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A Majestic Vacation: The Third Circuit Takes a Break from the Modern Trend of Including Subchapter S Elections in the Property of a Bankruptcy Estate

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NOTE

A *MAJESTIC* VACATION: THE THIRD CIRCUIT TAKES A BREAK FROM THE MODERN TREND OF INCLUDING SUBCHAPTER S ELECTIONS IN THE PROPERTY OF A BANKRUPTCY ESTATE

By: C. Chadwick Cullum

Abstract

Subchapter S elections provide small businesses and their owners with substantial tax benefits. These elections allow the businesses to avoid taxation at the corporate level and cause the tax liability of the company to pass through to the shareholders. When a Subchapter S entity enters bankruptcy, the company expects tax liability to continue to pass through to the shareholders, but the shareholders often want to shift the tax liability back onto the company because they do not have access to the company's income while it is in bankruptcy. Whether Subchapter S elections are property of the company's bankruptcy estate is a significant factor in the ability of shareholders of these entities to revoke these elections to avoid the tax liability. Until recently, courts had found that a Subchapter S election is property of the bankruptcy estate, but never addressed a situation involving qualified subsidiaries of Subchapter S Corporations. In In re Majestic Star*, the Third Circuit held that these elections are not property rights and vacated the lower bankruptcy court's order to restore the tax statuses of a subsidiary in bankruptcy and its parent corporation.*

Comparing the broad application of property rights in bankruptcy used in In re Dittmar*, this Note demonstrates that the Third Circuit Court of Appeals improperly limited its analysis concerning the property nature of these elections. Subchapter S elections should be property of the estate because they provide an economic benefit to the company that can satisfy claims of creditors. The inequities and negative implications that resulted from the lower bankruptcy court's order are also not as significant as the Third Circuit would make them seem. Some of these negative consequences could have been remedied by fixing an error in the order.*

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I. INTRODUCTION

For over fifteen years, courts have held that S Corporation elections are property of the debtor company's bankruptcy estate.[1] This causes shareholders to continue to be liable for the taxes from any income of the bankrupt company—when they no longer have access to the company's income—and prevents the shareholders from revoking these elections.[2] Many have discussed the fairness of this tax liability on shareholders of S Corporations in bankruptcy.[3] Recently in *In re Ma-*

1. *See infra* Section II.B.3–4.
2. *See infra* Section II.
3. *See* Niki Wilkinson, *Furthering Congress' Intent Through* Mourad v. Commissioner of Internal Revenue*, but with Inequitable Results to Shareholders of a Liquidated S-Corporation*, 8 T.M. COOLEY J. PRAC. & CLINICAL L. 201, 218–22 (2006); Camilla Berit Galesi, *Shareholders' Rights Regarding Termination of a Debtor Corporation's S Status in a Bankruptcy Setting*, 10 J. BANKR. L. & PRAC. 157, 158–59 (2001); Richard A. Shaw, *Taxing Shareholders on the Income of an S Corporation in Bankruptcy*, BUS. ENTITIES, Nov.–Dec. 1999, at 46–47, *available at* 1999 WL 1419055.

jestic Star Casino, LLC, the Third Circuit Court of Appeals held that Subchapter S elections are not property of the estate, highlighting this alleged inequity and other negative implications of the lower court's ruling.[4] Nevertheless, Subchapter S tax elections reflect the nature of property interests, and should be considered property of the debtor company's bankruptcy estate because they create an opportunity for future economic benefit to the company, which creditors may use to satisfy claims.

Section II of this Note sets forth the tax and bankruptcy law pertaining to Subchapter S entities including the Internal Revenue Code, Bankruptcy Code, and relevant case law. The statutory requirements of S Corporations and Qualified Subchapter S Subsidiaries ("QSubs") provide substantial tax benefits, but they also place restrictions on the shareholders and parent companies.

Sections III and IV present the facts and ruling of *Majestic Star* and evaluate the Third Circuit's legal arguments related to whether Subchapter S elections should be property of the estate. The court incorrectly relied on a comparison between these elections and net operating losses to conclude that the elections were not property. A better comparison can be found in *In re Dittmar,* where the Tenth Circuit properly applied a broad definition of property holding that stock appreciation rights were property of the estate.[5]

Section V illustrates how the inequities and negative implications raised by the *Majestic Star* court are not as negative as the court would make them seem. A timing and specificity error in the bankruptcy court's order created some of these problems, and the Third Circuit could have fixed the error rather than vacating the order.

II. Subchapter S Entities

S Corporations and QSubs are two tax status elections for business entities created by Subchapter S of the Internal Revenue Code ("IRC").[6] While the requirements of Subchapter S elections place serious restrictions on shareholders, they also provide substantial tax benefits.[7] The pass-through nature of S Corporations, and the disregarded status of QSubs, also complicate bankruptcy proceedings because the debtor company and the company's owners want to avoid any potential tax liability.[8]

4. Majestic Star Casino, LLC v. Barden Dev., Inc. (*In re* Majestic Star Casino, LLC), 716 F.3d 736, 745–46, 752–58, 760 (3d Cir. 2013).

5. Parks v. Dittmar (*In re* Dittmar), 618 F.3d 1199, 1202 (10th Cir. 2010).

6. I.R.C. § 1361(a)–(b) (2012).

7. *See infra* Section II.A.

8. *See infra* Section II.B.3–4.

A. *Taxation of S Corporations and Qualified Subchapter S Subsidiaries*

Congress added Subchapter S to the IRC so that small businesses and their owners could enjoy a number of benefits over C Corporations.[9] The main feature of Subchapter S Corporations is that "shareholder's pro rata share of the corporation's" tax items including income, losses, deductions, or credits pass through to the shareholder.[10] Income from a C Corporation is taxed both at the corporate level and again at the individual level when dividends are distributed.[11] An S Corporation avoids this double taxation of income because it is not subject to regular taxes under the IRC.[12] Instead, income is taxed only at the individual level after it passes through to the shareholders based on their percentage of ownership of the corporation.[13] Depending on the difference between the corporate tax bracket and the shareholder's individual tax bracket, the shareholder may incur a lower tax liability.[14] Congress also intended a "substantial benefit" for small corporations to be able to offset losses that could not otherwise be offset at the corporate level against the shareholder's other income at the individual level.[15] Not surprisingly, most corporations elect to file as S Corporations to take advantage of these benefits.[16]

The IRC automatically classifies a corporation as a C Corporation.[17] However, a small business corporation may elect under § 1362(a)(1) to be treated as an S Corporation.[18] All the shareholders of the small business corporation must consent to take this election.[19] The IRC defines a small business corporation as a domestic corporation that does not "(A) have more than 100 shareholders, (B) have as a shareholder a person . . . who is not an individual, (C) have a nonresident alien as a shareholder, and (D) have more than [one] class of stock."[20]

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9. Wilkinson, *supra* note 3, at 205 (citing S. Rep. No. 85-1983 (1958), *reprinted in* 1958 U.S.C.C.A.N. 4791, 4876).

