

OKLAHOMA TAX COMMISSION

TAX POLICY AND RESEARCH DIVISION
TONY MASTIN, DIRECTOR



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December 7, 2005

Re: Our file number LR 05-198; Income Tax - Small Business Capital Formation Incentive Act

Dear

This is in response to your inquiry of November 8, 2005 wherein you posed a series of ruling requests relating to the Small Business Capital Formation Incentive Act (the "Act") [68 O.S. § 2357.60 et. seq.]. Following is a restatement of the facts outlined in your letter, the specific rulings requested and our responses thereto.

FACTS:

(The Fund) is a limited liability company formed under the laws of the State of Oklahoma on [redacted]. The purpose of the Fund is to raise equity capital from accredited investors, to borrow funds from lenders, and to aggregate such equity capital and borrowed funds for investment in [redacted] an Oklahoma limited liability company ("Hospital").

The Fund will be managed by [redacted] ("Manager"). Manager will also be a member of the Fund, owning 110 shares of Common membership equating to approximately two and one-tenth percent (2.1 %) of 5,310 shares to be outstanding after the offering hereinafter described. An additional 5,200 shares of Common membership ("Shares") will be issued to other investors in the Fund ("Investors").

For purposes of this letter, the terms "qualified small business capital company," "Oklahoma small business ventures," "equity," "near-equity" and "subordinated debt" shall have the same meanings as are provided in the Act, as appropriate.

[redacted] is a Delaware limited liability company organized to provide the direct investment of equity and near-equity funds to companies within the state of Oklahoma. [redacted] principal place of business [redacted]. The capitalization, " as defined in the Act, of [redacted] is greater than \$1,000,000. Measured either at the time of the investment or at [redacted] fiscal year end, [redacted] will not have more than 20% of its "capitalization," as defined in the Act, invested in anyone company.

Hospital was recently formed to acquire a _____ and to construct and operate a 50 bed acute care hospital on the site. The owners of the Manager are also the owners of Hospital.

The owners of Hospital and Manager are _____

While known to each other for several years as competing business consultants, they first began attempting to provide health services to the underserved community of _____ located in _____. They worked with consultants and experienced professionals in the health care field in forming their plan for commencement of the business of Hospital.

_____ have separate small business consulting organizations which they separately own individually. _____ is also the sole owner of an _____

_____ It is a qualified participant in the United States Department of Agriculture Rural Development Community Facilities Program under 7 U.S.C. § 1921, et. seq., as administered pursuant to regulations contained in 7 C.F.R., Part 1980. This program grants guarantees by the United States Department of Agriculture through qualified participants for lending activities to provide rural communities necessary services for housing such as water districts, energy utilities, solid and sanitary waste disposal districts, libraries, telecommunications and hospitals, among others.

Pursuant to their plan for starting Hospital as a small business, the owners formed a separate real estate development activity, _____ an _____ limited liability company in _____ to acquire a 66 acre tract in _____. The Hospital's activity will be the primary healthcare business in that tract. The Hospital will be placed on 12 acres of the tract. _____ will have no receipts prior to the closing of the investment transaction described in this letter. Hospital will purchase from _____ the 12 acre tract for its fair value of approximately _____ and the associated construction activity currently being accomplished on that tract, which will aggregate approximately _____ at closing of the investment transaction described herein.

Other than _____ which has no employees and no receipts, there are no other activities of the owners of Hospital which should be aggregated with Hospital's activities for purpose of determining Hospital as an Oklahoma small business venture as defined in 68 O.S. § 2357.61 (5).

_____ has been engaged by the Hospital to assist in design, construction, and opening of the Hospital. _____ will also be the initial manager of hospital activities pursuant to a long-term _____ management agreement with the Hospital. The agreement may be terminated at any time for cause by either party and _____ may terminate without cause with _____ months advance notice. A copy of the Hospital Management Agreement is included.

