Walking Away From a Corporation or an LLC

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WALKING AWAY FROM A CORPORATION OR AN LLC

Many of our clients form corporate or passthrough entities and never use them, or the business fails and the shareholders, LLC members, or partners simply abandon the business and go to work somewhere else. In many of these cases, the shareholders/partners/members do not formally dissolve the entity with the SOS. These shareholders/owners subsequently receive a bill from the FTB for the minimum tax, plus penalties and interest. If certain conditions are met, the FTB may not hold the shareholder/member liable for any taxes due. **Note:** Relief does not apply to a general partner.

For years, this resulted in a prolonged nightmare for many shareholders/members as there were limited options available to address this issue. However, in 2018, legislation was passed that allows for administrative dissolution for California corporations and LLCs. (AB 2503 (Ch. 18-679)) For entities formed outside California or California entities that are ineligible for administrative dissolution, ***Ralite*** relief or an offer-in-compromise (both discussed later) might be the best option.

VOLUNTARY ADMINISTRATIVE DISSOLUTION

California corporations or LLCs that registered with the California Secretary of State but either never commenced business or ceased operations but never formally dissolved with the Secretary of State's office can now apply to the FTB for a voluntary administrative dissolution. (R&TC §23310)

This applies to entities that:

- Were not doing business at any time after they were formed in California, or
- Ceased doing business and have filed all required returns for the tax years prior to their cessation of doing business. **Note:** In these situations, the entity must have been compliant in filing and paying taxes during the years that business was conducted.

WHO IS ELIGIBLE?

Entities that are eligible for administrative dissolution include:

- Only those entities that have no assets. An entity does not need to be suspended by either the SOS or the FTB before applying for voluntary dissolution. However, an entity that has been suspended may apply for administrative dissolution rather than wait for the FTB to apply the involuntary dissolution provisions of the law; and
- According to the FTB, an entity whose appeal was denied by the OTA may apply for dissolution.

INELIGIBLE ENTITIES

Administrative dissolution does not apply to foreign entities (non-California entities that register to do business in California) or California entities that move their operations outside California.

Example of ineligible foreign entity

Smarty formed Did It Myself, Inc. as a Delaware corporation and registered it in California as a foreign corporation in 2010. Smarty never started his business and thought he was qualified for voluntary administrative dissolution.

He does not qualify because his corporation is not a California corporation. He may qualify under the ***Ralite*** case, discussed later.

Example of ineligible California entity doing business outside California

Homegrown Beauty, LLC organizes in California in 2010 and obtains a FEIN. Homegrown grows flowers and sells them at local flower markets. It operates in California for three years and files all its applicable returns. It decides to relocate to Oregon in 2012. It marks its 2012 Form 568 as "final" but does not dissolve with the SOS. It retains its name and FEIN, but after 2012 conducts all of its activities and makes all of its sales in Oregon. The taxpayer is ineligible for administrative dissolution because it has retained its name and FEIN and is actively engaging in activities for profit. Homegrown would continue to be liable for the $800 California minimum/annual tax, penalties, or interest for 2013 through the present.

BENEFITS OF ADMINISTRATIVE DISSOLUTION

If the application for administrative dissolution is approved, the FTB will abate all outstanding liabilities for the $800 minimum/annual tax for the periods that the entity was not conducting business and related penalties and interest. However, taxes based on income related to an entity's activities or operations while it was still conducting business will not be abated.

Example of abatement relief

Real Wheels, LLC was an on-demand bicycle rental company that formed in 2015. Wheels rented a warehouse/office building and purchased bikes and vans to transport the bikes. Unfortunately, the city banned having bikes left on the sidewalks, and Real Wheels was forced to close its operations. It filed the 2016 return, marking the final return box, but failed to pay the LLC tax and fee for 2016 and never formally dissolved with the SOS. In 2016, it sold all its equipment.

Wheels can request voluntary dissolution in 2019 and have the $800 annual tax and associated penalties and interest abated for 2017 and 2018. However, it remains liable for the LLC annual tax and fees for 2016.

Income and franchise tax still due

While the minimum tax is forgiven, the entity is still liable for tax on net income. For example, suppose a C corporation had $100 in interest income for a particular year but no expenses. The corporation must pay $9 ($100 × 8.84%) on that income.

APPLYING FOR VOLUNTARY DISSOLUTION

To apply, taxpayers that have been registered more than 12 months with the California Secretary of State's office may submit either a:

- Form 3715 PC, Domestic Corporation Request for Administrative Dissolution; or
- Form 3716 PC, Domestic Limited Liability Company Request for Administrative Dissolution.

If they have not already done so, before they are approved, the entity must also:

- Submit all tax returns filed up to the date the entity ceased conducting business in California; and
- Pay all taxes, penalties, and interest up to the date the entity ceased doing business in California.

Forms 3715 PC and 3716 PC ask for information regarding any potential assets the entity may still have such as assets, bank accounts, real property, any contracts, inventory, accounts receivable, or shareholder/member loans. It also asks for information regarding any business licenses the entity may have, and any employees, independent contractors, or commissioned agents.

In addition, taxpayers must provide information regarding any assets that might have previously been distributed by the entity.

