Venture

Loan(s)") from one or more lending institutions. Investors in the Common Units will be admitted as "Members" of the Fund. Proceeds from the sale of Common Units and the Venture Loan(s), after deduction for expenses and reserves, will be invested in a series of the Capital Company's Preferred Units to be invested in Venture Companies. The Fund will also make direct investments in Venture Companies pursuant to the direct investment provisions of the Business Incentive Acts. The Capital Company is intended to qualify as a "qualified small business capital company" and also as a qualified rural small business capital company" as defined in the Business Incentive Acts. The fund's investment in the Capital Company is intended to qualify as a "Qualified Investment" as defined in the Business Incentive Acts.

Capital Company and Fund investments in Venture Companies will be in the form of "equity and near equity securities" as defined in the Business Incentive Acts. Typically, investments will be in the form of a convertible subordinated debenture. If required by the Fund's lender, a Venture Company may be required to escrow a portion of the proceeds from the investment in a lender controlled account to secure the Fund's indebtedness. As additional collateral, the Capital Company may also be required to pledge to the Fund or the Fund's lender, the securities issued to the Capital Company by the Venture Company.

As mentioned above, the Fund intends to reserve a portion of its capital to cover expenses and then to make a Qualified Investment in the Capital Company. In conjunction with the Fund's Qualified Investment in the Capital Company, it will also make direct investments in Venture Companies. The Fund's direct investments in Venture Companies are intended to qualify as a tax credit qualified investments under the requirements of the respective Business Incentive Acts. The Fund will be a partner of the Capital Company and the Fund's direct investment will be made under the same terms and conditions as the Capital Company's investment in a Venture Company. The Fund's direct investment will be limited to the lesser of 200% of the Fund's investment in the Capital Company or 200% of the Capital Company's investment in that Venture Company,

As a result of the transactions outlined above, it is anticipated that the Fund will become entitled to a 30% tax credit on its investment in the Capital Company used to fund rural small business ventures and a 20% tax credit on its investment in the Capital Company used to fund other (metropolitan) qualifying small business ventures. Likewise, it is anticipated that the Fund will become entitled to the same tax credits for its direct investments in Venture Companies. Pursuant to the Fund's Operating Agreement, all of the tax credits earned by the Fund for its investment in the Capital Company and its direct investments in Venture Companies, will be allocated to the Members

Supplemental Facts

I. In our client's venture capital program, Capital Company investments in Venture Companies represent irrevocable funding commitments

In a typical transaction, a Venture Company will submit a business plan for review by the Fund's Manager. The business plan usually includes "pro-forma" financial projections demonstrating the financial viability of the Venture Company's business model. Representations in the business plan

along with financial projections create "milestones" which are segregated into short term, medium term, and long term business objectives. If the Venture Company satisfies the investment criteria established by the particular investment program the Fund may commit to funding to the short, medium, and long term financial requirements of the Venture Company. This type of financing is generally used when a Venture Company's business model involves manufacturing medium to high cost products, usually with long production times, and the expectation that the Venture Company will provide manufacturer financing to customers.

The transaction documents accompanying the Capital Company's investment govern the terms of the investment and the use of investment proceeds by the Venture Company. Capital Company investments in Venture Companies involve the investment of cash proceeds usually in exchange for subordinated debt securities convertible into Venture Company equity securities. Once funds are committed to the Capital Company and invested in a Venture "Company, the commitment becomes an irrevocable obligation on the part of the investors.

The use of proceeds provisions in the transaction documents are based upon the representations made in the Venture Company's business plan and the financial projections accompanying the business plan. As a result, Venture Companies have an incentive to provide accurate representations and projections. Typically, a portion of the investment proceeds is available to the Venture Company for general working capital purposes. Another portion of the Funds is available for capital expenditures, such as equipment, inventory, and work in progress. The remaining funds are usually used for financing finished goods under contracts with customers.

To reduce investment risk and to help ensure that funds are used for the intended purposes, the Fund will usually require a pledge of assets, including undeployed funds, to secure the Fund's indebtedness to its venture lender. Absent a breach of the transaction documents, the funds remain available for the purposes set forth in the transaction documents. Events that might cause a breach include excessive compensation, failure to meet material milestones in the business plan, and criminal acts on the part of Venture Company management.

As we discussed, we do not believe that the pledge of undeployed funds changes the nature of the Capital Company's investment in a Venture Company, The investment represents an irrevocable commitment on the part of the investors and the funds are available to the Venture Company for the purposes set forth in the transaction documents at all times. As described in our prior Supplement, any potential abuse of this structure is minimized by the Venture Company's business judgment in deciding how much capital it needs, taking into consideration interest costs and ownership dilution.

