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Feature

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Nondebtor Parent's Revocation of Its S-Corp Status Is Not an Unlawful Post-Petition Transfer



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Under the Internal Revenue Code (IRC), an S corporation is treated as a “pass through entity” for federal income tax purposes. As such, it receives no income benefits and pays no income taxes. Instead, the S corporation’s shareholders report the company’s income on their own personal tax returns. An S corporation that directly or indirectly wholly owns a subsidiary corporation may elect to treat the subsidiary as a qualified subchapter S subsidiary (a “QSub”) so that its tax benefits and burdens pass through to the parent. If the parent S corporation ceases to be an S-Corp, the QSub automatically becomes a taxable C corporation.

In a case of first impression for federal courts of appeal, the U.S. Court of Appeals for the Third Circuit held in *In re Majestic Star Casino LLC*¹ that a parent S-Corp’s revocation of its S corporation status, which automatically terminated its subsidiary debtor’s QSub status, did not constitute an unlawful post-petition transfer of the subsidiary debtor’s estate property in violation of §§ 362 and 549 of the Bankruptcy Code. In so doing, the Third Circuit overturned the bankruptcy court.

Majestic Star Casino II Inc. (the “debtor subsidiary”) and its affiliated debtors owned and operated casino properties. Before their chapter 11 filings, the debtor subsidiary’s ultimate nondebtor parent, Barden Development Inc., operated as an S corporation and elected to classify the debtor subsidiary as a QSub.² After the filings, the nondebtor parent’s sole shareholder, Don H. Barden, revoked the nondebtor parent’s S corporation status (the “S-Corp revocation”) and filed a notice to that effect with the

Internal Revenue Service (IRS).³ The S-Corp revocation by the nondebtor parent caused the debtor subsidiary to lose its status as a QSub.⁴ The debtor subsidiary’s change in corporate status meant that it became subject to income tax liability on account of its operations, a liability that was previously passed through to the nondebtor parent.⁵ Neither the nondebtor parent nor the shareholder sought bankruptcy court authority for the S-Corp revocation.⁶

In response, the debtor subsidiary sued the nondebtor parent, shareholder, IRS and the Indiana Department of Revenue (DOR) to avoid the S-Corp revocation as an unauthorized post-petition transfer of estate property under 11 U.S.C. § 549 and as a violation of the automatic stay under 11 U.S.C. § 362.⁷ The nondebtor parent, shareholder and IRS argued that the debtor subsidiary’s QSub status was not property of the estate and was not subject to the automatic stay because such status depended on the independent actions of the nondebtor parent through the shareholder.⁸ The bankruptcy court disagreed and granted the debtors’ motion for summary judgment.⁹ The court also directed the nondebtor parent, shareholder, IRS and DOR to take all actions necessary to restore the debtor subsidiary’s QSub status and ordered the DOR to return all tax monies paid as a result of the unauthorized S-Corp revocation.¹⁰

The Third Circuit noted that the bankruptcy court’s order had significant repercussions for the parties.¹¹ Neither the nondebtor parent nor the share-

3 *Id.* at *2.

4 *Id.*

5 *Id.*

6 *Id.* at *3.

7 *Id.*

8 *Id.*

9 *In re Majestic Star Casino LLC*, 466 B.R. 666 (Bankr. D. Del. 2012).

10 *Id.* at 679-80.

11 *In re Majestic Star Casino LLC*, 2013 WL 2162781, at *4.

1 No. 12-3200, 2013 WL 2162781 (3d Cir. May 21, 2013).

2 *Id.* at *1-2.

holder was part of the debtor subsidiary's bankruptcy case and, therefore, were not eligible for the so-called "bankruptcy exception," where a taxpayer in bankruptcy does not recognize cancellation of indebtedness (COD) income on debt that is cancelled or written down as part of a reorganization plan.¹² Consequently, if the S-Corp revocation is deemed void, as the bankruptcy court held, the nondebtor parent, as well as the shareholder, would be liable for taxes on approximately \$170 million in COD income.¹³ Moreover, the bankruptcy court's decision resulted in the IRS losing the benefit of having an administrative claim against the debtor subsidiary for its tax liabilities.¹⁴

In addition, if the S-Corp revocation was avoided, the debtor subsidiary's tax-free QSub status would remain intact, while the nondebtor parent would retain liability for the debtor subsidiary's income taxes even though the nondebtor parent no longer enjoyed the benefit of the debtor subsidiary's income to fund those tax payments.¹⁵ Further, because the liability for COD income would remain with the nondebtor parent, the debtor subsidiary would not have to use the bankruptcy exception.¹⁶ The IRC provides that a debtor making use of the bankruptcy exception must reduce the value of other tax attributes "dollar-for-dollar" by the amount of COD income excluded from gross income,¹⁷ which is an unfavorable result because the reorganized debtor loses the ability to use various deductions and credits that would have been available to reduce its taxes in the future.¹⁸ The bankruptcy court's order, however, enabled the debtors to avoid liability for COD income without losing their tax attributes.

