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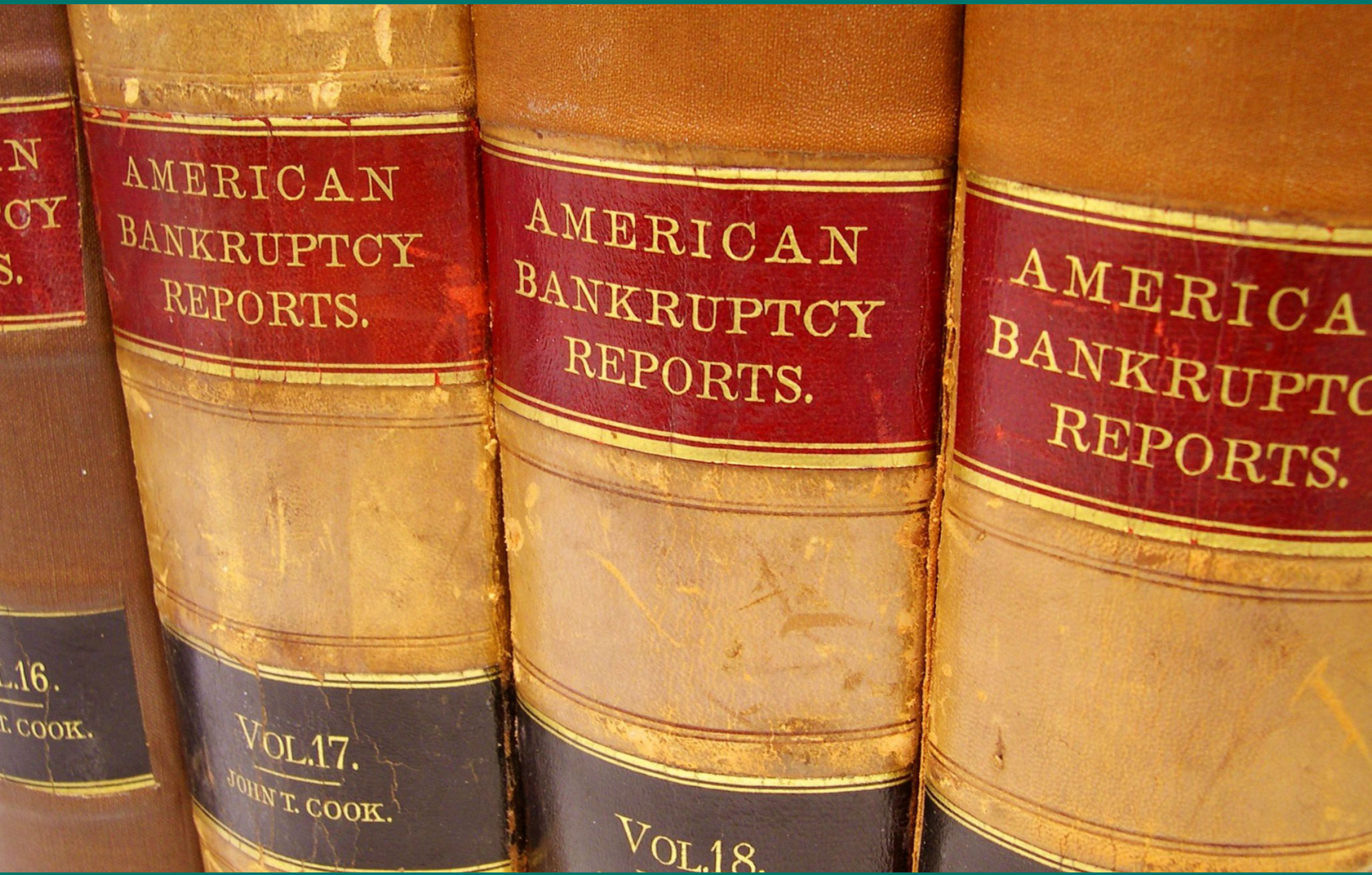

