

## **Who Controls Tax Status? S-Corps., QSubs and Bankruptcy.**

Corporations can be classified in different ways for tax purposes. The default, a C corporation, is a taxable entity under the Internal Revenue Code. Certain corporations are eligible to elect status as a small business corporation or S-Corp. under Section 1362 of the Code, which means that they are pass-through entities: their income and losses are passed through to the shareholders, who report the income or loss on their own returns. I.R.C. §§ 1363(b); 1366(a). An S-Corp. can, in turn, have a subsidiary that is also treated as a pass-through entity, which is known as a QSub, by making an election under Section 1361(b)(3)(B). If QSub status is elected then all of the subsidiary's assets, liabilities, income and losses are treated as belong to its S-Corp. parent. I.R.C. § 1361(b)(3)(A).

S-Corp. or QSub status can be valuable as it means that the relevant corporation pays no taxes. What happens if that status is lost during a bankruptcy? A change in the tax status of a debtor corporation could have a big impact on its creditors; does that mean the bankruptcy court can control whether a change in tax status occurs? The Third Circuit recently weighed in on this issue, and the answer was a resounding no. *In re Majestic Star Casino*, 2013 U.S. App. LEXIS 10186 (3d Cir. 2013).

*Majestic Star Casino* involved a QSub, which operated a casino and was a wholly-owned subsidiary of an S-Corp. *Id.* slip op. at \*4. After the bankruptcy was filed, the owner of the parent S-Corp. filed an election revoking its election to be treated as an S-Corp.; this automatically terminated the debtor's QSub status as of the close of the prior tax year. *Id.* at \*10-11. In response, the debtor filed an adversary complaint challenging the revocation against its parent, the parent's shareholder and the Treasury. *Id.* at \*14-\*15. Although the bankruptcy court granted summary judgment in favor of the debtor, the Court of Appeals reversed, concluding that tax status was not property of the debtor's estate within the scope of Section 541(a) of the Bankruptcy Code.

While Section 541(a) of the Bankruptcy Code provides a sweeping definition of "property of the estate" as "all legal or equitable interests of the debtor in property as of the commencement of the case," 11 U.S.C. § 541(a), the Third Circuit determined that the debtor's status as a QSub was not property of the estate, rejecting prior case law suggesting that S-Corp. status was estate property under the Bankruptcy Code. 2013 U.S. App. LEXIS 10186, slip op. at \*35-\*70. In reaching this conclusion, the court focused upon the fact that the shareholders of an S-Corp. have the right to revoke it at will, and that there are steps that an individual shareholder can take unilaterally that would automatically terminate S-Corp. status, such as selling shares to a corporation or a non-resident alien. *Id.*, slip op. at \*49. Since a corporation cannot control its status as an S-Corp., the Third Circuit concluded that its tax status cannot be property, even if it is valuable. *Id.* at \*52.

In addition, equitable factors played a role: typically in an S-Corp., the entity that is paying the relevant taxes associated with the S-Corp.'s income can extract income from it to pay the associated taxes. In the bankruptcy context, if a trustee can set aside the termination of the S-Corp. status, the income would likely stay in the S-Corp. to pay claims of creditors, while the shareholder would be saddled with the taxes. *Id.* at \*53-\*54.

In light of the court's conclusion that S-Corp status would not represent property, Q-Sub tax status had an even weaker claim as property of the estate, as it faced another layer of

contingencies: its status as a QSub could terminate at the election of the parent's shareholders to revoke the parent's S-Corp. election, if the parent no longer qualified, or if the parent sold any of the QSub's stock. *Id.* at \*54-55.

This is a solidly reasoned opinion that suggests little room for serious debate, even if the impact on creditors of an S-Corp or a QSub is adverse.

Jim Malone is a tax lawyer in Philadelphia. © 2013, MALONE LLC.