Assignment

Assigned Reading—All:

1. FOREWORD TO CLASS 13
2. BNA, Corporate Bankruptcy, Section XC1-4 (pages 110-119)
3. Internal Revenue Code §§ 382(l)(5), (6)
4. Treas. Reg. §§ 1.382-9, 1.269-3(d)
5. In re Prudential Lines, Inc., 928 F.2d 565 (2d Cir. 1991)
6. In re UAL Corporation, 412 F.3d 775 (7th Cir. 2005)
8. Asofsky, TAX ATTRIBUTES AS PROPERTY OF THE ESTATE

Optional Reading:

1. In re Majestic Star Casino, Ltd, 716 F.3d 736, (3d Cir 2013)

Problems for class discussion:

D is a publicly held corporation that files a chapter 11 petition on January 1, 2009. D’s assets and liabilities consist of the following:

Assets:

Depreciable property, basis $1 million, value $1 million
Other property, basis $7 million, value $6 million
Total assets, basis $8 million, value $7 million

Liabilities:

Senior bank debt (secured), $3 million
8% debentures issued in 2000 and due 2020, $6.66 million (no interest paid after filing)
Trade debt, $3.33 million
Total liabilities, $13 million

D has a NOL of $9 million from years prior to 2009, but expects to break even for 2009 without considering any interest on the debentures.

D expects to emerge from bankruptcy on December 31, 2009 if the plan described below can be confirmed.

There is no significant single holder of the debentures, but it is rumored that VF, a vulture fund, is considering buying up the debentures on the open market.

X, an independent investor, is willing to invest cash in D to acquire 33.33 percent of the stock at fair market value.

Pursuant to a plan being negotiated among the parties, the following would occur: (1) The bank debt will be rolled over without a change in terms; (2) the $3.33 million trade debt would receive $1.33 million new short term notes having an appropriate rate of interest; and (3) The $6.66 million debentures would be exchanged for 100% of the common stock of D, having a value of $2.66 million. No amount would be paid in respect of the 2009 interest on the debentures.

Where relevant, assume that the long-term tax-exempt rate applicable to and ownership change is 5%.

Q – Do the transactions described constitute a reorganization for federal income tax purposes?

Q – Does the transaction qualify as a G reorganization?

Q – What are the tax consequences to the banks?

Q – What are the tax consequences to the holders of trade debt?

Q – What are the consequences to holders of the debentures?

Q – Does D recognize COD?

Q – What happens to it?

Q – Are these numbers affected by whether or not D deducts the debenture interest for 2009?

Q – If D doesn’t like this result, is there anything it can do?
Q – What about IRC § 382? Does D qualify for IRC § 382(l)(5)?

Q – How much NOL will D have left if it qualifies for IRC § 382(l)(5)?

Q – What would be the result under IRC § 382(l)(6)?

Q – Should the election be made?


Q – What happened in Prudential Lines?

Q – The parent wasn’t in bankruptcy. It wasn’t generally under the jurisdiction of the court. By what authority did the court enjoin it from claiming on its own return a deduction to which it was entitled?

Q - How far does Prudential Lines go? Can the bankruptcy court prevent a non-debtor, non-insider from selling his shares to avoid a possible ownership change that would destroy the NOL?

Q – What if a transaction in violation of the order occurs? What if it creates an ownership change? Can the court undo it? Will the IRS recognize the rescission?

Q - Would the debtor ever want an order restricting trading in claims?

Q – When should the debtor seek this relief? It may not know in advance of any transaction that may have an adverse effect.

Q – On the facts of the problem we’ve been discussing, what should you be thinking about as the debtor’s tax advisor?
UNIVERSITY OF HOUSTON LAW CENTER

BANKRUPTCY TAX

Professor Paul H. Asofsky

FOREWORD TO CLASS 13

As we've seen, there is an underlying policy prohibiting trafficking in tax losses. Congress first tried to deal with this in the tax avoidance motive rules of section 269, but they were an ineffective weapon. IRC § 382 is supposed to deal with the enforcement problems through objective rules that will eliminate or scale down loss carryovers when ownership change thresholds are exceeded.

Bankruptcy professionals have long argued that these rules should never apply when the ownership change occurs as part of a bankruptcy reorganization pursuant to a confirmed chapter 11 plan. They argue that the corporate losses were really funded in part with the creditors' money, and if they have to give up their claims in exchange for stock they shouldn't be treated as new shareholders who trigger any loss limitation rules. Also, tax incentives are needed to make reorganization rather than liquidation an attractive alternative.

Prior to 1980, it was possible to accomplish this result if the creditors took 80% control of the loss corporation as part of the plan. A Tax Court case held that claims against the corporation were "property" for purposes of IRC § 351, and so the exchange of claims, even short term debt, for stock of the debtor could be a tax free exchange. That was important because the original 1954 version of IRC § 382 applied only when there was a 50% ownership change by "purchase," meaning a taxable transaction. As a result, most tax planning in this period tried to funnel bankruptcy reorganizations through this IRC § 351 mechanism.

In 1980, there were restrictive changes made to IRC § 351. First, there was a new provision stating that a claim against the debtor would not be considered "property" for purposes of IRC § 351 unless the claim constituted a security. The purpose of this was apparently a desire to achieve symmetry between a recapitalization transaction and a two party G reorganization. In the latter, creditors would have a tax free exchange only if they held securities, but not otherwise, because IRC § 354 governed. It was thought that similarly situated creditors in a one party reorganization should not have a different result. This made recapitalizations unattractive as a planning device.

At the same time, Congress liberalized the IRC § 382 treatment of tax free reorganizations. Under these rules, if creditors in a bankruptcy case received stock of the debtor, they were treated as pre-existing stockholders and didn't count toward an ownership change. If they received 20% or more of the stock of the acquiring corporation, there was no reduction of the NOL under IRC§ 382. If they received less than 20%, the NOL carryover was reduced proportionately. As a result, between 1980 and 1986, almost every bankruptcy reorganization was structured as a G reorganization because of the more favorable IRC § 382 rule.
In 1986, as seen in the last two classes, Section 382 was overhauled and the present version enacted. Among other things, it tried to harmonize the tax treatment of taxable acquisitions of control and tax free two party reorganizations. This obviated the need for the G reorganization with all its complexities.

In writing the rules Congress had to decide what kind of bankruptcy tolerance they should give for ownership changes that would otherwise have invoked the section 382 limitation. This provoked a fierce debate.

A Senate study group came up with a proposal that if shareholders and historic creditors as a group rode through the bankruptcy with 50% control, there should be no annual limitation. But they thought it was not right for corporations to have deducted interest on debt that was being converted into stock and keep the NOL attributable to the interest. They proposed two limitations. First, if the corporation was taking advantage of the stock for debt exception to avoid COD and attribute reduction, 1/2 that benefit should reduce the NOL. Second, to the extent that the corporation had claimed interest deductions in the last three years on debt now being converted into stock, that piece of the loss should be backed out. Effectively, the debt was retroactively treated as stock for purposes of calculating the carryover.

In the House bill, they took a simpler approach. Under the regular 382 limitation, the use of the value of the equity immediately before the ownership change would result in a zero NOL in most cases. To alleviate this, the House bill would allow the value of the stock to be determined immediately after the ownership change in a bankruptcy case, rather than before, so that the creditors could enhance the 382 limitation by turning more of their debt into stock.

The Houses couldn’t agree, so they adopted both versions! The Senate version is now IRC § 382(l)(5). PLEASE READ IRC § 382(l)(5). If 50% ownership by stockholders and certain creditors is achieved, there is no annual limitation, but the interest chargeback rule applies (when the stock for debt exception was repealed in 1993, the other limitation became irrelevant). The House version is now IRC § 382(l)(6). The section 382 limitation after a bankruptcy change of ownership is the value immediately after multiplied by the long term tax exempt rate. PLEASE READ IRC § 382(l)(6).

The 382(l)(5) version is usually more favorable because there is no annual limitation, but won’t be if there is too much of an interest haircut. If the debtor meets the requirements of IRC§ 382(l)(5), it will apply, but it may be hard to satisfy the 50% shareholder/creditor continuity conditions. If those conditions are not satisfied, IRC § 382(l)(6) will apply. Also, if the taxpayer doesn’t like the IRC§ 382(l)(5) result because the interest haircut is too great, it can elect out of it and into IRC § 382(l)(6).

After reading the statute and regulations, please work your way through the assigned problem.
United States Court of Appeals,
Second Circuit.

In re PRUDENTIAL LINES INC., Debtor.
The OFFICIAL COMMITTEE OF UNSECURED
CREDITORS and Cold Spring Shipping, L.P., Ap-
pellees/Cross-Appellants,

v.

PSS STEAMSHIP COMPANY, INC., Appel-
lant/Cross-Appellee.
Nos. 1023, 1131, Dockets 90-5063, 90-5073.


Before TIMBERS, NEWMAN and ALTIMARI, Cir-
cuit Judges.

TIMBERS, Circuit Judge:

Appellant/cross-appellee PSS Steamship Company, Inc. (PSS) appeals from an order entered September 28, 1990, in the Southern District of New York, Robert P. Patterson, District Judge, affirming an or-
der of the bankruptcy court that permanently enjoined it from taking a worthless stock deduction on its 1988
federal income tax return with respect to its bankrupt subsidiary Prudential Lines, Inc. (PLI), since that would have adversely affected PLI’s ability to carry-forward its net operating loss (NOL) to offset future income.

On appeal, PSS contends that (1) the NOL generated by PLI was not property of PLI’s estate within the meaning of § 541 of the Bankruptcy Code; and (2) the bankruptcy court erred in enjoining PSS from taking a worthless stock deduction on its 1988 federal income tax return as violative of the automatic stay. On cross-appeal, the Official Committee of Unsecured Creditors (Creditors’ Committee) and Cold Spring Shipping, L.P. (Cold Spring) contend that the bankruptcy court erred in denying relief based on a violation of PSS’ fiduciary duty to PLI.

Since we agree with Judge Patterson’s excellent district court opinion and for the reasons that follow, we affirm the judgment of the district court.

I.

We shall summarize only those facts and prior proceedings believed necessary to an understanding of the issues raised on appeal.

At all times relevant to this appeal, PLI was a wholly owned subsidiary of PSS that provided United States flag shipping between ports in Europe and the Black Sea. Spyros S. Skouras, Sr. is chief executive officer and a director of PSS, and was Chairman and President of PLI until his resignation in November 1989. Spyros S. Skouras, Jr. was Vice President, General Manager, and a director of PLI. In addition, Skouras, Jr. has participated in the financial and tax affairs of PSS since 1986. In that capacity, he consults with PSS’ tax counsel and accountants and relays information to his father.

PSS and PLI, along with two other affiliated entities have filed consolidated tax returns since 1976 pursuant to 26 U.S.C. § 1501 et seq. (1988). In 1988, these entities had a combined NOL of $75 million available to be offset against income. Of that amount, $74 million was attributable to PLI’s pre-bankruptcy operations. NOLs are tax deductible and may be carried back and applied against income in previous years (carryback), or carried forward and applied against income in subsequent years (carryforward). 26 U.S.C. § 172 (1988).

On September 12, 1986, an involuntary petition for reorganization under Chapter 11 of the Bankruptcy Code was filed against PLI. Soon thereafter, PLI consented to an order for relief. The Creditors’ Committee was appointed pursuant to 11 U.S.C. § 1102 (1988) to represent the interests of PLI’s unsecured creditors. Cold Spring purchased a participation interest in the unsecured claim of the United States Maritime Administration (MARAD).

In the summer of 1988, Skouras, Sr. and Skouras, Jr. began to formulate a plan for reorganization on behalf of PLI (the “PLI plan”). In connection with that plan, they prepared a term sheet dated August 4, 1988, which indicated that, under the PLI plan, the Skouras family would retain control of PLI and a NOL carryforward of $74 million would be available to offset future income of the reorganized company.

In February 1989, PSS was informed by tax counsel and by its accountants that it could take a $38.9 million worthless stock deduction in connection with its PLI stock on its 1988 federal income tax return. If PSS took that action, it would effectively eliminate the value of the NOL to PLI. Later that month, PLI filed a plan for reorganization with the bankruptcy court. Under that plan, Skouras, Jr. would retain a 75 percent interest in the reorganized company and serve as President. Skouras, Sr. would serve as Chairman of the reorganized company. The disclosure statement accompanying the PLI plan contemplated the availability of PLI’s NOL to offset future income of the reorganized company.

