

# OKLAHOMA TAX COMMISSION

TAX POLICY AND RESEARCH DIVISION  
TONY MASTIN, DIRECTOR

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October 31, 2006

Re: Our file number LR-06-152; Supplemental Ruling

Dear

This letter ruling is in response to your inquiries dated September 27, 2006 and October 27, 2006 wherein you posed a series of ruling requests relating to the Small Business Capital Formation Incentive Act (68 Okla. Stat. §2357.60 et. seq.) and Rural Venture Capital Formation Incentive Act (68 Okla. Stat. §2357.70 et seq.). Following a restatement of the facts outlined in your letters, are the specific rulings requested and our responses thereto.

Statement of Facts:

1. On October 7, 2004, the Fund respectfully submitted a letter ruling request to the Oklahoma Tax Commission (the "OTC") seeking a ruling that (i) the proposed investments outlined in the letter ruling request qualified for the Oklahoma Tax Credits, and (ii) the Oklahoma investors were eligible to utilize the Oklahoma Tax Credits upon the investment in the Portfolio Companies (the "Ruling Request").
2. In response, the Tax Policy and Research Division of the OTC issued the Initial Ruling by letter dated December 22, 2004. In the Initial Ruling, the OTC provided that the proposed investments outlined in the Ruling Request would qualify for the Oklahoma Tax Credits, and the Oklahoma investors were eligible to utilize the Oklahoma Tax Credits upon the investment in the Portfolio Companies.
3. Senate Bill 1577, signed by the Governor of the State of Oklahoma on June 6, 2006, made certain amendments to the Business Incentive Acts which became effective July 1, 2006 (the "Amendments"). The Amendments, among other things, (i) added certain criteria to

qualify as an "Oklahoma small business venture" and an "Oklahoma rural small business venture," (ii) eliminated the use of the Oklahoma Tax Credits against Oklahoma gross production tax and the additional excise tax on oil and gas imposed under 68 Okla. Stat. § 1101 and 1002, and (iii) reduced the carry forward of the Oklahoma Tax Credits from ten (10) years to three (3) years.

4. The Amendments also provided a "grandfather clause" for those persons or entities who had obtained a favorable determination letter from the OTC prior to March 15, 2006. Under the Amendments, any person or entity that had obtained a favorable determination letter from the OTC prior to March 15, 2006, regarding the ability to claim or otherwise utilize the Oklahoma Tax Credits would not be subject to the Amendments to the Business Incentive Acts made by Senate Bill 1577 for investments made in Portfolio Companies prior to November 1, 2006 and which meet the statutory requirements set forth in 68 Okla. Stat. § 2357.63EA and/or 68 Okla. Stat. § 2357.74EA.

5. On July 7, 2006, the Fund respectfully submitted a letter ruling request to the OTC seeking a ruling that (i) the rulings made by the Tax Policy and Research Division of the OTC in its Ruling to the Fund dated December 22, 2004 were still valid and effective after the enactment of Senate Bill 1577 due to the "grandfather clause" set forth in 68 Okla. Stat. § 2357.63E and 68 Okla. Stat. § 2357.74E, (ii) the Fund and the Capital Company were entities that had obtained a favorable determination letter from the OTC prior to March 15, 2006 regarding their ability to claim or otherwise utilize the Oklahoma Tax Credits authorized by the Business Incentive Acts, and (iii) the Fund, the Capital Company and their investors, as entities who obtained a favorable determination letter from the OTC prior to March 15, 2006, were not subject to the Amendment to the Business Incentive Acts made by Senate Bill 1577 on qualified investments made in Portfolio Companies prior to November 1, 2006 and which met the statutory requirements set forth in 68 Okla. Stat. § 2357.63E and/or 68 Okla. Stat. § 2357.74E (the "Supplemental Ruling Request").