The FTB has just begun processing applications so does not yet have a sense of how long it will take to review these applications. There is no right to appeal if the FTB denies the application.

DISSOLVE WITH THE SOS

Once a taxpayer receives an approval letter from the FTB, it must formally dissolve with the SOS within 12 months by filing the applicable dissolution form(s):

- LLC-4/7, Certificate of Cancellation and LLC-3, Certificate of Dissolution, if applicable; or
- ELEC-STK, Certificate of Election to Wind Up and Dissolve and DISS-STK, Certificate of Dissolution, if applicable.

Note: If the entity fails to dissolve after obtaining an FTB approval, the $800 minimum/annual tax will continue to accrue, and the taxpayer will be required to restart the whole process. The FTB will allow taxpayers 12 months from approval to formally dissolve or cancel with the SOS.

PENALTIES

Which penalties will be abated?

According to the FTB, the related penalties and fees that will be abated include the:

- Demand penalty;
- Estimated tax penalty;
- Late-filing and late-payment penalties; and
- Filing enforcement fee (if the demand penalty is abated).

All abated taxes, penalties, and interest will be reinstated and a 50% penalty plus interest will be imposed if the entity:

- Continues to do business after it is dissolved or cancelled; or
- Has any remaining assets that were not disclosed when it applied for administrative dissolution. (R&TC §23311)

DISSOLVING IN THE FIRST YEAR

If the entity is registered less than 12 months, it can apply for a dissolution/cancellation by filing a timely final tax return on or before the extended due date for the preceding taxable year. The entity must not have done business in California after the end of that year.

The entity must also file a DSF-STK − Short Form Certificate of Dissolution, Surrender, or Cancellation, with the SOS before the end of the 12-month period beginning with the date the final return was filed. (R&TC §§17948.3, 23332; FTB Publication 1038, Guide to Dissolve, Surrender, or Cancel a California Business Entity)

An entity that dissolves within the first 12 months is not subject to the $800 minimum/annual tax. However, if the $800 has already been paid, the FTB will not refund it. (R&TC §17941(e))

INVOLUNTARY DISSOLUTION

The FTB will involuntarily administratively dissolve a domestic corporation or LLC if, as of January 1, 2020, or at any time thereafter, the entity has been suspended for a period of at least 60 continuous months and has no outstanding liabilities for LLC fees, corporate income tax, or tax on unrelated business income. (Corp. Code §§2205.5, 17713.10.1) There are specific procedures that the FTB and SOS are required to follow prior to administratively dissolving an entity.

Prior to administratively dissolving the entity, the FTB must:

- Mail a written notice to the entity's last known address (if no valid address is on file, the SOS posting is deemed sufficient notice); and
- Transmit to the SOS the entity's name and corporation file number.

The SOS must provide 60 days' notice of the pending administrative dissolution on its website, during which time the entity may file a written objection with the FTB to the administrative dissolution. If no objection is received, the entity will be administratively dissolved at the end of the 60-day period.

Example of involuntary dissolution

Freddy's Faux Furs, LLC operated in San Diego in 2008 and closed in 2009. It filed its 2008 and 2009 returns, paid the tax and fee due, and marked the 2009 return as "final" but never formally dissolved with the SOS. The SOS suspended Freddy's in 2012 for failing to file its Statement of Information, and the FTB also suspended Freddy's in 2012 for failing to file tax returns.

On January 1, 2021, the FTB sends a Notice FTB 5126 C to Freddy's last known address. Freddy's doesn't respond by March 1, 2021, so the FTB sends Freddy's name to the SOS, which posts Freddy's name and file number on its website. If no objection is filed within 60 days of posting, the FTB will administratively dissolve Freddy's, and Freddy's will be relieved of liability for the $800 annual tax and associated penalties and interest for 2010–2020.

Avoiding involuntary administrative dissolution

Entities wanting to avoid administrative dissolution (because they are still engaged in business or still have assets in the business name) must file an objection with the FTB within 60 days of the

SOS's posting, and within 90 days of filing its objection (up to 180 days with the approval of the FTB) must:

- File all outstanding returns;
- Pay or otherwise satisfy all accrued taxes, penalties, and interest;
- File a current statement of information with the SOS; and
- Apply for a revivor.

Although a dissolved entity is relieved of qualified back state minimum franchise tax, the administrative dissolution does not discharge the entity's liability to any other creditors, or relieve the entity's directors, shareholders, transferees, or other related persons from their liabilities. Nor does the dissolution impact the attorney general's ability to enforce any other liabilities.

REVIVING VERSUS DISSOLVING

In most cases, an entity will want to accept the involuntary dissolution and relief of tax and penalties. However, an entity may want to revive rather than be dissolved if:

- There was an expected payment in the near future to the entity, such as a final payment on an installment sale or royalties; or
- The entity still owned property, such as raw land that would create income for the entity. In the case of the corporation, distribution of the property would be a taxable distribution to both the corporation and its shareholders.

