OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of: **J. SMITH, TRANSFEREE OF CONVERSION MEDIA LLC**	) OTA Case No. 19024303)))))

OPINION

Representing the Parties:

For Appellant: J. Smith

For Respondent: Kamalpreet Khaira, Tax Counsel

D. BRAMHALL, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19045, J. Smith (appellant) appeals an action by respondent Franchise Tax Board (FTB) proposing that he is liable, as transferee, for the following amounts due, plus interest, from Conversion Media LLC (CM) for the 2015 tax year: additional tax of $158,888.00; a late-payment penalty of $26,119.69; an underpayment of estimated tax penalty of $3,097.60; lien fees of $40.00; and a collection cost recovery fee of $365.00.

Appellant waived the right to an oral hearing; therefore, this matter is being decided based on the written record.

ISSUE[1]

Whether FTB has established that appellant is liable as transferee for the unpaid tax liability, penalties, fees, and interest of CM for 2015.

FACTUAL FINDINGS

1. Appellant was the president, chief executive officer, and sole member of CM, doing business as MyVideoToMP3Converter. CM was a Nevada limited liability company

[1] Given our opinion that FTB failed to establish that appellant is liable for CM taxes as transferee, we will not further address the derivative issues of whether appellant is liable for CM's unpaid penalties, fees, and interest. (See *Commissioner v. Stern* (1958) 357 U.S. 39 (*Stern*).)

(LLC),[2] but was taxed as an S corporation for federal and California income tax purposes. CM was located in Las Vegas, Nevada, and appellant lived in Las Vegas, Nevada.

2. CM timely filed a 2015 California S Corporation Franchise or Income Tax Return (Form 100S), which reported tax due of $158,888 but zero payments, including estimated tax payments. The return self-assessed an estimated tax penalty of $3,098, resulting in a total amount due of $161,986. No payment was remitted when CM filed its 2015 return.
3. CM reported on both the 2015 Schedule K attached to its 2015 California tax return and the 2015 Schedule K-1 issued to appellant that appellant's distributive share of California source income (net capital gain) was $10,498,545 and "total property distributions (including cash)" was $7,292,643.
4. CM's 2015 Schedule L Balance Sheet reflected year end cash of $4,989,197, total assets of $6,416,900, and current liabilities of $158,888 (the amount due as shown on its 2015 return).
5. On October 15, 2016, appellant filed a California Nonresident or Part-Year Resident Income Tax Return (Form 540NR),[3] on which he reported his distributive share of California source income of the net capital gain from CM of $10,498,545.
6. Commencing on January 9, 2017, FTB issued CM a series of collection notices that included tax, penalty, interest, lien information, forfeiture authority, and collection cost recovery fees.
7. In 2017 and 2018, CM remitted five payments totaling $75,918.43, to be applied to its outstanding 2015 tax liability. These payments consisted of the following: (1) a payment of $41,842.51 on May 2, 2017; (2) a payment of $27,183.85 on June 19, 2017; (3) a payment of $5,349.34 on July 25, 2017; (4) a payment of $1,365.23 on December 18, 2017; and (5) a payment of $177.50 on March 13, 2018.
8. On April 16, 2018, FTB recorded two liens against CM in Sacramento County, each of which resulted in total fees due of $20, resulting in total lien fees of $40.

[2] Appellant asserts in his protest letter that CM was a Nevada LLC, an assertion undisputed by FTB.

[3] On Schedule CA (540NR), although appellant checked a box indicating he was a California resident, he then indicated in the same section that, during the 2015 tax year, he spent zero days in California and was domiciled in Nevada. Therefore, it appears appellant was a Nevada resident during 2015, a fact not disputed by FTB.

9. On August 21, 2018, FTB issued a Notice of Proposed Assessment (NPA) to appellant as transferee of CM for its 2015 unpaid liability, pursuant to R&TC sections 19071 through 19074, after application of the above payments.
10. On October 17, 2018, appellant protested the NPA.
11. On November 27, 2018, FTB issued appellant a Notice of Proposed Assessment Protest - Demand to Furnish Information, which states that the NPA was based on the net capital gain of $10,498,545 that CM "distributed" in full to appellant, CM's sole shareholder, as reported on Schedule D of CM's 2015 California tax return and the 2015 Schedule K-1 issued to appellant.
12. On December 31, 2018, FTB issued a Notice of Action on Proposed Assessment, affirming the NPA.
13. This timely appeal followed.