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Recent Development in S Corporation and Qualified Subchapter S Subsidiary Tax Status in Bankruptcy: *In re Majestic Star Casino*

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This discussion reviews a recent judicial decision at the intersection of tax law and bankruptcy law: The Majestic Star Casino, LLC, et al. v. Barden Development, Inc., et al. *The decision is the first federal appellate court case to examine whether S corporation and qualified subchapter S subsidiary (Q subsidiary) tax status constitute property of a debtor corporation's bankruptcy estate. The United States Court of Appeals for the Third Circuit concluded that taxable status is not property of the bankruptcy estate. Therefore, in courts subject to* Majestic Star Casino *as controlling precedent, taxable status is not protected by the "automatic stay," and the debtor corporation or a bankruptcy trustee may not use bankruptcy "avoidance powers" to undo a transaction that results in the revocation or termination of S corporation or Q subsidiary tax status. Notably, the court reached the opposite conclusion from several lower courts that previously considered the same issue. Owners of S corporations presumably will welcome the holding. Professional advisers to, and creditors of, financially distressed S corporations and their Q subsidiaries should take a cautionary note from the decision. Legal counsel, tax planners, and financial advisers should give due consideration to these issues during the pre-bankruptcy planning process, if possible, to anticipate potential consequences.*

Introduction

An important legal decision at the intersection of tax law and bankruptcy law came down in May of this year from the U.S. Court of Appeals for the Third Circuit. The Third Circuit is influential for bankruptcy issues because of the long history and high volume of large, complex bankruptcy cases in the Third Circuit in Delaware.

The case, called *The Majestic Star Casino, LLC, et al. v. Barden Development, Inc., et al.* ("*In re The Majestic Star Casino, LLC*"), examined, for the first time at the federal appellate court level, whether S corporation status and qualified subchapter S subsidiary status ("Q subsidiary") for federal income taxation purposes constitute property of a debtor corporation's bankruptcy estate.[1]

In answering the question in the negative and vacating the Delaware Bankruptcy Court's opposite conclusion, the Third Circuit parted ways from several lower courts that previously considered the same issue.

Owners of S corporations may welcome the decision. Professional advisers to, and creditors of, financially distressed S corporations and their Q subsidiaries may take a cautionary note from this decision.

As explained below, the "property of the estate" determination affects other bankruptcy issues such as the application of the "automatic stay" and the rights of the debtor or a trustee to reverse certain pre- and post-bankruptcy transactions by using so-called "avoidance powers."

There can be significant financial impact as well, through taxation on the debtor's estate and the emerging reorganized debtor. The decision should prompt the legal and financial advisers of S corporation or Q subsidiary corporations and their shareholders to give due consideration to these issues during the pre-bankruptcy planning process, to anticipate potential consequences. In some circumstances, advance planning may prevent or diminish the potential impacts of, a change in taxable status during or just prior to the bankruptcy.

S Corporation and Q Subsidiary Status in a Nutshell

Under Internal Revenue Code Section 1362, a "small business corporation" (as defined in Section 1361) may elect to be an S corporation for purposes of federal income taxation. As an S corporation, the entity is not subject to federal income taxation on an independent basis. Instead, its income and losses pass through to its shareholders, who bear the obligations to report, account for and pay any federal taxes owed on the S corporation's tax-relevant financial performance.[2]

In turn, if the S corporation is the owner of 100 percent of the stock of a corporate subsidiary, the S corporation may elect to treat the subsidiary as a Q subsidiary under Section 1361. The election would mean that the Q subsidiary would not be treated as a separate taxable entity from its S corporation sole shareholder.

All of its assets, liabilities and income would be treated, for federal income tax purposes, as the assets, liabilities and income of the S corporation. As a result, neither the S corporation nor the Q subsidiary would pay federal income taxes, and any federal income tax obligations associated with either of them would shift upward and rest with the S corporation shareholders.