When Ralite and OIC may still apply

Although the new administrative dissolution process will provide relief for the vast majority of California taxpayers that never conducted business or ceased doing business and never formally dissolved, some taxpayers may still need to raise the ***Ralite*** defense or apply for an OIC. These may still come into play in the following situations:

- Shareholders/members of corporations or LLCs that previously conducted business in California but were not compliant with tax reporting and payment obligations prior to ceasing business may still request ***Ralite*** relief if they are unable to comply with reporting and payment of taxes other than the $800 minimum/annual tax liabilities for the years they were operating;
- If a corporation or LLC retained a balance due for taxes other than the $800 annual/minimum tax for the tax years prior to the cessation of doing business and was unable to pay in full for those years, they may apply for an OIC to settle those liabilities. Once the tax years prior to the cessation of doing business are resolved, the entity may be eligible for an administrative dissolution; or
- Out-of-state corporations or LLCs that previously conducted business, or registered to do business, in California and have outstanding tax liabilities do not qualify for administrative dissolution and must request relief through ***Ralite*** or the OIC process.

Example of corporation that may use Ralite

Dr. Slim formed Lose Weight Fast, Inc. in 2010 and sold his sugar pills as a weight loss program. The corporation had net income of $100,000 for 2010. He had a large loss in 2011 and went out of business in 2012 due to his arrest for fraud. He never filed a return for 2010 or any subsequent years.

Dr. Slim may qualify for ***Ralite***, assuming he did not take compensation without consideration.

SUMMARY OF THE *RALITE* DECISION

The following is a synopsis of the ***Ralite*** case (***Appeal of Howard Zubkoff and Michael Potash, Assumers and/or Transferees of Ralite Lamp Corporation*** (April 30, 1990) 90-SBE-004), a citable BOE opinion. Although the shareholders lost this case and were liable for the corporate tax, your clients may use this case to win the argument that the shareholder is not liable for the tax.

In ***Ralite***, the corporation had approximately $106,000 in cash, which apparently came from earnings because the corporation owed the state about $10,000 in franchise taxes. The two shareholders took the cash as a dividend and walked away from the corporation without paying the tax.

At the appeal, the FTB conceded that there was no law that allowed the FTB to pierce the corporate veil and hold shareholders liable because the "shareholders did not expressly assume the liabilities of Ralite." The Board stated that the only way shareholders could be held liable for the corporation's franchise tax would be in equity based on the law of fraudulent conveyances. (R&TC §19073(a); Civil Code §3439.12)

This meant that the FTB had to prove all of the following before the shareholders could be held liable for the corporation's franchise tax:

- The corporation transferred property to the shareholder(s) for less than full and adequate consideration;
- At the time of the transfer and at the time the shareholder liability was asserted, the corporation was liable for the tax;
- The transfer was made after liability for the tax was accrued, whether or not the tax was actually assessed at the time of the transfer;
- The corporation was insolvent at the time of the transfer or the transfer left the corporation insolvent; and
- The FTB had exhausted all reasonable remedies against the corporation.

Because all five of these conditions were met in ***Ralite***, the Board held that the shareholders were liable for the corporation's franchise tax.

BEWARE OF THE BUSINESS STILL IN BUSINESS

Often, a taxpayer decides that being a corporation or LLC is too cumbersome, or decides to get rid of employees and just continue the business as a sole proprietor. In this case, you will have a difficult time using ***Ralite*** to save the shareholder from being personally liable for taxes owed by the entity.

The FTB has previously stated that:

- Corporate property taken over by the principal will be considered as liquidating dividends and a return of capital;
- Sole proprietors may be held liable as transferees for delinquent corporate taxes unpaid before the change or transfer; and
- The sole proprietor should report the income from the business on his or her personal income tax return (Schedule C).

Corporate property taken by the shareholder to use in the Schedule C business includes goodwill and trademark value. These assets are often well in excess of the shareholder's loans and capital stock.

HOW YOU CAN HELP YOUR CLIENTS AVOID LIABILITY

Knowing what the rules are for establishing shareholder liability, it should be fairly easy for you to help your clients follow the rules that prevent them from being liable for their corporation's franchise tax. Because all five of the conditions must be met in order to establish shareholder liability, shareholders only need to avoid one of the conditions to prevent liability.

We suspect that, in most cases, the first condition — the transfer of property to the shareholders without full and adequate consideration — will be the easiest one to avoid.

Although cash was transferred from the corporation to the shareholders in ***Ralite***, it would seem that after a corporation's tax liability accrued, a transfer for less than full and adequate consideration of any corporate asset should be avoided, including but not limited to:

- Notes and accounts receivable;
- Inventories;
- Furniture, machinery, and equipment;
- Real property;
- Goodwill; and
- Client list.

If a corporation transfers any cash or property to the shareholders, you should make sure that "full and adequate consideration" is given in return. Although the term "full and adequate consideration" was not defined, we think that you could make a strong case that most transfers to a corporation at fair market value — including but not limited to the following — could qualify:

- Loans from shareholders;
- Services performed for the corporation with fair market value included in compensation;
- Expenses incurred on behalf of the corporation; and
- Stock in the corporation.

Example of abandoned corporation

Al owned 100% of the stock in ABC, Inc., a construction company organized in Nevada. Al's business dropped from more than $1 million to less than $250,000. Al loaned money to the company for two years and finally realized that he had to walk away from the corporation. He got a job at the Home Center, and he will not go back into business.

