OKLAHOMA TAX COMMISSION

TAX POLICY DIVISION
DAWN CASH, DIRECTOR

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December 15, 2008

Re: Our File No. LR-08-177

Dear

This letter ruling is in response to your letter ruling request dated December 3, 2008 wherein you posed a series of ruling requests relating to 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. §2357.70 et seq.). Following a verbatim restatement of the facts as outlined in your letter, are the specific rulings requested and our responses thereto.

The Oklahoma Tax Commission issued letter rulings on March 29, 2007, July 20, 2007, March 19, 2008 and September 15, 2008 under Oklahoma Tax Commission File No. LR 07-03 (collectively, the "Original Ruling") in favor of [redacted] (the "Fund"), [redacted] (the "Capital Company"), one or more Series (each, a "Series") established by the Fund pursuant to Section 2054.4 of the Oklahoma Limited Liability Company Act, and others (together with the Fund, the Capital Company and the Series, the "Ruling Recipients"), which Original Ruling is incorporated herein by reference. The purpose of this letter is to request on behalf of the Ruling Recipients a supplemental ruling to the Original Ruling relating to the Oklahoma Rural Venture Capital Formation Incentive Act, 68 Okla. Stat, § 2357.71, et. seq (the "Rural Act") and the Small Business Capital Formation Incentive Act, 68 Okla. Stat. § 2357.60, et. seq (the "Small Business Act"). Capitalized terms not otherwise defined herein will have the meanings set forth in the Original Ruling.

The Original Ruling states that, under the circumstances we described to you in our request dated September 10, 2008, the allocation of tax credits to a member of the Fund or a Series "who is not a 'pass-through entity" may be based on the total investment by that member in the Fund or the Series using, in part, funds borrowed on a nonrecourse basis. Sections 2357,62(G) and 2357.63(E) of the Small Business Act and Sections 2357.73(G) and 2357,74(E) of the Rural Act (collectively, the "Pass-Through Provisions") define the term "pass-through entity" as follows (the "Definition"):

> [A) corporation that for the applicable tax years is treated as an S corporation under the internal Revenue Code, general partnership, limited partnership, limited liability partnership, trust, or limited liability company that for the applicable tax year is not taxed as a corporation for federal income tax purposes.

Section 2357.73(0) of the Rural Act also provides:

> If a pass-through entity is entitled to a credit under this section, the pass-through entity shall allocate such credit to one or more of the shareholders, partners or members of the pass-through entity; provided, the total of all credits allocated shall not exceed the amount of the credit to which the pass-through entity is entitled, The credit may only be claimed for funds borrowed by the pass-through entity to make a qualified investment if a shareholder, partner or member to whom the credit is allocated has an unlimited and continuing legal obligation to repay the borrowed funds but the allocation may not exceed such shareholder's, partner's or member's pro-rata equity share of the pass-through entity . . .

The remaining Pass-Through Provisions include substantially similar provisions. The terms "shareholder," "partner," "member," and "pro-rata equity share" are not defined in the Small Business Act or the Rural Act. As discussed below, we respectfully suggest that the application of the Pass-Through Provisions to certain types of trusts is ambiguous and request your advice on specific issues related to these provisions.

As you know, the taxation of a trust for federal income tax purposes differs depending on the terms of the trust arrangement. The Treasury Regulations governing entity classification generally separate trust arrangements into two categories, those which are considered "business entities" and those which are not. See Treas Reg. § 301.7701-2(a); 301.7701-4. A trust arrangement which is considered a business entity is subject to the check-the-box regulations, pursuant to which it may either be classified as a disregarded entity or a partnership (depending on the number of beneficiaries) or elect to be taxed as a corporation. Treas. Reg. § 301.7701-2. A trust arrangement that is not considered a business entity is taxed under Subchapter J of the Internal Revenue Code. Treas. Reg. § 301.7701-2; 301.7701-4.

Subchapter J provides that certain types of trusts (including "complex trusts," as defined below) are taxed separate from their grantors and beneficiaries. The income, deductions, and credits of these trusts, similar to those of Subchapter C corporations, are reported separately by the trust and tax is paid on that income by the trust. Other trusts are not taxed separately and their income is taxed directly to a grantor, beneficiary or third party.

Under Subchapter J, trusts can be divided into three general categories: (1) grantor trusts, including trusts taxed to certain persons other than the grantors, (2) simple trusts, and (3) complex trusts. In the context of the Definition and application of the Pass-Through Provisions, we believe the treatment of certain complex trusts should differ from that of other types of trusts for the reasons outlined below.

A "grantor trust" is one under which certain powers are retained by the grantor or specified persons who are considered susceptible to the grantor's influence or control. IRC § 671 - 679. A grantor trust may be revocable or irrevocable. A sub-set of grantor trusts are trusts taxed to persons other than the grantors who have been given the sole power to vest trust corpus or income in themselves. IRC § 678. In a grantor trust arrangement, the trust itself is essentially disregarded for federal income tax purposes. Grantor trusts do not compute their income separately, but instead the grantor or third party reports the income, deductions, credits and other tax items on his or her individual income tax return as if he or she owned the trust assets directly.