Under Section 1362(d)(1)(B), if more than half of the S corporation's shareholders consent, the S corporation may revoke its election to be treated as an S corporation. Revoking S corporation status necessarily causes the termination of Q subsidiary status, because Q subsidiary status requires that the sole owner of all of the equity in the Q subsidiary be an S corporation.

The revocation and resulting termination would cause the formerly Q subsidiary entities to become taxable as C corporations and responsible for filing their own income tax returns and for paying income taxes on their own holdings and operations.

The Potential Financial Impact of S Corporation and Q Subsidiary Status in Bankruptcy

S corporation and Q subsidiary status can have significant financial implications for debtor corporations under the Bankruptcy Code, as well as for their equity holders. In many reorganizations, the debtor corporation emergence from bankruptcy results in the cancellation of a substantial amount of indebtedness.

This debt cancellation creates "cancellation of debt" (COD) income. The amount of the COD income equals the amount of the cancelled debt (i.e., the face amount of the outstanding debt less the value of any consideration paid in respect of the debt).

Typically, outside of bankruptcy, COD income is subject to federal taxation.[3] Section 108(a), however, allows for a "bankruptcy exception." Due to that exception, a taxpayer in bankruptcy does not recognize COD income on debt that is cancelled or written down as a function of a title 11 plan of reorganization.[4]

If the debtor relies on the bankruptcy exception, the debtor generally will, in turn, reduce the value of its tax attributes (beginning with the net operating loss (NOL) in an amount equal to the amount of COD income excluded from gross income by the bankruptcy exception.[5]

As a result, deductions and credits that the debtor otherwise may have used to reduce future income and taxes become diminished or possibly eliminated.[6]

As noted above, if the debtor is a Q subsidiary or an S corporation, the COD income and any federal tax obligation on that income will pass through to the shareholders. If the shareholders are not themselves in bankruptcy, the bankruptcy exception would not apply to them. The shareholders could be liable to pay tax on the COD income unless they can establish eligibility for other exceptions to taxation.

The Scope of Property of a Bankruptcy Estate

Under bankruptcy law, property of the bankruptcy estate includes "all legal or equitable interests of the debtor in property as of the commencement of the [bankruptcy] case."[7]

The scope of estate property is intended to be very broad and inclusive, covering interests that are legal, equitable, tangible, intangible, residual, contingent or noncontingent.

Nonetheless, bankruptcy law generally does not expand the debtor's preexisting rights and interests in property. Nor does it create new property rights that the debtor did not already possess before commencing the bankruptcy case.[8]

Rather, the debtor property rights are generally determined by applicable nonbankruptcy law. Most often, state law is the source. If, however, "some federal interest requires a different result," then federal law may define the relevant property rights.[9]

One may suspect that federal income tax status is just such an instance. Indeed, in *Majestic Star Casino*, after comparing state law, the Internal Revenue Code, and the Bankruptcy Code as possible sources to govern the characterization of entity taxable status as a property interest for bankruptcy purposes, the Third Circuit determined that the Internal Revenue Code governs the issue.[10]

This determination, however, provided no quick or easy solution to the characterization question. This is because the Internal Revenue Code "does not [answer the question of entity taxable status being property] explicitly and the case law is not entirely clear."[11]

By contrast, a line of cases has determined that the right to elect to carry forward an NOL is, indeed, property of the bankruptcy estate.[12]

The Facts of Majestic Star Casino

One of the Majestic Star Casino corporations, Majestic Star Casino II, Inc. ("MSC2"), owned and operated the Majestic Star II Casino and the Majestic Star Hotel in Gary, Indiana. MSC2 was a Q subsidiary of an S corporation named Barden Development, Inc. (BDI). BDI was not a debtor under the Bankruptcy Code with MSC2 and MSC2's affiliated debtors. The BDI sole shareholder, president, and chief executive officer, Don Barden, was also not a debtor under the Bankruptcy Code.