DISCUSSION

California generally conforms to the federal income tax treatment of S Corporations and their shareholders. (R&TC, §§ 23800 and 23800.5; see also *Valentino v. Franchise Tax Bd.* (2001) 87 Cal.App.4th 1284, 1288.) An S Corporation is a "small business corporation" for which a valid election has been made to be taxed under Subchapter S of Chapter 1 of the Internal Revenue Code (IRC). (IRC, § 1361(a)(1) & (b).) An S Corporation generally does not pay federal income taxes at the entity level. (Treas. Reg. § 1.1363-1(a)(1).) However, in general, an S Corporation is liable for California taxes on its income at a tax rate of 1.5 percent. (R&TC, § 23802(b)(1).) For both federal and state tax purposes, the S Corporation files an informational return each year reporting its gross income (or loss) and deductions, its shareholders, and the shareholders' pro rata shares of each item. (IRC, § 6037(a).) These items are passed through on a pro rata basis to the shareholders, who report them on their personal income tax returns. (*Valentino v. Franchise Tax Bd.*, *supra*, 87 Cal.App.4th at p. 1288.)

In California, one's status as a member or manager of an LLC[4] does not, in and of itself, cause one to be liable for the LLC's debts. (See Corp. Code, § 17703.04(a)(2) & (b); see also its predecessors, former Corp. Code, §§ 17101 and 17158.) In fact, the general rule in California is

[4] While CM elected to be taxed as an S Corporation, its organizational structure and governance is as an LLC.

that members of an LLC are not liable for the debts, obligations, or other liabilities of the LLC. (*CB Richard Ellis, Inc. v. Terra Nostra Consultants, et al.* (2014) 230 Cal.App.4th 405.)

In this appeal, FTB contends that appellant is "secondarily liable" as "transferee" for the taxes (including penalties, fees, and interest) due from CM pursuant to R&TC sections 19071 through 19074. The transferee liability procedures set forth in those provisions (in particular, R&TC section 19073) are, in pertinent part, substantially similar to those found in IRC section 6901. Accordingly, federal authorities interpreting IRC section 6901 are relevant and persuasive in interpreting and applying R&TC section 19073. (See generally *Meanley v. McColgan* (1942) 49 Cal.App.2d 203, 209 [interpretations of similar federal tax statute are instructive in state statute analysis].)

Under both California and federal law, the secondary liability of a transferee does not involve the imposition of a new tax liability. Rather, it is a means to enforce an existing liability against a person that is a transferee of a taxpayer. (*Stern, supra,* 357 U.S. 39; IRC, § 6901.)

In determining the liability of a transferee for the tax obligations owed by a transferor, one applies the law of the state where the transfer occurred. (*Stern, supra,* 357 U.S. at pp. 44-45; *Adams v. Commissioner* (1978) 70 T.C. 373, 389, affd. without published opinion (2d Cir. 1982) 688 F.2d 815; *Appeal of Farmanfarmai, Transferee* (87-SBE-029) 1987 WL 59538.) It is FTB's position that California law applies in this appeal and that position has not been contested by appellant.[5] Therefore, we will apply California law here.

FTB contends that appellant is liable for the taxes of CM in equity under the former sections 3439 through 3439.12 of the California Civil Code (Civ. Code). Those sections were part of California's Uniform Fraudulent Transfer Act (the UFTA, former Civ. Code sections 3439 through 3439.12), which we apply in this appeal.[6]

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[5] As mentioned above, we note that appellant was a resident of Nevada during 2015, a fact not disputed by FTB, and that CM is a Nevada organized entity. It is therefore unclear how FTB supports its view that with a Nevada transferee and transferor, the transfer occurred in California and therefore that it is appropriate to apply California law. We further note that Nevada has adopted, effective for 2015, the Uniform Fraudulent Transfer Act. (See Nev. Rev. Stat., § 112.140 et seq.)