10. I.R.C. § 1366(a) (2012).

11. *Id.* §§ 11(a), 61(a)(7).

12. *Id.* § 1363(a).

13. *Id.* § 1366(a).

14. Wilkinson, *supra* note 3, at 205 (citing S. Rep. No. 85-1983 (1958), *reprinted in* 1958 U.S.C.C.A.N. 4791, 4876).

15. S. Rep. No. 85-1983 (1958), *reprinted in* 1958 U.S.C.C.A.N. 4791, 4876.

16. *Table 1: Selected financial data on businesses 1980-2008*, IRS Statistics of Income Div., http://www.irs.gov/file_source/pub/irs-soi/80ot1all.xls (last updated Dec. 18, 2013).

17. I.R.C. § 1361(a)(2) (2012).

18. *Id.* § 1362(a)(1).

19. *Id.* § 1362(a)(2).

20. *Id.* § 1361(b)(1).

The election to be an S Corporation remains in effect until terminated.[21] The election will be revoked if: (1) shareholders owning more than 50 percent of the corporation's stock consent to a revocation; (2) the company no longer qualifies as a "small business corporation"; or (3) "passive investment income exceeds 25 percent of gross receipts for three consecutive taxable years and [the] corporation has accumulated earnings and profits."[22] Once terminated, a small business corporation may not make an election to become an S Corporation again for five years, unless permitted by the Secretary of the Internal Revenue Service ("IRS").[23]

These requirements and limitations for Subchapter S elections make these entities somewhat fragile, so that the tax status must be "carefully monitored and maintained."[24] For example, one shareholder could sell his or her shares to one of the restricted parties, causing the company to no longer qualify as a small business corporation.[25] This would revoke the S Corporation status, and none of the other shareholders could prevent it.[26]

In 1996, Congress created the Qualified Subchapter S Subsidiary, so that an S Corporation might function as a holding company.[27] A QSub has its own corporate charter under state law but from the perspective of the IRS is not a separate entity from its parent S Corporation; its separate corporate status is disregarded.[28] For tax purposes, all of its assets, liabilities, income, deductions, and credits belong to the parent S Corporation.[29] To qualify as a disregarded entity, the parent S Corporation must own 100 percent of the subsidiary and elect to treat the subsidiary as a QSub.[30] Failure to maintain these requirements will result in termination of the QSub elections.[31] The parent corporation must also continue to meet the requirements of a small business corporation.[32] A parent S Corporation may revoke its subsidiary's QSub status at any time by filing a statement with the

21. *Id.* § 1362(c).

22. *Id.* § 1362(d).

23. *Id.* § 1362(g).

24. Jerald David August, *Benefits and Burdens of Subchapter S in a Check-The-Box World*, 4 FLA. TAX REV. 287, 305 (1999).

25. I.R.C. § 1361(b)(1).

26. *Id.* § 1362(d)(2).

27. S. REP. NO. 104-281, at 52 (1996), *reprinted in* 1996 U.S.C.C.A.N. 1474, 1526. Congress believed that S Corporation "shareholders should be allowed to arrange these separate corporate entities under parent-subsidiary arrangements as well as brother-sister arrangements." *Id.*

28. August, *supra* note 24, at 329; Treas. Reg. § 1.1361-4(a)(2) (as amended in 2014).

29. I.R.C. § 1361(b)(3)(A) (2012).

30. *Id.* § 1361(b)(3)(B).

31. *Id.* § 1361(b)(3)(C).

32. Treas. Reg. §§ 1.1361-5(a)(ii) (as amended in 2000), 1.1362-2(b) (as amended in 2002).

IRS.[33] If the QSub election is terminated the corporation may not elect to be a QSub or S Corporation for five years unless the Secretary of the IRS consents to the election.[34]

B. *Subchapter S Entities in Bankruptcy*

The nature of Subchapter S entities creates certain complications in bankruptcy proceedings. The shareholders and the debtor company in bankruptcy are no longer aligned in their interests. The company wants to hold onto its tax status in order to continue to pass the tax liability through to the shareholders while the shareholders would prefer to shift the tax liability back onto the debtor company. Whether a Subchapter S election is property of the debtor company's bankruptcy estate affects which party must pay the taxes.

1. Property of the Estate, the Automatic Stay, and Voidable Transfers

The filing of a petition immediately creates a bankruptcy estate under § 541 of the Bankruptcy Code.[35] This estate contains "all legal and equitable interests of the debtor in property" with some exceptions.[36] The property right must be in place at the commencement of the bankruptcy and not created later.[37] The Bankruptcy Code does not define "property" or "interests in property" but generally relies on the state law, unless federal law is controlling.[38] The Supreme Court has recognized that the scope of "property" is construed more generously for bankruptcy purposes than other contexts in order to "secure for creditors everything of value the bankrupt may possess."[39] In the 1978 revision to the Bankruptcy Code, Congress intended property of the estate to include even "contingent interests and future interests whether or not transferable by the debtor."[40]

A bankruptcy filing also automatically stays all parties from any action that might diminish the property of the estate.[41] The automatic stay in § 362 protects both creditors' and debtors' interests. By protecting creditors from any attempts by another party to remove prop-

33. *Id.* § 1.1361-3(b) (as amended in 2000).
34. I.R.C. § 1361(b)(3)(D) (2012).
35. 11 U.S.C. § 541 (2012).
36. *Id.* § 541(a)(1).
37. *Id.*; Bracewell v. Kelley (*In re* Bracewell), 454 F.3d 1234, 1241–42 (11th Cir. 2006) ("If an interest is not property on the date a case is filed, it is not covered.").
38. Nobelman v. Am. Sav. Bank, 508 U.S. 324, 329 (1993).
39. Segal v. Rochelle, 382 U.S. 375, 379 (1966) ("Whether an item is classed as 'property' by the Fifth Amendment's Just-Compensation Clause or for purposes of a state taxing statute cannot decide hard cases under the Bankruptcy Act, whose own purposes must ultimately govern.").
40. H.R. Rep. No. 95-595, at 175–76 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6136.
41. 11 U.S.C. § 362(a) (2012).

erty from the estate, the stay retains the creditors' potential satisfaction of claims.[42] The debtor is afforded protection because the stay prohibits any collection efforts or enforcements of judgments against the debtor.[43] Willful violation of the stay can result in both actual and punitive damages.[44] Most United States Circuit Courts including the Third Circuit, consider any act in violation of the stay to be void *ab initio*, regardless of the reason for the transfer.[45]

The Bankruptcy Code gives additional avoidance powers to the trustee to protect the estate from unlawful transfers.[46] A transfer includes: "each mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with (i) property; or (ii) an interest in property."[47] The Bankruptcy Code allows the trustee to avoid a transfer of property from the debtor's estate that occurs within two years *before* the filing of a bankruptcy under § 548 if the transfer was made to "hinder, delay or defraud" creditors.[48] The trustee may avoid any transfer that occurs *after* the commencement of the bankruptcy if the transfer is made without permission from the court under § 549.[49] An avoidable pre- or post-petition transfer may be recovered at the trustee's discretion.[50]