In July 1989, PSS’ accountants prepared a draft federal income tax return for 1988 that reflected a worthless stock deduction in connection with the PLI stock. The following month PLI filed an amended plan of reorganization. The disclosure statement accompanying the amended PLI plan still reflected the availability of the NOL carryforward to the reorganized company. It did not mention the possibility of PSS taking a worthless stock deduction on its 1988 federal income tax return.

The PLI plan failed to win the support of the creditors. On September 11, 1989, the Creditors’ Commit-
te and Cold Spring filed a draft of a joint plan for reorganization (creditors' plan). That plan provided for new management of the reorganized company and provided for no distributions to the Skouras family. The PLI stock owned by the Skouras family was to be cancelled. Like PLI's plan, it also contemplated a carryforward of PLI's $74 million NOL. In an objection to this plan, filed September 19, 1989, PSS announced for the first time its intention to take a worthless stock deduction in the amount of $38.9 million in connection with its PLI stock on its 1988 tax return.

Skouras, Jr. attended three meetings with officials of MARAD, the unsecured creditor holding the largest single claim against PLI, to urge them to support the PLI plan and reject the creditors' plan. At one of these meetings, Skouras, Jr. provided MARAD with a written comparison of the two plans that described the NOL as preserved under the PLI plan and uncertain under the creditors' plan. Skouras, Jr. informed MARAD that PSS might take a worthless stock deduction on its 1988 tax return, which would limit any NOL available to a reorganized PLI.

*568 On October 10, 1989, counsel for PLI met with counsel for the Creditors' Committee and Cold Spring. At that meeting counsel for PLI broached the subject of personal releases in favor of Skouras, Sr. and Skouras, Jr. in the event the creditors' plan was confirmed. The Creditors' Committee and Cold Spring sought assurances that PSS would not take the worthless stock deduction. PSS agreed, subject to revocation by written notice, that it would not take the deduction while negotiations continued.

On November 6, 1989, after the negotiations failed, PSS informed Cold Spring by letter that it reserved the right to take the worthless stock deduction. On the following day Skouras, Jr. met with officials at MARAD and presented them with a copy of the letter. He told them that he did not know whether PSS actually intended to take the worthless stock deduction on its 1988 federal income tax return.

PLI rejected the request of the Creditors' Committee and Cold Spring to take steps to prevent PSS from taking the worthless stock deduction. Skouras, Sr. resigned from his positions with PLI, effective November 3, 1989, after PSS decided to take the worthless stock deduction on its 1988 tax return.

On November 13, 1989, the Creditors' Committee and Cold Spring commenced an adversary proceeding in the bankruptcy court seeking to have PSS preliminarily and permanently enjoined from taking the worthless stock deduction on its 1988 tax return. Count one of the complaint alleged that taking the worthless stock deduction on its 1988 tax return would amount to a breach of PSS' fiduciary duty to PLI. Count two alleged that PSS was using the threat of the worthless stock deduction only to interfere with the creditors' plan to reorganize PLI. Count three alleged that the NOL attributable to PLI was property of PLI's bankruptcy estate and that taking the worthless stock deduction would violate the automatic stay provision of the Bankruptcy Code.

On November 21, 1989, the bankruptcy court held a hearing on plaintiffs' motion for a preliminary injunction. At the conclusion of the hearing, the bankruptcy court denied relief on counts one and two, holding that there was a legitimate business purpose for taking the worthless stock deduction and that the business judgment rule precluded further review of the propriety of that decision. On December 4, 1989, the bankruptcy court granted preliminary injunctive relief on count three. Official Committee of Unsecured Creditors v. PSS S.S. Co., Inc. (In re Prudential Lines, Inc.). 107 B.R. 832 (Bankr. S.D. N.Y. 1989).

The bankruptcy court held that the NOL generated by PLI was property of PLI's bankruptcy estate and that the worthless stock deduction was an attempt to exercise control over that property in violation of the automatic stay. On December 19, 1989, the bankruptcy court permanently enjoined PSS from taking the worthless stock deduction on its 1988 tax return. Official Committee of Unsecured Creditors v. PSS S.S. Co., Inc. (In re Prudential Lines, Inc.). 114 B.R. 27 (Bankr. S.D. N.Y. 1989). The creditors' plan for reorganization was confirmed on December 15, 1989. PSS has not yet filed its 1988 tax return.

PSS appealed from the decision of the bankruptcy court to the district court pursuant to 28 U.S.C. § 158(a) (1988). The Creditors' Committee and Cold Spring cross-appealed from the bankruptcy court's denial of the injunction on counts one and two. On September 28, 1990, the district court affirmed the judgment of the bankruptcy court. Official Committee

This appeal followed.

II.

Initially, we set forth our standard of review. Our review of the district court order is plenary. Gulf States Exploration Co. v. Manville Forest Prods. Corp. (In re Manville Forest Prods. Corp.), 836 F.2d 1384, 1388 (2 Cir.1988); Brown v. Pennsylvania State Employees Credit Union, 851 F.2d 81, 84 (3 Cir.1988). "This court exercises the same review over the district court's decision that the district court may exercise [over the bankruptcy court's decision]." Brown, supra, 851 F.2d at 84. Accordingly, we will accept the bankruptcy court's findings of fact unless clearly erroneous. In re Manville Forest Prods., supra, 896 F.2d at 1388; Bankr. Rule 8013. We review the bankruptcy court's legal conclusions de novo. In re Manville Forest Prods., supra, 896 F.2d at 1388.

III.

[1] With the foregoing in mind, we turn first to PSS' contention that the NOL attributable to PLI does not constitute property of PLI's bankruptcy estate within the meaning of § 541 of the Bankruptcy Code. PSS contends that the law of consolidated tax returns gives it, and not PLI, the right to use PLI's NOL to offset income. PSS contends that the right to the NOL carryforward is not PLI's property and cannot be considered property of PLI's estate. We disagree.

Our inquiry begins with the definition of property of the estate set forth in the Bankruptcy Code. Property of the estate encompasses "all legal or equitable interests of the debtor in property as of the commencement of the case." 11 U.S.C. § 541(a)(2) (1988). In construing this section, we are mindful that Congress intended § 541 to be interpreted broadly. United States v. Whiting Pools, Inc., 462 U.S. 198, 204, 103 S.Ct. 2309, 2313, 76 L.Ed.2d 515 (1983). To facilitate reorganization, it is vital to include all the debtor's property in its bankruptcy estate. Id. at 203, 103 S.Ct. at 2312.

The legislative history of § 541 demonstrates that Congress agreed with the result reached by the Segal Court.

"The estate is comprised of all legal or equitable interest of the debtor in property, wherever located, as of the commencement of the case. The scope of this paragraph is broad. It includes all kinds of property, including tangible or intangible property, causes of action ... and all other forms of property currently specified in [the predecessor statute to § 541]. ... The result of Segal v. Rochelle, 382 U.S. 375 (86 S.Ct. 511, 15 L.Ed.2d 428) (1966), is followed, and the right to a refund is property of the estate."


Courts, applying Segal, have held that a subsidiary is entitled to a tax refund due to its NOL carryback to the extent that it offsets its own income. E.g., Jump, supra, 579 F.2d at 452; In re Bob Richards, supra, 473 F.2d at 264; In re Revco D.S., Inc., 111 B.R. 631, 639 (Bankr.N.D.Ohio 1990). Courts considering whether NOL carryforwards constitute property of the estate have reached varying conclusions in varying contexts. Compare Jump, supra, 579 F.2d at 453 ("the right to use its net operating loss to gain carryover tax advantage was not an asset of [a liquidating subsidiary] because its value was conditioned on the existence of future income potential of [the subsidiary]"); and Davis v. Commissioner, 89 T.C. 814, 827 (1987) *572 ("net operating loss carryover cannot constitute property" of an individual debtor's estate) with In re Beery, 116 B.R. 808, 819 (D.Kan.1990) (right to use NOL carryforward is property of debtor's estate).

PSS contends that Segal does not control the instant case since it involved a NOL carryback rather than a NOL carryforward, and an individual rather than a
corporate debtor filing a consolidated return. Those distinctions do not require a contrary result here.

[5] Carryforwards differ in nature from carrybacks. Carrybacks result in the right to a tax refund of a definite amount. Carryforwards, by contrast, are speculative since their value depends on the availability of future income against which to apply them. The speculative nature of carryforwards does not place them outside the definition of property of the estate. "[T]he term 'property' has been construed most generously and an interest is not outside its reach because it is novel or contingent or because enjoyment must be postponed." Segal, supra, 382 U.S. at 379, 86 S.Ct. at 515; see also H.R. Rep. No. 95-595, 95th Cong., 2d Sess. 175-76, reprinted in 1978 U.S.Code Cong. & Admin.News 5963, 6136 (property of the estate “includes all interests, such as ... contingent interests and future interests, whether or not transferable by the debtor”). The fact that the right to a NOL carryforward is intangible and has not yet been reduced to a tax refund also does not exclude it from the definition of property of the estate. In re Golden Plan, supra, 37 B.R. at 169. In short, interests whose value is speculative and interests that involve intangible rights that are subject to regulation may be included as property of the estate. E.g., Neuton v. Dunning (In re Neuton), 922 F.2d 1379, 1382-83 (9 Cir.1990) (interest in trust contingent on survivorship is property of the estate); Tringali v. Hathaway Mach. Co., 796 F.2d 553, 560 (1 Cir.1986) (liability insurance policy is property of the estate); Beker Indus. Corp. v. Florida Land & Water Adjudicatory Comm’n (In re Beker Indus. Corp.), 37 B.R. 611, 622 (Bankr.S.D.N.Y.1986) (right to truck products from mine is property of estate); In re Golden Plan, supra, 37 B.R. at 169 (corporate name is property of the estate). Thus, the nature of the interest involved in the instant case does not compel a conclusion that it is not property of the estate.

As the Segal Court observed, the main hurdle to including NOL carryforwards as property of the estate is the detrimental impact it could have on the fresh start policy that is promoted by the Bankruptcy Code. Segal, supra, 382 U.S. at 381, 86 S.Ct. at 515. Subsequent legislation has ameliorated that concern with respect to individual debtors and suggests that Congress intended that NOL carryforwards be included in the property of the estate of individual as well as corporate debtors.

Corporations attempting to reorganize under Chapter 11 are ongoing concerns that generate income used to pay pre-petition creditors. Whiting Pools, supra, 462 U.S. at 203, 103 S.Ct. at 2312. Furthermore, a liquidating corporation’s debts are not discharged in bankruptcy. 11 U.S.C. § 727(a)(1) (1988). The fresh start policy, therefore, does not apply to corporate debtors. City of New York v. Quanta Resources Corp. (In re
Finally, in determining the scope of § 541 we must consider the purposes animating the Bankruptcy Code. Kokoszka v. Belford, 417 U.S. 642, 645, 94 S.Ct. 2431, 2433, 41 L.Ed.2d 374 (1974); Lines v. Frederick, 400 U.S. 18, 21 S.Ct. 113, 113, 27 L.Ed.2d 124 (1970); Segal, supra, 382 U.S. at 379, 86 S.Ct. at 515. Including NOL carryforwards as property of a corporate debtor's estate is consistent with Congress' intention to "bring anything of value that the debtors have into the estate." H.R.Rep. No. 95-595, 95th Cong., 2d Sess. 176, reprinted in 1978 U.S.Code Cong. & Admin.News 5963, 6136. Moreover, "[a] paramount and important goal of Chapter 11 is the rehabilitation of the debtor by offering breathing space and an opportunity to rehabilitate its business and eventually generate revenue." International Ass'n of Machinists and Aerospace Workers v. Eastern Air Lines, Inc., 121 B.R. 428, 432 (S.D.N.Y.1990), aff'd, 923 F.2d 26 (2d Cir.1991). Including the right to a NOL carryforward as property of PLI's bankruptcy estate furthers the purpose of facilitating the reorganization of PLI. The fact that both plans for reorganization contemplated its availability to the reorganized company suggests that PLI's $74 million NOL was a valuable asset of PLI.

We hold that the right to a carryforward attributable to its $74 million NOL was property of PLI's bankruptcy estate.

IV.

[7] We turn now to PSS' contention that the bankruptcy court erred in enjoining it from taking a worthless stock deduction on its 1988 tax return. We hold that the injunction entered by the bankruptcy court was proper.


