Skadden

Skadden, Arps, Slate, Meagher & Flom LLP & Affiliates

If you have any questions regarding the matters discussed in this memorandum, please contact the following attorneys or call your regular Skadden contact.

Andre LeDuc
Washington, D.C.
202.371.7320
andre.leduc@skadden.com

Maxwell M. Miller
Chicago
312.407.0538
maxwell.miller@skadden.com

Steven J. Matays
New York
212.735.2372
steven.matays@skadden.com

Jennifer Y. Golden
Washington, D.C.
202.371.7331
jennifer.golden@skadden.com

Matthew J. Hofheimer
Chicago
312.407.0550
matthew.hofheimer@skadden.com

* * *

Four Times Square, New York, NY 10036
Telephone: 212.735.3000

WWW.SKADDEN.COM

Potential New Tax Planning Opportunities for Financially Distressed Pass-Through Entities

In a decision issued last week, the U.S. Court of Appeals for the Third Circuit held that a debtor's qualified subchapter S subsidiary (QSub) status is not property of the bankruptcy estate. The Third Circuit's opinion appears to break with previous cases that have expanded the tax attributes that qualify as property of the estate and are accordingly entitled to protection under the automatic stay. This decision could impact whether other favorable tax attributes of a debtor — such as an entity's check-the-box pass-through classification — are considered property of its bankruptcy estate. The decision appears to create potential new tax planning opportunities, although challenges may remain.

On May 21, 2013, the Third Circuit issued its opinion in *Majestic Star Casino, LLC v. Barden Development Inc*. Majestic Star Casino II, Inc. (Majestic), a debtor in a bankruptcy case, was a QSub of a subchapter S corporation (S corporation) that was not a debtor in the case. The Third Circuit held that Majestic did not have a property interest in its QSub status and thus could not challenge the loss of that status as violating the automatic stay. Majestic's loss of QSub status had been triggered by its nondebtor parent corporation voluntarily revoking its own status as an S corporation. The Third Circuit's decision vacated a prior bankruptcy court decision that had been appealed directly to the Third Circuit. The bankruptcy court had held that Majestic had a property interest in its QSub status and ordered the IRS and Majestic's parent corporation to reinstate Majestic's QSub status. As a result of the Third Circuit's decision, Majestic's parent corporation successfully avoided an estimated $170 million of taxable cancellation of debt (COD) income.

Background

In November 2009, Majestic and other affiliated debtors (collectively, the Debtors) filed voluntary petitions for bankruptcy under Chapter 11. Majestic was a wholly owned subsidiary of an S corporation. Majestic had made a QSub election, which caused it to be disregarded for federal income tax purposes. Majestic's S corporation parent, Barden Development, Inc. (BDI), and BDI's sole shareholder, Barden (an individual), did not join in the bankruptcy petitions. Sometime after the bankruptcy petitions were filed, BDI filed a notice of S corporation revocation with the IRS. Thus, Majestic's status as a QSub was automatically terminated because it was no longer wholly owned by an S corporation. As a result, Majestic became a fully taxable corporation. For insolvent businesses, incorporation often triggers an immediate tax under Internal Revenue Code Section 357(c) because the taxpayer's basis in its assets is less than the amount of its liabilities. Somewhat puzzlingly, the Third Circuit did not address this potential issue.

At issue was the treatment of an estimated $170 million of COD, which would result from the reduction of the Debtors' obligations in bankruptcy. Without QSub status, the COD amount generated as a result of the restructuring would not flow through to BDI (and ultimately Barden). Instead, Majestic would recognize the COD amount and reduce its tax attributes in lieu of including the COD amount in taxable income. Because the revocation of QSub status shifted the COD amount, the Debtors alleged that Majestic's QSub status was property of Majestic and that the revocation of such status caused an unlawful postpetition transfer of property of the bankruptcy estate, in violation of the automatic stay. The Debtors' complaint sought recovery of the property through an order retroactively restoring BDI's S corporation status and Majestic's QSub status. The IRS, BDI and Barden argued that the revocation of BDI's S corporation election, and the attendant loss of QSub status for Majestic, could not be overturned by the bankruptcy court.