He took tools with a value of $5,000 and the $1,000 from the corporate bank account. He never liquidated the corporation with the Office of the California Secretary of State or filed final tax returns. When Al walked away, the tax-basis balance sheet showed:

Assets		**Liabilities**	
Cash	$ 1,000	Loan from shareholders	$50,000
Tools (FMV $5,000)	19,000	Retained earnings	(30,000)
Total assets	$20,000	**Total liabilities**	$20,000

Al received a total of $6,000 when he abandoned the corporation. The corporation owed him $20,000. Thus, he would not be personally liable for the $800 minimum franchise tax for the years he failed to file.

Note

Ralite does not apply to sales and use or employment taxes, which may be assessed against an individual shareholder.

WALKING AWAY FROM AN LLC

With the FTB's aggressive position regarding filing and paying tax for any LLC member who can spell "LLC," many of our customers have asked about using ***Ralite*** in situations involving unpaid LLC liabilities.

We believe, and the FTB has concurred, that because the LLC member has the same liability protection as a shareholder, the FTB should not be able to pierce the entity and hold the member liable except under the law of fraudulent conveyances. ("Tax News," Franchise Tax Board, February 2015)

Under California law, the liability of corporate shareholders and LLC members upon the dissolution of the entity is almost identical. Actions against the entity may only be enforced against the shareholder/member to the extent any of the entity's assets were distributed to the shareholder/member upon dissolution. (Corp. Code §§2011(a), 17707.07(a))

And in situations in which a member abandons an LLC (rather than having it dissolved), a member's liability is the same as that of a corporate shareholder's. (Corp. Code §17703.04)

✐ **Practice Pointer**

In these cases, first see if the LLC qualifies for voluntary dissolution. If not, consider using ***Ralite***.

WALKING AWAY FROM A LIMITED PARTNERSHIP

An LP provides liability relief for limited partners. However, each LP must have at least one general partner. Under partnership law, the general partner is liable for the debts of the partnership, unless the debt was incurred prior to the general partner becoming a general partner. (Corp. Code §15904.04) This liability extends to the partnership's unpaid taxes. So, if the partnership does not formally dissolve, the liability will continue to increase by $800 per year, plus penalties and interest, until the proper forms are filed with the Secretary of State.

Neither administrative dissolution nor the ***Ralite*** decision applies to general partners, so the general partner may be held liable for the partnership's unpaid taxes. There is only one set of circumstances under which we think a general partner may be relieved of a liability:

- The general partner is a corporation or LLC;
- The shareholders abandoned the corporation or LLC;
- The corporation or LLC had no assets; and
- The shareholders were eligible for relief of corporate liabilities under the ***Ralite*** case.

If all these apply, the shareholder would likely be relieved from liability under ***Ralite***. Similarly, LLC members would be relieved from liability as well. In other words, the FTB could go after a corporation/LLC that was the general partner, but not a shareholder of that corporation or LLC member.

A limited partner may be held liable to the limited partnership if it received a distribution knowing that the distribution or transfer would leave the partnership unable to pay its debts or would otherwise be insolvent. (Corp. Code §15904.09)

FEDERAL INCOME TAX LIABILITIES

A ***Ralite*** defense applies to federal income tax liabilities as well, as outlined in the following cases. These decisions are especially important because the courts held that the federal transferee liability statute (IRC §6901) only applies if the transferee was substantively liable for the tax under **state tax law**. This means that for California taxpayers, transferee liability for a corporation's or LLC's unpaid federal tax liability may only be imposed against a shareholder/member if the conditions laid out in ***Ralite*** are satisfied.

MINORITY SHAREHOLDERS WERE LIABLE FOR CORPORATION'S UNPAID TAX

Minority shareholders of an insolvent corporation were liable for a portion of the corporation's unpaid tax liability even though:

- They were completely ignorant of the fraudulent embezzlement scheme undertaken by the two majority shareholders; and
- The IRS had entered into an installment plan with the corporation to pay off the liability. (***Kardash v. Comm.***, TCM 2015-51)

The decision provides a thorough analysis of when and how a minority shareholder transferee may be held liable for a corporation's unpaid tax liability.

Background

Kardash and Robb were two of four shareholders of Florida Engineered Construction Products Corporation (FECP) and had ownership interests in FECP of 8.65% and 1.13%, respectively. FECP makes precast concrete products used in home construction. During the housing boom of the 2003–2007 tax years, FECP had revenues of over $500 million dollars.

Kardash was an engineer and was involved only in the operations end of FECP. Robb was in charge of sales, and neither was involved in the business or financial operations of the company. These matters were handled by the majority shareholders.

Unbeknownst to Kardash and Robb, the majority shareholders:

- Began an elaborate embezzlement scheme starting in 2003;
- Filed fraudulent corporate tax returns during 2003 and 2004; and
- Failed to file any corporate tax returns for the 2005, 2006, and 2007 tax years.