The nondebtor parent, shareholder and the IRS appealed the bankruptcy court's order. The case was certified for a direct appeal to the Third Circuit pursuant to 28 U.S.C. § 158(d)(2) and Fed. R. Bankr. P. 8001(f).

On May 21, 2013, the Third Circuit overturned the bankruptcy court's decision in a 55-page opinion, holding that the nondebtor parent's switch to a "C" corporation during the debtor subsidiary's bankruptcy — which subjected them both to federal taxation — did not amount to an improper transfer of estate property. At issue was whether the debtor subsidiary had (1) standing to challenge the S-Corp revocation and (2) a property interest in its QSub status to enable the challenge of the post-petition transfer of that interest.¹⁹ Consideration of the debtor subsidiary's standing required consideration of the substantive basis for the bankruptcy court's decision.²⁰ The Third Circuit noted that for the S-Corp revocation to be void under § 362 or avoidable under §§ 549 and 550, QSub status must be (1) "property" (2) "of the bankruptcy estate" (3) that has been "transferred."²¹

The Third Circuit first reviewed the concept of "property of the estate" under § 541 of the Bankruptcy Code.²² It noted that the bankruptcy court relied on *In re Trans-Lines West Inc.*,²³ a case that addressed whether a corporation's

revocation of its S-Corp status before filing for bankruptcy, was an avoidable fraudulent transfer pursuant to § 548.²⁴ In *Trans-Lines West*, the court concluded that the debtor possessed a property interest in its subchapter S status and thus, that property interest was property of the estate under § 541. The *Trans-Lines West* decision and cases that follow it base their conclusion that S-Corp status is "property" on a series of precedents holding net operating losses (NOLs) to be "property."²⁵ Because the bankruptcy court found QSub status to be analogous to S-Corp status in reliance on *Trans-Lines West*, it concluded that QSub status is "property" of the estate.²⁶

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The Third Circuit disagreed with the bankruptcy court's reliance on *Trans-Lines West* and its progeny. First, the Third Circuit noted that it had not yet addressed whether NOL carrybacks or carryforwards constitute property.²⁷ Second, the court held that the bankruptcy court failed to consider important substantive differences between an S-Corp status and NOLs. For example, NOLs are a "defined universe" of property because at the time of a bankruptcy filing, they are a function of the debtor's pre-petition operations and are not subject to revocation or termination.²⁸ An S-Corp's "pass-through" status, to the contrary, can be terminated at will by its shareholders.²⁹

In addition, NOLs have a value that S-Corp status does not. An NOL has value that is readily ascertainable — in the form of a tax refund.³⁰ The value of an S-Corp's status, however, depends on it not being revoked, as well as on the amount and timing of future earnings. Additionally, NOLs can be monetized in a way that S-Corp status cannot.³¹ Those vast differences make the NOL-as-property principle too attenuated to support S-Corp-as-property cases.³²

The Third Circuit also criticized the bankruptcy court's pronouncement that S-Corp status is a "right" of the debtor to enjoy certain tax benefits.³³ It reasoned that because numerous factors that can trigger a loss of S-Corp status are outside of the taxpayer's control, it is arguably not a right at all.³⁴ The Third Circuit then noted that § 541 defines property only in terms of "legal or equitable interests of the debtor in property as of the commencement of the case." The definition does not negate rights statutorily granted to shareholders to control the tax status of the entity they own.³⁵

12 *Id.*

13 *Id.*

14 *Id.*

15 *Id.* at *5.

16 *Id.*

17 *Id.*

18 *Id.*

19 *Id.* at *6.

20 *Id.* at *6-8.

21 *Id.* at *8-9.

22 *Id.* at *9.

23 203 B.R. 653 (Bankr. E.D. Tenn. 1996).

24 *Id.*

25 *In re Majestic Star Casino LLC*, 2013 WL 2162781, at *12.