[6] The UFTA was the successor to the Uniform Fraudulent Conveyance Act (the UFCA, Stats. 1939, Ch. 329, § 7), which was codified at former Civ. Code sections 3439 through 3439.12. Effective January 1, 2016, the UFTA was amended and renamed as the Uniform Voidable Transactions Act (the UVTA, current Civil Code sections 3439 through 3439.14). (Stats. 2015, ch. 44, S.B. 161.) However, the UFTA applies in deciding this appeal, since any transfer(s) at issue from CM to appellant occurred prior to the effective date of its repeal. (Civ. Code, § 3439.14(a).) We also note that many of the UVTA's provisions are substantially the same as those of the UFTA and, as a result, the UVTA provides that, to the extent that the provisions of both acts are "substantially the

To establish transferee liability in equity, FTB must prove the following five elements: (1) the taxpayer-transferor transferred property to the transferee for less than full and adequate consideration; (2) at the time of the transfer and at the time transferee liability is asserted, the taxpayer-transferor was liable for the tax; (3) the transfer was made after the liability for the tax accrued, whether or not the tax was actually assessed at the time of the transfer; (4) the taxpayer-transferor was insolvent at the time of the transfer or the transfer left the taxpayer-transferor insolvent; and (5) FTB has exhausted all reasonable remedies against the taxpayer-transferor. (Civ. Code, § 3439 et seq.; *Appeal of Zubkoff and Potash, Assumers and/or Transferees of Ralite Lamp Corp.* (90-SBE-004) 1990 WL 117932.) Since FTB has failed to establish the fourth element, we need not discuss, except by footnote comment, the other elements.

Civ. Code section 3439.02(a) and (c), upon which FTB appears to rely, provides in full:

> (a) A debtor is insolvent if, at fair valuations, the sum of the debtor's debts is greater than all of the debtor's assets.
> …
> (c) A debtor who is generally not paying his or her debts as they become due is presumed to be insolvent.
> …

Appellant essentially argues that he bears no personal liability for debts or any other liabilities of CM. He further alleges that he realized no personal gain from CM as all funds received were reinvested back into CM and that he only became aware of CM's 2015 California tax liability in August 2018. Additionally, appellant, as the sole member/shareholder of CM, filed its 2015 return and provided as evidence of current solvency and capital contributions a self-generated balance sheet and copies of the front pages of CM's 2016 and 2017 federal S Corporation tax returns.

FTB notes that CM filed a 2015 S Corporation return, which reported a net capital gain from Schedule D of $10,498,545 that accounted for almost all of CM's 2015 net income for tax purposes of $10,592,506. Applying an S Corporation tax rate of 1.5 percent against CM's net income for tax purposes of $10,592,506, CM self-assessed tax due of $158,888 and did not make any payment of its 2015 tax either through estimated tax payments or with its 2015 return.

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same," the UVTA provisions "shall be construed as restatements and continuations [of the UFTA], and not as new enactments." (Civ. Code, § 3439.14(d).)

However, in 2017 and 2018, CM remitted five payments totaling $75,918.43, which reduced CM's outstanding tax liability.

FTB further asserts that CM's 2015 California Schedule K and the 2015 Schedule K-1 issued to appellant show that CM distributed a net long-term capital gain of $12,544,057 to appellant, which was reduced by a California adjustment of -$2,045,512, resulting in a total amount for California purposes of $10,498,545. FTB notes that appellant reported tax on pass-through income of $10,498,545 at the shareholder level on his 2015 California personal income tax return. Accordingly, FTB argues that the only issue is whether appellant is liable as a transferee for CM's 2015 S Corporation tax of $158,888, apparently as reduced by the payments noted, as a result of CM's transfer of $10,498,545 to him.

We find that FTB has failed to show that CM transferred $10,498,545 to appellant. We find instead that the evidence shows that CM transferred only $7,292,643. CM's 2015 S Corporation return reflects that CM recognized a California net gain of $10,498,545, but, contrary to FTB's assertion, only distributed property (including money) to appellant having a value of $7,292,643.[7] FTB has provided no evidence or argument to dispute the accuracy of CM's tax return information. In fact, FTB relies upon that return to establish CM's tax liability but fails to properly interpret its information.[8] We specially note that the Schedule L Balance Sheet that is part of CM's 2015 S Corporation return, which was accepted as filed by FTB, shows total assets as of December 31, 2015, of $6,416,900 and total current liabilities of only $158,888.

FTB asserts that CM became insolvent after its distribution to appellant. For purposes of transferee liability, FTB has the burden of proving that a transferor is insolvent or was made insolvent following a transfer. FTB further asserts that insolvency may be determined by Civ.

[7] It appears FTB has wrongly interpreted the reporting of a pro rata distributable share amount as an actual distribution.