2. Discharge of Indebtedness Income

The discharge of debt received in bankruptcy may result in a higher tax liability for the debtor because the discharge actually increases the taxpayer's wealth. Under the IRC, "income from discharge of indebtedness" must be reported as gross income,[51] which is "all income from whatever source derived, unless excluded by law."[52]

The IRC and Treasury Regulations provide some situations where income from discharge of indebtedness can be excluded from gross income.[53] For example, discharge of indebtedness of the taxpayer is not included in gross income "if the discharge occurs in a title 11 [bankruptcy] case . . . ."[54] To qualify for this exclusion, the taxpayer must be "under the jurisdiction of the court" and the discharge must be "granted by the court or . . . pursuant to a plan approved by the

42. *Id.* § 362(a)(2)–(5) (stay as applied to the property of the estate).
43. *Id.* § 362(a)(1)–(2), (6)–(8) (stay as applied to the debtor).
44. *Id.* § 362(k)(1).
45. Mar. Elec. Co. v. United Jersey Bank, 959 F.2d 1194, 1206–07 (3d Cir. 1991).
46. 11 U.S.C. §§ 548(a)(1), 549(a) (2012).
47. *Id.* § 101(54) (stating that transfers also include the creation of a lien, the retention of title as a security interest, and the foreclosure of a debtor's equity of redemption).
48. *Id.* § 548(a)(1)(A).
49. *Id.* § 549(a).
50. *Id.* § 550(a).
51. I.R.C. 61(a)(12) (2012).
52. Treas. Reg. § 1.61-1 (1960).
53. I.R.C. § 108; Treas. Reg. § 1.61-12(b) (as amended in 1997).
54. I.R.C. § 108(a)(1)(A).

court."[55] The taxpayer must pay a price for this exclusion of income.[56] A number of the taxpayer's tax attributes that could be used to offset future income, including net operating losses and other carryovers, must be decreased by the amount of the excluded income.[57]

3. The Modern Trend of Including Subchapter S Elections in the Property of the Estate

Until recently, courts have held that a trustee can avoid the revocation of S Corporation tax status whether the revocation was pre-petition or post-petition because the election was property of the S Corporation's bankruptcy estate.[58] These rulings allowed the debtor companies to retain their tax elections and continue to pass the tax liability through to the shareholders.

In *In re Bakersfield Westar, Inc.*, the shareholders revoked a company's S Corporation status two weeks before the company filed for Chapter 7 bankruptcy.[59] The revocation would have shifted the capital gains associated with the liquidation of the company from the shareholders to the debtor company thereby decreasing the property available to creditors.[60] The trustee—complaining that this was a fraudulent transfer intended "to hinder, delay and defraud the creditors"—sought to avoid the transfer, arguing that an election to be an S Corporation was a "valuable property right."[61] The IRS argued that the tax status was not a property interest because it had no present value.[62] The Bankruptcy Appellate Panel of the Ninth Circuit disagreed, holding that a quantifiable present value is not a requirement for the existence of an interest in property.[63] The pre-petition revocation was an avoidable transfer of property of the estate under § 548(a).[64]

An S Corporation's revocation of its tax status after the commencement of the bankruptcy was void for violating the stay and voidable as a post-petition transfer in *In re Walterman Implement Inc.*[65]

55. *Id.* § 108(d)(2).
56. Grant W. Newton & Robert Liquerman, Bankruptcy and Insolvency Taxation 81 (4th ed. 2012).
57. I.R.C. § 108(b) (2012).
58. Thomas E. Taylor & Douglas W. Charnas, *Can a Bankruptcy Trustee Avoid an Election to be Treated as a Corporation?*, 117 J. Tax'n 77, 91–97 (2012); Parker v. Saunders (*In re* Bakersfield Westar, Inc.), 226 B.R. 227 (B.A.P. 9th Cir. 1998) (rejecting a pre-petition revocation); Hanrahan v. Walterman (*In re* Walterman Implement, Inc.), Bankr. No. 05-07284, 2006 WL 1562401 (Bankr. N.D. Iowa 2006) (rejecting a post-petition revocation).
59. *In re Bakersfield Westar, Inc.*, 226 B.R. at 229.
60. *Id.* at 229.
61. *Id.* at 229–30.
62. *Id.* at 232.
63. *Id.* at 232–33.
64. *Id.* at 236.
65. Hanrahan v. Walterman (*In re* Walterman Implement, Inc.), Bankr. No. 05–07284, 2006 WL 1562401, at *4 (Bankr. N.D. Iowa May 22, 2006).

Walterman, the president and major shareholder of Walterman Implement, Inc., revoked the company's S Corporation election a few weeks after the creditors filed an involuntary petition for bankruptcy.[66] In a motion for summary judgment, the trustee contended that the revocation violated the automatic stay and was voidable as a post-petition transfer.[67] Walterman argued that the trustee lacked standing to rescind the revocation because if "the corporation can not rescind the revocation without shareholder consent, neither can the Trustee."[68] Relying on dicta from its bankruptcy appellate panel, the bankruptcy court recognized a debtor corporation's property interest in its Subchapter S election and granted the trustee's motion.[69]

4. The Seminal Case: *In re Trans–Lines West, Inc.*

Both *Bakersfield Westar* and *Walterman Implement* rely on the seminal decision in *In re Trans–Lines West, Inc.* where a Tennessee bankruptcy court first decided that an S Corporation election was property of the debtor company's estate.[70] The debtor's sole shareholder elected to revoke the S Corporation election a month before filing for bankruptcy under Chapter 11.[71] The trustee initiated an adversary proceeding arguing that the revocation was voidable as a fraudulent transfer under § 548.[72]

Noting that "property is nothing more than a collection of rights," the court reasoned that tax status is property because, under federal law, an S Corporation has the "right to use, enjoy, and dispose of that status."[73] The right to use and enjoy the tax status is guaranteed and protected by I.R.C. § 1362(c), and the right to dispose of the tax status is guaranteed and protected by I.R.C. § 1362(d)(1)(A).[74]

The court then stated that the tax status revocation was a transfer of property by comparing the revocation to an election to carry forward net operating losses ("NOLs").[75] An NOL is "the excess of the deductions allowed . . . over gross income" in a particular year.[76] These losses may be deducted from the taxpayer's income in other taxable

66. *Id.* at *1.
67. *Id.*
68. *Id.* at *1, *3.
69. *Id.* at *3–4 (relying on Halverson v. Funaro (*In re* Frank Funaro, Inc.), 263 B.R. 892, 898 (B.A.P. 8th Cir. 2001)).
70. Parker v. Saunders (*In re* Bakersfield Westar, Inc.), 226 B.R. 227, 233 (B.A.P. 9th Cir. 1998); *In re Walterman Implement Inc.*, Bankr. No. 05–07284, 2006 WL 1562401, at *3; Guinn v. Lines (*In re* Trans–Lines West, Inc.), 203 B.R. 653, 662 (Bankr. E.D. Tenn. 1996).
71. *In re Trans–Lines West, Inc.*, 203 B.R. at 656.
72. *Id.*
73. *Id.* at 661–62.
74. *Id.*
75. *Id.* at 662.
76. I.R.C. § 172(c) (2012).