MSC2 and certain of its affiliates commenced their chapter 11 bankruptcy cases in November 2009. Sometime in early 2010, Barden, acting as the sole shareholder of BDI, caused BDI to have the Internal Revenue Service (the "Service") revoke its S corporation status, as prescribed in, and in accordance with, the Internal Revenue Code and applicable Treasury Regulations. BDI took these steps without notice to, or permission from, the debtor's and the bankruptcy court.

As a direct consequence of revoking the BDI S corporation status, MSC2 lost its Q subsidiary status, effective retroactively to January 1, 2010. Thereby, quite involuntarily and unexpectedly, MSC2 became a C corporation responsible for filing its own tax returns and directly subject to state and federal income taxation on its operational and other income from its casino and hotel operations.

In fact, in addition to multimillion dollar operational income, MSC2 and its affiliated debtors benefitted from debt reduction through their bankruptcy plan, which was estimated to create approximately $170 million in COD income. Without passing this income through to BDI and Barden by way of MSC2's Q subsidiary status, the income would remain at the debtor level and create tax liability or, with respect to the COD income, the reduction of tax attributes via the use of the bankruptcy exception to eliminate the taxation of the COD income.

Seeking to avoid these consequences if possible, MSC2 and its affiliated debtors brought an action in the bankruptcy court in Delaware against BDI, Barden, the Service, and the Indiana Department of Revenue. The debtors contended that the MSC2's Q subsidiary status was property of its bankruptcy estate. They argued that revoking the status violated the "automatic stay" in bankruptcy and was an unlawful and avoidable transfer of estate property.

The bankruptcy court agreed. It granted summary judgment in the debtors' favor and ordered a "recovery" of the taxable status "property" by way of compelling the federal and state tax authorities to "take all actions necessary to restore the status of [MSC2] as a Q subsidiary of BDI." Barden and BDI appealed.

The Third Circuit took up the case on direct certification (skipping the federal district court, which ordinarily would have served as the first appellate level court over the bankruptcy court).

The Third Circuit's Analysis in Majestic Star Casino

The Third Circuit disagreed with the bankruptcy court and held that S corporation and Q subsidiary status are not property of a bankruptcy estate. Consequently, in bankruptcy cases in the Third Circuit, the debtor's taxable status is not protected by the automatic bankruptcy stay. Nor is it within reach of the debtor's or a bankruptcy trustee's avoidance powers to recapture if it is "transferred" (by way of being revoked or terminated) prior to or during bankruptcy under circumstances satisfying the other elements of the avoidance powers statutes of the Bankruptcy Code.

In reaching its conclusion, the Third Circuit began by examining a series of earlier decisions from lower courts on the same issue: S corporation status as property of the estate. These decisions had reached the opposite conclusion, holding that a debtor corporation's taxable status is indeed property of its bankruptcy estate.[13]

The Third Circuit focused in particular on the *Trans-Lines West* decision as the perceived groundbreaking case on the issue, and one in which the bankruptcy court's reasoning resulted in a trustee avoiding a corporation's pre-bankruptcy revocation of its S corporation status as a fraudulent transfer of property of the estate.

The Third Circuit outlined four major concerns with the rationale of these precedents. First, the court noted that these cases based their reasoning in key part on extrapolation from other court decisions—including a United States Supreme Court decision in *Segal v. Rochelle*,[14] and the Second Circuit's *Prudential Lines* decision noted above—which had held that a debtor's rights to elect to carry back and to carry forward NOLs are property of the bankruptcy estate.

But in the Third Circuit's view, this extrapolation "fail[s] to consider important differences between the two putative property interests" (i.e., NOLs and S corporation or Q subsidiary taxable status).[15] "[T]he analogy of S corporation status to NOLs is of limited validity" for several reasons, according to the Third Circuit.[16]

NOLs are not subject to revocation and termination by the debtor's shareholders and the Service, whereas tax status is.

