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S-Corp and QSub Tax Status as Property of the Bankruptcy Estate

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Introduction

Under the Internal Revenue Code, a corporation can elect to be an "S" Corporation ("S-Corp") for federal income tax purposes.[1] Electing for S-Corp status will make the corporation a pass through entity, meaning that the corporation itself will not have any tax benefits or liability. Instead, the company's income will be passed on to it shareholders, who will have to report it on their personal tax returns.[2] Similarly, an S-Corp that owns a subsidiary corporation can elect to treat it as qualified subchapter S subsidiary ("QSub").[3] A QSub is also a pass through entity that passes its tax benefits and liabilities on to the parent corporation.[4] S-Corp and QSub status may be revoked at any time with shareholder consent.[5] In addition, these tax statuses can be automatically revoked when certain events occur, including the purchase of the corporation's stock by more than 100 shareholders, purchase by a shareholder who is not a natural person or nonresident alien, or by the corporation's issuance of more than one class of stock.[6]

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[1] *See* 26 U.S.C.A § 1361 (2007).
[2] *See id*.
[3] *See id*.
[4] *See id*.
[5] *In re Majestic Star Casino, LLC*, 716 F.3d 736, 743 (3d Cir. 2013).
[6] *Id*. at 743 n.7.

Recently, in *In re Majestic Star Casino, LLC*, the Court of Appeals for the Third Circuit held as a matter of first impression that a chapter 11 debtor's status as a QSub for taxation purposes did not constitute "property" of the bankruptcy estate.[7] Although other courts have ruled on the issue of S-Corp status as property of the estate, the Third Circuit was the first to decide the issue with respect to QSub status. Furthermore, the Third Circuit also questioned the prevailing logic that other courts had used when deciding that S-Corp statuses were property of the estate.[8] As such, the non-debtor parent company's revocation of its S-Corp status, which automatically revoked the debtor's QSub status, did not constitute an avoidable post-petition transfer of property of the bankruptcy estate.[9]

This Article is separated into three parts. Part I discusses the state of the law on this issue of whether S-Corp and QSub tax status are considered property of the bankruptcy estate prior to the *Majestic Star Casino* decision. Part II discusses the facts, holding, and reasoning of the Third Circuit in the *Majestic Star Casino* case. Part III discusses the practical effects of the decision.

I. S-Corp and QSub tax status as property of the estate

Prior to the *Majestic Star Casino* decision, bankruptcy courts had consistently held that S-Corp status was considered property of the bankruptcy estate within the meaning of section 541 of the Bankruptcy Code.[10] If a company revoked its S-Corp status, it would be considered an unlawful post-petition transfer of property of the bankruptcy estate, and thus would be avoidable under Section 548 of the Bankruptcy Code.[11] Since the debtor's status as a pass

[7] *Id*. at 758 –759.
[8] *Id*. at 758.
[9] *Id*.
[10] *See In re Trans-Lines West*, 203 B.R. 653 (Bankr. E.D. Tenn. 1996).
[11] *See id* at 662–663.

through entity is preserved, the shareholders are responsible for the tax consequences of the debtor's bankruptcy proceeding, as opposed to the debtor's bankruptcy estate shouldering the liability.[12]

The most prominent case supporting S-Corp status as property of the estate is *In re Trans-Lines West, Inc.*[13] In this case, the debtor corporation elected to revoke its S-Corp status just over a month before filing a petition for bankruptcy under chapter 11. The trustee sought to avoid the S-Corp election under section 548 of the Bankruptcy Code. The Internal Revenue Service ("IRS") opposed this, contending that the Debtor's revocation of its S-Corp status was not a transfer of a property interest of the Debtor. Therefore, the IRS argued that the status was properly revoked.[14] Both sides sought summary judgment on the issue.[15]

The *Trans-Lines West* court held that a debtor's revocation of its S-Corp status constituted an unlawful transfer of property and thus was avoidable under section 548(a) of the Code.[16] The court based its decision in part on prior holdings that net operating losses ("NOLs") were property of the estate.[17] NOLs are created when deductible business expenses exceed net income for a given year.[18] If a taxpayer has NOLs, he may elect to use them offset either past or future income.[19]

