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Revocation of Tax Election by Non-Debtor Declared Void

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The intersection between the tax law and the bankruptcy law can be a dangerous place to stand. Each discipline has its own underlying concepts, complex statute, and set of judicial doctrines, and the results can be unpredictable—for a bankrupt and its owners, as well as for the Internal Revenue Service (the "Service")—when the two worlds collide.[1]

The interplay between the Internal Revenue Code (the "IRC") and the "Bankruptcy Code"[2] was recently addressed by the Bankruptcy Court for the District of Delaware in a case involving special tax rules applicable to "S corporations" and "qualified subchapter S subsidiaries."[3] Perhaps unsurprisingly, the court's decision favored the bankrupt corporation that was under the court's jurisdiction, to the detriment of the corporation's indirect shareholder and possibly of the Internal Revenue Service as well.[4]

Relevant Tax Rules

The IRC recognizes two major classes of corporations: C corporations, which are themselves subject to corporate income tax, and S corporations, which are generally treated as "pass-through entities" the income of which, whether or not distributed, is taxed to their shareholders.[5] In order for a corporation to be treated as an S corporation, it must satisfy a number of statutory requirements. These requirements include that the corporation have no more than 100 shareholders, that it have as shareholders only individuals, estates, and certain specified trusts and tax-exempt organizations, that it not have a nonresident alien as a shareholder, and that it not have more than one class of stock.[6] The corporation must also file an appropriate election with the Service, to which all of its shareholders must consent.

An S corporation's election can be terminated, and the corporation can become a C corporation, by revocation of the election or by ceasing to meet one of the other statutory requirements.[7]

The IRC also recognizes a special class of corporation known as a "qualified subchapter S subsidiary," or "QSub." A corporation may qualify to be a QSub if 100% of the stock of the corporation is held by the S corporation. An election requirement is applicable here as well, but the election must be made, and can be revoked, by the S corporation, rather than by the QSub itself. A QSub ceases to be classified as such, and becomes a C corporation, when its parent ceases to be an S corporation by reason, for example, of revocation of the parent's election.[8]

A QSub is not treated as a separate corporation for income tax purposes, and all of its assets, liabilities, and items of income, deduction, and credit are treated as assets, liabilities, and items of the S corporation. Accordingly, the QSub's items of income and deduction are ultimately taken into account by the S corporation's shareholders in computing the amount of income or loss passed through to them.

Corporations in bankruptcy generally continue to be subject to the same tax rules that applied to them before bankruptcy,[9] and such corporations may realize significant amounts of taxable income from the disposition of assets or other transactions. If a bankrupt corporation is a C corporation, the need to pay tax liabilities incurred during bankruptcy may reduce the amounts distributable to creditors. On the other hand, if the corporation is an S corporation, the pass-through of such income to the corporation's shareholders may impose significant tax liabilities on them, without their having access to the proceeds of asset dispositions or other corporate funds to enable them to pay the tax. These results can be exacerbated when the gain on an asset disposition is a "phantom gain," arising by reason of an excess of liabilities discharged over the tax basis of the asset and giving rise to little or no cash proceeds.

A Bit of Bankruptcy

Section 549 of the Bankruptcy Code empowers a bankruptcy trustee to "avoid a transfer of property of the estate that occurs after the commencement of the case; and ... that is not authorized under [the Bankruptcy Code] or by the court." Section 548 of the Bankruptcy Code empowers the trustee to avoid certain "transfers of an interest of the debtor in property" that occurred

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before commencement of the bankruptcy case.

The terms "transfer" and "property" are broadly defined in the Bankruptcy Code. "Transfer" is defined to mean "every mode, direct and indirect, absolute and conditional, voluntary or involuntary, of disposing of or parting with property,"[10] and "property" is defined to include "all legal or equitable interests of the debtor in property as of the commencement of the case."[11]

The Bankruptcy Code also contains an "automatic stay" that prohibits "any act to obtain possession of property of the estate ... or to exercise control over property of the estate."[12]

These provisions have been interpreted over the years to authorize the bankruptcy courts to prohibit the making of certain tax filings by a non-bankrupt shareholder of a bankrupt debtor, if those filings could adversely affect the tax position of the debtor, and even to invalidate filings that had already been made.

In a leading case, *In re: Prudential Lines Inc. (Official Committee of Unsecured Creditors v. PSS Steamship Co.*,[13] PLI, a wholly-owned corporate subsidiary of PSS, entered bankruptcy in September 1986. During September 1989, the creditors' committee proposed a plan of reorganization for PLI under which all of the PLI stock owned by PSS would be cancelled.