During the 2003 and 2004 tax years, Kardash and Robb received advance bonus payments in addition to their regular salary. These payments were made in lieu of the payments previously received under the company's annual bonus plan that was temporarily suspended in 2003. During the 2005–2007 tax years, they also received several million dollars in company dividends.

Upon audit, the IRS found that FECP owed over $120 million in back taxes, penalties, and interest. FECP entered into an installment payment plan with the IRS under which FECP agreed to pay $70,000 per month until the liability was paid off, which was estimated would take over 150 years.

The IRS also recouped some of the unpaid liability from the majority shareholders. However, in an effort to collect as much as possible, the IRS also instituted proceedings against Kardash and Robb for the bonus advances received in 2003 and 2004, and the dividends received in 2005, 2006, and 2007.

Transferee liability

Under federal law, transferee liability is determined under state law. (IRC §6901(a)) Under the Florida Uniform Fraudulent Transfer Act (FUFTA), a transferee may be held liable if it can be found that there was either constructive or actual fraud. (Fla. Stat. Ann. §§726.101–726.112) In examining the issues at hand, the court made two baseline determinations by:

- Separately examining the advance bonuses and the dividend transfers; and
- Refusing to impute the majority shareholder's intentional fraudulent actions to Kardash and Robb in determining whether the transfers involved actual or constructive fraud.

Constructive fraud

Constructive fraud will be found to exist under Florida law if the debtor makes a transfer without receiving a reasonably equivalent value, and at the time of the transfer the debtor was insolvent. (Fla. Stat. Ann. §§726.105(1)(b), 726.106(1))

The advance payments were essentially compensation, and because FECP received a reasonably equivalent value for the transfer, there was no constructive fraud in regard to these payments. However, under FUFTA, dividends are not considered a transfer in exchange for reasonably equivalent value.

FECP was insolvent during the 2005–2007 tax years because after it made the dividend payments to its shareholders, the fair market value of its assets was less than the sum of its debts. Because the dividends were paid by FECP when it was insolvent, they were constructively fraudulent transfers for which transferee liability may be imposed.

Actual fraud

The court then went on to consider whether the advance bonus payments were made with the intent to hinder, delay, or defraud the IRS. Under FUFTA, a variety of factors may be examined in making the determination. On one hand, Kardash was secretary of the corporation and therefore was a corporate insider. Additionally, the payments were not disclosed at the time by loan documents or wage forms, and the transfers occurred shortly after FECP incurred the tax liabilities.

However, according to the Tax Court, the following factors outweighed these factors; therefore, there was no actual fraud, and thus, no transferee liability:

- FECP was not under audit until 2005, after the payments were made;
- The payments involved were a little over $500,000 per year, which was an insignificant portion of FECP's assets at the time;
- The payments were not "concealed," as evidenced by bank transaction records;
- The payments made were of a reasonably equivalent value to the services provided; and
- FECP was solvent during the 2003 and 2004 tax years.

Failure to exhaust other collection remedies

Kardash and Robb also argued that the IRS should be precluded from pursuing transferee liability against them because the IRS failed to exhaust collection efforts against the more culpable parties. However, the Tax Court made short shrift of these contentions as follows:

- Entering into the installment agreement with FECP only stops the IRS from pursuing collections against any person not named in the agreement (Proced. & Admin. Regs. §301.6159(1)(f)(3));
- Even though the IRS could have collected more in taxes by seizing and selling FECP's assets, under FUFTA, the IRS was not required to pursue all reasonable collection efforts against the transferor before asserting transferee liability against Kardash and Robb (Fla. Stat. Ann. §§726.101–726.112); and
- The IRS was not required to exhaust all collection efforts against the more culpable majority shareholders before pursuing collections against them because transferee liability is several under IRC §6901, and the IRS may proceed against any or all transferees in no particular order. (***Cullifer v. Comm.***, TCM 2014-208)

Comment

Under the ***Ralite*** decision discussed previously, the Board of Equalization (currently the Office of Tax Appeals) did rule, in contrast to the Tax Court's discussion, that the FTB is required to exhaust all reasonable remedies against the corporation before pursuing transferee liability. Thus, the taxpayers' argument that the IRS was required to collect more from the corporation by having it sell some or all of its assets before pursuing transferee liability against them might have more traction in California.

However, given that the corporation's assets only totaled $3 million, forcing it to sell its assets would not have made a significant difference in the IRS's efforts to collect the $120 million tax liability, so it is unclear whether California would have required this.

MORE FEDERAL CASES

In a case similar to the ***Ralite*** decision, a federal appellate court held that a transferee was liable for a corporation's unpaid federal tax liability, but only after finding that the transferee knew that the corporation's fraudulent conveyance of its assets was undertaken to avoid the tax liability. (***Salus Mundi Foundation, Transferee v. Commissioner of Internal Revenue*** (December 22, 2014) U.S. Court of Appeals for the Ninth Circuit; No. 12-72527)

A similar approach was taken by the Tax Court in a case involving an intermediary transaction. In ***Stuart v. Comm.*** (2015) 144 TC 12, corporate shareholders agreed to a corporate stock sale after the corporation had sold its sole real estate property. After the land sale, the corporation's only asset was the cash proceeds it had received from the sale. In a series of transactions, the corporation essentially gave its cash to the stock purchaser (Midcoast) in exchange for the purchaser's promise to pay the corporation's tax liability. At the same time the shareholders received cash for their sale of stock from Midcoast, at a price higher than the corporation's worth because the corporation had not yet paid the tax liability. However, Midcoast never paid the corporation's tax liability, and the IRS came after the shareholders for the unpaid tax.