6. In response, the Tax Policy and Research Division of the OTC issued the Supplemental Ruling to the Fund by letter dated July 20, 2006. In the Supplemental Ruling, the OTC ruled that (i) the rulings made by the Tax Policy and Research Division in its Ruling dated December 22, 2004 were contained within a favorable determination letter as required under § 2357.63E and § 2357.74E and were issued prior to March 15, 2006, (ii) the Fund and the Capital Company were entities that had obtained a favorable determination from the OTC prior to March 15, 2006 regarding their ability to claim the Oklahoma Tax Credits, and (iii) the Fund, the Capital Company and their investors were not subject to the amendments contained within Senate Bill 1577 if all the requirements for investments contained in § 2357.63E and § 2357.74E were met.

7. In the Supplemental Ruling Request the Fund also requested a ruling from the Tax Policy and Research Division that "[e]ntities who have obtained a favorable determination letter from the Oklahoma Tax Commission prior to March 15, 2006 will be deemed to have made a qualified investment and met the requirements of 68 Okla. Stat. § 2357.63E and § 2357.74E if: (1) such investment is made prior to November 1, 2006 "... to satisfy a legitimate business purpose of the entity receiving such investment which is consistent with its organizational instruments, bylaws or other agreement responsible for the governance of the business venture"; (2) the capital company's funds were at risk; and (3) if the investments meet

the requirements of (1) above they will be deemed not to have been made chiefly for the purpose of reducing tax liability."

8. In its Supplemental Ruling the Tax Policy and Research Division responded to the Fund's request in the affirmative, stating "[y]es, provided, it will be necessary for the Tax Policy Division to review the investment plans, the bylaws or similar documents of the business venture (Portfolio Company), and any other necessary documentation prior to issuing a ruling as to whether the provisions of § 2357.63E and § 2357.74E have been met to qualify the investments for the Credits."

9. The Fund is an Oklahoma limited liability company. The purposes of the Fund are to raise venture capital from accredited investors (the "Investors") to be invested in qualified small business capital companies and qualified rural small business capital companies as defined in 68 Okla. Stat. § 2357.61 and § 2357.72 and Oklahoma small business ventures and Oklahoma rural small business ventures as defined in 68 Okla. Stat. § 2357.61 and § 2357.72.

10. an Oklahoma limited liability company and the Investors in the Fund will be the members of the Fund. The Fund intends to issue two types of securities, Common Units, and Preferred Units, to investors. The Investors will be issued all of the Preferred Units. Avondale will be issued Common Units. The Preferred Units will be specially allocated 100% of the Oklahoma Tax Credits and cash or property distributed from the Fund until they have realized a 200% return of their subscription amount in either Oklahoma Tax Credits or cash/property distributions. Investors in the Preferred Units will have an opportunity for obtaining cash profits should the investments in the Portfolio Companies turn out to be successful. It is anticipated that the holders of the Preferred Units will have a right, but not the obligation, to put their interests in the Fund to an affiliate of its Manager during a specified period, which is expected generally to be 48 to 60 months after purchase of the Units for a fixed amount which may be substantially less than the price paid for the Units. In addition, the Fund will obtain loans from financial institutions as discussed in paragraph 16 below.

11. The Capital Company is an Oklahoma limited liability company. The purpose of the Capital Company is to qualify as a "qualified rural small business capital company" and/or a "qualified small business capital company" as defined in the Business Incentive Acts and to make qualified investments of "equity," "near equity" or "subordinated debt," in companies qualifying as "Oklahoma rural small business ventures" or "Oklahoma small business ventures" as defined in the Business Incentive Acts. For purposes of this letter, the terms "equity," "near equity" or "subordinated debt," shall have the same meanings as provided in the Business Incentive Acts.

12. The Fund will be the sole member of the Capital Company.

13. The Fund and the Capital Company will not elect to be treated as corporations for Federal income tax purposes. Therefore, the Fund will be treated as a partnership for both Federal and state income tax purposes and the Capital Company will be treated as a disregarded entity for both Federal and state income tax purposes.

14. an Oklahoma limited liability company will be the manager of the Fund and the Capital Company.