Hospital needs financial assistance in order to commence its business which is intended to provide healthcare services. This capital will be raised by the Fund and invested in Hospital as provided in the

Act. The amount of total capital to be raised by the Fund is _____ The amount of equity investment into the Fund will be _____ for _____ shares of Common membership in the Fund. An additional _____ of capital will be borrowed; _____ from the principals of Management and Hospital, and _____ from _____ and its participants. _____ corporation, an affiliate of _____ will be a _____ participant in the bank loans, and will covenant with the other participants that _____ will purchase the bank loans not held by _____ if, either the Hospital fails to generate sufficient cash flow after fourteen months of operations to permit long term mortgage financing, or the Hospital fails to cure a non-monetary event of default in the construction loan documents. _____ will guarantee _____ performance of these covenants.

The Fund's investment in _____ will take the form of equity capital. The _____ investment will be in the form of equity capital as a result of the Fund purchasing _____ the Fund will make an additional "in conjunction with" investment into the Hospital of _____. These investments will aggregate _____ new capital to the Hospital. The amounts of the equity capital contributions to the Fund of _____ will earn the entire 20% small business capital formation credit of _____ ("Credits"). This is equivalent to an equity contribution rate of 48.0022% of the Credits earned for such investment.

_____ and the Fund, in proportionate amounts, will loan _____ in subordinated debt to the Hospital and will invest _____ in the Hospital's 6% cumulative Preferred membership equity capital. _____ will make approximately 34.4% of the capital available and the Fund will provide approximately 65.6% of the capital through "in conjunction with" investments pursuant to 68 O.S. § 2357.63. The debt will be subordinate to all other debt of Hospital issued or to be issued to a financial lending institution as required by 68 O.S. § 2357.61 (8). The debt will be "near equity" as defined in 68 O.S. § 2357.61 (3) and required by 68 O.S. § 2357.63(B)(2) by being convertible dollar for dollar (\$1 for \$1) into Hospital's 6% cumulative Preferred membership interest upon the unanimous consent of all members of the Fund or _____, with respect to the debt held by each.

The bank lenders will require the Fund to pledge the _____ that it receives as collateral for the Fund's loans and will also require the Fund to pledge its "in conjunction with" investments in the _____ equity and subordinated debt of the Hospital as collateral for such loans. Further the Hospital will be required to guarantee the bank loans. The _____ shares of the Fund will be pledged to the Bank loans and the owners of Hospital will also be required to pledge additional cash and real estate collateral to support the bank loans.

In addition, the Investors and the Manager will grant to each other overlapping call and put options for the Shares of the Fund owned by the Investors at _____ per Share, exercisable in _____

It is anticipated that the Manager will acquire all the Shares effective _____ Copies of the form of such agreements are also included.

Immediately after the investment, Hospital will have 100% of its employees and assets located in Oklahoma. Hospital will conduct the activities resulting in at least seventy-five percent (75%) of its respective gross annual revenues from its principal place of business _____ The

Hospital's business activities will be described in the Standard Industrial Classification Manual as Division I - Services; Major Group 80 - Health Services; Industry Group 806 - Hospitals; SIC 8062 - General Medical and Surgical Hospitals.

The Fund believes that the Hospital will qualify as a small business as defined by the federal Small Business Administration. The Small Business Administration defines a "small business concern" as a business entity organized for profit, with a place of business located in the United States, which operates primarily within the United States and meets the size standard applicable for the NAICS code in which the business entity operates. The NAICS code for the Hospital is _____ with a size standard of _____ in annual revenues. Whether or not a business entity meets the size standards described above is determined by reference to an entity's "annual receipts," which is defined as gross or total income, including cost of goods sold, of a company as reported on the company's Federal income tax return and averaged over the latest three completed fiscal years. As a start-up company, the Hospital will not have any historical annual receipts and will not have annual receipts at the time of the investment in excess of the applicable size standards listed above. In addition, in the second year after opening, the Hospital is projected to have gross revenues of approximately _____. The Hospital is an entity organized for profit with a business location in the United States and will operate primarily in the United States. Therefore, the Fund believes that the Hospital will qualify as a "small business," as defined by the Small Business Administration.

RULINGS REQUESTED AND RESPONSES:

1. _____ meets the definition of a "qualified small business capital company" within the meaning of 68 O.S. § 2357.61(7).