WHEN TO INVOKE *RALITE*

Here is an example of when ***Ralite*** may work.

Example of previously filed final return

Done It All, Inc. is a Nevada corporation that conducted some of its business in California. Done It All filed a 2015 return and checked the "final" box. However, the shareholder never formally surrendered Done with the SOS. What Done should do:

- **Shareholder took large liquidating distribution**: Done must revive the corporation and file 2015 and later unfiled returns, paying the $800 franchise tax plus penalties and interest for each year. They will not be subject to the current year's minimum tax, provided they dissolve with the SOS and file a timely final return for the prior year, and pay the $800 for that year. If Done fails to follow these procedures, the FTB may hold the shareholder liable.
- **Shareholder qualifies for *Ralite***: If the corporation owed the shareholder money equal to or greater than the liability and the situation fits the ***Ralite*** criteria, the shareholder may do nothing. Under the ***Ralite*** case, the FTB cannot come after the shareholder for the back taxes. See the following discussion of the ***Ralite*** process.

THE PROCESS

Ralite applies to the shareholder (member), not the corporation (LLC). Here is the process for asserting the ***Ralite*** decision for a corporation and an LLC.

You cannot use the decision until the FTB has made its assessments, given up trying to collect from the now-defunct corporation (LLC), and actively pursues the individual shareholder (member) to pay the tax liability. Here is how the chain of events will occur:

1. The shareholder (member) gives up the business, does not formally dissolve, cancel, or surrender, and didn't file tax returns or pay tax for the years it was in operation. However, the taxpayer did not formally dissolve with the SOS.
2. Because the taxpayer did not dissolve or surrender, the FTB sends the corporation a Demand to File notice. Do nothing when the notice is received. If you respond by claiming exemption

under the ***Ralite*** decision, the FTB will send a notice stating that ***Ralite*** doesn't apply because it applies to the shareholder (member), not the corporation (LLC).

3. The taxpayer still does nothing and the FTB sends a Notice of Proposed Assessment and begins billing the corporation. Assuming the corporation (LLC) has no assets, there will be nothing for the FTB to collect.
4. Eventually, the FTB may come to the shareholder (member) and demand payment from him or her. At this time, you should invoke the ***Ralite*** decision, explaining that the taxpayer did not take assets without consideration. For corporations you would enclose:
    - A copy of the final balance sheet, which probably includes loans from shareholders to the corporation and capital stock, as well as a negative earnings account;
    - A list of assets with book value and fair market value. Indicate which shareholders took which assets; and
    - A list of loans from each shareholder to the corporation, debts each shareholder paid, and basis of each shareholder's capital stock.

    In the case of an LLC, you would see if the FMV of assets taken was in excess of the member's capital account.

Example of assets taken

ABC, LLC dissolves with $100 cash equipment with a depreciated basis of $500 but a fair market value of $2,000. The member's capital account is $600. The member received consideration of $1,500 ($2,100 minus $600 capital account). Using the ***Ralite*** case, the FTB can hold the member liable for up to $1,500.

If it is clear that the shareholder (member) did not receive more value out of the corporation (LLC) than was owed, the FTB will generally stop pursuing the shareholder(s) (member(s)) and close the account.

CONSIDER AN OIC TO EXPEDITE THE PROCESS

The FTB has informed us that taxpayers can expedite the ***Ralite*** process by applying for an offer in compromise (OIC). The FTB has stated, "In evaluating an offer, we consider all relevant facts and circumstances which may include the taxpayer's ability to pay, present and future income and expenses, equity in the taxpayer's assets, and other considerations. For a corporation, we may consider the Board of Equalization's decision in the ***Ralite*** case, if applicable."

The program has also successfully resolved cases involving failed entities in which the owners simply walked away and failed to dissolve or cancel the entity with the Secretary of State's office.

Many of these entities that formerly applied for an OIC will qualify for administrative dissolution. However, for those ineligible for administrative dissolution, an OIC might be a good alternative.

Although we know that in these cases there is no money to actually collect from the entity — and in most cases the FTB cannot collect these assessments from the entities' members or shareholders — it might be worth it to some taxpayers to pay a nominal amount to make these endless collection notices and bills go away more quickly.

Note: The FTB can go after the member/shareholder if there was a fraudulent transfer of assets or if there is successor liability.

Entities and shareholders/members who qualify for ***Ralite*** are perfect candidates for an OIC because there are no assets to pay the outstanding liabilities. Rather than wait years for the FTB to pursue futile collection efforts against the entity and then the shareholder/member, taxpayers may want to simply apply for an OIC to put the matter behind them as soon as possible.

