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Nondebtor Parent's Revocation of S Corporate Election Held to Be Void

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In *In re Majestic Star Casino LLC,* U.S. Bankruptcy Court Judge Kevin Gross of the District of Delaware answered a question of first impression: whether a nondebtor parent's revocation of its S corporation status, which, subsequently, by operation of the Internal Revenue Code revoked the debtor-subsidiary's "qualified Subchapter S subsidiary" (QSub) status, is an avoidable transfer of estate property in violation of Bankruptcy Code §549. The court answered the question in the affirmative, voided the parent corporation's revocation of its Subchapter S status and the termination of the subsidiary corporation's QSub status, and directed the defendants to take all actions necessary to restore the subsidiary corporation's QSub status and to return all sums paid by the subsidiary as a result of the termination of its QSub status.

The facts of the case set forth in the opinion are not complicated. The debtors owned casino properties in Indiana and other states. Barden Development Inc. (BDI) was the nondebtor parent of the debtor, the Majestic Star Casino II (MSC II). Prior to the petition date, BDI and its sole shareholder, Don Barden, elected to treat BDI as an S corporation, and BDI in turn had elected to treat its wholly owned subsidiary, MSC II, as a QSub.

An S corporation election has the effect of characterizing the corporation as a "pass-through" entity, with all items of income, loss, deduction and credit flowing through the corporation to be reported on the personal tax returns of the corporation's principals. Thus, unlike a C corporation, which is subject to two levels of taxation - both at the corporate level and, in the case of any distributions to its shareholders, at the shareholder level - an S corporation is subject to only one level of taxation. All of an S corporation's income and losses flow directly through to its shareholders and are reported on their returns rather than the returns of the corporation. A QSub is a domestic corporation that is a wholly owned subsidiary of an S corporation that the S corporation elects to treat as a QSub. A QSub is like an S corporation in that all of its income and losses flow up to the parent S corporation (and then out to the S corporation's shareholders). As a result, a QSub pays no federal income taxes.

The opinion said that, after the petition date, BDI filed a notice with the IRS revoking its Subchapter S election. Neither BDI nor Barden sought or obtained authorization from the court to revoke BDI's S corporation status. As a result of the revocation, MSC II's QSub status was automatically terminated because it no longer met the requirement of being wholly owned by an S corporation. MSC II then became responsible for filing its own tax returns and paying income taxes on its holdings and operations. The opinion said that the termination of MSC II's QSub status required it to pay approximately $2.26 million in estimated income tax to the state of Indiana that it otherwise would not have had to pay and made it responsible for payment of its own federal income taxes.

MSC II brought an adversary action against BDI, Barden, the Internal Revenue Service and the Indiana Department of Revenue seeking to avoid the termination of its QSub status under Sections 549, 550 and 362 of the Bankruptcy Code as an unauthorized post-petition transfer of property of the estate and a violation of the automatic stay. The defendants moved to dismiss the complaint and for judgment on the pleadings, while MSC II filed a cross-motion for summary judgment. The key issue before the court was whether MSC II's QSub status was property of the bankruptcy estate.

The court began with the proposition that property of the estate includes all legal or equitable interests of the debtor in property as of the commencement of the case, whether tangible or intangible. Property belongs to the debtor if its transfer will deprive the bankruptcy estate of something that could otherwise be used to satisfy the claims of creditors.

The court noted that numerous federal courts have previously held that a debtor's prepetition status as an S corporation is property of the estate. Those cases held that debtor S corporations had a property interest in the benefits that the S corporation status affords them, particularly the ability to pass through tax liability and net operating losses to their shareholders. Revocation of the S corporation status would require the

debtor's estate to pay taxes that it would otherwise not be required to pay and therefore diminishes the amount of monies available to satisfy claims of the debtor's remaining creditors.

For the same reasons, the court concluded that a debtor that is a QSub has a property interest in the benefits that the QSub status affords it, most notably the right to be free of a tax burden that will diminish estate funds that would otherwise be available to satisfy the claims of the debtor's creditors. The effect of the parent corporation's revocation of its S corporation status, resulting in the termination of the debtor's QSub status, was that a potentially significant tax burden was shifted from the parent corporation's sole shareholder back to the debtor. As a result, potential tax liabilities became an obligation of the estate and its creditors, and the payment of those tax liabilities will diminish funds of the estate, which otherwise would have been available to satisfy creditors' claims.

The court rejected arguments by the defendants that sought to distinguish those cases involving revocation of a debtor's S corporation status on the grounds that an S corporation has the right to make or revoke its Subchapter S status, but a QSub does not have the same right to make or revoke its QSub tax status; the QSub's status depends entirely on the actions of its parent corporation. The defendants argued that the parent corporation could cease to be an S corporation in any number of ways in addition to revoking its election to be an S corporation, for example, by creating a second class of stock, having more than the permitted number of shareholders or having a portion of its stock owned by an ineligible shareholder such as an LLC, a partnership or a nonresident alien. In each of these cases, the QSub did not control its own destiny.

However, the court noted that a property interest may exist even if it is contingent on a nondebtor's action. Moreover, regardless of whether the S corporation or QSub elections are controlled by the S corporation, the reality is that both elections are controlled by the principal shareholders of the S corporation. In the case of MSC II, it was Barden as the sole shareholder and principal of BDI that made the decision to treat MSC II as a QSub and subsequently to terminate that status by revoking the parent's S corporation election.

Having determined that the debtor's QSub status was a property interest, the court quickly disposed of the remaining elements necessary to make out a claim under Sections 549 and 362. First, the defendants' revocation of BDI's S corporation status, because it automatically and irrevocably terminated MSC II's QSub status, caused a transfer of property from the bankruptcy estate because it involved disposing of or parting with property or with an interest in property in keeping with the Bankruptcy Code's definition of "transfer" in 11 U.S.C.§101(54). Second, the transfer occurred post-petition. Third, the transfer was not authorized by statute or the bankruptcy court. Lastly, the termination of the debtor's QSub status by reason of the revocation of BDI's S corporation status violated the automatic stay because §362 of the code prohibits unauthorized post-petition transfers of the debtor's property.

The court ordered the defendants to take all actions necessary to restore the status of MSC II as a qualified Subchapter S subsidiary of BDI. The actual mechanics of how this could be accomplished were not addressed by the parties in argument before the court nor discussed by the court. Presumably, restoring QSub status to MSC II requires restoring the S corporation status of BDI. The court also ordered the Indiana Department of Revenue to return to the debtor all monies paid as a result of the unauthorized post-petition termination of its QSub status. The effect of the court's order will be to cause the sole shareholder of BDI to again become responsible for any federal or state income taxes payable by MSC II. The court's order has been appealed by the defendants to the district court and the appeals are pending.

Savvy bankruptcy practitioners representing owners of potential debtors caution against filing a bankruptcy for a Subchapter S corporation because of the potential income tax consequences to their clients. The court's decision now extends that caution to filing for bankruptcy on behalf of a qualified subsidiary of an S corporation.

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