years resulting in a lower tax liability.[77] NOLs can be carried back up to two years to be deducted against past income to generate tax refunds or carried forward up to twenty years to offset future income.[78] Once made, elections to carry back or carry forward an NOL are irrevocable.[79]

In determining whether a transfer occurred, the court relied on the analysis of NOLs in *In re Russell*.[80] In *Russell*, the debtor made elections before and after filing for bankruptcy under Chapter 11 to carry forward NOLs.[81] This prevented the trustee from carrying back the NOLs and applying them to previous years' income in order for the estate to receive a tax refund.[82] The *Russell* court held that NOLs were property of the estate and that an election to carry forward the NOLs was a transfer because it took away the estate's right to carry back the NOLs.[83] Even though the NOL carry-forward elections were irrevocable, the trustee could avoid the elections.[84] Since this effect of NOLs on a taxpayer's liability is similar to the effect of revoking the Subchapter S election and because the carry-forward of the NOL was considered a transfer, the *Trans–Lines* court concluded that the revocation of the S Corporation's tax status was also a transfer.[85]

III. THE *MAJESTIC* VACATION

The general consensus regarding the inclusion of a Subchapter S entity's tax status in the bankruptcy estate has recently been challenged by *In re Majestic Star Casino, LLC*.[86] The Bankruptcy Appellate Panel of the Ninth Circuit and bankruptcy courts in the Sixth and Eighth Circuits have all held that an S Corporation tax election is property of the corporation's bankruptcy estate, but no court had addressed the tax election of a qualified Subchapter S subsidiary until *Majestic Star*.[87] In this case of first impression, the Third Circuit Court of Appeals vacated the lower bankruptcy court's ruling and held that

77. *Id.* § 172(a).

78. *Id.* § 172(b)(1)(A).

79. *Id.* § 172(b)(3).

80. *In re Trans–Lines West, Inc.*, 203 B.R. at 662; *see* Gibson v. United States (*In re* Russell), 927 F.2d 413 (8th Cir. 1991).

81. *In re Russell*, 927 F.2d at 414–15.

82. *Id.* at 415.

83. *Id.* at 417–18.

84. *Id.* at 417. The case was remanded to determine if the post-petition transfer was in ordinary course of business and if the pre-petition transfer was made with intent to hinder, delay, or defraud. *Id.* at 418–19.

85. *In re Trans–Lines West, Inc.*, 203 B.R. at 663.

86. Majestic Star Casino, LLC v. Barden Dev., Inc. (*In re* Majestic Star Casino, LLC), 716 F.3d 736, 741–42 (3d Cir. 2013).

87. Parker v. Saunders (*In re* Bakersfield Westar, Inc.), 226 B.R. 227, 234 (B.A.P. 9th Cir. 1998); *In re Trans–Lines West, Inc.*, 203 B.R. at 662; Hanrahan v. Walterman (*In re* Walterman Implement, Inc.), Bankr. No. 05–07284, 2006 WL 1562401, at *3 (Bankr. N.D. Iowa May 22, 2006); *In re Majestic Star Casino, LLC*, 716 F.3d at 759–60.

the tax status of a QSub entity was not property of the bankruptcy estate.[88] In reaching this conclusion, the court also held that S Corporation tax status was not a property right.[89] This ruling was significant because it allowed the owner of a debtor company to shift the tax liability that would normally pass through to the owner back onto the debtor company, decreasing the amount of property available to creditors.

A. *The Bankruptcy of Majestic Star Casino, LLC*

Majestic Star Casino, LLC was a holding company for Majestic Star Hotels and Casinos that operated in Indiana, Colorado, Mississippi, and Nevada and was formerly owned by Detroit businessman, Don Barden.[90] In November 2009, the holding company along with some affiliates and subsidiaries ("Debtors") filed a voluntary petition for Chapter 11 bankruptcy citing increased competition, the recession, and a recent smoking ban.[91] One of the Debtors, Majestic Star Casino II, Inc. ("MSC II"), was a qualified subsidiary of Barden Development Inc. ("BDI"), an S Corporation, of which Don Barden was the sole shareholder.[92] As a QSub, MSC II did not exist for tax purposes, but all its assets and liabilities and any profits or losses belonged to its parent company, BDI. However, BDI's profits and losses passed through directly to Barden due to BDI's S Corporation status. Therefore, Barden, through BDI, owned and controlled MSC II and was liable for any taxes related to MSC II's income.

After filing for bankruptcy both BDI and MSC II initially retained their tax elections. However, the automatic stay would have prevented Barden from using any assets of MSC II to pay taxes related to MSC II's income.[93] In an attempt to avoid this tax liability and without permission from the bankruptcy court, Barden successfully petitioned the IRS to revoke the S Corporation status of BDI.[94] The revocation of the S Corporation status prevented BDI's profits and losses from passing through to Barden. MSC II's QSub status disappeared because it was dependent on BDI existing as an S Corporation. There-

88. *In re Majestic Star Casino, LLC*, 716 F.3d at 758–59, 763–64.

89. *Id.* at 758.

90. Nick Bunkley, *Don Barden, 67, a Success in Cable TV and Casinos*, N.Y. TIMES, May 20, 2011, at B12, *available at* http://www.nytimes.com/2011/05/20/business/20barden.html; *In re Majestic Star Casino, LLC*, 716 F.3d at 742.

91. *Competition Factor in Majestic Star Bankruptcy*, CASINO CITY TIMES (Sept. 21, 2010), http://www.casinocitytimes.com/news/article/competition-factor-in-majestic-star-bankruptcy-195054.

92. *In re Majestic Star Casino, LLC*, 716 F.3d at 742. MSC II was a subsidiary of BDI through two other wholly owned intermediate subsidiaries. Thus, MSC II was owned by The Majestic Star Casino, LLC, which was owned by Majestic Holdco, LLC, which was owned by BDI. *Id.* at 742 n.5.

93. *See* 11 U.S.C. § 362(a)(3) (2012).