In the instant case, if PSS were allowed to take a worthless stock deduction on its 1988 tax return, it would effectively eliminate the value of the NOL carryforward to PLI and thus have an adverse impact on PLI's reorganization. The use of NOLs as tax deductions following a change in ownership of a corporation is governed by 26 U.S.C. § 382 (1988). The amount of the deduction is limited to "the value of the old loss corporation" multiplied by "the long-term tax-exempt rate", 26 U.S.C. § 382(b) (1988). A change of ownership is deemed to have occurred if a greater than 50 percent shareholder takes a worthless stock deduction, but retains the stock at the end of the taxable year. 26 U.S.C. § 382(c)(4)(D) (1988). The value of the old loss corporation is generally measured by the value of the stock immediately prior to the ownership change. 26 U.S.C. § 382(e)(1) (1988). Since PSS owned 100 percent of the stock of PLI, if it declared that stock to be worthless and retained ownership of the stock at the end of the taxable year, the value of the PLI stock would be zero for the purposes of § 382. Accordingly, the "new" corporation would not be entitled to any NOL carryforward.
In 48th St. Steakhouse, Inc. v. Rockefeller Group, Inc. (In re 48th St. Steakhouse, Inc.), 835 F.2d 427 (2 Cir.1987), cert. denied, 485 U.S. 1035, 108 S.Ct. 1596, 99 L.Ed.2d 910 (1988), we held that a landlord's attempt to terminate its lease with a non-debtor was subject to the automatic stay and that it would have had the legal effect of terminating the debtor's sublease. Id. at 431. Despite the fact that the landlord's action was not directed specifically at the debtor, we held that

"where a non-debtor's interest is intertwined ... with that of a bankrupt debtor ... [and an] action taken against the non-bankrupt party would inevitably have an adverse impact on property of the bankrupt estate, then such action should be barred by the automatic stay."

Id. Similarly, where a non-debtor's action with respect to an interest that is intertwined with that of a bankrupt debtor would have the legal effect of diminishing or eliminating property of the bankrupt estate, such action is barred by the automatic stay.

In the instant case, PSS' interest in its worthless stock deduction is intertwined with PLI's NOL. If PSS were permitted to take a worthless stock deduction on its 1988 tax return, it would have an adverse impact on PLI's ability to carry forward its NOL. Accordingly, despite the fact that PSS' action is not directed specifically at PLI, it is barred by the automatic stay as an attempt to exercise control over property of the estate.

[8] The permanent injunction entered by the bankruptcy court also is supported by its equitable powers pursuant to § 105(a). That provision grants the bankruptcy court power to "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of [the Bankruptcy Code]." 11 U.S.C. § 105(a) (1988). "This provision has been construed liberally to enjoin [actions] that might impede the reorganization process." MacArthur Co. v. Johns-Manville Corp. (In re Johns-Manville Corp.), 837 F.2d 89, 93 (2 Cir.), cert. denied, 488 U.S. 868 (1988). In light of the testimony of the parties that the $74 million NOL was a valuable asset of PLI, we will not disturb the bankruptcy court's finding that elimination of the right to apply its NOL to offset income on future tax returns would impede PLI's reorganiza-

tion.

Finally, we consider PSS' claim that the bankruptcy court was without jurisdiction to enter the injunction. PSS relies for this proposition on a series of cases that held that § 505(a)(1) of the Bankruptcy Code, which gives the bankruptcy court the power to "determine the amount or legality of any tax", does not confer jurisdiction on the bankruptcy court to adjudicate the tax liability of non-debtors. E.g., American Principals Leasing Corp. v. United States, 904 F.2d 477, 480-81 (9 Cir.1990); *575Brandt-Airflex Corp. v. Long Island http://www.westlaw.com/Find/Default.wl?rs=dfa1.0&vr=2.0&DB=350&FindType=Y&ReferencePosition-Type=S&SerialNum=1988043670&ReferencePosition=95Trust Co. N.A. (In re Brandt-Airflex Corp.), 843 F.2d 90, 93-96 (2 Cir.1988); In re Vermont Fiberglass, Inc., 88 B.R. 41, 43-44 (D.Vt.1988).

In the instant case, the bankruptcy court did not determine the amount or legality of PSS' tax liability. The bankruptcy court's power was based on its jurisdiction over property of the estate. In re Johns-Manville Corp., supra, 837 F.2d at 91. Having properly exercised jurisdiction, the bankruptcy court may enter an injunction that affects derivative rights of a non-debtor. Id. at 92-93.

V.

Since we hold that the bankruptcy court's injunction was justified based on count three of the complaint, we find it neither necessary nor appropriate to consider the issues raised by the cross-appeal of the Creditor's Committee and Cold Spring.

VI.

To summarize:

We hold that the right to carryforward a tax deduction due to the NOL attributable to PLI's pre-bankruptcy operation was property of PLI's bankruptcy estate. We further hold that PSS' attempt to take a worthless stock deduction with respect to its PLI stock that would effectively destroy the value of
the NOL carryforward generated by PLI was properly enjoined by the bankruptcy court. We do not consider the issues raised by the cross-appeal.

Affirmed.


In re Prudential Lines Inc.

When United Airlines entered bankruptcy in December 2002, workers owned slightly more than half of its stock through an Employee Stock Ownership Plan. Fearing that the ESOP might sell this stock and that the Internal Revenue Service would deem the sale a change of control, which might jeopardize United's ability to use net operating losses as tax deductions in future years, see 26 U.S.C. § 382, United asked the court to forbid sales by the ESOP. Chief Bankruptcy Judge Wedoff granted this motion on the date the bankruptcy began and continued the injunction after a hearing two months later. The court did not require United to post a bond to protect the ESOP against loss (compare Fed.R.Civ.P. 65(c) with Fed. R. Bankr. P. 7065) or direct United to provide "adequate protection" of the investors' interests under 11 U.S.C. § 362(d)(1). State Street Bank and Trust Company, the Trustee of the ESOP, did not ask the district court (or this court) to require security or adequate protection, though it did file an appeal that lingered on the district judge's calendar for almost two years.

While that appeal was pending, the IRS issued a regulation that permits ESOPs to pass shares through to the employees, who may hold or sell them without jeopardizing the issuer's ability to use loss carry-forwards to offset future profits. 26 C.F.R. § 1.382-10T. United terminated the ESOP on June 27, 2003, and the Trustee distributed the shares to their beneficial owners, who have since been entitled to hold or sell as they please. The bankruptcy judge's injunction lapsed—it was not formally vacated, but the ESOP it addressed had ceased to exist, so it no longer had any effect. United asked the district judge to dismiss the proceedings as moot. Surprisingly, the judge brushed aside that request and proceeded to affirm on the merits. The Trustee has appealed—though its brief does not explain what relief we could afford given the ESOP's termination—and United has renewed its mootness argument.

Responding to United's position, the Trustee con-
billion should it return to profitability. There is no reason why investors who need liquidity should be sacrificed so that other investors (principally today's debt holders) that will own United after it emerges from bankruptcy can reap a benefit; bankruptcy is not supposed to appropriate some investors' wealth for distribution to others. United should have been told to back up its assertions with cash, so that put-upon shareholders could be made whole. If United's views are right, it would not have had any trouble borrowing to underwrite a bond or other form of protection; and if lenders would not make such loans, that would have implied to the court that United's contentions are hot air. See In re Knart Corp., 359 F.3d 866, 873 (7th Cir.2004).

A carefully drafted adequate-protection agreement could have protected stockholders against an erosion of their position while requiring them to indemnify United if the market price of the stock should rise, and the expense of a bond or other security turn out to have been unnecessary. Because there were gains from trade in this situation, United and the ESOP could have made a mutually beneficial deal outside of bankruptcy. Instead of cramming one side's position down the throat of the other in bankruptcy, the judge should have crafted a mutual-protection covenant that mirrored the likely non-bankruptcy transaction. See In re James Wilson Associates, 965 F.2d 160 (7th Cir.1992); In re Roomgarden, 780 F.2d 657 (7th Cir.1985).

[1] Lack of security is doubly regrettable because the bankruptcy judge's injunction is problematic on the merits. The weaker the claim behind the injunction, the greater the investors' uncompensated risk of injury. The bankruptcy court relied on 11 U.S.C. § 105(a) plus § 362, the automatic-stay provision. The former is a means to enforce the Code rather than an independent source of substantive authority, see Knart, 359 F.3d at 871 (citing cases), and the latter speaks to the matter indirectly if at all. Section 362(a)(3), the only arguably pertinent provision, blocks "any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate". Whether or not tax benefits are "property" under the Bankruptcy Code's capacious definition, see In re Prudential Lines Inc., 928 F.2d 565, 571-73 (2d Cir.1991), an ESOP's sale of stock does not "obtain possession ... or exercise control" (emphasis added) over that in-

Requiring investors to bear the costs of illiquidity and underdiversification was both imprudent and unnecessary. United wants to preserve the value of tax deductions that, it contends, are worth more than $1
Although a sale of stock could affect United's interest in its loss carry-forwards, this would not occur because of anything the ESOP possessed or controlled. *Prudential Lines,* the principal authority invoked in support of the bankruptcy court's decision, dealt with a distinct problem. A *779* family of related corporations had filed consolidated tax returns until one of the firms entered bankruptcy. One non-bankrupt member of the group then proposed to take a worthless-stock deduction on account of its investment in the bankrupt entity; that tax benefit would have come in lieu of the corporate family's accumulated operating losses. *Prudential Lines* holds that taking the deduction would have exercised control over the debtor's operating losses; there is no equivalent example of control (or consumption) of a loss carry-forward in an investor's simple sale of stock. 228 F.2d at 569-70.

But the Trustee does not rely on any legal right to compensation that it would have enjoyed had this suit never been filed. Nor does it contend that the injunction required a reversible transaction. The harms (loss of liquidity plus uncompensated risk) that investors suffered do not correspond to any gain United enjoyed, nor does United's gain (retention of the loss carry-forwards) match any investor's loss. Instead the Trustee contends that United's gain is a form of enrichment at the investors' expense, "unjust" because (in the Trustee's view) the injunction should not have been issued. If that were enough to require compensation, then the rule stated in *W.R. Grace* would be defunct, because *every* injunction affords the victor some benefit (why else did the plaintiff sue?) at the loser's expense (why else did the defendant resist?). *Coyne-Delany* observed that the no-damages rule reflects the norm in American litigation that the parties bear their own expenses; the injunction bond creates a limited exception to that norm. If the Trustee were correct, however, defendants injured by erroneously issued injunctions *always* would be compensated (at least to the extent of the plaintiffs' gains), and the rule would be overturned. To repeat what was said in *Coyne-Delany:* the American Rule allowing expenses and injuries of litigation to lie where they fall may be questionable, but its revision is a task for Congress, the Supreme Court, or the bodies that prescribe the federal rules of procedure; the subject is out of an inferior federal court's hands.

[5] The Trustee's contention that the judge's mistake is a "taking" of property, so that the Constitution itself requires compensation, is frivolous. See *In re Chicago, Milwaukee, St. Paul & Pacific Ry.,* 759 F.2d 317, 321-28 (7th Cir.1985).

The judgment of the district court is vacated, and the case is remanded with instructions to remand to the bankruptcy court, so that the injunction may be vacated as much to the extent it blocks sale of shares by the ESOP or any of the investors whose stock came through the ESOP. See *United States v. Manningwear, Inc.,* 340 U.S. 36, 71 S.Ct. 106, 95 L.Ed. 36 (1950).

C.A.7 (Ill.), 2005.

In re UAL Corp.
Internal Revenue Service (I.R.S.)
IRS PLR

Private Letter Ruling

Issue: February 3, 2006
October 28, 2005

Section 382 -- Limitation on Net Operating Loss Carry-forwards and Built-in Losses Following Ownership Changes
382.00-00 Limitation on Net Operating Loss Carry-forwards and Built-in Losses Following Ownership Changes

CC:CORP:1
PLR-139276-05

Legend:
Company =

date 1 =
date 2 =
date 3 =
date 4 =
date 5 =
State =
a =
b =
c =
d =
Manager =

Small Investor Fund = 
Large Investor Fund =
Foreign Investor Fund =
General Partner =
Individual =
Country =

Dear ***:

This letter responds to your letter dated July 22, 2005, requesting rulings under section 382 of the Internal Revenue Code (Code). Submissions dated August 8, September 23, and October 24, 2005, supplement the original letter. The relevant information in the letter and supplements is summarized below.

Company is the common parent of an affiliated group of corporations filing a consolidated return. Company is a loss corporation. The stock of Company is widely held and publicly traded on an over-the-counter market using what are known as “pink sheets.”