15. The Fund will initially raise approximately 10-15% of its capital in the form of equity from Investors.

16. The Fund will initially borrow approximately 85-90% of its capital (the "Financing Loan") from a financial institution (the "Financial Institution") provided such amount may be increased or decreased. The Fund does not have a firm commitment from any Financial Institution for any Financing Loan, but, based on discussions with Financial Institutions, it is anticipated that the loan will be advanced to the Fund contemporaneously with the admission of the Investors to the Fund, will have a variable interest rate based on a common index plus a percentage, will have a term of at least one year and will be secured by the Fund's interest in the Capital Company and will be guaranteed by both the Capital Company and the Portfolio Companies. The Capital Company will secure its guarantee by pledging any equity or near equity interest it obtains in the Portfolio Companies (including subordinated debt instruments), and the Portfolio Companies will secure their guarantees by pledging specified assets. In addition, the Financing Loan will be secured by any equity or near equity interest in the Portfolio Company (including subordinated debt instruments) acquired by the Fund from direct investments in Portfolio Companies. It is expected that the Financial Institution will require the funds to be invested in temporary liquid investments. The funds will typically be used for specific budgeted items or for working capital and the extent to which such funds may be used by the Portfolio Company for such purposes will be subject to covenants and restrictions which will vary for each Portfolio Company, depending upon the financial condition of the Portfolio Company, the Portfolio Company's business plan and objectives, requirements of the Capital Company's lenders and general industry standards. It is also expected that the Financial Institution will require that the Fund use 100% of the cash returns that it receives directly or indirectly from the Portfolio Companies to make interest and principal payments on the Financing Loan until such loan is repaid in full. Consequently, funds will not be available to make distributions to the members of the Fund until the Financing Loan has been repaid in full. This arrangement in effect facilitates the borrowing of funds for the benefit of the businesses of the Portfolio Companies by creating cross collateralization through the Fund and the Capital Company of the various businesses.

17. The Fund intends to transfer a portion of its capital (i.e., its Investor Equity and proceeds of its financing loan), less organization expenses, to the Capital Company in return for all the ownership interest (common units) in the Capital Company. The balance of the capital of the Fund will be retained to make direct investments in the Oklahoma small business ventures or in the Oklahoma rural small business ventures which are intended to qualify for the Oklahoma Tax Credits (collectively the "Direct Investments"). In the event that the Capital Company qualifies as a small business capital company under 68 Okla. Stat. §2357.61, the diversification requirement is no more than twenty percent (20%) of the Capital Company funds invested in any one Portfolio Company, and in the event the Capital Company qualifies as a qualified rural small business capital company under 68 O.S. §2357.72, the diversification requirement is no more than twenty-five percent (25%) of the Capital Company funds invested in any one Portfolio Company.

18. The Fund intends to make its Direct Investments, in the form of equity or near equity (i.e. Common Stock, Redeemable Convertible Preferred Stock, Preferred Stock Warrants, or Subordinated Debt, collectively the "Portfolio Company Stock") in the Portfolio Companies upon the same terms and conditions as the Capital Company investments in the Portfolio Companies.

19. None of the Portfolio Companies will be engaged in oil and gas exploration, real estate development, real estate sales or rentals, wholesale sales, retail sales, farming, ranching, banking or lending, investing funds in other businesses or in any other type of business which would prevent the investment of the Capital Company in any Portfolio Company from qualifying for the Oklahoma Tax Credits. Each of the Portfolio Companies will have at least 50% of its employees or assets located in Oklahoma and shall meet the statutory definition of an Oklahoma small business venture or an Oklahoma rural small business venture by the end of the fiscal year or within 180 days of the initial investment by the Capital Company in the Portfolio Company. Each of the Portfolio Companies will need financial assistance in order to commence or expand its business.

20. The Capital Company intends to notify the Fund immediately when investments are made in qualifying Portfolio Companies and the Fund will then notify the holders of the Preferred Units of their proportionate shares of the Oklahoma Tax Credits earned from such investment.