The bankruptcy court granted summary judgment in favor of the Debtors. The court held that Majestic's QSub status was property of the bankruptcy estate, and therefore, BDI's revocation of its S corporation status — and the resulting termination of Majestic's QSub status — were void. The bankruptcy court ordered the defendants, including the IRS, BDI and Barden, to take all actions necessary to restore Majestic's QSub status.

As a consequence of the bankruptcy court's order, Majestic would have received significant tax benefits. Majestic would not be required to reduce its tax attributes as a result of the anticipated COD. If Majestic were restored to QSub status and BDI to S corporation status, then Barden would likely incur the federal income tax on Majestic's COD. Because Majestic would not be deemed to generate the COD if it were a QSub, it would not need to avail itself of the so-called "bankruptcy exception" to avoid recognition of the COD as taxable income. Furthermore, Majestic would not be required to reduce the value of its tax attributes. The defendants, including the IRS, appealed the bankruptcy court's order directly to the Third Circuit.

Third Circuit Reasoning

The Third Circuit held that Majestic's QSub status was not property of the bankruptcy estate. The court reasoned that S corporation status was not property, and thus, *a fortiori*, QSub status was not property. In reasoning that S corporation status was not property, the Third Circuit broke with previous case law that had expanded the definition of property to include favorable tax attributes for purposes of bankruptcy. In *Prudential Lines*, the Second Circuit barred the debtor's corporate parent from taking a worthless stock deduction because that would have eliminated the value of the debtor's net operating losses (NOLs) for future use. In *In re Trans-Lines West, Inc.*, the bankruptcy court relied on *Prudential Lines* to hold that S corporation status was property of the bankruptcy estate, thus allowing the trustee to avoid a corporation's prepetition revocation of its S corporation status as a fraudulent transfer of property. Other courts below the circuit court level have similarly concluded that S corporation status is property. The precise limit of this line of cases continues to evolve, and the tax attributes protected by fraudulent transfer rules and the automatic stay (other than NOLs) have not been entirely clear.

In breaking with this emerging doctrine, the Third Circuit noted three grounds for rejecting the reasoning of the *Trans-Lines West* line of cases. First, the court said that the analogy of S corporation status to NOLs is limited because NOLs have a clearly defined value and are not revocable by the debtor's shareholders or by the IRS. S corporation status, on the other hand, is contingent on the will of the shareholders, who can revoke the S corporation status at any time, and the value of an S corporation election is dependent on the amount and timing of future earnings. Second, the Third Circuit believed the *Trans-Lines West* line of cases was incorrect in deciding that S corporation status was a right guaranteed by the Internal Revenue Code. The Third Circuit reasoned that the Internal Revenue Code does not guarantee a corporation's right to S corporation status because the corporation's shareholders can revoke that status. Thus, because the Bankruptcy Code protects only the property rights of the debtor, the court concluded that the inability of a QSub to ensure its continuing pass-through status precludes invoking the protection of the automatic stay to block a loss of that status caused by others. Finally, the Third Circuit reasoned that the *Trans-Lines West* line of cases produced "substantial inequities" because it could impose a tax burden on the S corporation shareholders while depriving those shareholders of the income that gave rise to the liability. Any income generated during the restructuring process would likely remain in the hands of the S corporation (and ultimately, its creditors), while the former S corporation shareholders would be left without funds to pay the tax on the income passed through.

In the alternative, the Third Circuit concluded that, even if QSub status were property, it would be property of the QSub's S corporation parent. The Third Circuit reasoned that because an S corporation exists merely as a conduit for tax benefits that flow through to its shareholders, any "ownership" of S corporation status would flow through to the shareholders as well. Similarly, a QSub is disregarded for federal income tax purposes and would not "own" its tax status; that tax attribute would belong to its S corporation parent. Assigning "ownership" of S corporation status to its shareholders (and QSub status to its S corporation parent) would properly preserve the shareholders' (and S corporation parent's) rights to terminate the S corporation election (and the resulting loss of the QSub election).

As Delaware is in the Third Circuit, the *Majestic* decision may have significant impact due to the practical importance of Delaware bankruptcy proceedings. However, the *Majestic* decision is not yet final, as the Supreme Court could potentially grant *certiorari* should a petition be filed.