On date 1 (more than three years ago), Company and subsidiaries filed voluntary bankruptcy petitions in the United States Bankruptcy Court for the District of State (Bankruptcy Court). On date 2 (while Company was a loss corporation), Company filed a motion with the Bankruptcy Court requesting the Bankruptcy Court to impose trading restrictions on Company stock. The restrictions were intended to give Company the ability to prevent an ownership change by limiting owner shifts in Company stock. The Bankruptcy Court imposed the requested restrictions by interim order effective date 3 and by final order effective date 5.

The restrictions relate to acquisitions or dispositions of Company stock involving any person (Restricted Owner) that owns or comes to own at least a percent (greater than 4 but less than 5 percent) of Company stock. Ownership for this purpose takes into account the constructive ownership rules of section 382 and the regulations thereunder. Under the interim and final orders, any person that is or becomes a Restricted Owner is required to notify Company of the person’s status as such. Also, any person intending to acquire Company stock is required to notify Company if the proposed acquisition (Purported Acquisition) would either (i) cause any person to become a Restricted Owner or (ii) increase the percentage of stock owned by any Restricted Owner. In addition, any person intending to dispose of Company stock is required to notify Company if the proposed disposition (Purported Disposition) would either (i) cause any person to cease to be a Restricted Owner or (ii) decrease the percentage of stock owned by any Restricted Owner. Within a specified time of receiving notice of a Purported Acquisition or Disposition (Purported Transaction), Company may object to the transaction. If Company objects in accordance with the order, any Purported Transaction is not effective unless approved by an order of the Bankruptcy Court.

Shortly before date 3, three private investment funds under common management (Funds) began to acquire Company stock. The Funds informed Company that as of date 4 (while the interim order was in effect), the Funds owned in the aggregate b percent (greater than 5 percent) of Company stock. The Funds also informed Company that each Fund individually owned less than a percent of Company stock (taking into account the constructive ownership rules of section 382 and the regulations thereunder).
Company was concerned that the Funds together might be an entity under Treas. Reg. § 1.382-3(a)(1). If the Funds together were an entity, the acquisitions of Company stock would result in an owner shift under section 382(e)(2) and Treas. Reg. § 1.382-2T(g)(1). In addition, if the Funds together were an entity, one or more of the acquisitions would be Purported Acquisitions. Thus, Company considered objecting to the acquisitions as in violation of the interim order. Ultimately Company agreed that if the Funds together were not an entity, Company would not object to the acquisitions.

The Funds consist of Small Investor Fund (Small), Large Investor Fund (Large), and Foreign Investor Fund (Foreign). Small and Large are State limited partnerships, and Foreign is a Country corporation. General Partner is the general partner of Small and Large and the sponsor of Foreign. General Partner owns a 2 percent interest in each Fund's net profits. General Partner is owned by Individual and persons or entities affiliated with Individual, such as family members, trusts for the benefit of family members, and the like. Individual and affiliates own limited partnership interests in the Funds equal to approximately d percent (less than 10 percent) of the total capital interests in the Funds.

Manager is an LLC that serves as manager and investment advisor of the Funds. Individual and affiliates own Manager.

Each Fund is organized to attract specific types of investors. No Fund shares an investor with any other Fund. The Funds qualify for exemption from registration under the Investment Company Act of 1940. Each Fund's specific exemption depends on the type of investor it attracts.

Each Fund has the same investment objectives. Thus, in virtually every case Manager decides to invest each Fund's assets in the same stock or security. Moreover, Manager invests the same percentage of each Fund's total assets in that stock or security. That is, Manager invests based on the percentage of each Fund's assets to be invested in a particular issuer's stock or security; Manager does not invest based on the percentage of an issuer's stock or security to be acquired by one or more of the Funds. Manager acts in accordance with its fiduciary duty to the Funds. However, even in the absence of a fiduciary duty, Manager would use this investment approach because each Fund has the same investment objectives.

In addition to serving as investment advisor to the Funds, Manager also serves as investment advisor to other private investment funds. The investment objectives of these other funds differ from that of the Funds. Thus, for example, none of these other funds owns Company stock.

The Funds represent as follows:
(a) The Funds:
   (i) did not acquire any Company stock for the purpose of the Funds' accumulating ownership of any particular minimum percentage of the total outstanding stock of Company,
   (ii) have not acquired equity interests in any other issuer for the purpose of the Funds' accumulating ownership of any particular minimum percentage of the equity interests of that issuer, and
   (iii) have not indicated to investors in the Funds that the Funds would acquire equity interests in any other issuer for the purpose of the Funds' accumulating ownership of any particular minimum percentage of the equity interests of any issuer.

(b) The Funds:
   (i) did not acquire any Company stock for the purpose of changing or influencing the control of Company,
   (ii) have not acquired equity interests in any other issuer for the purpose of changing or influencing the control of that issuer, and
   (iii) have not indicated to investors in the Funds that the Funds would acquire equity interests in any other issuer for the purpose of changing or influencing the control of any issuer.
In the event of a Purported Transaction, Company may seek to compel certain actions related to Company stock acquired or disposed of in the Purported Transaction (Prohibited Company Stock), as described in (I) through (III) below.

(I) Within 30 business days of learning of a Purported Transaction, Company will notify the Bankruptcy Court and the person engaging in the Purported Transaction that the transaction is in violation of the order.

(II) In the event a person (Purported Transferee) acquires Prohibited Company Stock in a Purported Acquisition:

(i) Within 30 business days of learning of the Purported Acquisition, Company will demand that the Purported Transferee sell the Prohibited Company Stock in an arm's length transaction using the "pink sheets" if possible. If the Purported Transferee does not sell the Prohibited Company Stock within 30 days of the demand, Company will institute legal proceedings to compel the sale.

(ii) If the amount realized by the Purported Transferee on the sale reduced by related costs (net proceeds) exceeds the Purported Transferee's basis in the Prohibited Company Stock, then

a. After selling the Prohibited Company Stock, the Purported Transferee will promptly donate the net proceeds from the sale minus its basis in the Prohibited Company Stock, together with any distributions received on the Prohibited Company Stock while the order is in effect, to one or more organizations described in section 501(c)(3). If the Purported Transferee received the Prohibited Company Stock by gift or inheritance, its basis for this purpose shall be the fair market value of the Prohibited Company Stock at the time received.

b. The Purported Transferee will promptly notify the Bankruptcy Court and Company, in a certificate signed by a person authorized by the Purported Transferee, of the number of shares of Prohibited Company Stock sold, the date of each sale, the price at which each share was sold, the related costs of each sale, the basis of each share sold, the date on which each share was acquired, the gain recognized on each sale, the amounts received as distributions while the order is in effect, the fair market value of the share at the time received if received by gift or inheritance, and the section 501(c)(3) organizations to which net proceeds minus basis, together with distributions, were donated.

(iii) If the net proceeds from the sale do not exceed the Purported Transferee's basis in the Prohibited Company Stock, then:

a. After selling the Prohibited Company Stock, the Purported Transferee will promptly donate any distributions received on the Prohibited Company Stock while the order is in effect, minus costs related to the sale, to one or more organizations described in section 501(c)(3). If the Purported Transferee received the Prohibited Company Stock by gift or inheritance, its basis for this purpose shall be the fair market value of the Prohibited Company Stock at the time received.

b. The Purported Transferee will promptly notify the Bankruptcy Court and Company, in a certificate signed by a person authorized by the Purported Transferee, of the number of shares of Prohibited Company Stock sold, the date of each sale, the price at which each share is sold, the related costs of each sale, the basis of each share sold, the date on which each share was acquired, the loss, if any, recognized on each sale, the amounts received as distributions while the order is in effect, the fair market value of the share at the time received if received by gift or inheritance, and the section 501(c)(3) organizations to which distribution minus costs related to the sale were donated.

(III) In the event a person (Purported Transferor) disposes of Prohibited Company Stock in a Purported Disposition (including a disposition by a Purported Transferee selling Restricted Company Stock before demand by Company, and any other Purported Disposition):

(i) If the net proceeds from the Purported Disposition exceed the Purported Transferor's basis in the Prohibited Company Stock, upon receiving notice from Company the Purported Transferor will promptly donate the net proceeds from the sale minus its basis in the Prohibited Company Stock, together with any distributions received on the Prohibited Company Stock while the order is in effect, to one or more organizations described in section 501(c)(3), and will promptly notify the Bankruptcy Court and Company as provided in (II)(ii) above.

(ii) If the net proceeds from the Purported Disposition do not exceed the Purported Transferor's basis in the
Prohibited Company Stock, upon receiving notice from Company the Purported Transferor will promptly donate any distributions received on the Prohibited Company Stock while the order is in effect, minus costs related to the sale, to one or more organizations described in section 501(c)(3), and will promptly notify the Bankruptcy Court and Company as provided in (II)(iii)b., above.

Based on the foregoing, we rule as follows:

1. The Funds together are not an entity within the meaning of Treas. Reg. § 1.382-3(a)(1).

2. Provided that:
   (i) the Purported Transferee or Transferor complies with the procedures described in (I) through (III) above, or
   (ii) Company complies with the prompt enforcement requirements described in (I) through (III) above and is continuing to seek enforcement against a Purported Transferee or Transferor at the end of a taxable year of Company,

the person acquiring Prohibited Company Stock in the Purported Transaction will not be treated as having acquired ownership of that stock for purposes of section 382 and the regulations thereunder.

3. Should a court or other adjudicative body issue a final order declaring the restrictions in the Bankruptcy Court's interim or final orders unenforceable ab initio, then for purposes of section 382 and the regulations thereunder ownership of Prohibited Company Stock will be treated as having been acquired by a person in a Purported Transaction on the date actually acquired.

The ruling contained in this letter is based on facts and representations submitted by the taxpayer and accompanied by a penalties of perjury statement executed by an appropriate party. This Office has not verified any of the materials submitted in support of the request for rulings. Verification of the information, representations, and other data may be required as part of the audit process.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

A copy of this letter should be attached to the federal income tax return of the taxpayers involved for any relevant taxable year.

Pursuant to the power of attorney on file with this office, a copy of this letter is being sent to your authorized representatives.

Sincerely,
Martin Huck
Assistant Chief, Branch 1
Office of the Associate Chief Counsel (Corporate)

This document may not be used or cited as precedent. Section 6110(k)(3) of the Internal Revenue Code.

TAX ATTRIBUTES AS PROPERTY OF THE ESTATE

Paul H. Asofsky

June 17, 2015

I. Jurisdiction of Bankruptcy Court over Non-debtor’s Tax Elections and Tax Planning


1. Debtor subsidiary files chapter 11.

2. Non-debtor parent and creditors of sub can’t reach agreement on a plan of reorganization.

3. Parent threatens to claim worthless stock deduction under IRC sec 165.
   a. Under IRC sec 382(g)(4), parent will be treated as having sold its stock in sub on the first day of the succeeding taxable year.
   b. Section 382 limitation will probably be zero; NOL will be eliminated.

4. Bankruptcy Court holds that Debtor’s NOL is “property” and is “property of the estate” under BC sec 541.
   a. Claiming worthless stock deduction would be an exercise of control over property of the estate, prohibited by BC sec 362(a)(3)
   b. Enjoins parent from claiming worthless stock deduction prior to consummation of the plan
   c. The decision is based on a literal reading of the Bankruptcy Code, not on any fiduciary duty of the majority shareholder to the loss corporation or its creditors.
   d. Second Circuit affirms, adopting the reasoning of the Bankruptcy Court.

B. Fallout: Cases extend *Prudential Lines* to regulate transactions in loss corporation’s stock and debt, and to tax planning by S corporation shareholders.

1. Under IRC sec 382(g)(1), an ownership change occurs when the “5% shareholders” of a loss corporation increase their ownership of a loss corporation’s stock (as defined) by more than 50 percentage points during a three year testing period.

   a. Thereafter, NOL utilization is limited on an annual basis to the product of the value of the loss corporation’s stock immediately before the ownership change and the “long-term tax-exempt rate” (a variable interest rate published monthly by the IRS).
b. Ownership changes occurring during a bankruptcy case will destroy the NOL because the value of the debtor’s stock is likely to be zero or minimal.

c. Following Prudential Lines, many courts enjoin, or require debtor clearance for, transfers of debtor stock during a bankruptcy case.