PLI had incurred losses during pre-bankruptcy years, and those losses continued to be available as "net operating loss carryovers" that could generally be carried forward by PLI and used to offset its post-bankruptcy income. However, if an "ownership change" of PLI occurred during a taxable year prior to the year in which the existing stock was formally cancelled, PLI's ability to carry its losses forward would be severely impaired under applicable provisions of the IRC,[14] and the claiming by PSS, on PSS's tax return, of a "worthless stock" deduction with respect to PSS's stock in PLI would give rise to such an "ownership change."[15] In the course of negotiations between PSS and the creditors' committee immediately following the proposal of the creditors' committee's plan, PSS threatened to claim such a deduction on its 1988 tax return.

The creditors' committee successfully sought an injunction in the Bankruptcy Court prohibiting PSS from filing a return that claimed the deduction, and the District Court and the Court of Appeals affirmed. The Court of Appeals—without even mentioning the question of whether the claiming of a worthless stock deduction was proper as a matter of Federal income tax law—concluded that PLI's interest in its right to carry its net operating loss forward, in order to offset future income, was "property" of PLI's bankruptcy estate. Moreover, PSS's claiming of such a deduction was barred by the automatic stay as an attempt to exercise control over property of the estate, because "PSS' interest in its worthless stock deduction is intertwined with PLI's NOL." Accordingly, an injunction was proper, even though "PSS' action is not directed specifically at PLI."

Similar principles were applied in other cases to conclude that a pre-petition revocation of a debtor corporation's election to be an S corporation could be avoided by a trustee under Bankruptcy Code section 548 as a prohibited transfer of property of the debtor to the Service.[16] When the Service asserted before the Bankruptcy Court that granting the relief sought by the trustee, which would, in effect, order the Service on an ongoing basis to recognize the invalidity of a facially proper revocation, would violate the Anti-Injunction Act[17] or the exclusion of Federal tax controversies from the Declaratory Judgment Act,[18] the courts held against the Service.

Majestic Star Casino

The bankruptcy courts' jurisdictional creep continues with *Majestic Star Casino*. MSC was a wholly-owned corporate subsidiary of BDI, an S corporation, and, at least as early as 2005, BDI had elected for MSC to be a QSub. MSC apparently incurred losses that "passed through" to BDI and were then claimed as deductions by BDI's sole shareholder.

MSC filed a bankruptcy petition on November 23, 2009; BDI was not in bankruptcy. On an unspecified date between November 23, 2009, and March 16, 2010, and without seeking authorization from the Bankruptcy Court in which MSC's case was pending, BDI and its shareholder filed a revocation of BDI's election to be an S corporation, to be effective January 1, 2010. As noted above, a revocation of BDI's election to be an S corporation would automatically revoke the election for MSC to be a QSub, with the effect that MSC, rather than BDI's shareholder, would be responsible for paying income tax on any gain realized by MSC in the course of the bankruptcy proceeding.

MSC filed a complaint in Bankruptcy Court against the Service and BDI, seeking to "avoid a transfer and disposition of alleged property of the estate" under section 549 of the Bankruptcy Code. After dismissing the Service's argument that the court lacked jurisdiction because the matter was not yet ripe for review (in the absence of a controversy about a specific amount of tax for which MSC's liability was contingent on whether or not it had continued to be a QSub), the court turned to whether MSC's status as a QSub constituted "property" of the bankruptcy estate.

The court quoted from legislative history of the Bankruptcy Code noting that the definition of the term "property" is "expansive," and pointed to the cases that have held that a corporation's prepetition status as an S corporation, or interest in the tax benefits that such status affords to the debtor, is considered "property" for this purpose. In the same manner, a QSub "has a property interest in the benefits that status affords the debtor, most notably the right to be free of a heavy tax burden that will 'diminish estate funds that would otherwise be available to satisfy the claims of ... creditors.'"[19]

The court rejected arguments made by the Service and BDI to the effect that the revocation of BDI's S election "merely caused collateral change to MSC," that MSC had no property interest in its tax status "because the QSub

has no separate [*sic*] for tax purposes from the 'S' corporation," and that QSubs are unlike S corporations and should not be governed by the existing case law, because "QSubs do not have the right to make or revoke their QSub tax status." The court noted that, in substance, it is the shareholder or shareholders of the parent S corporation who decide both whether the parent corporation will elect to be an S corporation and whether it will elect for its subsidiaries to be QSubs. Accordingly, the court gave little weight to the formalities of the procedures that distinguished one election from the other.[20]

Having found that MSC's status as a QSub was "property," the court quickly concluded that the purported revocation of that status was an unauthorized "transfer" of that property, which it ordered to be "void and of no effect." The court also ordered BDI, its shareholder, and the Service to "take all actions necessary to restore the status" of MSC as a QSub of BDI.