II. In our client's venture capital program, the Capital Company meets the diversification test at all times.

In our ruling request we asked that you provide a determination that not more than twenty-five percent (25 %) of the funds of the Capital Company would be invested in each rural Venture Company under 68 O.S. § 2357.72 and that not more than 20 percent (20%) of the funds of the Capital Company would be considered to be invested in each metropolitan Venture Company under 68 O.S. § 2357.61.

The request discussed that in order to ensure that the amount invested in each Venture Company does not exceed the applicable statutory percentage, the Capital Company will review the sum of the amounts invested in each Venture Company plus cash on hand and, to the extent necessary, cash on hand is increased by borrowed funds (which are secured by certificates of deposit or government securities).

Our client's venture capital program mandates that the Capital Company meet its obligations under 68 O.S. § 2357.61 and § 2357.72 each and every day of the year, not just at a point in time or at the end of the year. Prior to any investment, capitalization is reviewed to make sure that the investment will not cause a violation of the diversification requirement. If the statutory requirement is not met, cash on hand is enhanced by secured loans or additional subscriptions.

Rulings Requested

1. The 30% credit earned by the Fund on its investment in the Capital Company under 68 O.S. § 2357.73 and the 20% credit on its investment in the Capital Company under 68 O.S. § 2357.62 will pass through and be available to the Members of the Fund in proportion to their investments in the Fund.

Yes. In the case of flow-through entities (LLC's, partnerships, and Sub S corporation), the credit is generally distributed to the appropriate member, partner or shareholder. The Tax Commission has historically allowed the distributing entity to determine how the amounts of credits are distributed so long as the following two conditions are met. One, the amount distributed does not exceed the amount of available credit and two, distribution must be made to a member, shareholder or partner of the flow through entity that has generated the credit.

2. The credits will pass through to the Members and be usable by them against any tax of the Member then due for the current tax year plus any carry-forwards under the tax provisions of the statute, including estimated income tax payments, immediately upon the statutory requirements being met, i.e. investment into the Capital Company and investment by it into a Venture Company.

The credits are available to be used to offset Oklahoma taxes when due, provided income tax year integrity is maintained. For example, an investment made in 2006 generates a credit that is available to offset tax year 2006 taxes and would not be available to pay 2005 income tax that may be due in 2006.

3. The Capital Company will be considered to have invested not more than twenty five percent (25%) of its funds in each rural Venture Company under 68 O.S. § 2357.72 and not more than twenty percent (20%) of its funds in each metropolitan Venture Company under 68 O.S. § 2357.61.

Based on the supplemental facts outlined above, it appears that the Capital Company will not have invested not more than twenty five percent (25%) of its funds in each rural Venture Company under 68 O.S. § 2357.72 and not more than twenty percent (20%) of its funds in each metropolitan Venture Company under 68 O.S. § 2357.61.

4. The direct investment by the Fund in each specific Venture Company will qualify for the tax credits described under either 68 O.S. § 2357.63 or § 2357.74.

Based on the supplemental facts outlined above, the irrevocable obligation of the Capital Company of the cash proceeds in exchange for subordinated debt securities appears to meet the definition of either equity or near equity security as required by the Act.

5. Tax credits earned pursuant to 68 OS 2357.62, 2357.63, 2357.73 and 2357.74 and being carried forward up to ten years under the relevant provisions of those sections should be allowed to offset gross production tax due beginning July 1, 2006, or, at the very least, credits earned after May 31, 2004 and carried forward should be allowed to offset the gross production tax.

Tax credits earned pursuant to 68 OS 2357.62, 235.63, 2357.73 and 2357.74 are eligible to offset gross production taxes becoming due July 1, 2006. It is the position of the Tax Commission that any credits that are available to a taxpayer under the carryover provisions of 68 O.S. § 2357.62 (B), 2357.63 (B), 2357.72(B) or 2357.73 (B) may be used only by that specific taxpayer to offset gross production taxes due on or after July 1, 2006. Tax credits authorized under the Small Business Capital Formation Incentive Act and the Rural Venture Capital Formation Incentive Act are not generally transferable.

This response applies only to the circumstances set out in your request of September 20, 2005. Pursuant to Commission Rule 710:1-3-73(e), this Letter Ruling may be generally relied upon **only** by the entity to whom it is issued, assuming that all pertinent facts have been accurately and completely stated, and that there has been no change in applicable law.

Please also be advised that the issuance of this ruling does not preclude the Oklahoma Tax Commission from conducting an audit or examination under 68 O.S. § 206 of _____, any direct or indirect investors, or any member of these LLC.'s regarding the transactions outlined in this letter ruling. The Commission further reserves the right to issue any assessment, correction, or adjustment authorized under 68 O.S. § 221.

If I can be of further assistance, please feel free to call me at (405) 521-3133.

Sincerely,
FOR THE OKLAHOMA TAX COMMISSION

Tony Mastin
Director