[8] Appellant attached a federal Balance Sheet for the year ended December 31, 2017, which shows total assets of $10,239.79 and liabilities plus equity of the same amount. The equity column includes a single member contribution from appellant of $11,857,658.00, which is cancelled out by business operations income and gains/losses of -$12,664,627.21, resulting in total equity of -$806,969.21. However, appellant has not shown that this 2017 balance sheet ties into other contemporaneous books and records, such as CM's federal or state returns or a general ledger. Appellant has provided copies of the first pages of CM's 2016 and 2017 federal S Corporation returns, which show losses of $2,871,384 for 2016 and $4,236,322 for 2017. Both returns also show substantial yearend assets in Box F in the amounts of $2,807,585 for 2016 and $1,754,401 for 2017. These amounts suggest that appellant may have made additional contributions to CM from the amount distributed to him in 2015; however, any such contributions do not impact the question of whether there was consideration for the 2015 distribution or the question of whether the distributions caused CM's insolvency as of the end of 2015.

Code section 3439.02(a) and (c), mentioned above, which provide in relevant part that "[a] debtor is insolvent if, at fair valuations, the sum of the debtor's debts is greater than all of the debtor's assets" and "[a] debtor who is generally not paying his or her debts as they become due is presumed to be insolvent."

Some preliminary discussion of the burden of proof that applies in this appeal is in order. It is true that ordinarily the burden of proving insolvency is on the creditors, and, as a general rule, solvency and not insolvency is presumed. (*Stearns v. Los Angeles City School Dist*. (1966) 244 Cal.App.2d 696, 737; *Miller v. Keegan* (1949) 92 Cal.App.2d 846, 851-852 (*Miller*).) To overcome the presumption of solvency, there must be some basis in evidence for determining that the amount of the debtor's obligations exceeded the then present fair salable value of the debtor's nonexempt assets.

In *Miller, supra,* the only evidence relating to the transferor's financial affairs was certain statements by his wife. The court noted the presumption of solvency, stating that "[t]o overcome this presumption a fair interpretation of the statute requires some basis in evidence for determining that the amount of the debtor's obligations exceeded the then present fair salable value of his nonexempt assets." (*Miller, supra,* 92 Cal.App.2d 846, 852.) The extent of the transferor's debts was not shown, except for the amount owed to the plaintiff, while the record disclosed assets in a greater amount. In *Miller*, the creditor therefore failed to even produce enough evidence to establish a prima facie case of insolvency.

In *Neumeyer v. Crown Funding Corp.* (1976) 56 Cal.App.3d 178, 190, the court held that "under the [UFCA] a voluntary conveyance, one made without fair consideration, when the evidence shows that there are existing indebtednesses, is presumptively fraudulent. It is then incumbent upon the grantee to prove that the conveyor was solvent."

Here, the only unpaid obligation documented by FTB is the tax liability at issue. As in *Miller*, there was no evidence presented showing the extent of the transferor's (CM's) indebtedness beyond the tax debt at issue. Further, the record here reflects assets in a significantly greater amount than all liabilities disclosed in the record.[9]

[9] Disclosed assets include those reflected on CM's 2015 California tax return year-end balance sheet, and those reflected on the face of CM's 2016 and 2017 federal S Corporation tax returns. While FTB sought substantial amounts of additional information from appellant, and appellant failed to provide the specific information requested, we do not believe the requested information was necessary as the record provided is adequate for the determination at issue.

FTB's principal argument in this case rests upon the assertion that CM distributed substantially all of its assets to appellant during 2015. The record does not reflect that assertion to be accurate. Without deciding the issue, it is also not certain that evidence of a single unpaid debt, without a showing of inadequate assets to pay it, is adequate to establish a prima facie case of insolvency. We do find, however, that even if a prima facie case of insolvency is established, the record sufficiently proves that CM had more than adequate assets to pay disclosed liabilities and was thus not insolvent at the time of its distribution to appellant. Accordingly, we find that FTB has failed to establish by a preponderance of the evidence the insolvency of CM.

For the above reasons, we find that FTB has failed to establish that appellant is liable as transferee of CM for CM's 2015 tax liability pursuant to R&TC sections 19071 and 19074.

HOLDING

FTB has failed to establish that appellant is liable as transferee for the unpaid tax liability, penalties, fees, and interest of CM for 2015.

DISPOSITION

FTB's action is reversed.

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Douglas Bramhall
Administrative Law Judge

We concur:

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Kenneth Gast
Administrative Law Judge

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Elliott Scott Ewing
Administrative Law Judge

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