What's Next?

Viewed in isolation, the *Majestic Star Casino* decision may represent only a small extension of some of the doctrines developed in *Prudential Lines* and in the earlier cases involving revocation of S corporation elections. However, the decision is a clear indication that the bankruptcy courts view themselves as having the power to prohibit actions that by their terms are directed solely at non-bankrupts, but that may have an adverse "collateral" effect on the tax liability of a corporation under their protection. In the case of a bankrupt S corporation or QSub, this power could intrude on actions as distant from the bankrupt corporation as the shareholder's selection of a place of residence outside the United States (if the shareholder has been a resident, but not a citizen, of the U.S.). We wait anxiously for some indication that there are limits to this doctrine!

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[1] For illustrations of some of the issues that may arise, see authorities cited in E. Pisem & L. Zhang, *Loss Carryovers and Carrybacks When Part of a Consolidated Group Is Bankrupt: PT-1 Communications*, 110 J. Tax. 327, 328 n.1 (June 2009).

[2] The term "Bankruptcy Code" is not found in the statute, and the IRC refers to the Bankruptcy Code as "title 11 of the United States Code (related to bankruptcy)."

[3] *In re: Majestic Star Casino, LLC (Majestic Star Casino, LLC v. Barden Development, Inc.)*, Case No. 09-14136 (KG), 109 AFTR 2d 2012-698 (Jan. 24, 2012).

[4] Decisions such as *Majestic Star Casino*, regarding the continuation of S corporation status, may impact the amount of taxes payable, because the effective tax rate applicable to a corporation's shareholders may be very different from the rate applicable to the corporation itself. From the perspective of the Service, a more significant consideration may be that disbursement of funds of a bankrupt corporation is made under the supervision of the Bankruptcy Court, thereby increasing the likelihood that taxes payable by the corporation will actually get paid, while the Service may be relegated to its ordinary audit and collection procedures when dealing with the shareholders.

[5] Regulated investment companies, real estate investment trusts, and certain other corporations that are not S corporations are subject to special treatment under, for example, IRC § 11(c), (d) and Treasury Regulation § 1.337(d)-7.

[6] IRC §1361(b)(1). The corporation must also not be an "ineligible corporation" described in IRC § 1361(b)(2).

[7] IRC § 1362(d)(1), (2).

[8] See IRC §1361(b)(3).

[9] See IRC §1399. One important exception is that income from the discharge of indebtedness realized by a C corporation in bankruptcy is generally excluded from its gross income, but may be applied to reduce other favorable tax attributes. *See generally* IRC §108(a), (b). The confusing rules governing income from the discharge of indebtedness realized by an S corporation in bankruptcy have a tortured history that is beyond the scope of this article. *See generally Gitlitz v. Commissioner*, 531 U.S. 206 (2001), and cases cited therein.

[10] Bankruptcy Code §101(54).

[11] Bankruptcy Code §541.

[12] Bankruptcy Code §362(a)(3).

[13] 928 F.2d 565 (2d Cir. 1991).

[14] *See generally* IRC §382.

[15] IRC §382(g)(4)(D).

[16] *E.g., Parker v. Saunders*, 226 B.R. 227 (B.A.P. 9th Cir. 1998); *In re: Trans-Lines West, Inc.*, 203 B.R. 653 (Bankr. E.D. Tenn. 1996). Where the shareholders purported to implement a post-petition revocation of S corporation status without the

Bankruptcy Court's consent, a violation of the automatic stay was easily found. *In re: Walterman Implement Inc. (Hanrahan v. Walterman)*, 97 AFTR 2d 2006-2626 (Bankr. N.D. Iowa 2006).

The same principles were applied to set aside the prepetition making of an election to waive the right to carry net operating losses back to earlier taxable years. *United States v. Towers (In re Feiler)*, 83 AFTR 2d 99-2295 (B.A.P. 9th Cir. 1999) (carryback would have produced cash refund that would have gone to the estate under *Segal v. Rochelle*, 382 U.S. 375 (1966), but carryover to later years might have benefitted debtor post-bankruptcy).

[17] IRC § 7421(a) (prohibiting suits "for the purpose of restraining the assessment or collection of any tax").

[18] 28 U.S.C. § 2201.

[19] *Majestic Star Casino,* quoting from *In re Feiler, supra* n. 16, 83 AFTR 2d 2295, at 2298.

[20] The Court was also influenced by the fact that BDI's shareholder had been allowed to claim MSC's prepetition losses as deductions against his own income on a pass-through basis, and one senses that the shareholder's perceived attempt to pick and choose which tax consequences should, and should not, pass through to him disturbed the Court.

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