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[12] *See id*. at 660 n.9.
[13] *See id*. at 662–663.
[14] *Id*. at 656.
[15] *Id*. at 656–657.
[16] *Id*. at 665.
[17] *See id* at 663; *See also* Segal v. Rochelle, 382 U.S. 375 (1966) (holding that right to offset net operating losses against past income is property of the debtor); Official Committee of Unsecured Creditors v. PSS Steamship Company, Inc. (*In re* Prudential Lines, Inc) 982 F.2d 565 (2d. Cir. 1991) (holding that right to use net operating losses to offset future tax liability is debtor's property).
[18] *See* 26 U.S.C.A. §172 (2007).
[19] *See id*.

The court concluded that an election to carry forward NOLs and an election to revoke S-Corp status were indistinguishable because both actions result in a potential increase of a debtor's tax liability.[20] Since both are said to have "value," they fall within the broad definition of property of the estate in section 541 of the Bankruptcy Code. Therefore, the court held that the revocation of a corporation's S-Corp status constituted a transfer of the debtor's interest in property.[21]

II. The Decision in *In re Majestic Star Casino, LLC*

In *In re Majestic Star Casino, LLC*, the Court of Appeals for the Third Circuit held as a matter of first impression that a chapter 11 debtor's status as a QSub entity for taxation purposes does not constitute "property" of the bankruptcy estate.[22] The debtors, Majestic Star Casino II ("MSC II") and other subsidiaries and affiliates, were wholly owned by a non-debtor corporation called Barden Development, Inc. ("BDI").[23] Don H. Barden ("Barden") was the sole shareholder, CEO, and president of BDI.[24] In November of 2009, the debtors filed for bankruptcy under chapter 11 of the Bankruptcy Code.[25] Later that year, Barden chose to revoke BDI's status as an S-Corp for tax purposes, thus forfeiting the company's pass-through tax status.[26] As a result of that election, MSC II's status as a QSub was also automatically revoked.[27] Thus, MSC II was now subject to federal and state taxes that it used to pass on to Barden.[28]

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[20] 203 B.R. at 663.
[21] *Id*.
[22] 716 F.3d at 758–759.
[23] *Id*. at 741.
[24] *Id*.
[25] *Id*. at 743.
[26] *Id*. at 744.
[27] 716 F.3d at 744.
[28] *Id*.

The trustee reasoned that QSub status was analogous to S-Corp status, and thus asserted that the revocation of BDI's S-Corp status, which had automatically revoked MSC II's QSub status, constituted an avoidable post-petition transfer of property of MSC II's bankruptcy estate.[29] The Third Circuit reversed the bankruptcy court's decision to grant summary judgment to the trustee, holding that MSC II's status as a QSub for tax purposes was not property. The court further concluded that even if it was, the tax status would belong to the shareholders of its non-debtor parent corporation and not to MSC II.[30]

The Third Circuit chose to depart from the reasoning of the *Trans-Lines West* court and other courts that follow it, and specifically explained why the *Trans-Lines West* court had misinterpreted the concept of "property of the estate" with respect to S-Corp tax status.[31] First, the Third Circuit disagreed with the comparison between tax status and NOLs, stating that unlike NOLs, S-Corp tax status does not have a readily ascertainable value.[32] An NOL is a tax refund that with a value that can be clearly estimated and is immediately available to the bankruptcy estate.[33] The value of S-Corp status, on the other hand, is dependent on it not being revoked.[34]

Furthermore, the Third Circuit criticized the *Trans-Lines West* court's reasoning that S-Corp status was a "right" of the debtor protected by the Internal Revenue Code.[35] The court stated that the Internal Revenue Code could not guarantee a corporation's right to S-Corp status because that status could be revoked at will by the shareholders.[36] Because the S-Corp status is contingent on a number of factors beyond the debtor's control, and because it is not transferrable,

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[29] *Id*. at 745.
[30] *Id.* at 763–764.
[31] *See id*. at 754–755
[32] 716 F.3d at 755–756.
[33] *Id*.
[34] *Id*. at 756.
[35] *Id*. at 756–757.
[36] *Id*. at 756.

