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New Case May Present Planning Opportunities for Financially Troubled S Corporations and Qsubs

S corporation (S corp) bankruptcies frequently result in an unfunded tax liability for the shareholders. To avoid this result, shareholders have sought to revoke the S corp status before filing for bankruptcy. However, courts have voided this revocation when it is done in contemplation of bankruptcy. A recent case out of the Third Circuit (*In Re: The Majestic Star Casino, LLC*), however, permitted an S corp revocation when a qualified subchapter S subsidiary (Qsub) was in bankruptcy. This case may open the door to a business structure that insulates shareholders from income tax triggered in the bankruptcy.

POSTED:

Aug 27, 2013

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Background on S Corps and Qsubs

Shareholders typically elect S corp status to avoid double taxation associated with C corporations. An S corp may elect qualified Qsub for a wholly-owned subsidiary. If the S corp parent's S election is revoked, the subsidiaries Qsub status is automatically revoked.

If the business files for bankruptcy, the S corp's assets are typically sold to generate cash to pay creditors and remaining liabilities are discharged. The asset sale may generate taxable gain (including gain taxed as ordinary income), which "flows through" to the shareholders. Such gain may generate a tax liability for the shareholders. The shareholders also may have an obligation to pay taxes on deemed income resulting from the cancellation of debt (COD) generated from any remaining liabilities, although some or all of this income may be sheltered under a bankruptcy or insolvency exception to COD income. In addition, the shareholders are removed as equity holders of the S corp, and they may not be able to use any associated capital loss to offset ordinary income generated in the bankruptcy.

Majestic Star Casino

In *Majestic Star*, the Third Circuit Court of Appeals ruled that a parent company's revocation of its S corp status (which also terminated the elector's Qsub status) was not void as a post-petition transfer of property of the bankruptcy estate.

In the case, Barden Development, Inc. (BDI) had elected to be treated as an S

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corp. As an S corp, BDI passed its income and losses through to its sole shareholder, Don Barden. BDI acquired 100% of the stock of the Majestic Star Casino II, Inc. (MSC II). BDI elected to treat MSC II as a Qsub, meaning that all of the assets, liabilities and income of MSC II were taxed as the assets, liabilities,and income of BDI. MSC II's income and losses flowed through to Barden via BDI.

MSC II and some of its subsidiaries and affiliates (Debtors) filed petitions for relief under Chapter 11 of the Bankruptcy Code. BDI, however, was not part of the bankruptcy proceeding. After the filing, Barden revoked BDI's S corp status, and such revocation automatically terminated MSC II's Qsub status. As a result, BDI was able to cause MSC II to be subject to federal taxation as a C corporation. The creditors sought to overturn the revocation, arguing that the revocation of BDI's S corp status caused an unlawful post-petition transfer of property of the MSC II bankruptcy estate.

The Third Circuit rejected the creditor's position. In reaching its holding, the court rejected the line of cases under *Trans-Lines West*, which found that S corp status guarantees a property right until the S corp election is terminated, making revocation of S corp status an unlawful post-petition transfer of estate property. Although only Qsub status was directly at issue in *Majestic Star*, the Third Circuit addressed S corp status as "property" and held that it was not a property right.

The court went a step further by concluding that Qsub status is even less like property than S corp status. The court reasoned that Qsub status is not property because it is "neither alienable nor assignable," and a debtor has even less control of its Qsub status than S corp status. Above is a diagram showing the difference in the corporate structures of *Trans-Lines West* and *Majestic Star*.

Why This Case Is Important

Before *Majestic Star*, S corp shareholders had few options to avoid a tax bill in certain bankruptcies. The *Majestic Star* business structure, however, might enable the pass-through tax burdens to shift from the S corp owners to the bankrupt subsidiary. A shareholder has a better chance of revoking its S corp election with a Qsub structure because the property right argument is weaker with Qsub status, and this corporate structure further detaches the shareholder from the subsidiary. Although not entirely clear whether other circuits (such as the 7th Circuit, which presides over Wisconsin bankruptcy appeals) will follow *Majestic Star*, companies might use the rationale of the case to achieve a better result if the business fails. Companies considering a restructuring should act well in

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advance of a bankruptcy.

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