



It is tax time again, at least in the United States, so I trust everyone has appropriately done their tax planning and have minimized their taxes. Since we're on the subject of taxes, and since I am the one who is always saying that you must consider tax consequences in **every** transaction, I thought I would concentrate this letter on some of those subtle taxes that hit hard but that we oftentimes overlook.

Consider the formation of an entity, whether it is a corporation or a partnership including a limited partnership or a limited liability company. In California, forming and operating a business under a limited liability company can be taxing; in addition to the fees you have to pay to the State of California for forming the entity, California imposes an \$800 franchise tax fee every year, a small fee to file an annual statement of information about the manager and other information, and a gross receipts tax. The last one should be called a grotesque receipts tax because it is just that. This is a tax simply for the privilege of having your limited liability company in California. While the tax maxes out at about \$12,000, it is charged on your gross income, not on your net income. Say, for example, you bought a property and when you sold it you lost \$1.0 million even though your net sale proceeds, your gross receipts, were \$10.0 million; you must still pay the tax. Or say your gross income from your operations is \$3.0 million but you lost \$500,000, you must still pay the tax. See why I call it grotesque. Yes, the tax benefits still pass through to the members of the LLC, assuming you elected to have the LLC treated as a partnership rather than as a corporation for tax purposes; but you can get that same benefit with a limited partnership or a S elected corporation.

Another tax of forming an entity is license fees imposed by a local government agency for the privilege of doing business in that town or area. Cities are frequently catching home-based businesses that have not applied for a license and paid license fees by the cities searching State records of entity formations. On the other hand, I understand but have no actual experience that the IRS audits sole proprietorships something like 10 times more often than they audit formal entities like corporations. Even if you pass an audit as quickly as having a speed pass on a toll road, there is still substantial time and potential costs involved, including your own time and the likely time of your accountant or tax preparer, to fight an audit.

California and many states are also imposing a fun new tax on businesses when a general partner or LLC manager is located in that State, even though the entire business and all the other partners or members are located in another state. For example, we operate oil and gas wells in Ohio and we, the general partner, are located in California. There are also a few other general partners in various states of the United States. All our income is derived from the operations in Ohio and the limited partners are located all over, including outside the United States. California imposes the \$800 franchise tax fee on the partnership because one of the general partners is located in California. Ohio charges a fee on each general partner even though none of them is located in Ohio. Plus both Ohio and California require the limited partnership to file tax returns in those respective states, which cost additional monies and time, and Ohio charges a tax on the gross income.

A limited partnership has some of the same benefits of an LLC or a S elected corporation; however, the general partner stands alone and to get the liability protections offered by a corporation or an LLC the general partner must itself be a corporation or LLC, which means more entities to form and maintain. Personally, I like S corporations (which is just a corporation but one which you filed an S election with the IRS) since they offer all the benefits of a partnership, an LLC and limited partnership except that you can't get disproportionate allocations. I had to mention that last thing, which means explaining another thing. "Disproportionate allocations" are simply that, that you allocate, for example, losses differently than you allocate profits. This can be a great tool, especially when you are trying to attract an investor. Assume you need to raise \$1.0 million to start a company or to buy a property and you attract a sugar momma who will invest the \$1.0 million. Assume further that she has lots of passive income (net income from properties, for example) that she needs to offset whereas you, being the poor person that you are, don't need the benefits. And last assume that you have decided and sugar momma agreed to split potential profits 50/50. Under a partnership, including a limited partnership and an LLC, you can allocate all the losses to sugar momma, who needs them to offset her net income, even though profits are allocated on a 50/50 basis. However, you cannot do this with an S corporation. Being one to take advantage of this can be particularly attractive in the early days of oil and gas deals (intangible drilling costs, depreciation and IRC Section 179 losses can be great in the first couple of years) or in real estate deals (depreciation and operating losses) since you will likely have at least paper losses, which the sugar momma can use but you can't because you have nothing to offset the losses, and it makes the investment more attractive to the investor – yes, getting tax benefits of losses can be attractive, especially when the future will bring operating income and gains.

I am sorry, but I am not a big fan of forming entities on-line even though it can be a cheap alternative. The reason I am not in favor of your doing that is not because I am an attorney and I want your business but because you get no advice - tax, legal, etc. - and so you probably get what you pay for. Some obvious rhetorical questions are what type of entity works best for you? What effect does the entity you have chosen have on decisions like pension plans and employment taxes? Does the entity you have chosen work well for your investors or outside principals? Does the entity you have chosen allow it to be licensed, like with a real estate broker's license?

In any event, remember that taxes are in EVERY transaction and everywhere. Find them and conquer!