Observations

Majestic presented a difficult case, in part because the necessary remedy to preserve the debtor's QSub status was so far-reaching. Preserving that status would affect the parent corporation and its shareholder, both of which were outside the bankruptcy process. Moreover, however formalistic some of the court's reasoning may appear, it correctly found that Majestic itself did not have the ability to preserve its pass-through status.

Some of the Third Circuit's reasoning nevertheless appears questionable. The court stated that NOLs and S corporation status are not analogous for purposes of the automatic stay because the value of NOL carry forwards is readily defined, whereas the value of S corporation status depends on the amount and timing of future income, if any. However, the value of NOL carry forwards arguably depends on the amount and timing of future income as well. Furthermore, if the value of NOL carry forwards can be sufficiently estimated to give them "readily defined" value, then a similar valuation would appear possible for S corporation status. S corporation status carries with it certain tax attributes, including pass-through of income and losses, that can be estimated with some precision. Moreover, the benefit of those attributes may be effectively transferred by a shareholder when basis is preserved when COD is incurred, even if the entity loses S corporation status in the restructuring. In the case of financially distressed pass-through entities, looming COD income may make the benefit of pass-through status immediate and quantifiable.

The Third Circuit attempts to reach a "fair" result by ensuring that the person paying tax on the QSub's cancellation of debt income also had the benefit of any income generated from the QSub during bankruptcy. But the Third Circuit's reasoning creates a potential mismatch of tax and tax benefits in other scenarios. For instance, S corporation shareholders could use the S corporation's economic losses, then revoke S corporation status during bankruptcy. Under *Majestic*, the corporation would be unable to challenge the revocation of its S corporation status. Thus the corporation would be forced to reduce tax attributes as a result of excluding COD from taxable income. This is the type of result that *Prudential Lines* would have precluded when it prohibited a corporate parent from taking a worthless stock deduction that would have eliminated its subsidiary's NOL carry forwards.

The *Majestic* decision likely presents its most significant practical implications in the case of financially distressed limited liability companies (LLCs) that are treated as pass-through or disregarded entities. For these entities, whether treated as partnerships or disregarded entities, the prospect of cancellation of debt income is often very important because the bankruptcy and insolvency exceptions to COD income recognition are applied at the partner or owner, rather than LLC, level. The reasoning of *Majestic* suggests that a check-the-box election to become taxable as a corporation immediately before or during bankruptcy may withstand challenge under the Bankruptcy Code. If so, such a check-the-box election may significantly reduce the tax cost of restructuring such entities. Checking the box will trap the COD amounts in the debtor, avoiding potential taxable income at the owner level at the cost of an associated reduction of tax attributes at the debtor level. Taxpayers exploring the use of such a strategy will need to be attentive to the potential risks and the potential cost associated with deemed transfers, especially where liabilities exceed the basis of the deemed contributed property.

It may be that the Third Circuit would not apply the reasoning of *Majestic* to more common pass-through contexts; *Majestic* was arguably unusual insofar as the loss of pass-through status occurred as a result of unilateral actions by the debtor's parent and the parent's shareholder. Revocation of S corporation status or a check-the-box election by an LLC to be treated as a corporation cannot be made unilaterally by the shareholders or interest holders but rather also requires action by the affected entity. But it is not clear that the distinction as to who makes the relevant tax election should be determinative. *Prudential Lines*, of course, also presented the case of a loss of tax attributes as a result of unilateral action by a controlling shareholder, and the Second Circuit did not find that feature dispositive of the question of whether NOL carry forwards were assets of the bankruptcy estate.

Outside the Third Circuit, courts may continue to take a more expansive approach to the definition of property. Courts taking such an approach may likely continue to challenge attempts to block the pass-through of cancellation of debt income with the associated cash tax cost or reduction of favorable tax attributes.

Financially distressed pass-through entities may have new planning opportunities but also face new questions in restructuring. The IRS's success in preserving the revocation of the debtor's QSub status in *Majestic* may prove to be a pyrrhic victory if it permits other debtors to secure the benefits of the bankruptcy and insolvency exceptions for COD, or otherwise protects taxpayers from the adverse tax consequences of the pass-through status of related entities.