BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of HOWARD ZUBKOFF AND MICHAEL POTASH, ASSUMERS AND/OR TRANSFEREES OF RALITE LAMP CORPORATION, TAXPAYER	)	No. 82A-2172-CB

Appearances:

For Appellant: Larry Rothman
Attorney at Law

For Respondent: Karen D. Smith
Counsel

O P I N I O N

This appeal is made pursuant to section 25666[1/] of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Howard Zubkoff and Michael Potash, Assumers and/or Transferees of Ralite Lamp Corporation, Taxpayer, against a proposed assessment of additional franchise tax and penalty in the total amount of $10,604.95 for the income year ended October 31, 1980.

1/ Unless otherwise specified, all section references are to sections of the Revenue and Taxation Code as in effect for the income year in issue.

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The issue presented in this appeal is whether the appellants are liable as assumers and/or transferees of the tax liability of Ralite Lamp Corporation.

Ralite Lamp Corporation (Ralite) filed a timely corporate franchise tax return for the income year ended October 31, 1980, indicating a tax liability was due. However, no remittance accompanied the return. Respondent issued a notice of proposed assessment (NPA) for the tax liability of $10,119 and assessed a payment penalty of $485.95.

Howard Zubkoff and Michael Potash were each 50-percent shareholders of Ralite. Respondent's assessment of the two shareholders as assumers and/or transferees of Ralite was based upon loans made by Ralite to them in the amount of $74,899 during the appeal year and cash distributions to them totaling $106,200 in the year subsequent to the appeal year.

Section 2570la(1) provides for the assessment of

> (1) The liability, at law or in equity, of a transferee of property of a taxpayer, in respect of the tax (including interest, additional amounts, and additions to the tax provided by law) imposed upon the taxpayer by this part.

Since this section is substantially similar in pertinent part to Internal Revenue Code section 6901, federal authority interpreting this section is highly persuasive as to the proper application of the comparable state statute. (Meanley v. McColgan, 49 Cal.App.2d 203, 209 [121 P.2d 45] (1942).)

The liability of a transferee may be enforced either at law or in equity. Respondent concedes that liability at law cannot be established in this appeal because, among other reasons, appellants did not expressly assume the liabilities of Ralite. Therefore, appellants' liability, if any, for Ralite's taxes must be established in equity. The transferee liability in equity is based on the law of fraudulent conveyances. To find transferee liability in equity, respondent must prove the following 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 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) respondent has exhausted all reasonable remedies against the taxpayer-transferor. (Rev. & Tax. Code, § 25701a; Civ. Code, §§ 3439-3439.12.)

While appellants admit that a loan of $74,899 was outstanding at the end of Ralite's 1980 tax year, they contend that the subsequent year's tax return accounted for the loan. Also, they assert that an individual transferee did pay individual income tax on funds received. Furthermore, appellants contend that there is no evidence that a transfer occurred after the tax accrued. Finally, appellants assert that full or adequate consideration was paid because the disputed amounts were paid to them in 1981 as salary.

For the reasons that follow, we agree with respondent that transferee liability is applicable and appropriate in this appeal. To establish transferee liability in equity, at a minimum beneficial ownership of corporate property must have been transferred to the transferee. (Paulyn E. Tomfohr v. Commissioner, 44 B.T.A. 730 (1941).) Civil Code section 3439.04, applicable for the appeal year, provided that:

> Every conveyance made . . . by a person who is or will be thereby rendered insolvent is fraudulent as to creditors without regard to his actual intent if the conveyance is made . . . without a fair consideration.

In this matter, Ralite loaned $74,899 to appellants during the appeal year. As appellants concede, the loan was still outstanding on November 1, 1980, after the end of the appeal year. Although appellants contend that the loan was repaid during Ralite's 1981 tax year, a $106,200 cash distribution to Ralite's only two shareholders occurred during that year. It is the $106,200 cash distribution to the shareholders after Ralite's tax liability had accrued in the appeal year from which appellants' liability arises. Clearly, the $106,200 cash distribution to the shareholders may be reportable as taxable income to the shareholders. The payment of a personal tax liability, however, does not affect a corporation's tax liability. There is no evidence to indicate that the cash distributions were payments of salary or that Ralite received fair consideration in return. Ralite's tax return for the year ended October 31, 1981, demonstrates that no compensation of officers or other salaries were paid during the year of the cash distributions.

The transferees' liability for the tax is derivative or secondary to that of the taxpayer-transferor. Therefore, for respondent to assert liability against a transferee, the taxpayer-transferor must be liable for the tax at the time of transfer and at the time the transferee liability is assessed. Ralite's liability is based on the fact that no payment was made with the tax return for the appeal year and no subsequent payment for the appeal year was received by respondent. Appellants have not disputed the amount or nature of the assessment against Ralite.

The transfer of property must have been made after liability for the tax accrued, but not necessarily after assessment of the tax.

> [T]he transferee is retroactively liable for the transferor's taxes in the year of the transfer and prior years, and penalty and interest in connection therewith, to the extent of the assets received from the transferor even though the transferor's tax liability was unknown at the time of the transfer.

(Leon Papineau v. Commissioner, 28 T.C. 54, 58 (1957).)

Here, Ralite made a loan to the shareholders in the appeal year and a cash distribution to them in the subsequent year, thereby preventing respondent from collecting the tax from Ralite.

Respondent must show that the taxpayer-transferor was insolvent at the time of transfer or became insolvent as a result of the transfer. (Kreps v. Commissioner, 351 F.2d 1 (2d Cir. 1965).) The requirement of insolvency is met if a transfer is one of a series of liquidating transfers which ultimately renders the taxpayer-transferor insolvent. (Phillips v. Commissioner, 283 U.S. 589 [75 L.Ed. 1289] (1931).) Here, between the shareholder loan in the appeal year and the cash distributions to the shareholders in the ensuing tax year, Ralite was appropriately deemed insolvent because its liabilities greatly exceeded its assets.

Generally, respondent must exhaust all of its remedies against the taxpayer-transferor. An exception to the general rule exists where it is shown that it would be futile to exhaust all remedies against an insolvent taxpayer-transferor. (Benoit v. Commissioner, 238 F.2d 485 (1st Cir. 1956).)

In this matter, it would have been futile for respondent to exhaust all collection efforts against Ralite, because Ralite did not have sufficient assets available to satisfy the deficiency.

Accordingly, because cash was distributed to the shareholders without adequate consideration and Ralite became insolvent, the shareholders are liable for Ralite's tax. Therefore, respondent correctly determined that appellants should be assessed Ralite's tax liability under the theory of transferee liability.

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O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Howard Zubkoff and Michael Potash, Assumers and/or Transferees of Ralite Lamp Corporation, Taxpayer, against a proposed assessment of additional franchise tax and penalty in the total amount of $10,604.95 for the income year ended October 31, 1980, be and the same is hereby sustained.

Done at Sacramento, California, this 30th day of April 1990, by the State Board of Equalization, with Board Members Mr. Dronenberg, Mr. Carpenter, and Mr. Davies present.

_____, Chairman

Ernest J. Dronenberg, Jr., Member

Paul Carpenter, Member

John Davies * **, Member

_____, Member

*Abstained

**For Gray Davis, per Government Code section 7.9