21. The Capital Company will make investments in Portfolio Companies. The investment will be in the form of Portfolio Company Stock. The funds from the investment in the Portfolio Company Stock will be deposited by the Portfolio Company in its corporate accounts. The funds from the investment in the Portfolio Company Stock will typically be used by the Portfolio Company for specific budgeted items or for working capital and the extent to which such funds may be used by the Portfolio Company for such purposes will be subject to covenants and restrictions which will vary for each Portfolio Company, depending upon the financial condition of the Portfolio Company, the Portfolio Company's business plan and objectives, requirements of the Capital Company's lenders and general industry standards. In addition, as noted in paragraph 16 above, it is anticipated that the Financial Institution will retain the right to approve uses of the portion of the Capital Company's investment in the Portfolio Companies that is financed from the Financing Loan and will require the Portfolio Companies to provide security to the Financial Institution in a form acceptable to the Financial Institution.

22. will be entitled to receive an annual management fee from the Fund.

23. Cash and property distributions by the Fund, after payment of amounts owed on the Financing Loan and payment of the management fees as described in the preceding paragraph will be made first to the holders of Preferred Units until they have realized a return of 200% of their subscription amount in either Oklahoma Tax Credits or cash/property distributions from the Fund. After that, the holders of Preferred Units will be entitled to a 10% allocation of cash and property distributions from the Fund.

24. The holders of the Common Units will receive no distributions from the Fund until the holders of the Preferred Units have realized a 200% return of their subscription amount in either Oklahoma Tax Credits or cash/property distributions from the Fund. After that, holders of Common Units will be entitled to a ninety percent (90%) allocation of cash and property distributions from the Fund.

25. The Operating Agreement of the Fund will provide that all of the Oklahoma Tax Credits earned by the Fund will be allocated to the holders of the Preferred Units and none of the Oklahoma Tax Credits will be allocated to the holders of the Common Units.

26. The Operating Agreement of the Fund will provide that profits and losses will be allocated (i) 100% to the holders of the Preferred Units until they have received 200% of their subscription amount in Oklahoma Tax Credits or distributions of cash/property from the Fund, and (ii) thereafter 90% to the holders of the Common Units and 10% to the holders of the Preferred Units.

27. Prior to November 1, 2006, the Capital Company and the Fund intend to make an investment in Oklahoma \_\_\_\_\_ an Oklahoma limited liability company (the "Venture") in return for Portfolio Company Stock which qualifies for the Oklahoma Tax Credits. The Venture then intends to enter into a joint venture with \_\_\_\_\_ for the purpose of mixing and packaging agricultural products.

28. The Venture is a limited liability company formed under the laws of the State of Oklahoma on September 25, 2006. The Capital Company and the Fund intend for the Venture to qualify as an "Oklahoma rural small business venture" as defined in the Business Incentive Acts. The operations of the Venture are governed by its Articles of Organization filed with the Oklahoma Secretary of State on September 25, 2006 and its Operating Agreement dated September 25, 2006.

29. The Venture will have at least fifty percent (50%) of its employees or assets located in Oklahoma after the Capital Company makes a qualified investment in the Venture.

30. The Venture needs financial assistance in order to commence or expand such business which provides or intends to provide goods or services.

31. The Venture will be engaged in a lawful business activity under any Industry Number appearing under any Major Group Number of Divisions A, C, D, E, F, or I of the Standard Industrial Classification Manual, 1987 revision.

32. The Venture will qualify as a small business as defined by the Federal Small Business Administration.

33. The Venture has its principal place of business in Logan County, Oklahoma (Logan County), a nonmetropolitan area of Oklahoma as defined in the Business Incentive Acts. The Venture will also conduct the activity resulting in at least seventy-five percent (75%) of its gross annual revenue in nonmetropolitan areas of Oklahoma as defined in the Business Incentive Acts.

Rulings Requested:

Based upon these facts, the Fund respectfully requests a letter ruling from the Tax Policy and Research Division of the OTC that:

1. The Venture will qualify as an Oklahoma rural small business venture as that term is defined in 68 Okla. Stat. § 2357.72(6).