2. Under IRC sec 382(l)(5), debtor may be able to preserve most of its NOL, with no annual limitation, if, as a result of a confirmed plan of reorganization, 50% of the stock will be owned by existing shareholders and creditors who have held their claims for at least 18 months prior to the bankruptcy filing.

   a. Speculators and strategic investors buying up claims during the bankruptcy case may destroy the ability of the debtor to propose a plan of reorganization qualifying under IRC sec 382(l)(5).

   b. Following Prudential Lines, many courts enjoin, or require debtor clearance for, transfers of claims against the debtor during a bankruptcy case.

   c. See, e.g., In re McLean Industries, Inc., Bankr. S.D.N.Y., Ch. 11 Case nos. 86 B 12238 through 12241, order dated February 16, 1989; and cases collected at Henderson & Goldring, Tax Planning for Troubled Corporations, sec. 1002.4.1 (CCH 2015).

3. After a corporation makes an election under IRC sec 1362 to be treated as an S corporation, if it meets the definitional requirements of IRC sec 1361, it will be a pass-thru entity not subject to corporate income tax.

   a. If the election is made after the corporation has operated as a C corporation, corporation may continue to be taxed on certain passive income and built-in gains and items of income. See IRC secs 1375, 1374.

   b. The shareholders will be taxed on corporate income and, subject to limitations, will be able to claim corporate losses on their personal returns.

4. A corporation in which an S corporation owns stock will generally not be eligible for pass-thru treatment.

   a. If an S corporation owns 100% of the stock of a subsidiary, the parent S corp may elect to treat the subsidiary as a “qualified subchapter S subsidiary (“Q Sub”).

   b. Q Sub will be a disregarded entity. The parent S corp will include its items of income and deduction. IRC sec 1361(b)(3)(B)(ii).
c. Ultimate shareholders of the parent S corp will be taxable on the Q sub income.

d. If S corp status is lost for any reason, Q sub will thereafter be taxable as a C corp.

5. S corp status may be terminated in any of a number of ways, including ceasing to meet the requirements for S corp status, or an election by shareholders holding more than 50% of the stock of the corporation.

a. S corp will be a C corp from and after the effective date of the termination.

b. Any Q sub will be a C corp from and after the effective date of the termination.

c. Following Prudential Lines, some courts hold that a debtor S corp’s freedom from corporate income tax is property of the estate

i. Revocation made prior to bankruptcy may be avoided as a fraudulent conveyance if the requirements of BC sec 548 are met

ii. Revocation made after bankruptcy may be nullified or enjoined.


B. Seventh Circuit, in dictum, expresses doubt as to the correctness of Prudential Lines. In re UAL Corporation, 413 F. 3d 775 (7th Cir, 2005).

1. Debtor corporation, more than half of whose stock was owned by an ESOP, filed under chapter 11.

2. Debtor obtained an order, based on Prudential Lines and its progeny, enjoining the ESOP from disposing of its stock, including distributing it to the employee beneficial owners. The judge did not require a bond to protect the ESOP and its beneficiaries against loss (the trustee did not ask for one).

3. The trustee appealed. When the court heard the case, it was already moot, but the court made clear its feeling that the bankruptcy judge had erred.

a. The debtor should have been required to post a bond to protect the ESOP and its beneficiaries against market risk.
b. Although it is true that the creditors would benefit by an order preventing dilution of the NOL, “bankruptcy is not supposed to appropriate some investors’ wealth for distribution to others.”

c. Whether or not tax benefits are “property” within the meaning of BC sec 541, the ESOP’s sale of stock does not obtain possession or exercise control over them.

d. Conceded, without deciding, that the claiming of the worthless stock deduction in Prudential Lines may have been qualitatively different from a transfer of shares.

C. Third Circuit, in In re Majestic Star Casino, LLC, 716 F.3d 736 (3d Cir. 2013), distinguishes Prudential Lines, but clearly doesn’t like it.

1. Q sub was a chapter 11 debtor; parent S corp was not.

2. After Q sub’s bankruptcy petition was filed, Parent S corp shareholders revoked its S election. As a result, thereafter the Q sub would be a C corp and be taxed on its own income.


   a. Bankruptcy Court granted relief.

   b. Third Circuit reversed, holding that Q sub status was not property and was not property of the estate. Noted that contrary result would mean S corp shareholders would be taxed on Q sub income without having access to Q sub’s income or cash flow.

4. Usually, state law determines whether an interest constitutes property for bankruptcy law purposes. Here, that determination is made under the Internal Revenue Code, because it creates the applicable rights or obligations.

   a. The question is who controls the enjoyment and transfer of the rights.

   b. S corp status is different from NOLs because its continued vitality is subject to the whim of the shareholders.

   c. The term “property” is not so broad that it obliterates the rights of the shareholders.

   d. NOL is a specific dollar amount. Q sub is a status.

5. Refuses to follow In re Trans-Lines West and its progeny.

   a. Concludes that Q sub status is not property.

   b. In any event, Q sub status is not property of the estate because its benefits are enjoyed by someone other than the debtor,
c. Any other holding would place too many burdens on the parent, e.g., it can’t revoke its own election or transfer its stock in the Q sub.

6. Because Q sub doesn’t hold a property interest, neither it nor its creditors has standing to challenge the revocation.

7. Is the validity of Prudential Lines called into question?

a. Non-debtor stockholders are burdened by their inability to claim worthless stock deductions (majority shareholders only) or buy or sell their shares of debtor stock.

b. Footnote 18 of the Third Circuit’s opinion states: “The reasoning of the ‘NOL-as-property’ cases is itself not without flaws.” Those cases looked, in part, to Congressional intent that ‘property of the estate’ be construed to “include[] all interests, such as… contingent and future interests’….But Code sec 541 contains no reference to ‘contingent’ or ‘future’ interests and refers only to ‘legal or equitable interests of the debtor in property as of the commencement of the case.’….Moreover, ‘the critical analytical key [is] not…an abstract articulation of the statute’s purpose, but… an analysis of the nature of the asset involved in the light of those principles.’”[citation omitted]
716 F.3d 736
United States Court of Appeals,
Third Circuit.

In re The MAJESTIC STAR CASINO, LLC, et al,
Debtors.
The Majestic Star Casino, LLC, et al.
v.
Barden Development, Inc.; United States of
America on behalf of the Internal Revenue
Service; State of Indiana Department of Revenue;
John M. Chase, Jr., as Personal Representative of
Don H. Barden
United States of America on behalf of the Internal
Revenue Service, Appellant No. 12-3200.
Barden Development, Inc and John M. Chase, Jr.,
as Personal Representative of Don H. Barden,
Appellants No. 12-3201.

Filed: May 21, 2013.

Synopsis
Background: Adversary proceeding was brought to set
aside, as unauthorized postpetition transfer and violation
of automatic stay, conduct resulting in termination of
debtor’s status as qualified subchapter “S” subsidiary. The
United States Bankruptcy Court for the District of
Delaware, Kevin Gross, J., 466 B.R. 666, granted Chapter
11 debtor’s motion for summary judgment and denied
motions to dismiss or for judgment on the pleadings, and
defendants appealed.

Holdings: Addressing issues of first impression, the
Court of Appeals, Jordan, Circuit Judge, held that:

[1] when subchapter S (sub-S) corporation files for
bankruptcy, its sub-S status is not “property” interest, of
kind included in “property of the estate”;

[2] corporate debtor’s status as of commencement of its
bankruptcy case, as qualified subchapter S subsidiary
(QSub), was not “legal or equitable interest in property,”
such as would have been brought into Chapter 11 estate;

[3] even assuming that debtor’s status as QSub was in
nature of “legal or equitable interest in property,” it was
property interest, not of debtor-subsidiary, but of its
nondebtor corporate parent, and was not included in
estate; and

[4] debtor lacked prudential standing to challenge
revocation of its parent’s sub-S status, though this
automatically resulted in termination of debtor’s QSub
status.

Vacated and remanded.

West Headnotes (33)

[1] Bankruptcy
★★Carrying out provisions of Code
To extent that corporate Chapter 11 debtor’s
status as qualified subchapter S subsidiary
(QSub) was included in “property of the estate,”
and that nondebtor parent’s voluntary revocation
of its subchapter S (S-corp) status and debtor’s
resultant loss of its QSub status was in nature of
unauthorized postpetition transfer of estate
property, bankruptcy court, in exercise of
authority granted to it to enter “necessary or
appropriate” orders, could direct the Internal
Revenue Service (IRS) to reinstate nondebtor
parent’s status as S-corp and debtor’s status as
QSub. 11 U.S.C.A. §§ 105(a), 362(a)(3), 541(a),
549.

[2] Bankruptcy
★★Conclusions of law; de novo review
Bankruptcy
★★Clear error

On direct appeal from bankruptcy court’s grant
of summary judgment, the Court of Appeals
would review findings of fact for clear error and
exercise plenary review over legal
8013, 11 U.S.C.A.
Bankruptcy

Conclusions of law; de novo review

On appeal in bankruptcy case, appellate court exercises plenary review over bankruptcy court’s rulings on motions to dismiss, or on motions for judgment on the pleadings.

Federal Civil Procedure

In general; injury or interest

Doctrine of standing focuses upon the party seeking to get his complaint before federal court and not on issues that he wishes to have adjudicated.

Internal Revenue

Loss, termination or revocation

Corporation cannot alter its tax status as subchapter S corporation through election, revocation or rescission without some form of shareholder consent, and corporation, standing alone, cannot challenge validity of prior subchapter S revocation without consent of at least those shareholders who consented to revocation.

Federal Civil Procedure

In general; injury or interest

Rights of third parties or public

Doctrine of standing involves both constitutional limitations on federal court jurisdiction and prudential limitations on its exercise, such as prudential requirement that plaintiff generally must assert his own legal rights and interests and not rest his claim to relief on legal rights or interests of third parties.

Bankruptcy

In general; standing

Trustee or corporate debtor-in-possession that attempts to challenge validity of revocation of corporation’s subchapter S status without consent of at least those shareholders who consented to revocation is asserting rights of third party, i.e., the equity holders, and does not have standing.

Federal Civil Procedure

Rights of third parties or public

Prohibition on third party standing is not invariable.

Federal Civil Procedure

Rights of third parties or public

Three preconditions must be met in order for...
plaintiff to have standing to assert rights of third party; (1) plaintiff must suffer injury; (2) plaintiff and third party must have a close relationship; and (3) third party must face some obstacles that prevent it from pursuing its own claims.

φ=Nature and form; adversary proceedings
Bankruptcy
φ=Validity of acts in violation of injunction or stay
Bankruptcy
φ=Post-petition transactions

Automatic stay operates differently from unauthorized postpetition transfer statute and statute governing the liability of transferees: while trustee or debtor-in-possession must commence adversary proceeding in order to avoid transaction as unauthorized postpetition transfer, transfer that violates stay is generally viewed as void without any action on part of debtor. 11 U.S.C.A. §§ 362, 549, 550.

[12] Bankruptcy
φ=Property of Estate in General
Bankruptcy
φ=Particular Items and Interests
Bankruptcy
φ=Tangible personality in general
Bankruptcy
φ=Rights of Action; Contract Rights Generally

Definition of "property of the estate" is intended to sweep broadly so as to include all kinds of property, including tangible or intangible property, and causes of action. 11 U.S.C.A. § 541(a).

[13] Bankruptcy
φ=Particular Items and Interests
Bankruptcy
φ=Future interests

Interest is not outside reach of "property of the estate" merely because it is novel or contingent, or because enjoyment thereof must be postponed. 11 U.S.C.A. § 541(a).

1 Cases that cite this headnote

[14] Bankruptcy
φ=Future interests

Mere opportunity to receive economic benefit in future is "property" with value under the Bankruptcy Code. 11 U.S.C.A. § 541(a).

[15] Bankruptcy
φ=Effect of Bankruptcy Relief; Injunction and Stay

Filing of bankruptcy petition does not create new property rights or value where none previously existed.

[16] Bankruptcy
φ=Creation of estate; time

Bankruptcy estate is determined at time of initial filing of bankruptcy petition. 11 U.S.C.A. § 541(a).

[17] Bankruptcy
φ=Effect of state law in general

Congress has generally left determination of
property rights in assets of bankruptcy estate to state law; however, if some federal interest requires a different result, then property interests may be defined by federal law. 11 U.S.C.A. § 541(a).

Internal Revenue

Application of state-created rights and interests in general

Internal Revenue Code creates no property rights, but merely attaches consequences, federally defined, to rights created under state law.

Internal Revenue

Application of state-created rights and interests in general

State law controls in determining nature of legal interest which taxpayer has in property, for federal revenue purposes.

Internal Revenue

Application of state-created rights and interests in general

Once it has been determined that state law creates sufficient interests in taxpayer to satisfy requirements of federal revenue statute, state law is inoperative, and tax consequences thenceforth are dictated by federal law.