the Third Circuit concluded that it was not a property right guaranteed by the Internal Revenue Code.[37] If anybody had a "right" to the S-Corp status, it is the shareholders, who have a statutorily granted right to control the tax status of the corporation which they own.[38]

In addition, the Third Circuit emphasized the inequitable result that would follow from the decision of the bankruptcy court. The court noted that if the trustee were allowed to avoid the revocation of the debtor's S-Corp or Q-Sub status, then the benefit of the cancellation of debt income generated would remain with the company, and thus in the hands of the creditors, while the liability would remain with the shareholders.[39] Furthermore, Barden and BDI would not qualify for the "Bankruptcy Exception" under Section 108(a)(1)(A) of the Internal Revenue Code because they were not the ones in bankruptcy.[40] Therefore, the tax liabilities that Barden would be forced to pay would be substantial.

Finally, The Third Circuit concluded that since S-Corp status was not property, QSub status was not property either.[41] QSub status has an even weaker claim than S-Corp status.[42] QSub status in contingent on many factors, including that the parent owns all of its stock, that its parent does not revoke the QSub status, and that its parent does not lose its S-Corp status.[43] Therefore, QSub status can be revoked not only by the S-Corp parent, but also by reasons outside of the parent's control.[44] The Third Circuit went further to conclude that even if QSub status were property, it would be property of the S-Corp parent, and not the debtor subsidiary itself.[45]

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[37] 716 F.3d at 757.
[38] *See id*.
[39] *Id*.
[40] *Id*. at 746.
[41] 716 F.3d at 758–759.
[42] *Id*. at 758.
[43] *Id*.
[44] *Id*.
[45] *Id*. at 760.

The reasons for this are twofold. First, the S-Corp parent and its shareholders retain the right to revoke QSub status, and thus have control or the "right."[46] Second, allowing the QSub status to be treated as property of the debtor subsidiary would place many restrictions on the rights of the shareholders of the parent company, such as the right to change the tax status of the parent company or the right to sell either the subsidiary or the parent company.[47] Therefore, even if QSub status were to be viewed as property, it would still not be property of the estate, and thus would fail the second prong of the requirements to be avoidable under Section 549 and 550 of the Code.[48]

III. Practical Effects of the *Majestic Star Casino Decision*

The Third Circuit's decision in *Majestic Star Casino* limited the broad interpretation of "property of the estate" under section 541 of the Bankruptcy Code.[49] The Third Circuit recognized that the definition of property of the estate was intended to be broad, and included both tangible and intangible interests.[50] Even interests that are "novel or contingent" may still represent property.[51] However, the court declined to extend the concept of "property of the estate" to override the statutorily granted right of shareholders to control the tax status of an entity that they own.[52] The court stated that, "a tax classification over which the debtor has no control is not a 'legal or equitable interest of the debtor in property' for purposes of [section] 541."[53]

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[46] 716 F.3d at 760.
[47] *Id*.
[48] *See id*. at 761.
[49] *See* 11 U.S.C. § 541 (2006).
[50] 716 F.3d. at 750.
[51] *Id*. at 757..
[52] *Id*.
[53] *Id*.

The practical effect of this is that it allows an owner of a parent company to shift substantial tax liabilities from himself to his debtor subsidiaries by validly revoking its S-Corp status. Accordingly, there will be an additional claim in the debtor's bankruptcy case. As a result, creditors will likely receive lower distributions than they would have if the S-Corp status had been retained.

Conclusion

The Third Circuit's holding in *Majestic Star Casino, LLC* redefines the way that courts analyze S-Corp and QSub status under section 541 of the Bankruptcy Code. Even though S-Corp and QSub tax status arguably have some value to the bankruptcy estate, they do not have a readily ascertainable value, and thus can be distinguished from NOLs.[54] Since the decision to revoke entity's pass through tax status lies with the shareholders and not with the entities themselves, the entities do not control their tax status.[55] Therefore, the Third Circuit departed from the reasoning of *Trans-Lines West* and other bankruptcy courts, and held that S-Corp and QSub status are not property.[56] Since no other courts have addressed this issue yet, it remains to be seen whether the Third Circuit's reasoning will be adopted in future cases.

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[54] *See id*. at 754–755.
[55] *See* 716 F.3d at 757.
[56] *Id*. at 758–759.