*Yes: It is the ruling of the Tax Policy Division that Oklahoma Agri-Builder, LLC meets the definition of an "Oklahoma rural small business venture" within the meaning of*

§2357.72(6) based on the following representations:

- a. \_\_\_\_\_ will have at least 50% of its assets and employees located within Oklahoma;
- b. \_\_\_\_\_ needs financial assistance in order to acquire equipment to fund its operations;
- c. At least seventy-five percent (75%) of \_\_\_\_\_ gross annual revenues will be a result of activities conducted in Washington County, in an area deemed to be a non-metropolitan area;
- d. \_\_\_\_\_ is engaged in a lawful business activity under Division D of the Standard Industrial Classification Manual; and
- e. \_\_\_\_\_ meets the definition of a small business by the federal Small Business Administration.

2. After reviewing the Investment Plan, the Articles of Organization, the Operating Agreement and any other agreements responsible for the governance of the Venture and in light of the facts and assumptions set forth in this letter ruling request, the provisions of 68 Okla. Stat. § 2357.63E and 68 Okla. Stat. § 2357.74E have been met and the investment by the Fund in the Capital Company followed by the investment by the Capital Company in the Venture prior to November 1, 2006, will qualify for the Oklahoma Tax Credits described in 68 Okla. Stat. § 2357.62 and 68 Okla. Stat. § 2357.73.

*It is the ruling of the Tax Policy Division that the investment by the Fund in the Capital Company followed by the investment by the Capital Company in the Venture prior to November 1, 2006, will qualify for the Oklahoma Tax Credits described in 68 Okla. Stat. §2357.62 and 68 Okla. Stat. §2357.73 based on the following representations:*

- a. A qualified investment will be made in \_\_\_\_\_ prior to November 1, 2006, to be used for the investment in plant, property and equipment used in the business of mixing and packaging agricultural products.
- b. It is assumed that the "investment in temporary liquid investments" is not an indication that the portfolio company will not have access to the funds or that the portfolio company will not be allowed to expend the funds. It is further assumed that the transaction is not a "temporary" placing of funds with the portfolio company for the purpose of reducing tax liabilities. So long as the investor's funds will be invested in assets which will be used for the production of income, then the funds will be considered at risk.
- c. The primary purpose of the investment is to generate long-term cash flows from the successful operation of \_\_\_\_\_ not chiefly to generate tax benefits.

3. After reviewing the Investment Plan, the Articles of Organization, the Operating Agreement and any other agreements responsible for the governance of the Venture and in light of the facts and assumptions set forth in this letter ruling request, the provisions of 68 Okla. Stat. § 2357.63E and 68 Okla. Stat. § 2357.74E have been met and the Direct Investments by the Fund in the Venture prior to November 1, 2006, will qualify for the Oklahoma Tax Credits described in 68 Okla. Stat. § 2357.63 and 68 Okla. Stat. § 2357.74.

*Yes. Based upon the facts and other assertions contained in your September 27 and October 27 requests and the attached exhibits, qualified investments by the Fund in the Venture in conjunction with qualified investments made by the Capital Company in the Venture prior to*

*November 1, 2006 will qualify for the tax credits under Sections 2357.63 and 2357.74 of Title 68.*

4. After reviewing the Investment Plan, the Articles of Organization, the Operating Agreement and other agreements responsible for the governance of the Venture and in light of the facts and assumptions set forth in this letter ruling request, the investment by the Capital Company in the Venture and the Direct Investment made by the Fund in the Venture satisfies a legitimate business purpose of the Venture which is consistent with its organizational instrument, bylaws and other agreements responsible for the governance of the business venture, as stated in 68 Okla. Stat. § 2357.63E(A)(1) and § 2357.74E(A)(1).