Bankruptcy

Property of Estate in General

Bankruptcy Code's definition of "property of the estate" is not without limitations. 11 U.S.C.A. § 541(a).

Bankruptcy

Particular Items and Interests

Bankruptcy

Particular Items and Interests
Tax classification over which debtor has no control is not "legal or equitable interest of the debtor in property," of kind included in "property of the estate" when debtor files for bankruptcy. 11 U.S.C.A. § 541(a)(1).

Bankruptcy

Corporate Chapter 11 debtor’s status as of commencement of its bankruptcy case, as qualified subchapter S subsidiary (QSub), was tax attribute entirely within control of shareholder of its corporate parent, and did not qualify as "legal or equitable interest in property," such as could have been brought into "property of the estate." 11 U.S.C.A. § 541(a)(1).

Bankruptcy

As practical matter, rights to which debtor asserts a "property interest" must be readily alienable and assignable, in order to fulfill equitable purpose of bankruptcy, which is to generate funds to satisfy creditors.

Bankruptcy

Even assuming that corporate Chapter 11 debtor’s status as of commencement of its bankruptcy case, as qualified subchapter S subsidiary (QSub), was in nature of "legal or equitable interest in property," it was property interest, not of debtor-subsidiary, but of its nondebtor corporate parent, so as not to be included in "property of the estate"; accordingly, when corporate parent’s owner elected to revoke parent’s subchapter S status, which resulted in automatic termination of debtor’s QSub and its ability to pass through income, there was no postpetition transfer of property of the estate, nor was there any attempt to exercise control over property of the estate, of kind implicating automatic stay or unauthorized postpetition transfer provision. 11 U.S.C.A. §§ 362(a)(3), 541(a)(1), 549.

Bankruptcy

Notwithstanding Congress’s intention, in its definition of "property of the estate," to bring anything of value that debtors have into estate, definition is not intended to expand debtor’s rights against others more than they exist as of commencement of bankruptcy case. 11 U.S.C.A. § 541(a).

Bankruptcy

Only net amounts diverted from, that is, damages consequently suffered by creditor body of, debtor may be recovered from transferee on avoided transfer. 11 U.S.C.A. § 550.
Trustee is entitled to only a single satisfaction under bankruptcy statute governing liability of transferees on avoided transfer. 11 U.S.C.A. § 550.

While it may be that third party standing need not be denied because of a slight, essentially theoretical conflict of interest between plaintiff and third party whose rights plaintiff is asserting, genuine conflicts strongly counsel against third party standing.

2 Cases that cite this headnote

Attorneys and Law Firms

*740 Kathryn Keneally, Thomas J. Clark, Ivan C. Dale, [Argued], Melissa L. Dickey, *741 United States Department of Justice, Tax Division, Washington, DC, Charles M. Oberly, United States Attorney, Wilmington, DE, for Appellants The United States of America.

Steven D. Carpenter, Indianapolis, IN, for Appellant Indiana Department of Revenue.

Mary F. Caloway, Buchanan Ingersoll & Rooney, Wilmington, DE, Gerald M. Gordon, [Argued], Erika Pike Turner, Gordon Silver, Las Vegas, NV, Anthony Iardi, Jr., Katherine Murphy, William Lentine, Dykema Gossett, PLLC, Bloomfield Hills, MI, for Barden Appellants.


Before: AMBRO, JORDAN, and VANASKIE, Circuit Judges.

Opinion

OPINION OF THE COURT

JORDAN, Circuit Judge.

This case arises from a corporate reorganization under Chapter 11 of the Bankruptcy Code, 11 U.S.C. § 101 et seq. (the "Code"), and puts at issue whether a non-debtor company's decision to abandon its classification as an "S" corporation for federal tax purposes, thus forfeiting the pass-through tax benefits that it and its debtor subsidiary had enjoyed, is void as a postpetition transfer of "property
of the bankruptcy estate,” or is avoidable, under §§ 362, 549, and 550 of the Code. This appears to be a question of first impression in the federal Courts of Appeals.

Barden Development, Inc. ("BDI"), John M. Chase, as the personal representative of the estate of Don H. Barden1 (together with BDI, the "Barden Appellants"), and the Internal Revenue Service (the "IRS") appeal an order of the United States Bankruptcy Court for the District of Delaware granting summary judgment to The Majestic Star Casino, LLC and certain of its subsidiaries and affiliates (collectively "Majestic" or the "Debtors") on their motion to avoid BDI’s termination of its status as an "S" corporation (or "S-corp"), an entity type that is not subject to federal taxation. In November 2009, the Debtors, which had been controlled by Barden, filed petitions for relief under Chapter 11 of the Code. After the bankruptcy filing, Barden, as sole shareholder of BDI, successfully petitioned the IRS to revoke BDI’s S-corp status. Under the Internal Revenue Code ("I.R.C."), that revocation also caused Majestic Star Casino II, Inc. ("MSC II"), an indirect and wholly-owned BDI subsidiary and one of the Debtors, to lose its status as a qualified subchapter S subsidiary (or "QSub"), which meant that it, like BDI, became subject to federal taxation.

The Debtors were then effectively controlled by their creditors and, naturally, did not agree with shouldering a new tax burden. They filed an adversary complaint asserting that the revocation of BDI’s S-corp status caused an unlawful postpetition transfer of property of the MSC II bankruptcy estate. The Bankruptcy Court agreed and ordered the Barden Appellants and the IRS to reinstate both BDI’s status as an S-corp and MSC II’s status as a QSub. The case was certified to us for direct appeal. For the reasons that follow, we will vacate the Bankruptcy Court’s January 24, 2012 order and *742 remand this matter to the Court with directions to dismiss the complaint.

I. BACKGROUND

A. Facts

1. The Parties

Defendant–Appellant BDI is an Indiana corporation with its headquarters in Detroit, Michigan. Defendant–Appellant Barden was, at pertinent times, the sole shareholder, chief executive officer, and president of BDI. At the time of the complaint, BDI qualified as a "small business corporation" under I.R.C. § 1361(b), and, presumably at Barden’s direction, had elected under I.R.C. § 1362(a) to be treated as an S-corp for purposes of federal income taxation. As an S-corp, BDI was not subject to federal taxation, see I.R.C. § 1363(a),10 or state taxation.11 Rather, its income and losses were passed through to its shareholder, Barden, who was required to report BDI’s income on his individual tax returns. See I.R.C. §§ 1363(b), 1366(a).12

Plaintiff–Appellee MSC II is a Delaware corporation that owns and operates the Majestic Star II Casino and the Majestic Star Hotel in Gary, Indiana. MSC II generates income from those operations. BDI acquired MSC II in 2005 and was, at all times relevant to this dispute, the ultimate owner of 100 percent of its stock.13 Prior to the Debtors’ bankruptcy petition, BDI elected to treat MSC II as a QSub for federal tax purposes, pursuant to *743 I.R.C. § 1361(b)(3)(B).14 That meant that MSC II was not treated as a separate tax entity from BDI, but rather that all of its assets, liabilities, and income were treated for federal tax purposes as the assets, liabilities, and income of BDI. See id. § 1361(b)(3)(A). As a result, MSC II paid no federal taxes and all of its income and losses flowed through to Barden (through BDI), and he was required to report them on his individual tax returns. See Treas. Reg. § 1.1366–1(a). BDI was able to elect to treat MSC II as a QSub because the latter met the statutory requirement that it was wholly owned by an S-corp, ultimately BDI. See I.R.C. § 1361(b)(3)(B); supra notes 5 and 6.

2. The Majestic Bankruptcy and the Revocation of MSC II’s QSub Status

On November 23, 2009 (the “Petition Date”), MSC II and the other Debtors filed voluntary petitions for bankruptcy relief under the Code, and the Bankruptcy Court subsequently ordered that their Chapter 11 cases be jointly administered. The Debtors became debtors-in-possession of their respective bankruptcy estates, and thus had, with limited exceptions not relevant here, all of the powers and duties of a bankruptcy trustee in a Chapter 11 case. At the Petition Date, both BDI and MSC II retained their status as, respectively, an S-corp and a QSub. Barden and BDI did not file bankruptcy petitions, nor did they participate as debtors in any of the petitions at issue in this case.

In addition to certain events that automatically revoke an entity’s election to be treated as an S-corp,17 that tax status may also be revoked if more than half of the corporation’s shareholders consent to the revocation. I.R.C. § 1362(d)(1)(B). If S-corp status is revoked, the entity
cannot elect such status again within five years of the revocation without the consent of the Secretary of the Treasury. Id. § 1362(g). 4

Sometime after the Petition Date, Barden, BDI’s sole shareholder, caused and consented to the revocation of BDI’s status as an S-corp, and BDI filed a notice with the IRS to that effect. The revocation was retroactively effective to January 1, 2010, the first day of BDI’s taxable year.5 As a result, MSC II’s QSub status was automatically terminated as of the end of the prior tax year (the “Revocation”), because it no longer met the requirement that it be wholly owned by an S-corp. Thus, both BDI and MSC II became C-corporations as of January 1, 2010. As a consequence of becoming a C-corporation, MSC II became responsible for filing its own tax returns and paying income taxes on its holdings and operations.

Neither BDI nor Barden sought or obtained authorization from the Debtors or from the Bankruptcy Court for the Revocation. The Debtors did not learn of the Revocation until July 19, 2010, which is believed to be at least four months after Barden and BDI filed the S-corp revocation with the IRS. See supra note 9. The Debtors allege that, because MSC II was not informed of the Revocation, it was unaware that it had a new obligation to report and pay income taxes. They also allege that, due to the change in MSC II’s tax status, MSC II had to pay approximately $2.26 million in estimated income tax to the Indiana Department of Revenue for 2010 that it otherwise would not have had to pay. However, as of April 2011 (the first date federal taxes would have been due following the Revocation), the Debtors had paid no federal income taxes as a result of the Revocation.

3. Confirmation of the Majestic Plan and Its Effect on MSC II

On December 10, 2010, prior to the Debtors’ filing of the adversary complaint that initiated this action, the Bankruptcy Court issued an order permitting the Debtors to convert MSC II from a Delaware corporation to a Delaware limited liability company (“LLC”). On March 10, 2011, the Court entered an order confirming the Debtors’ Second Amended Plan of Reorganization (the “Plan”). Pursuant to the Plan, as of December 1, 2011 (the “Effective Date”), new membership interests representing all of the equity interests in MSC II were to be issued to holders of certain senior secured debt. On November 28, 2011, just prior to the Effective Date, the Debtors went ahead and caused MSC II to convert to an LLC. That conversion meant that MSC II would no longer have qualified for QSub status, even if the Revocation had not already occurred. See I.R.C. § 1361(b)(3)(B) (requiring that a QSub be a “domestic corporation”).6 Also, as part of the Plan of Reorganization, MSC II ceased to be wholly owned by an S-corp, so that, even absent the LLC conversion, and independent of the Revocation, MSC II would no longer have qualified as a QSub. The Debtors’ Plan of Reorganization was substantially consummated on December 1, 2011, and *745 MSC II emerged from bankruptcy together with the other Debtors on that date.

B. Procedural History

On December 31, 2010, the Debtors filed an adversary complaint in the Bankruptcy Court, asserting that the Revocation caused an unlawful postpetition transfer of MSC II’s estate property, in violation of §§ 362 and 549 of the Bankruptcy Code. The complaint sought recovery of that “property” under Code § 550, through an order “directing the IRS and [the] Indiana [Department of Revenue] to restore BDI’s status as an S corporation and MSC II’s status as a QSub retroactively effective January 1, 2010.” (App. at 50.).

The IRS moved to dismiss the Debtors’ adversary complaint on February 14, 2011, contending that the Bankruptcy Court lacked jurisdiction and that the Debtors failed to state a claim under Federal Rules of Civil Procedure 12(b)(1) and 12(b)(6) (incorporated by Federal Rule of Bankruptcy Procedure 7012(b)). More particularly, the IRS argued that the Bankruptcy Court lacked jurisdiction under Code § 505(a)(1) because the Debtors had not alleged that MSC II had actually paid any federal corporate income taxes or filed any federal income tax returns prior to initiating their adversary proceeding, so that their claims were not ripe. The IRS also argued that the Debtors had failed to state a claim because MSC II’s status as a QSub was not “property” of the MSC II estate because MSC II “never had a right to claim, continue, or revoke” that status “either before or after it filed its bankruptcy petition” (App. at 81), and that no “transfer” of estate property occurred when BDI terminated its S-corp election and triggered the loss of MSC II’s QSub status, (App. at 83–84).