26 *Id.*

27 *Id.* at n.16.

28 *Id.* at *13.

29 *Id.*

30 *Id.*

31 *Id.*

32 *Id.*

33 *Id.*

34 *Id.*

35 *Id.*

Finally, the Third Circuit highlighted the unfairness of the bankruptcy court's decision.³⁶ If a trustee is allowed to avoid the termination of a debtor's S-Corp or QSub status, the corporation and its creditors would benefit from the income generated during or as part of the reorganization process. The resulting tax liability, however, would be assessed against the S-Corp shareholders.³⁷ Such a result, even as acknowledged in *Trans-Lines West*, is fundamentally inequitable.³⁸

For all of these reasons, the Third Circuit declined to follow *Trans-Lines West* and its progeny and concluded that S-Corp status is not property of the estate. Furthermore, the court held that QSub status was, *a fortiori*, not "property" given that a QSub has an even weaker claim to the control of its status than does an S-Corp.³⁹ The use and enjoyment of QSub status is contingent upon its S-Corp parent's continuing to own 100 percent of its stock,⁴⁰ a decision to not revoke the QSub election⁴¹ and its continuing to status itself as an S-Corp.⁴² Therefore, a QSub's use and enjoyment of its tax status may be terminated by factors not only outside its control, but also outside the control of its S-Corp parent, and the QSub cannot transfer or otherwise dispose of its QSub status. Thus, a QSub can barely be said to control the disposition of the purported property interest in its QSub elected status.⁴³ The Third Circuit concluded that a tax classification over which a debtor has no control and that is not alienable or assignable is not a "legal or equitable interest ... of the debtor in property."⁴⁴ Thus, the debtor subsidiary's QSub status was not "property."⁴⁵

With that holding, the Third Circuit did not need to consider the second and third elements: "[property] of the bankruptcy estate" "that has been 'transferred.'"⁴⁶ Nonetheless, the court did undertake a brief analysis of the second element and concluded that if QSub status was "property" at all, it would be property of the nondebtor parent and not property of the debtor subsidiary's estate.⁴⁷ The Third Circuit focused on the S-Corp's "flow-through" treatment for tax purposes.⁴⁸ In other words, the S-Corp debtor is merely a conduit for tax benefits that "flow through" to the shareholder.⁴⁹ Thus, if QSub status were considered property of the estate at all, it would be property of the S-Corp parent.⁵⁰ The Third Circuit noted that the bankruptcy court's decision places extraordinary restrictions on the rights of the parent, restrictions that are unfounded in the IRC or the Code.⁵¹ Under the bankruptcy court's holding in this case, for example, "a QSub in bankruptcy can stymie the legitimate transactions of its parent as unauthorized transfers of property of the estate, even though the QSub would have had no right to interfere with any of those transactions prior to filing for bankruptcy."⁵²

Having determined that a debtor's QSub status is not property of the estate, a debtor QSub that seeks to challenge the revocation of its tax status is asserting the rights of a third party, its S-Corp shareholder, and can do so only if it can satisfy third-party standing requirements.⁵³ The Third Circuit found that because the nondebtor parent was not precluded from asserting its own rights and did not share an identity of interest with the debtor subsidiary, the debtor subsidiary lacked standing to challenge the alleged transfer.⁵⁴

By taking issue with the bankruptcy court's reliance on the S-Corp-as-property cases, the Third Circuit disapproved of an expansive interpretation of "property of the estate," despite its recognition that a broad definition of that statutory concept would promote congressional goals of fostering reorganizations.⁵⁵ Whether *Majestic Star Casino* should be limited to its facts and the impact it will have on bankruptcy cases in the Third Circuit remains to be seen. **abi**

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36 *Id.* at *14.

37 *Id.*

38 *Id.*

39 *Id.*

40 See I.R.C. § 1361(b)(3)(B)(i) and (b)(3)(C)(i).

41 See *id.* § 1361(b)(3)(B)(ii).

42 See *id.* § 1361(b)(3)(B)(i).

43 See *In re Majestic Star Casino LLC*, 2013 WL 2162781, at *15.

44 11 U.S.C. § 541(a)(1).

45 *In re Majestic Star Casino LLC*, 2013 WL 2162781, at *15.

46 *Id.* at *9.

47 *Id.* at * 15.

48 *Id.*

49 *Id.* at *16.

50 *Id.*

51 *Id.*

52 *Id.*

53 *Id.* at *17.

54 *Id.* at *18.

55 *Id.*