94. *In re Majestic Star Casino, LLC*, 716 F.3d at 743–44.

fore, BDI and MSC II became separate C Corporations responsible for their own taxes effective January 2010.[95]

MSC II was not able to properly plan for this tax liability because it did not find out about this change until mid July 2010.[96] The company also had to pay a state income tax of $2.26 million to the Indiana Department of Revenue, which would not have occurred under its former tax status.[97]

In December 2010, the Debtors filed an adversary complaint arguing that MSC II's QSub status was property of the bankruptcy estate and that the revocation of BDI's S Corporation status was a post-petition transfer of estate property. The Debtors claimed that this post-election transfer was void for violating the automatic stay under § 362 and was voidable and recoverable under §§ 549-550 by the Debtors.[98] The Debtors requested an order to the IRS and the State of Indiana to reinstate BDI's S Corporation status and MSC II's QSub status.[99] The bankruptcy court ruled in favor of the Debtors and granted the order.[100]

B. *Appeal to the Third Circuit*

On appeal, the Third Circuit struck out into new territory by vacating the lower court's ruling that the bankruptcy court had no jurisdiction over the matter.[101] The Debtors did not have standing to bring the case because the QSub tax status was not property of the bankruptcy estate.[102]

The Third Circuit was troubled by a number of inequities resulting from the lower court's decision: (1) Barden would have owed taxes on income he did not receive;[103] (2) the IRS would not have received a priority payment as an administrative expense;[104] (3) Barden's rights as a shareholder and BDI's rights as a parent company would have been severely restricted;[105] and (4) neither BDI nor Barden would have been able to take advantage of the exception for income from discharge of debt while MSC II benefited from the discharge.[106]

The court noted three elements that must be found to determine whether a revocation of a Subchapter S tax election was void or avoidable: (1) Is the tax election property?; (2) If it is property, is this prop-

95. *Id.* at 744.
96. *Id.*
97. *Id.*; IND. CODE ANN. § 6-3-2-2.8(2) (West 2013).
98. *In re Majestic Star Casino, LLC*, 716 F.3d at 745.
99. *Id.*
100. *Id.*
101. *Id.* at 763–64.
102. *Id.* at 763.
103. *Id.* at 746.
104. *Id.*
105. *Id.* at 760.
106. *Id.* at 745–46.

erty part of the bankruptcy estate?; and (3) Is the revocation an avoidable transfer of property?[107] The *Majestic Star* court reasoned that both S Corporation and QSub elections are not property and, even if they were, this property would not be part of the bankruptcy estate because an S Corporation election would belong to the shareholders, and a QSub election would belong to its parent S Corporation.[108] The court did not consider the third element because the first two were not satisfied.[109]

IV. Subchapter S Tax Elections Should be Property of the Estate

Despite this recent anomaly in *Majestic Star*, the modern trend to include S Corporation tax elections in the property of the estate properly applies the relevant law and should also extend to QSubs. The arguments set forth by the *Majestic Star* court do not reflect most courts' generous construal of property rights for bankruptcy purposes. This Section will examine these tax elections to demonstrate that they exhibit the nature of property interests and belong to the debtor company.

A. *A Better Comparison:* In re Dittmar

The Third Circuit stated that "[t]he *Trans-Lines West* decision and those that follow it base their conclusion that S-Corp status is property on a series of precedents holding net operating losses . . . to be property."[110] The court limited its analysis of the property nature of Subchapter S election by requiring these elections to reflect the nature of NOLs.[111]

However, neither *Trans-Lines* nor *Bakersfield Westar* compares S Corporation elections to NOLs to determine whether the tax elections were "property." Rather, having already established that the elections were property, the courts have used the comparisons to argue that the revocation of an S Corporation tax election was a "transfer of property" just like carrying forward a NOL was a transfer of property.[112] *Trans-Lines* used the comparison to argue that even though the carry-back or -forward of an NOL and the revocation of an S Corporation election were irrevocable under the IRC, they were still transfers because both resulted in an increase in tax liability of the

107. *Id.* at 750; 11 U.S.C. § 549(a) (2012).
108. *In re Majestic Star Casino, LLC*, 716 F.3d at 758–59, 762.
109. *Id.* at 750.
110. *Id.* at 753 (internal quotation marks omitted).
111. *Id.* at 754–56.
112. Guinn v. Lines (*In re* Trans–Lines W., Inc.), 203 B.R. 653, 662–63 (Bankr. E.D. Tenn. 1996); Parker v. Saunders (*In re* Bakersfield Westar, Inc.), 226 B.R. 227, 234–36 (B.A.P. 9th Cir. 1998).

companies.[113] Therefore, the Third Circuit in *Majestic Star* did not fully and adequately address the nature of property rights regarding S Corporation elections, but incorrectly assumed that the S Corporation election must be of the same nature as NOLs to be property. Even though a comparison between NOLs and Subchapter S tax elections is not necessary to determine the property nature of the tax elections, this comparison will still be analyzed to demonstrate other weaknesses in the *Majestic Star* court's arguments.

A better application of the broad construal of property rights in bankruptcy context can be found in *In re Dittmar*, where the Tenth Circuit held that stock appreciation rights ("SARs") created by a collective bargaining agreement were property of the bankruptcy estate.[114] Similar to stock options, SARs are a form of employee compensation in which employees are rewarded based on the future growth of the company.[115] The company gives the employees SARs and promises that once the company meets certain goals spelled out in the SAR plan, it will pay the employees a cash bonus or stock based on the appreciation of the company's value.[116] These rights in *Dittmar* show a comparable degree of contingency, indeterminable valuation, lack of debtor control and transferability to S Corporation and QSub tax elections.

B. *Contingency and Valuation of Subchapter S Elections*

The Third Circuit focused on the contingency and valuation of S Corporation elections by comparing them to NOLs to argue that they are not property. Extending the property interest of NOLs to S Corporation status as in *Trans-Lines* "fail[s] to consider important differences between the two putative property interests."[117] An NOL is different from an S Corporation election because the tax status is "entirely contingent on the will of the shareholders" while NOLs are "hardly contingent at all."[118] An NOL also has a determinable value while the value of an S Corporation election is "dependent on its not being revoked, as well as the amount and timing of future earnings."[119]

The Supreme Court has held that an interest is not outside the scope of property simply because "it is novel or contingent or because enjoyment must be postponed."[120] The Third Circuit has even held

113. *In re Trans–Lines W., Inc.*, 203 B.R. at 663.
114. Parks v. Dittmar (*In re* Dittmar), 618 F.3d 1199, 1209–10 (10th Cir. 2010).
115. *See* Stuart R. Cohn, *Stock Appreciation Rights and the SEC: A Case of Questionable Rulemaking*, 79 COLUM. L. REV. 66, 70–73 (1979).
116. *See id.*; *In re Dittmar*, 618 F.3d at 1204.
117. Majestic Star Casino, LLC v. Barden Dev., Inc. (*In re* Majestic Star Casino, LLC), 716 F.3d 736, 755 (3d Cir. 2013).
118. *Id.*
119. *Id.* at 755–56.
120. Segal v. Rochelle, 382 U.S. 375, 379 (1966).

that the "mere 'opportunity' to receive an economic benefit in the future" is property of the estate.[121] The court's ruling in *Majestic Star* does not reflect this principle it claims to hold. The court argues that an S Corporation election is not property because it is entirely contingent on the will of the shareholders while a carried-back NOL is "hardly contingent at all."[122] Here, the court makes an error in its comparison—the contingency of the NOL is whether the company will benefit from it, which the court notes is very likely. The court should have compared this to the likelihood of benefitting from the tax election. The contingency of whether the S Corporation status will continue or be revoked is simply a factor of this benefit, not the contingency that should be directly compared to NOLs. In fact, the likelihood that an S Corporation will benefit from its tax status is very high, even if it might possibly be taken away in a revocation. A pass-through election benefits the company every time it should pay a corporate tax because its income is not subject to double taxation at the federal and, in most cases, state levels.[123]