In addition, the Third Circuit maintained that NOLs have "readily determinable" value based on known past and current income and losses. The court concluded that any value of S corporation status is speculative and contingent upon future earnings, in addition to being contingent upon the shareholders not filing to have it revoked. Moreover, "NOL carryforwards may be monetized in a manner that continuing S corporation status cannot."[17]

Second, the Third Circuit rejected the other courts' characterization of the Internal Revenue Code as affording an S corporation a guaranteed, indefinite right to use, enjoy and dispose of that status. Because the status is revocable at the will of the S corporation's shareholders, the status is neither guaranteed nor indefinite. "The IRC does not, and cannot, guarantee a corporation's right to S corporation status."[18]

Third, the Third Circuit disagreed with other courts that were willing to view taxable status as bankruptcy estate property "because it has value to the estate."[19]

The Third Circuit found this standard to be an inappropriate basis for defining property of the estate. Any value that taxable status may hold for the debtor cannot override the shareholders' statutory rights under the Internal Revenue Code to revoke the status, according to the Third Circuit.[20]

Fourth and finally, the Third Circuit expressed the view that "*Trans-Lines West* and its progeny (and the bankruptcy court's decision in this case) also produce substantial inequities."[21]

Specifically, the results of the decisions impair the S corporation shareholders' statutory tax structuring rights, and can force them to continue bearing tax burdens against their will, while simultaneously impairing their ability to extract the income from the S corporation to cover the tax payments owed. "For all these reasons . . . we conclude that S corporation status is not 'property' within the meaning of the [Bankruptcy] Code."[22]

As for Q subsidiary status, the Third Circuit concluded a fortiori that it too is not property at all, let alone property of the estate. Indeed, as the Third Circuit interpreted the Internal Revenue Code, "a Q subsidiary does not even exist for federal tax purposes."[23] Under the Internal Revenue Code, the Q subsidiary is "deemed to have liquidated into" its S corporation parent.[24]

Delving further into the analysis, the Third Circuit hypothecated that "[i]f Q subsidiary status were property at all, it would be the property of the subsidiary's S corporation parent," not of the subsidiary itself.[25]

On these grounds, the Third Circuit vacated the bankruptcy court's decision, which had avoided (or "undone") the revocation of the BDI S corporation status and the resulting termination of MSC2's Q subsidiary status. Reversing the effect of the bankruptcy court's ruling achieved Barden's original goal, sparing him from an estimated $170 million of otherwise taxable COD income arising from the Majestic Casino bankruptcy plan, as well as potential taxation on the multimillion dollar operational income.

Conclusion

The Third Circuit's decision in the *Majestic Star Casino* case is a significant step in the ongoing development of jurisprudence concerning the treatment of tax attributes and taxable status in bankruptcy cases.

This decision is noteworthy for its departure from lower court decisions to treat taxable status as a valuable component of estate property that is protected by the automatic stay and that can be "recaptured" if "transferred" prior to or during bankruptcy under certain circumstances.

In declining to follow the same path, the Third Circuit did not merely distinguish the particular fact scenario in the *Majestic Star Casino* case before it or qualify its decision as being limited in any respect. Rather, the court presented a thorough, reasoned analysis of why it perceived the other decisions to be flawed.

As a federal circuit court decision—the first at that level—from a leading circuit on bankruptcy issues, the decision is likely to be very influential. Moreover, with court decisions now split between opposing interpretations, future precedents on this topic are also likely to be influential by adding weight to one side of the debate or the other.

By staying abreast of this issue, legal and financial advisers to potential Chapter 11 debtors and their nondebtor affiliates may be able to factor the issue into tax and bankruptcy planning. The first question for advisers to consider is whether the venue of any possible bankruptcy case would be within the Third Circuit, in a jurisdiction where courts have reached the opposite holding of *Majestic Star Casino*, or in a jurisdiction where the issue remains unsettled.

Armed with this awareness, and drawing upon any other facts that may create leverage, an S corporation or Q subsidiary may be able to anticipate the intentions of the shareholders who control its taxable status.