The process will be the same as other OICs:

- All outstanding returns must be filed;
- The FTB requires a fully completed OIC application, Form FTB 4905BE, Offer In Compromise for Business Entities;
- The taxpayer must make some sort of payment offer. The FTB will not state how much must be offered; just that the offer should be based on the taxpayer's financial situation and represent the amount the FTB can expect to collect within a reasonable period of time. They will not accept a zero offer; and
- The application requires supporting documentation to reflect the taxpayer's financial condition. Documentation required can include verification of income and expenses, bank information, real property or leasehold information, assets such as securities, or medical information, depending on their circumstances.

Spidell also recommends including a copy of our Walking Away From a Corporation/LLC Qualifiers, which can be found at the end of these materials. **Note:** The financial information provided will be for the entity (corporation or LLC), not the member or shareholder unless the member/shareholder has successor liability.

BENEFIT TO OIC

Although the OIC application and negotiation process may be a bit tedious, it will help to properly dissolve the defunct corporation much more quickly than using the ***Ralite*** process.

For more information on the OIC process, see:

Website
https://www.ftb.ca.gov/pay/if-you-cant-pay/offer-in-compromise.html

☎ **Telephone**
(916) 845-4787

RALITE RELIEF CANNOT BE APPLIED AFTER TAXES ARE PAID

What happens if an LLC member pays the tax and then finds out later that he or she was never actually personally liable?

In ***Appeal of Queen***, the taxpayer found out the hard way that he was simply out the money. (***Appeal of Queen*** (September 26, 2017; released December 13, 2017) Cal. St. Bd. of Equal., Case No. 942813) The Board held that because the LLC's tax and penalties were properly assessed, the FTB properly denied the LLC member's claim for refund.

The same applies to voluntary or involuntary dissolution.

PROPER ASSESSMENT

The LLC was formed in 1999 but never commenced business and had no income, expenses, bank accounts, or employees. In 2013, the Secretary of State's office suspended the LLC, and subsequently the LLC filed $0 returns for 1999–2013. In 2015 the FTB issued a Final Notice Before Levy showing a balance due of $19,788.26 for the 2000–2014 tax years.

When the LLC member contacted the FTB to apply for an offer in compromise, he was informed that he was not authorized to do so because he was not an organizer of the entity or its duly authorized representative. However, according to the member, he was told by an FTB collections employee that he would be held personally liable for the tax and that the FTB could levy his bank accounts, although no notice was actually issued to the LLC member in the member's name.

After being told he could be held personally liable for the LLC's liability, the member entered into an installment agreement and paid $13,200 of the outstanding liability before finding out that under ***Ralite***, he could not be held personally liable. The taxpayer argued that it was inequitable that the FTB should be able to keep payments that it falsely misled him into paying.

However, the Board ruled that its jurisdiction is limited to determining whether the tax was properly assessed. Because the notices that were issued were issued to the LLC, and not the member, and the amount of tax, penalties, and interest were properly determined, the Board upheld the FTB's denial of the LLC member's refund claim.

Although the LLC member argued that the FTB's actions "namely, falsely inducing a non-liable individual to pay the tax liability of a corporate entity" should not be tolerated, the FTB never issued any written assessment against the LLC member.

The Board also noted that if the taxpayer had relied on any erroneous written advice provided by the FTB, his relief under R&TC §21012 would have been limited to relief from penalties and interest, not from the payment of the tax.

TRANSFEREE LIABILITY UPHELD

The Board of Equalization (currently the Office of Tax Appeals) upheld a transferee liability imposed against a sole shareholder who received a loan of over $600,000 from his suspended corporation. (R&TC §19073(b); ***Appeal of Kling*** (February 23, 2016) Cal. St. Bd. of Equal., Case No. 847081) The FTB successfully argued that the loan amounted to a fraudulent conveyance under California's Uniform Fraudulent Conveyance Act (renamed the Uniform Voidable Transactions Act by SB 161 (Ch. 15-44)). (Civ. Code §§3439–3449)

BACKGROUND

John Kling was the president and sole shareholder of Fire X-Tinguisher Service Co., Inc. Fire X's corporate status was suspended on August 1, 2007, for failing to file California corporation franchise tax returns. In 2010 and 2011, Fire X filed delinquent returns for the 2004 through 2010 tax years but only made minimal payments toward the amounts owed. These payments were received in 2012 and 2013. On May 9, 2013, the FTB issued notices of proposed assessment against Kling as a transferee of Fire X. The assessment totaled over $400,000 in delinquent taxes and penalties.

The basis of the transferee liability was a loan of $633,429 made from Fire X to Kling that was reported on Fire X's return for the 2009 tax year. According to documents submitted, the loan was made to Kling in consideration of Kling assuming responsibility for a loan of $974,943 that was owed by Fire X to Main Credit Corporation. However, Kling had originally been a personal guarantor on that loan.

FRAUDULENT CONVEYANCE

To impose transferee liability under California's Uniform Fraudulent Conveyance Act and the Board's decision in ***Ralite***, the FTB must prove all of the following elements by a preponderance of the evidence:

- The corporation transferred property to the shareholder(s) for less than full and adequate consideration;
- At the time of the transfer and at the time the shareholder liability was asserted, the corporation was liable for the tax;
- The transfer was made after liability for the tax was accrued, whether or not the tax was actually assessed at the time of the transfer;
- The corporation was insolvent at the time of the transfer, or the transfer left the corporation insolvent; and
- The FTB had exhausted all reasonable remedies against the corporation.