A Subchapter S election is no more contingent or indeterminable in value than a SAR. The value of a SAR is dependent on the "amount and timing of future earnings" just as is the value of a Subchapter S election.[124] Even though the potential for gain exists, there is no guarantee that the company will succeed in meeting these goals, so the employees could possibly never benefit from their SARs. Payment of the SARs in *Dittmar* was dependent on whether the "company completed an IPO, sale or merger."[125] The right was also contingent on the continued employment of the employee, which is not entirely under the employee's control.[126] Just as an S Corporation election is terminable "at will" by the shareholders,[127] a SAR is terminable if the employer fires or lays off the employee. Despite these contingencies, the *Dittmar* court held that SARs are property by reasoning that the suggestion "that a contingent interest cannot become property of the bankruptcy estate unless the contingency is entirely in control of the interest holder . . . amounts to nothing more than a statement that

121. Pension Transfer Corp. v. Beneficiaries Under the Third Amendment to Fruehauf Trailer Corp. Ret. Plan No. 003 (*In re* Fruehauf Trailer Corp.), 444 F.3d 203, 211 (3d Cir. 2006) (quoting Mellon Bank, N.A. v. Official Comm. of Unsecured Creditors of R.M.L., Inc. (*In re* R.M.L., Inc.), 92 F.3d 139, 148 (3d Cir. 1996)).

122. *In re Majestic Star Casino, LLC*, 716 F.3d at 755.

123. I.R.C. § 1363(a) (2012); James A. Amdur, Annotation, *State Income Tax Treatment of S Corporations and Their Shareholders*, 118 A.L.R. 5th 597, 618 § 2[a] (2004).

124. Cohn, *supra* note 115, at 70–71; *In re Majestic Star Casino, LLC*, 716 F.3d at 756.

125. *In re* Lowe, 380 B.R. 251, 254 (Bankr. D. Kan. 2007), *aff'd on other grounds*, Parks v. Dittmar (*In re* Dittmar), 410 B.R. 71 (B.A.P. 10th Cir. 2009), *rev'd*, 618 F.3d 1199 (10th Cir. 2010).

126. *In re* Dittmar, 618 F.3d at 1208.

127. *In re Majestic Star Casino, LLC*, 716 F.3d at 756.

virtually no contingent interest can be property of the bankruptcy estate."[128]

C. *Control, Alienability, and Assignability of Subchapter S Elections*

The *Majestic Star* court noted three other characteristics of S Corporation elections and QSub elections that attempt to further exclude these elections outside the scope of property. An S Corporation has little control over its tax status, but a QSub has even less control; it is dependent upon both the S Corporation's decision to keep the election and continuance of its S Corporation status.[129] S Corporation and QSub status are also not property rights because they are not "readily alienable and assignable" and therefore could not be sold to produce funds for creditors of the estate.[130] The court concluded that a "tax classification [such as a Qsub] over which the debtor has no control and that is not alienable or assignable" is not a property interest of the debtor.[131]

Majestic Star's strongest argument is in regards to the debtor company's control of its QSub tax election. An S Corporation is not fully out of the control of its election. Just as the beneficiaries of the SARs in *Dittmar* could only dispose of the property once the company met specified goals,[132] an S Corporation can only dispose of its election at any time by submitting a revocation letter to the IRS with consent from a majority of shareholders.[133] But a QSub has even less control than an S Corporation over its tax status, as it can only be created or revoked by the parent S Corporation or through actions of the S Corporation shareholders.[134] The election to be a QSub must be made by an officer of the parent S Corporation.[135] Nevertheless, this should not be determinative of whether it is an interest in property but is merely one factor to be considered.[136]

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128. *In re Dittmar*, 618 F.3d at 1208.
129. *In re Majestic Star Casino, LLC*, 716 F.3d at 758.
130. *Id.* at 756 n.21, 758.
131. *Id.* at 758.
132. *See supra* text accompanying note 124.
133. Treas. Reg. § 1.1362-6(a)(3)(i) (as amended in 2002).
134. *In re Majestic Star Casino, LLC*, 716 F.3d at 758.
135. Treas. Reg. § 1.1361-3(b) (as amended in 2000); *see* I.R.S. Form 8869 Qualified Subchapter S Subsidiary Election (Rev. Dec. 2008), *available at* http://www.irs.gov/pub/irs-pdf/f8869.pdf.
136. The First Circuit reasoned that "transferability, pecuniary value, control, enjoyment—should be treated as among the relevant considerations in a highly fact-specific inquiry" when discussing factors considered in *Drye v. United States*, 528 U.S. 49 (1999) to assess the nature of property for tax liens. United States v. Murray, 217 F.3d 59, 63 (1st Cir. 2000). The determination of property for bankruptcy purposes should be at least as broad, if not broader, than the determination of property for tax purposes.

The final factors addressed by the *Majestic Star* court are alienability and assignability of S Corporation and QSub statuses. Subchapter S elections by nature are not transferable or assignable by the debtor *or* by the trustee to raise funds for the estate.[137] The Third Circuit argued that a right should not be property of the estate if it is "dubious, as a practical matter, that any potential buyers would actually bid for the right."[138] SARs are also not generally transferable or assignable by the owner,[139] and it is unlikely that the trustee of a debtor employee would be able to find any potential buyers because payment of the SAR is contingent on both the growth of the employer's business and the continued employment of the employee.[140] Just as SARs in *Dittmar* brought value to the estate even though the trustee would not have been able to sell them, the inalienable and unassignable QSub status of MSC II brought value to its bankruptcy estate. The Third Circuit should not restrict its definition of property of the estate in this way when an interest still brings value to the estate even though no one would purchase it.

D. *Subchapter S Elections are Property of the Debtor Company's Estate*

While a Subchapter S election may not be fully-owned property of the debtor company, it is a property interest of the company because it creates an economic benefit to the company by preventing taxation at the corporate level, thereby providing funds to creditors in bankruptcy.

Even if the tax status of a QSub were property, the court argued that this property would not be part of the bankruptcy estate because it would be property of the parent S Corporation.[141] Looking at the relationship between shareholders and S Corporations, the court noted that the "flow-through" treatment of S Corporations indicates that any ownership rights would be held by the shareholders.[142] An S Corporation "retains no real benefit from its tax-free status in that, while there is no entity-level tax, all of its pre-tax income is passed on to its shareholders."[143] Similarly, since a QSub is a disregarded entity that does not exist for tax purposes but is deemed to be part of the parent S Corporation, it would be the S Corporation that has any ownership right.[144]

137. *In re Majestic Star Casino, LLC*, 716 F.3d at 756 n.21, 758.
138. *Id.* at 758 (citing Westmoreland Human Opportunities, Inc. v. Walsh, 246 F.3d 233, 250 (3d Cir. 2001)).
139. Cohn, *supra* note 115, at 70.
140. *See supra* text accompanying notes 124–25; Robert Anderson IV, *Employee Incentives and the Federal Securities Laws*, 57 U. MIAMI L. REV. 1195, 1211 (2003).
141. *In re Majestic Star Casino, LLC*, 716 F.3d at 759–60.
142. *Id.* at 759.
143. *Id.*
144. *Id.* at 759–60.