A "simple trust" is an irrevocable trust, the trustee of which is required to distribute all income currently. IRC § 651. The income of a simple trust is generally taxed to the beneficiaries and not the trust itself, although the trust separately computes its income. IRC § 651 652. A simple trust is similar to a grantor trust in that a simple trust does not pay tax on its income, although its income is separately computed. The instructions to Oklahoma Form 513 "Resident Fiduciary Return of Income" specifically address grantor trusts and simple trusts, noting that a grantor trust "will be treated the same on the Oklahoma return as it is on the Federal" and that a simple trust reports only "capital gain/loss minus the pro rata share of the Federal exemption, as all other income and deductions are passed on to the beneficiaries."

A "complex trust" is a trust that may accumulate trust income instead of distributing it currently. When a complex trust distributes income to a beneficiary, the trust receives a deduction (up to the amount of distributable net income for that taxable year) and the beneficiary must include that income (up to the amount of distributable net income for that taxable year) in the beneficiary's gross income for income tax purposes. Sec IRC § 661 - 668. "Distributable net income" is calculated separate from any tax credits earned by the trusts. See "2007 Instructions for [Federal] Form 1041 and Schedules A, B, D, G, I, J, and K-1." To the extent a complex trust does not distribute all its distributable net income for a taxable year, the complex trust is taxed separate from the beneficiaries. In addition, a complex trust must allocate deductions and credits between the trust and its beneficiaries. For federal income tax purposes, certain tax credits may not be allocated to a beneficiary. See id. Credits and deductions that may be allocated to a beneficiary generally are apportioned on the basis of income allocated between the trust and its beneficiaries. See id.

As outlined above, for federal income tax purposes, a complex trust may be taxed separate from the grantor, the beneficiaries, and any third parties. Similarly, for state income tax purposes, a complex trust separately reports its income, deductions, credits, and other tax items on Oklahoma Form 513. Generally, a complex trust that distributes all its income would allocate to the beneficiaries all or a portion of an Oklahoma tax credit to which the trust is otherwise entitled for that taxable year (a "Credit").' However, we believe that, in many circumstances and absent any application of the Pass-Through Provisions, a complex trust which distributes no income or distributes less than all of its

income for the taxable year could instead utilize a Credit on its Oklahoma Form 513 (line 24), applying that Credit against tax that would otherwise be owed by the complex trust and/or carrying the Credit forward to future taxable years of the trust. On the other hand, it appears that any grantor trust or simple trust would be required to allocate all Credits to its grantor or third-party or its beneficiaries, as applicable.

The Definition refers to various types of entities and arrangements. Neither an S corporation nor a general partnership, limited partnership, limited liability partnership, or limited liability company that has not elected to be taxed as a corporation under the cheek-the-box regulations is taxed separately from its owners and none of these entities would utilize a Credit on a separate income tax return. Each of these entities would allocate (separate from any application of the Pass-Through Provision) a Credit to its beneficial owners. Similarly (without regard to the application of the Pass-Through Provisions), a grantor trust or simple trust would allocate a Credit to the grantor, third party or beneficiaries. A complex trust, on the other hand might allocate a Credit to its beneficiaries or utilize the Credit against income tax owed by the complex trust itself, depending on additional facts. A complex trust that utilizes the Credit against its own income taxes and does not allocate the Credit to its beneficiaries is more analogous to a Subchapter C corporation, which is not included in the Definition, than an S corporation or other entity that allocates tax items to its owners, grantors or beneficiaries. In addition, trusts typically are not thought of as having shareholders, partners, or members. As a result, we respectfully suggest that the application of the Pass-Through Provisions to certain complex trusts is ambiguous.

A complex trust that does not distribute all of its income for the taxable year is separately subject to income tax and could (absent an application of the Pass-Through Provisions) apply a Credit against income tax that would otherwise be owed by the complex trust. As a result, we believe that a complex trust which, pursuant to recognized fiduciary accounting principles and other applicable law, does not allocate to its beneficiaries a Credit provided for under the Rural Act or the Small Business Act should not be considered a "pass-through entity" for purposes of the applicable Act.

We respectfully request your advice that, for purposes of determining whether tax credits available to the Fund and each Series under the circumstances described in our September 10, 2008 request may be allocated under the Rural Act or the Small Business Act by the Fund or Series to an Investor, a trust that (1) is taxed as a complex trust under Subchapter J and, (2) pursuant to recognized fiduciary accounting principles and other applicable law, does not allocate such credits to a beneficiary (a "Specified Trust") will not be considered a "pass-through entity" under the Rural Act or the Small Business Act, We further request your advice that the Original Ruling, and any supplement to the Original Ruling, may be relied upon by the Ruling Recipients, including but not limited to subsequent investors of the Fund or a Series.

At this time, neither the Fund nor any Series expects to have new Investors which are trusts other than Specified Trusts, and we specifically are not requesting your advice

with respect to whether any trust or entity other than a Specified Trust is considered a "pass-through entity" under the Rural Act or the Small Business Act.

A "Specified Trust" can use the Credit to offset its Oklahoma income tax liability and is not required to distribute the credits to its beneficiary.

This response applies only to the circumstances set out in your request dated December 3, 2008. 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 of 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.

Sincerely,

Oklahoma Tax Commission

Dawn Elizabeth Cash

Dawn Elizabeth Cash, Director
Tax Policy & Research Division