If significant concerns exist that the shareholders will cause the debtor' taxable status to be changed, and if *Majestic Star Casino* or similar, future cases control the analysis of that issue, perhaps the parties may try to negotiate some compromise in advance to accommodate each party's expectations as much as possible.

"The Third Circuit's decision in the *Majestic Star Casino* case is a significant step in the ongoing development of jurisprudence concerning the treatment of tax attributes and taxable status in bankruptcy cases."

For example, the facts and relationships may enable the Q subsidiary or S corporation to obtain the shareholders' commitment to preserve taxable status. Alternatively, the parties may have reason to agree in advance to divide the tax obligations that result from either preserving or changing taxable status.

Absent compromise, perhaps the S corporation's or Q subsidiary's advisers can use the available facts to establish grounds to make a preemptive strike, seeking judicial intervention and protective relief before any taxable status change occurs, rather than trying to rely on bankruptcy avoidance powers to undo the change retroactively.

By comparison, with respect to NOLs, a widespread practice has developed for debtor corporations to seek court orders at the beginning of the bankruptcy case to restrict securities trading (and, in some cases, claims trading as well) that may negatively affect NOLs. When granted, these orders rely on, among other things, the premise that the debtor corporation's rights to elect to carry back or to carry forward NOLs are property of the estate.

If a debtor corporation were to seek similar protection for its S corporation or Q subsidiary taxable status, the court either would have to disagree with the *Majestic Star Casino* decision and conclude that taxable status is property of the estate, or it would have to be persuaded that other reasons support the relief.

Please note that the views expressed herein are those of the author alone and do not reflect the views, positions, or policies of Jones Day or its clients. This discussion provides general information that should not be viewed or utilized as legal advice to be applied to fact-specific situations.

Notes:

1. In re The Majestic Star Casino, 716 F.3d 736 (3d Cir. 2013).
2. See Internal Revenue Code § 1363, 1366.
3. See Internal Revenue Code § 61(a)(12) (defining "gross income" to include "income from the discharge of indebtedness").
4. Internal Revenue Code § 108(a)(1)(A).
5. See Internal Revenue Code § 108(b)(1).
6. See Internal Revenue Code § 108(b)(2).
7. 11 USC § 541.
8. See, e.g., Butner v. United States, 440 U.S. 48 (1979); 4 Collier on Bankruptcy ¶ 541.06 (15th ed. 1996) (explaining that section 541 of the Bankruptcy Code "is not intended to expand the debtor's rights against others beyond what rights existed at the commencement of the case").
9. See Butner, 440 U.S. at 55.
10. Majestic Star Casino, 716 F.3d at 752.
11. Id. at 751.
12. See, e.g., Official Committee of Unsecured Creditors v. PSS Steamship Co. (In re Prudential Lines, Inc.), 928 F.2d 565 (2d Cir. 1991).)
13. See Halverson v. Funaro (In re Funaro), 263 B.R. 892 (8th Cir. BAP 2001); Parker v. Saunders (In re Bakersfield Westar, Inc.), 226 B.R. 227 (9th Cir. BAP 1998); Hanrahan v. Walterman (In re Walterman Implement Inc.), No. 05-07284, 2006 WL 1562401 (Bankr. N.D. Iowa May 22, 2006); In re Trans-Lines West, Inc., 203 B.R. 653 (Bankr. E.D. Tenn. 1996).
14. Segal v. Rochelle, 382 U.S. 375 (1966).
15. Majestic Star Casino, 716 F.3d at 754.
16. Id. at 756.
17. Id.
18. Majestic Star Casino, 716 F.3d at 756.
19. Id. at 757.
20. See id.
21. Id.
22. Majestic Star Casino, 716 F.3d at 758.
23. Id. at 759.
24. Id. (citing IRC §§ 332 and 377).
25. Majestic Star Casino, 716 F.3d at 760.

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