As noted above, Congress created Subchapter S in order to benefit both individual shareholders *and small corporations*.[145] The *Majestic Star* court was inaccurate and misleading to say that a pass-through corporation "retains no real benefit" of its tax election while downplaying the benefit of no corporate tax at the entity level.[146] The court also incorrectly presented the question of who has a right to this QSub election as an either/or option; either it is property of the QSub or property of the S Corporation. Yet the ruling of the lower bankruptcy court was that MSC II had a "property interest in its QSub status."[147] This does not mean that the parent S Corporation or the shareholders cannot also have a property interest in it.

V. Practical Implications and Inequities

The *Majestic Star* court did not rely solely on statutory and case analysis in forming its decision, but expressed concern about a number of implications and inequities caused by the lower court's ruling.[148] Some of these concerns are legitimate, but others are not as significant as the court presents and could have been remedied another way. The court's decision refused to alleviate inequities towards MSC II and its creditors. The *Majestic Star* court failed to demonstrate that the alleged inequities resulting from the bankruptcy court's order outweighed the inequities allowed by the Third Circuit.

A. *Tax Liability with No Access to Income and Administrative Expenses*

While in bankruptcy, the tax liability for MSC II passed through to BDI and Barden, who had no access to the company's income to pay the taxes. The court emphasized this inequity since taxes are usually "paid by those who derive some benefit from income."[149] The IRS generally recovers taxes from the property of the estate as administrative expenses before most other claims.[150] But if the pass-through tax status had remained in place, the court noted that the IRS would have lost its priority position and would have had to look for payment from Barden, who had no access to the income of the company.[151]

145. *See supra* Section II.A.

146. *In re Majestic Star Casino, LLC*, 716 F.3d at 759. The Debtors argued that MSC II was actually not benefitting Barden at all, which is why he elected for the company to enter bankruptcy. Brief for Debtors-Appellees at 36–37 *In re* Majestic Star Casino, LLC, 716 F.3d 736 (3d Cir. 2013) (No. 12-3200, 12-3201), 2012 WL 6813041 at *36–37.

147. Majestic Star Casino, LLC v. Barden Dev., Inc. (*In re* Majestic Star Casino, LLC), 466 B.R. 666, 676 (Bankr. D. Del. 2012), *vacated*, 716 F.3d 736 (3d Cir. 2013).

148. *See supra* Section III.B.

149. *In re Majestic Star Casino, LLC*, 716 F.3d at 757.

150. 11 U.S.C. §§ 503(b)(1)(B), 507(a)(2) (2012).

151. *In re Majestic Star Casino, LLC*, 716 F.3d at 746.

The court is right to consider this concern, yet the Debtors noted in their appellate brief that even the IRS has presented conflicting opinions regarding the tax liability of pass-through entities in bankruptcy.[152] In *In re Harbor Village Development*, the IRS actually defended the position that the tax liability of a partnership in bankruptcy should pass through to the partners, even though the partners could not access funds in the partnership to pay the taxes.[153] Yet the IRS, in its brief for *Majestic Star*, emphasized the inequitable results for Barden due to maintaining BDI's S Corporation status.[154] The *Majestic Star* court should not have decided whether Subchapter S elections were property of the estate based on this inequitable outcome, especially relying on the inconsistent opinion of the IRS.

Furthermore, considering this tax election to be a property interest of the estate does not necessarily result in this complication. Even if the tax election was included in the bankruptcy estate, the judge of the bankruptcy court still had authority to allow the revocation if Barden had requested it.[155] By ruling that the tax election is not property of the estate, the Third Circuit has completely removed the judge's discretion to determine whether the revocation should occur.

Based on the prior case law, Barden should have known that he might have to pay taxes for the company if it entered bankruptcy. This can be illustrated by another instance where a taxpayer does not have access to income from a pass-through company. For example, even though a pass-through entity may receive income resulting in a tax liability, it does not necessarily distribute funds to the owners to cover the liability.[156] Except when there is a shareholder or partnership agreement in place to require this distribution, shareholders and partners should expect that a distribution might not occur and that they would need to arrange to pay the liability from other funds.[157] Likewise, Barden should have been aware enough of the tax implications for Subchapter S entities enough to prepare for the likely tax liability without access to the company's income. In fact, the Debtors also argued that Barden was fully aware of the potential for tax liability in bankruptcy because MSC II had entered into a secured agree-

152. Brief for Debtors-Appellees, *supra* note 146, at 34.

153. *Id.* at 34–35 (citing *In re* Harbor Vill. Dev., 94-1188-JNF, 1994 WL 774514 (Bankr. D. Mass. Nov. 28, 1994)).

154. Brief for Appellant United States of America, at 31–32 *In re* Majestic Star Casino, LLC, 716 F.3d 736 (3d Cir. 2013) (No. 12-3200, 12-3201), 2012 WL 5893859 at *31–32 ("The inequities in the *Trans-Lines West* line of cases apply with equal force to this case.").

155. *See* Manges v. Seattle-First Nat'l Bank (*In re* Manges), 29 F.3d 1034, 1037 n.4 (5th Cir. 1994); Taylor & Charnas, *supra* note 58, at 96.

156. In this case, "MSC II was under no contractual obligation to make tax distributions to Barden." Brief for Debtors-Appellees, *supra* note 146, at 3.

157. *In re* Cumberland Farms, Inc., 162 B.R. 62, 65 (Bankr. D. Mass. 1993).

ment with creditors to prevent any distributions of income to Barden in the event of default.[158]

B. *Rights of the Shareholders Restricted*

The court also argued that "rights statutorily granted to shareholders to control the tax status of the entity they own" should not be overridden by such a "capacious" definition of property.[159] Inclusion of the QSub status in the property of the estate would place "remarkable restrictions on rights of the parent," preventing them from: (1) voluntarily terminating the QSub status or its own S Corporation status; (2) selling subsidiary shares to any purchasers other than a S Corporation; or (3) selling the parent to a C Corporation, non resident, or to more than 100 shareholders.[160] Exercising any of these statutory rights would have terminated MSC II's QSub status, but these rights would have been unfairly taken away had the court prevented the revocation.

The court's label of "statutory rights" regarding selling shares is somewhat misleading. The purpose of § 1361 is not to grant shareholders a right to sell their shares but to place restrictions on whom shares can be sold to if the company wants to retain its tax election.[161] The only statutory right actually granted by the IRC and regulations is the right to terminate the tax elections.[162] This "inequity" is not very significant because it is not likely that anyone would have bought shares of MSC II while it was in bankruptcy, especially when the creditors were taking over as equity holders. In fact, the secured credit agreement prevented Barden from selling any MSC II shares to anyone other than Majestic Star LLC or its subsidiaries.[163] When the statute creating Subchapter S elections is designed to restrict the actions of shareholders,[164] and when a Subchapter S entity is in the context of the restrictive proceedings of bankruptcy, owners of the company should anticipate that they might be limited in their actions.