Barden and BDI answered the Debtors’ adversary complaint on February 28, 2011, and moved for judgment on the pleadings under Federal Rule of Civil Procedure 12(c). They contended that because a QSub has no separate tax existence, MSC II had no cognizable property interest in that status. They also argued that, because a subsidiary’s QSub status depends entirely on elections made by its S-corp parent, even if MSC II’s
QSub status were a species of property, it was property that belonged to BDI and Barden.

The Debtors moved for summary judgment on March 16, 2011, and, on January 24, 2012, the Bankruptcy Court granted their motion and denied both the IRS’s motion to dismiss and the Barden Appellants’ motion for judgment on the pleadings. The Court held that MSC II’s status as a QSub was the property of MSC II, and that, as such, it belonged to MSC II’s bankruptcy estate. The Court therefore concluded that the revocation by non-debtor BDI of its status as an S-corp, and the resulting termination of MSC II’s status as a QSub, were void and of no effect. Finally, the Court ordered the defendants, including the IRS, to take all actions necessary to restore the status of MSC II as a QSub of BDI.

That order, of course, has significant practical implications for the parties. As with many bankruptcy reorganizations, the Debtors’ emergence from bankruptcy resulted in the cancellation of a substantial amount of indebtedness, which, in turn, generated “cancellation of debt” (“COD”) income equal to the amount by which the debt was reduced in bankruptcy. At oral argument before us, the IRS said that the amount of that COD income was $170 million. COD income is generally subject to federal taxation. See I.R.C. § 61(a)(12) (including in the definition of “gross income” “income from the discharge of indebtedness”). If BDI is restored to S-corp status, then it, and ultimately Barden, *746 is the taxpayer and would be liable for the taxes on the COD income. See Prop. Treas. Reg. § 1.108-9, 76 Fed.Reg. 20593-01 (Apr. 13, 2011) (providing that, when the debtor is a disregarded entity, such as an S-corp, then the owner of that entity is the taxpayer). Normally, under the so-called “Bankruptcy Exception,” a taxpayer in bankruptcy does not recognize COD income on debt that is cancelled or written down as part of a plan of reorganization. I.R.C. § 108(a)(1)(A). However, in this case, neither Barden nor BDI was part of the Majestic bankruptcy, so they may not qualify for the Bankruptcy Exception and could be liable for the tax on the COD income. See Prop. Treas. Reg. § 1.108-9 (limiting the Bankruptcy Exception to entities under the jurisdiction of the Bankruptcy Court). Also, the Bankruptcy Court’s order caused the IRS to lose the benefit of MSC II’s tax liabilities being treated as an administrative expense of the bankruptcy estate, which would have allowed the government to be paid before most other creditors. See 11 U.S.C. § 503(b)(1)-(B).

By contrast, the Debtors—or, more precisely, their former creditors who replaced BDI as the holders of MSC II’s equity—benefit in at least two dramatic ways if the Revocation is deemed to have been void or is otherwise avoided. First, if MSC II remains a QSub even after having emerged from bankruptcy, then it (and its new equity holders) will continue to enjoy its tax-free status, while BDI retains liability for MSC II’s income taxes, even though BDI no longer has access to MSC II’s income and cash flow to fund the tax payments. Second, by shifting the tax liability for COD income to BDI, MSC II need not make use of the Bankruptcy Exception, which would ordinarily come with a substantial cost. Under the I.R.C., a debtor that makes use of the Bankruptcy Exception must reduce the value of other tax attributes dollar-for-dollar by the amount of COD income excluded from gross income. See I.R.C. § 108(b)(1). That means that the reorganized debtor loses the value of various deductions and credits that would have been available to reduce taxes in the future. See id. § 108(b)(2). As a consequence of the Bankruptcy Court’s order, however, the Debtors avoid liability for COD income without the adverse impact on their tax attributes.

The Bankruptcy Court granted the IRS and the Barden Appellants leave to appeal on March 7, 2012, even though the Court’s judgment and order had left open the calculation of the damages for which Barden and BDI were liable as a result of the Court’s conclusion that they had violated the automatic stay. The United States District Court for the District of Delaware certified the appeals to us on May 23, 2012, and we authorized the appeals on July 9, 2012.

II. JURISDICTION AND STANDARDS OF REVIEW

The Bankruptcy Court had jurisdiction over the adversary proceeding pursuant to 28 U.S.C. §§ 157(b)(2), 1334(a)-(b). We have jurisdiction over this direct appeal under 28 U.S.C. § 158(d)(2)(A). We reject the Barden Appellants’ argument, raised for the first time in this appeal, that the Bankruptcy Court, as an Article I court, lacked jurisdiction to order the IRS to reinstate BDI’s status as an S-corp and MSC II’s status as a QSub. Leaving aside that arguments not raised below are normally waived on appeal, see In re American Biomaterials Corp., 954 F.2d 919, 927 (3d Cir. 1992), that argument is without merit. The Bankruptcy Code gives bankruptcy courts the power to “issue any order, process, or judgment that is necessary or appropriate to carry out [its] provisions.” Official Comm. of Unsecured *747 Creditors of Cybergenics Corp. ex rel. Cybergenics Corp. v. Chinery, 330 F.3d 548, 567 (3d Cir. 2003) (quoting 11 U.S.C. § 105(a)). The IRS is subject to that power as an “entity” referred to in specific provisions of the Code, because that term expressly includes a “governmental unit.” 11 U.S.C. § 101(13). The Court’s ability to exercise jurisdiction over the IRS has been
affirmed in a number of contexts. See United States v. Energy Res. Co., 493 U.S. 545, 549, 110 S.Ct. 2139, 109 L.Ed.2d 580 (1990) (holding that "a bankruptcy court has the authority to order the IRS to apply the payments [made by a debtor] to trust fund liabilities if the bankruptcy court determines that this designation is necessary to the success of a reorganization plan"); United States v. Whiting Pools, Inc., 462 U.S. 198, 209, 103 S.Ct. 2309, 76 L.Ed.2d 515 (1983) (concluding that the Code authorizes a bankruptcy court to recover property seized to satisfy a lien prior to the filing of a petition for reorganization, and noting that "[w]e see no reason why a different result should obtain when the IRS is the creditor"). Transactions to which the IRS is a party are also subject to the general rule that they are void if they violate the automatic stay. See United States v. Galletti, 541 U.S. 114, 124 n. 5, 124 S.Ct. 1548, 158 L.Ed.2d 279 (2004) (noting that the automatic stay barred the IRS from bringing suit against a debtor in bankruptcy); In re Schwartz, 954 F.2d 569, 571 (9th Cir.1992) (holding that an IRS tax assessment that violated the automatic stay was void).

Although we reject the Barden Appellants’ argument that the Bankruptcy Court lacked jurisdiction, we note that this case raises a jurisdictional question of standing that the parties did not raise and the Bankruptcy Court did not consider. We address that question in Parts III.A and III.B, infra, in the context of the merits.

[1] When reviewing a bankruptcy court’s grant of summary judgment, “we review the ... findings of fact for clear error and exercise plenary review over the ... legal determinations.” In re Kiew Int’l Air Lines, Inc., 344 F.3d 311, 316 (3d Cir.2003) (citing In re Weckoh, 305 F.3d 177, 181 (3d Cir.2002)); In re Cont’d Airlines, 125 F.3d 120, 128 (3d Cir.1992). A grant of summary judgment is “proper only if it appears that there is no genuine issue as to any material fact and that [each of] the moving party[es] is entitled to a judgment as a matter of law.” Id. (alterations in original) (quoting Fed.R.Civ.P. 56(c)) (internal quotation marks omitted). In evaluating the evidence, we “view inferences to be drawn from the underlying facts in the light most favorable to the party opposing the motion.” Bartnicki v. Vopper, 200 F.3d 109, 114 (3d Cir.1999).


III. DISCUSSION

This appeal requires us to answer two related questions. As a threshold matter of justiciability, we must decide whether the Debtors have standing to challenge the revocation of MSC II’s QSub status. That, however, requires us to address the merits of whether the MSC II bankruptcy estate had a property interest in MSC II’s QSub status such that the Debtors had the right to challenge what they characterize as the postpetition transfer of that interest.

A. Standing

Front and center in this case is the question of whether a debtor subsidiary’s *748 entity tax status is “property” at all, and, if so, whether it is property belonging to that subsidiary or to its non-debtor corporate parent. That implicates standing, even though the issue was not addressed before this appeal. Inasmuch as the “[s]tanding doctrine embraces ... judicially self-imposed limits on the exercise of federal jurisdiction,” Allen v. Wright, 468 U.S. 737, 751, 104 S.Ct. 3315, 82 L.Ed.2d 556 (1984), we turn to it first.


[2] The Debtors’ effort to pursue claims under Code §§ 362, 549, and 550 is dependent upon Code § 541, which provides that a bankruptcy estate succeeds only to “legal or equitable interests of the debtor ... as of the commencement of the case,” 11 U.S.C. § 541(a)(1). It is a given that “[t]he trustee [or debtor-in-possession] can assert no greater rights than the debtor himself had on the date the [bankruptcy] case was commenced.” Guinn v. Lines (In re Trans–Lines West, Inc.), 203 B.R. 653, 666 (Bankr.E.D.Tenn.1996) (quoting Collier on Bankruptcy ¶ 541.06 (15th ed.1996)) (internal quotation marks omitted).
As discussed in more detail in Part III.B.1, infra, "a corporation cannot alter its tax status through election, revocation or rescission, without some form of shareholder consent," so that "the corporation, standing alone, cannot challenge the validity of a prior Subchapter S revocation ... without the consent of at least those shareholders who consented to the revocation." Trans-Line West, 203 B.R. at 660. As a result, "[a] trustee [or debtor-in-possession] who attempts to challenge the validity of a revocation without such consent is asserting the rights of a third party," i.e., the equity holder, and "does not have standing..." Id.; cf. Simon v. E. Ky. Welfare Rights Org., 426 U.S. 26, 37, 96 S.Ct. 1917, 48 L.Ed.2d 450 (1976) (declining to decide "whether a third party ever may challenge IRS treatment of another").

Following that reasoning, if we assume that a subsidiary's entity tax status, e.g., its existence as a pass-through entity, is "property" but hold that such status belongs not to the subsidiary itself but rather to its parent, then the right to challenge the revocation of QSub status solely to the parent corporation, and the bankruptcy estate of a QSub does not succeed to that right under Code § 541. If that is the case, then a debtor subsidiary that challenges a revocation, as MSC II has done in this case, is endeavoring to assert the rights of a third party, namely its S-corp parent, which is contrary to general principles of standing.

The prohibition on third party standing, however, "is not invariable and our jurisprudence recognizes third-party standing under certain circumstances." Pa. Psychiatric Soc'y v. Green Spring Health Servs., Inc., 280 F.3d 278, 288 (3d Cir.2002). We have recognized that "the principles animating ... prudential [standing] ... 749 concerns are not subverted if the third party is hindered from asserting its own rights and shares an identity of interests with the plaintiff." Id (citing Craig v. Boren, 429 U.S. 190, 193–94, 97 S.Ct. 45, 50 L.Ed.2d 397 (1976); Singleton v. Wulff, 428 U.S. 106, 114–15, 96 S.Ct. 2868, 49 L.Ed.2d 826 (1976) (plurality opinion); Eisenstadt v. Baird, 405 U.S. 438, 443–46, 92 S.Ct. 1029, 31 L.Ed.2d 349 (1972)). "More specifically, third-party standing requires the satisfaction of three preconditions: 1) the plaintiff must suffer injury; 2) the plaintiff and the third party must have a close relationship; and 3) the third party must face some obstacles that prevent it from pursuing its own claims." Id. at 288–89 (citing Campbell v. Louisiana, 523 U.S. 392, 397, 118 S.Ct. 1419, 140 L.Ed.2d 531 (1998); Powers v. Ohio, 499 U.S. 400, 411, 111 S.Ct. 1364, 111 L.Ed.2d 411 (1991); Pitt News v. Fisher, 215 F.3d 354, 362 (3d Cir.2000)).

If the entity tax status of MSC II is "property" that belongs to BDI, then the present case does not satisfy the third condition for third-party standing. Nothing in the record suggests that BDI, as the former shareholder of MSC II and the "third party" with standing, is unable to protect its own interests. The term "third party" is actually something of a misnomer here because BDI, as well as its ultimate shareholder Barden, are both defendant parties in the present action and have vigorously fought to protect their interests. Sticking with that nomenclature, though, it is settled that "third parties themselves usually will be the best proponents of their own rights," Singleotor, 428 U.S. at 114, 96 S.Ct. 2868, and the fact that BDI chose not to backtrack and challenge the Revocation does not mean that MSC II or the Debtors have standing to do so.