Yes. Based on the information provided, _____ appears to meet the definition of a qualified small business capital company.

2. Hospital meets the definition of an "Oklahoma small business venture" within the meaning of 68 O.S. § 2357.61(5).

Yes. Based on the information provided, Hospital appears to meet the definition of an Oklahoma small business venture.

3. Hospital's loans from _____ and the Fund will constitute "near-equity security" and "subordinated debt" as defined in 68 O.S. § 2357.61 (3) and (8), respectively.

Yes. Hospital's loans from _____ and the Fund are near equity and subordinated debt as defined in 68 O.S. § 2357.61 (3) and (8), respectively. However, the definitions under 68 O.S. § 2357.61 (3) and (8), respectively relate to the capitalization of a small business capital company and are not relevant when considering what is an investment in a qualified Oklahoma small business venture under 68 O.S. § 2357.62 (B).

4. Hospital's _____ cumulative _____ membership interest will constitute "equity" as defined in 68 O.S. § 2357.61(3).

Yes. Hospitals cumulative memberships interest will constitute equity as defined in 68 O.S. § 2357.61(3).

5. The investment by the Fund in _____ will meet the definition of a "qualified investment" within the meaning of 68 O.S. § 2357.61 (6) and will qualify for the credit against tax provided in 68 O.S. § 2357.62(B).

Yes, the investment by the Fund is a qualified investment within the meaning of 68 O.S. § 2357.61 (6). However, the loan of _____ would not be considered an investment under 68 O.S. § 2357.62(B).

6. The "in conjunction with" investment by the Fund in Hospital's loans and its cumulative membership interest will qualify for the credit against tax provided by 68 O.S. §2357.63(B).

Based on the fact pattern _____ (Fund) is making the "in conjunction" investment of _____ of which _____ is in the form of a loan. The loan of _____ would not be considered an investment under 68 O.S. § 2357.63(B).

7. The amount of the Credits under 68 O.S. §§ 2357.62(B) and 2357.63(B) is _____ of the funds invested by _____ and by the Fund in conjunction with _____ in Hospital.

No. See response to number 8 above.

8. The Credits resulting from the investments will be available to offset the Oklahoma tax liabilities, as defined in the Act, of the member(s) of the Fund and may be allocated among the members of the Fund, prorata to their ownership of Shares of Common membership interest on the date the investments are made.

Generally, properly earned credits are able to offset Oklahoma tax liabilities of and may be allocated among members of the Fund. In the case of flow-through entities _____ 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.

9. The Credits arising from the investments by the Fund will be immediately usable by the members of the Fund, or the ultimate taxpayers if the members are flow through entities, against any tax liability then due from such investor under 68 O.S. §2355 (the "Oklahoma income tax"), 68 O.S. § 2370 (the "bank privilege tax") and 36 O.S. §§ 624 and 628 (the "insurance premium tax"), including estimated tax payments, and beginning _____ against any tax liability thereafter due from such Investor under 68 O.S. §§ 1001, 1101 or 1102 (the

"gross production and excise taxes").

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 _____ generates a credit that is available to offset tax year _____ and would not be available to pay _____

10. The Credits arising prior to _____ but not used by an Investor against any other tax liability may be used by the investor against any gross production and excise taxes, beginning by claiming refunds for such gross production and petroleum excise taxes, which is collected by the purchaser of such production and remitted directly to the Oklahoma Tax Commission on behalf of the Investor, as the beneficial owner of relevant Oklahoma mineral properties.

Yes. Previously earned but not used Oklahoma Small Business Capital Company Credits may be used to offset gross production taxes due on or after _____

11. The rulings requested herein may be relied upon by the Fund and the Investor(s) in the Fund, including any indirect Investors through pass-through entities.

This response applies only to the circumstances set out in your request of November 8, 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.

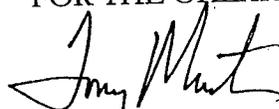
Please also be advised that the issuance of this ruling does not preclude the Oklahoma Tax Commission from conducting an audit or examination under 68 O.S. § 206 .

_____ any member of these 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