REASONABLE AND EQUIVALENT VALUE

The sole contested issue at the hearing was whether Fire X received "reasonable and equivalent value" for its loan to Kling when Kling assumed the liability for Fire X's payment of the Main Credit loan. Kling had conceded the other four factors listed above.

He argued that when he became the primary assumer of the Main Credit loan under the agreement he entered with Fire X, Fire X received equivalent value for the loan it made to him. Even though Kling had previously guaranteed the Main Credit loan, he contended that by assuming the loan and becoming the primary debtor, Main Credit could pursue Kling without pursuing payment from Fire X.

Furthermore, Kling surrendered any defense he might have had against liability for the loan as a guarantor. Finally, Kling could no longer pursue reimbursement from Fire X. Consequently, he contended that by changing these economic realities, adequate consideration was received by Fire X.

The FTB took the position that Kling's assumption of the loan was not for a "reasonable and equivalent value" because Civil Code §3439.03 specifically states that "value does not include an unperformed promise made otherwise than in the ordinary course of the promisor's business to furnish support to the debtor or another person."

The FTB argued that it was irrelevant that almost $800,000 in payments were made on the loan during the period between March 31, 2009, and October 31, 2011, because the point of time to determine whether an "unperformed promise" is made is at the time the transfer occurred.

The Board upheld the FTB's assessment of transferee liability but encouraged the taxpayer to pursue an offer in compromise.

WALKING AWAY FROM A CORPORATION QUALIFIER

Use this checklist to see if the FTB can hold the shareholder liable for unpaid corporate and franchise taxes.

PART I

1. Compensation taken from corporation:

A.	Cash	$________
B.	Fair market value of tangible personal property	________
C.	Fair market value of real estate	________
D.	Fair market value of inventory	________
E.	Fair market value of accounts/notes payable	________
F.	Face value of loans to shareholder	________
G.	Fair market value of goodwill	________
H.	Fair market value of other intangibles	________
I.	Other compensation taken	________
J.	Total compensation received by shareholder (Add lines A – I)	$________

2. Consideration given by shareholder:

A.	Wages or other compensation paid	$________
B.	Loans from shareholder to corporation	________
C.	Liabilities assumed by shareholder	________
D.	Corporate expenses paid by shareholder	________
E.	Other consideration	________
F.	Capital stock at shareholder's cost	________
G.	Total consideration given by shareholder (Add lines A – F)	$________

PART II

If the answer to ALL of the following questions is YES, the FTB may hold the shareholder liable for corporate income or franchise taxes:

		Yes	No
3.	Is the total on Part I, line 1J greater than the amount in Part I, line 2G?	☐	☐
4.	At the time of the transfer and at the time the shareholder liability was asserted, was the corporation liable for the tax?	☐	☐
5.	Was the transfer made after liability for the tax was accrued, whether or not the tax was actually assessed at the time of the transfer?	☐	☐
6.	Was the corporation insolvent at the time of the transfer or the transfer left the corporation insolvent?	☐	☐
7.	Had the FTB exhausted all reasonable remedies against the corporation?	☐	☐

Website
To download a copy of this worksheet, go to:
www.caltax.com/spidellweb/public/editorial/WalkingAwayCorp.pdf

WALKING AWAY FROM AN LLC QUALIFIER

Use this checklist to see if the FTB can hold the member liable for unpaid LLC fees and taxes.

PART I

1. Compensation taken from LLC

A.	Cash	$________
B.	Fair market value of tangible personal property	________
C.	Fair market value of real estate	________
D.	Fair market value of inventory	________
E.	Fair market value of accounts/notes payable	________
F.	Face value of loans to shareholder	________
G.	Fair market value of goodwill	________
H.	Fair market value of other intangibles	________
I.	Other compensation taken	________
J.	Total compensation received by shareholder (Add lines A – I)	$________

2. Consideration given by member

A.	Wages or other compensation paid	$________
B.	Loans from member to LLC	________
C.	Liabilities assumed by member	________
D.	Corporate expenses paid by member	________
E.	Other consideration	________
F.	Capital stock at shareholder's cost	________
G.	Total consideration given by member (Add lines A – F)	$________

PART II

If the answers to ALL of the following questions are YES, the FTB may hold the member liable for LLC taxes and fees:

		Yes	**No**
3.	Is the total on Part I, line 1J greater than the amount in Part I, line 2G?	☐	☐
4.	At the time of the transfer and at the time the member liability was asserted, was the LLC liable for the tax/fee?	☐	☐
5.	Was the transfer made after liability for the tax was accrued, whether or not the tax was actually assessed at the time of the transfer?	☐	☐
6.	Was the LLC insolvent at the time of the transfer or did the transfer leave the LLC insolvent?	☐	☐
7.	Had the FTB exhausted all reasonable remedies against the LLC?	☐	☐

Website

To download a copy of this worksheet, go to:
www.caltax.com/spidellweb/public/editorial/WalkingAwayLLC.pdf