*Yes. The mixing and packaging of agricultural products satisfies a legitimate business purpose of the Venture as required under 68 Okla. Stat. §2357.63E(A)(1) and §2357.74E(A)(1).*

5. Based on the facts and assumptions set forth in this letter ruling request, the Capital Company's funds are at risk as required under 68 Okla. Stat. § 2357.63E(A)(2) and § 2357.74E(A)(2), including both the portion representing Investor capital contributed to the Fund as well as the portion funded by Financing Loan proceeds borrowed by the Fund, with the secured guarantees provided by the Capital Company and the Portfolio Companies. Accordingly, the Oklahoma Tax Credits will be calculated as a percentage of the funds contributed by the Capital Company to the Portfolio Companies, whether such funds are derived from Investor equity or the Financing Loan.

*Yes. Based upon the facts and other assertions contained in your September 27 and October 27 requests and the attached exhibits, the funds invested by the Capital Company in the Venture are "at risk" as required under 68 Okla. Stat. §2357.63E(A)(2) and §2357.74E(A)(2).*

6. Based on the facts and assumptions set forth in this letter ruling request, the Fund's Direct Investments in the Portfolio Companies are at risk as required under 68 Okla. Stat. Section 2357.63E(A)(2) and Section 2357.74E(A)(2), including both the portion representing Investor capital contributed to the Fund as well as the portion funded by Financing Loan proceeds borrowed by the Fund, with the secured guarantees provided by the Capital Company and the Portfolio Companies. Accordingly, the Oklahoma Tax Credits with respect to Direct Investments by the Fund will be calculated as a percentage of the funds contributed by the Fund to the Portfolio Companies, whether such funds are derived from Investor equity or the Financing Loan.

*Yes. Based upon the facts and other assertions contained in your September 27 and October 27 requests and the attached exhibits, the funds invested by the Fund are "at risk" as required under 68 Okla. Stat. §2357.63E(A)(2) and §2357.74E(A)(2).*

7. Based on the facts and assumptions set forth in this letter ruling request, both the investment by the Capital Company in the Portfolio Companies and the Direct Investments by the Fund in the Portfolio Companies in exchange for Portfolio Company Stock (including subordinated debt) will be a "qualified investment" within the meaning of 68 Okla. Stat. § 2357.61 6. and 68 Okla. Stat. § 2357.72 7.

*Yes. Based upon the facts and other assertions contained in your September 27 and October 27 requests and the attached exhibits, both the investment by the Capital Company in*

*the Venture and the Direct Investments by the Fund in the Venture in exchange for Portfolio Company Stock (including subordinated debentures) meet the definition of a "qualified investment" as defined in 68 Okla. Stat. §2357.61(6) and 68 Okla. Stat. §2357.72(7).*

8. After reviewing the Investment Plan, the Articles of Organization, the Operating Agreement and other agreements responsible for the governance of the Venture, the investment by the Capital Company in the Venture and the Direct Investment made by the Fund in the Venture is not made chiefly for the purpose of reducing tax liability, as stated in 68 Okla. Stat. § 2357.63E(A)(3) and § 2357.74E(A)(3).

*Yes, the Tax Policy Division agrees that the qualified investments by the Capital Company in the Venture and direct investments made by the Fund in the Venture are not made chiefly for the purposed of reducing tax liability.*

9. Based on the facts and assumptions set forth in this letter ruling request and assuming the Fund is a partnership for federal income tax purposes, the Investors will be partners in the Fund for state income tax purposes and will be entitled to be allocated 100% of the Oklahoma Tax Credits available to the Fund.

*Yes, the Tax Policy Division agrees the partners in the Fund will be entitled to allocate 100% of the Oklahoma Tax Credits available to the Fund.*

This response applies only to the circumstances set out in your requests dated September 27, 2006 and October 27, 2006. 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 and its investors, assuming that all pertinent facts have been accurately and completely stated, and that there has been no change in applicable law.

Please be advised that the issuance of this ruling does not preclude the Oklahoma Tax Commission from conducting an audit or examination under 68 Okla. Stat. §206 if any report or return claiming a credit for the transactions outlined in this letter ruling. The Commission reserves the right to issue any assessment, correction, or adjustment authorized under 68 Okla. Stat. §221.

If I can be of further assistance, please feel free to contact me.

Sincerely,

OKLAHOMA TAX COMMISSION



Tony Mastin, Director  
Tax Policy & Research Division