C. *The Bankruptcy Court's Order*

The Third Circuit was correct that the order of the bankruptcy court created some complications by causing the company to emerge from

158. Brief for Debtors-Appellees, *supra* note 145, at 35–36.
159. Majestic Star Casino, LLC v. Barden Dev., Inc. (*In re* Majestic Star Casino, LLC), 716 F.3d 736, 757 (3d Cir. 2013).
160. *Id.* at 760.
161. I.R.C. § 1361 (2012). Shareholders already have the right to sell their shares regardless of § 1361.
162. *Id.* § 1362; Treas. Reg. § 1.1361-3(b) (as amended in 2000).
163. Brief for Debtors-Appellees, *supra* note 145, at 3.
164. August, *supra* note 24, at 322. The requirement of one class of stock prevents a "liquidation or distribution preference to any shareholder" and limits buy-sell agreements, agreements to restrict the transferability of stock, and cross purchase and redemption agreements. *Id.* at 298.

bankruptcy as a QSub from the perspective of the IRS. This was due to an error in the timing and specificity of the order rather than an incorrect judgment on the nature of tax elections as property of the estate.

The *Majestic Star* court noted that if the QSub tax status continued "even after having emerged from bankruptcy," Barden would remain liable even though the unsecured creditors were the new equity holders in the company.[165] However, the Debtors were not trying to emerge from bankruptcy as a QSub, but they had in fact been permitted by the bankruptcy court to reform the company as an LLC in November 2011.[166] When the Debtors requested the court to order the tax elections to be reinstated in December 2010 and moved for summary judgment on the issue in March 2011, they had not yet become an LLC.[167] If the court had granted this motion at that point, the tax elections would have been reinstated, the tax liability would have shifted back to BDI, and then the QSub status would have been revoked when MSC II became an LLC.

By the time the court ruled on the Debtors' motion for summary judgment in January 2012, the effective date of the reorganization plan had passed and the Debtors had already become an LLC, taking an equity position in the company.[168] The bankruptcy court's order simply stated that the revocation of BDI's S Corporation status and the termination of MSC II's QSub status were void and of no effect and that the IRS should restore both statuses.[169] So from the perspective of the state, the company was a multi-member LLC; yet from the perspective of the IRS, the company was a QSub. The order should have specifically requested that the tax elections be reinstated from the effective date of the revocation up until the effective date of the formation of the LLC. This would have prevented the company from emerging from bankruptcy as a QSub for federal tax purposes.

The *Majestic Star* court also pointed out that if Barden had retained liability when the discharge occurred, then he would have been liable for $170 million of "cancellation of debt" (COD) income while not benefitting from the Title 11 Bankruptcy Exception.[170] The Title 11 Exception allows the taxpayer to write down any COD income from a bankruptcy, but it requires that the taxpayer be under the jurisdiction of the bankruptcy court.[171] Because MSC II was an LLC when the discharge occurred on the effective date of the plan, the income from discharge of debt should have been applied to the new equity holders

165. *In re Majestic Star Casino, LLC*, 716 F.3d at 746.
166. *Id.* at 744.
167. *Id.* at 745.
168. *Id.*
169. Majestic Star Casino, LLC v. Barden Dev., Inc. (*In re* Majestic Star Casino, LLC) 466 B.R. 666, 679 (Bankr. D. Del. 2012), *vacated*, 716 F.3d 736 (3d Cir. 2013).
170. *In re Majestic Star Casino, LLC*, 716 F.3d at 745–46.
171. *See supra* Section II.B.2.

who could have then used the Title 11 Exception. However, the order retroactively reinstated the tax elections without a termination date. From the perspective of the IRS, MSC II was a QSub when the discharge occurred. Therefore, the income from discharge of indebtedness passed through to BDI and Barden. Since neither BDI nor Barden were under the jurisdiction of the bankruptcy court, they could not take the exception, and MSC II could avoid the tax liability of the COD income and not suffer any of the negative consequences of the Title 11 Exception.[172]

This problem was also due to the error in the order, and was not caused by holding the QSub tax election to be property of the estate. The judge did not approve a plan that would intentionally allow the new equity holders to keep the QSub status after bankruptcy, but the timing and lack of clarity in the order created the complication. If the reinstatement of the QSub status had only been effective until the date of the LLC formation, then the new equity holders would have been able to take the Title 11 Exception along with the tax attribute reductions that come with it. The Third Circuit could have remanded the case back to the bankruptcy court to fix the error in the court's order to avoid these complications rather than vacating the judgment.

D. *Inequities Allowed by the* Majestic Star *Decision*

The *Majestic Star* decision also permitted other inequities. The Third Circuit acknowledged MSC II's concern that the revocation would create tax difficulties for the company,[173] but failed to recognize that these inequities outweighed the other issues on which the court focused. Since Barden revoked the S Corporation status of BDI without the bankruptcy court's approval, MSC II was unaware of the revocation until more than six months after the revocation was effective.[174] The company was not able to plan for $2.26 million in taxes owed to the State of Indiana or the federal income taxes that would be due for 2010.[175] The State of Indiana was unjustly enriched by receiving property of the bankruptcy estate that should not belong to it.[176] The lack of notice also led MSC II to file incorrect and late quarterly financial statements.[177] MSC II incurred late penalties and interest because the tax payments were not made.[178] MSC II had no reason to expect this unforeseen tax liability based on the fifteen years of bank-

172. *In re Majestic Star Casino, LLC*, 716 F.3d at 746.
173. *Id.* at 744.
174. *Id.*
175. *Id.*
176. Debtors' Adversary Complaint, at 7 *In re* Majestic Star Casino, LLC, 466 B.R. 666 (Bankr. D. Del. 2012) (No. 09bk14136), 2010 WL 6560660.
177. *Id*. at 6.
178. *Id.* at 7.

ruptcy law that had included Subchapter S elections in the property of the bankruptcy estate.

VI. Conclusion

The Third Circuit surprisingly took a break from the modern trend regarding the property nature of Subchapter S elections in bankruptcy. It remains to be seen whether the IRS will convince other circuits to follow the *Majestic* vacation. The protection of creditors of Subchapter S entities in bankruptcy is no longer clear.

Subchapter S elections should be property of a bankruptcy estate because they provide a debtor company with an economic benefit that can be used to satisfy the claims of creditors. The Third Circuit erroneously restricted its analysis of the property nature of these elections and did not adequately assess the resulting inequities. The court should have applied a generous construal of property rights to MSC II's QSub status, just as the Tenth Circuit did to SARs in *Dittmar*. Including these tax elections in a debtor company's bankruptcy estate properly interprets the law, protects creditors, and provides more discretion to bankruptcy courts to determine an equitable result.