We thus find ourselves in a circumstance where what is ordinarily the preliminary question of standing cannot be answered without delving into whether the entity tax status of MSC II is "property" and, if so, whether it belongs to MSC II. In short, we must consider the merits.

B. QSub Status Claimed as "Property" of the MSC II Bankruptcy Estate

Referring to MSC II's QSub status, the Bankruptcy Court said that "because the debtor-corporation's subchapter 'S' status provided the debtor-corporation the ability to pass-through capital gains tax liabilities to its principals, the right to make or revoke its subchapter 'S' status had value to the debtor and constituted property or an interest of the debtor in property." In re Majestic Star Casino, LLC, 466 B.R. 666, 675 (Bankr.D. Del.2012). The Barden Appellants argue that the Bankruptcy Court erred in that conclusion because the Court "applied a general overarching bankruptcy principle that anything that brings value into a bankruptcy estate must be a property right" (Barden Appellants' Opening Br. at 21), despite the fact that "the Bankruptcy Code by itself ... does not constitute a source of property rights" (id. at 18). Likewise, the IRS asserts that simply because an S-corp election "means that the corporation may 'use' and 'enjoy' the benefits of a pass-through entity tax status, "it does not follow that the postpetition revocation of ... [that] election is a transfer of estate property." (IRS Opening Br. at 27.)

In their adversary proceeding, the Debtors sought relief under §§ 549, 550, and 362 of the Code. Section 549 provides 750 that a debtor-in-possession or trustee "may avoid a transfer of property of the estate that occurs after the commencement of the case [ ] and that is not authorized ... by the court," 11 U.S.C. § 549(a). Section 550 permits the debtor-in-possession or trustee to
"recover, for the benefit of the estate" property whose transfer has been avoided under § 549. Id. § 550(a). Finally, § 362 provides for an "automatic stay" such that the filing of a chapter 11 petition "operates as a stay applicable to all entities" of, inter alia, "any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate." Id. § 362(a)(3). Section 362 also provides that "an individual injured by any willful violation of [the] stay ... shall recover actual damages, including costs and attorneys' fees, and, in appropriate circumstances, may recover punitive damages." Id. § 362(a)(1).

Section 362 operates differently than §§ 549 and 550. Those latter sections authorize the bankruptcy court to "avoid" the "violation transfer, but the debtor-in-possession or trustee must commence an adversary proceeding. See Fed. R. Bankr.P. 7001(1) (requiring that a "proceeding to recover money or property" be brought as an "adversary proceeding"); In re Doll & Doll Motor Co., 448 B.R. 107, 111 (Bankr.M.D.Ga.2011) (denying bank's motion seeking an order to recover property sold by a Chapter 11 debtor because the bank had not filed an adversary proceeding against the buyer). By contrast, a transfer that violates the automatic stay is generally considered to be void without any action on the part of the debtor. In re Myers, 491 F.3d 120, 127 (3d Cir.2007) (citing In re Siciliano, 13 F.3d 748, 750 (3d Cir.1994) ("The general principle is that any creditor action taken in violation of an automatic stay is void ab initio.").

Notwithstanding that difference, all three sections have three elements in common for purposes of the problem before us. For the Revocation to be void under § 362 or avoidable under §§ 549 and 550, QSub status must be (1) "property" (2) "of the bankruptcy estate" (3) that has been "transferred." Though a lack of any one of those elements is dispositive, we choose to consider—in the alternative—only the first two.

1. QSub Status as "Property"

Section 541(a) of the Bankruptcy Code defines "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)(1). "We have emphasized that Section 541(a) was intended to sweep broadly to include all kinds of property, including tangible or intangible property, [and] causes of action." In re Kane, 628 F.3d 631, 637 (3d Cir.2010) (second alteration in original) (quoting Westmoreland Human Opportunities, Inc. v. Walsh, 246 F.3d 233, 241 (3d Cir.2001)) (internal quotation marks omitted). "[T]he term 'property' has been construed most generously and an interest is not outside its reach because it is novel or contingent because enjoyment must be postponed." In re Freeman Trailer Corp., 444 F.3d 203, 211 (3d Cir.2006) (quoting Segal v. Rochelle, 382 U.S. 377, 379, 86 S.Ct. 11, 25 L.Ed.2d 428 (1966)) (internal quotation marks omitted). "It is also well established that the mere opportunity to receive *751 an economic benefit in the future is property with value under the Bankruptcy Code." Id. (internal quotation marks omitted).

However, "[f]iling for bankruptcy does not create new property rights or value where there previously were none." In re Messina, 687 F.3d 74, 82 (3d Cir.2012); cf. Butler v. United States, 440 U.S. 48, 66, 99 S.Ct. 914, 59 L.Ed.2d 136 (1979) (noting that the holder of a property interest "is afforded in federal bankruptcy court the same protection he would have had under state law if no bankruptcy had ensued"). Consequently, "[t]he estate is determined at the time of the initial filing of the bankruptcy petition...." Kollar v. Miller, 176 F.3d 175, 178 (3d Cir.1999).

This appears to be a matter of deliberate Congressional choice. Although the constitutional authority of Congress to establish "uniform laws on the subject of Bankruptcies throughout the United States," U.S. Const., art. I, § 8, cl. 4, could, in theory, encompass a statutory framework defining property interests for purposes of bankruptcy, "Congress has generally left the determination of property rights in the assets of a bankrupt's estate to state law," Butler, 440 U.S. at 54, 99 S.Ct. 914; see also In re Bramon, 476 F.3d 170, 176 (3d Cir.2007) ("[W]e generally turn to state law for the determination of property rights in the assets of a bankrupt's estate." (internal quotation marks omitted)). However, if "some federal interest requires a different result," Butler, 440 U.S. at 55, 99 S.Ct. 914, then property interests may be defined by federal law. Cf. McKean v. Irving Trust Co., 323 U.S. 365, 370, 65 S.Ct. 405, 89 L.Ed. 305 (1945) (noting that, "[i]n the absence of any controlling federal statute," a creditor may acquire rights to property transferred by a debtor "only by virtue of state law").

Given the importance of federal tax revenues, one might assume that the Internal Revenue Code determines whether tax status constitutes a property interest of the taxpayer, but it does not do so explicitly and the case law is not entirely clear. See Drye v. United States, 528 U.S. 49, 57, 120 S.Ct. 474, 145 L.Ed.2d 466 (1999) (considering whether "state law is the proper guide to ... 'property' or 'rights to property' " under a provision..."
of the I.R.C. and noting that the Court’s “decisions in point have not been phrased so meticulously”). On one hand, the I.R.C. “creates no property rights but merely attaches consequences, federally defined, to rights created under state law.” United States v. Bess, 357 U.S. 51, 55, 78 S.Ct. 1054, 2 L.Ed.2d 1135 (1958). Thus, “[i]n the application of a federal revenue act, state law controls in determining the nature of the legal interest which the taxpayer had in the property.” United States v. Nat’l Bank of Commerce, 472 U.S. 713, 722, 105 S.Ct. 2919, 86 L.Ed.2d 565 (1985) (quoting Aquilino v. United States, 363 U.S. 509, 513, 80 S.Ct. 1277, 4 L.Ed.2d 1365 (1960)) (internal quotation marks omitted). On the other hand, “[w]hile it has been determined that state law creates sufficient interests in the taxpayer to satisfy the requirements of the federal revenue statute, state law is inapplicable, and the tax consequences therefore are dictated by federal law.” Id. (second alteration in original) (quoting Bess, 357 U.S. at 56–57, 78 S.Ct. 1054) (internal quotation marks omitted). In Drye v. United States, the Supreme Court ultimately concluded that “the [I.R.C.] and interpretive case law place under federal, not state, control the ultimate issue whether a taxpayer has a beneficial interest in any property subject to levy for unpaid federal taxes.” 528 U.S. at 57, 120 S.Ct. 474. Also, the I.R.C. addresses the handling of tax attributes in “752 the bankruptcy context, at least when “the debtor is an individual.” see I.R.C. § 1398(a), and provides that the “[s]tate succeeds to tax attributes of the debtor … determined as of the first day of the debtor’s taxable year in which the case commences…” I.R.C. § 1398(g); see also United States v. Sims (In re Foller), 218 F.3d 948, 953 (9th Cir.2000) (“I.R.C. § 1398 determines what tax attributes of the debtor rightfully belong to the bankruptcy estate.”). The Bankruptcy Code itself defers to the I.R.C. with respect to the creation and character of certain tax attributes of the bankruptcy estate. See 11 U.S.C. § 366(a) (providing that the I.R.C. governs whether the creation of a bankruptcy estate creates a tax entity separate from the debtor). Thus, we conclude that the I.R.C., rather than state law, governs the characterization of entity tax status as a property interest for purposes of the Bankruptcy Code.

With this background, we review the case law that the Debtors say supports their claim that MSC II’s QSub status was “property.”

i. S-Corp Status as “Property”

[22] The Bankruptcy Court reasoned that QSub status is analogous to S-corp status and, based on a few cases holding that the latter is “property” for purposes of the Code, concluded that the former is “property” too. The principal case is In re Trans-Lines West, Inc., 203 B.R. 653 (Bankr.E.D.Tenn.1996), which concerned whether a corporation’s revocation of its S-corp status prior to filing for bankruptcy was a prepetition transfer of property avoidable by the trustee pursuant to Code § 548. The bankruptcy court in that case acknowledged that, “[i]n the absence of controlling federal law, the question of whether a debtor possesses an interest in property is governed by state law,” but the court reasoned that, “[b]ecause the subject of the alleged transfer is the Debtor’s status as a Subchapter S corporation, a status created under title 26 of the United States Code, … federal law, and more specifically the Internal Revenue Code,” determines whether a debtor holds a property interest in its S-corp status. 203 B.R. at 661. The court observed that “‘property’ refers … to the right and interest or domination rightfully obtained over [an] object, with the unrestricted right to its use, enjoyment, and disposition.” Id. (quoting 63A Am.Jur.2d Property § 1 (1984)) (internal quotation marks omitted). It then jumped to the conclusion that, once a corporation elects to be treated as an S corporation, I.R.C. § 1362(c) guarantees and protects the corporation’s right to use and enjoy that status until it is terminated under I.R.C. § 1362(d). Moreover, § 1362(d)(1)(A) provides that “[a]n election under subsection (a) may be terminated by revocation.” I.R.C. § 1362(d)(1)(A). Thus, I.R.C. § 1362(d)(1)(A) guarantees and protects an S corporation’s right to dispose of that status at will.

Id. (first alteration in original). The court also noted that I.R.C. § 1362(c) provides that an S-corp election “shall be effective … for all succeeding taxable years of the corporation, until such election is terminated,” id. at 661–62 (internal quotation marks omitted), and it reasoned that the I.R.C. thus “affords a corporation which has elected the Subchapter S status a guaranteed, indefinite right to use, enjoy, and dispose of that status,” id. at 661. From that, the court concluded that “the Debtor possessed a property interest (i.e., a guaranteed right to use, enjoy and dispose of that interest) in its Subchapter S status….” Id. at 662. Other courts that have considered the issue of S-corp status as a property right have all come to the same conclusion. See Halverson v. Funaro (In re Funaro), 263 B.R. 892, 898 (8th Cir. BAP 2001) (“[A] corporation’s right to use, benefit from, or revoke its Subchapter S status falls within the broad definition of property [under the Code].”); Parker v. Saunders (In re Bakersfield Wester, Inc.), 226 B.R. 227, 234 (9th Cir. BAP 1998) (concluding that the holding in Trans-Lines West “is consistent with the Ninth...
Circuit's definition of property’’); *Hanrahan v. Waterman (In re Waterman Implement Inc.).* Bankr. No. 05-07284, 2006 WL 1552401, at *4 (Bankr.N.D.Iowa May 22, 2006) (“[T]he right to revoke [a] Subchapter S election is property ... as defined in § 541[ ] ... [a]nd the revocation of Debtor’s subchapter S status is also voidable under § 549 as a postpetition transfer.”).

The “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 (“NOLs”) to be property. In *Segal v. Rochelle*, the Supreme Court declared that the right to offset NOLs against past income (a “loss carryback”) is property of an individual debtor, because it entitles the debtor to a refund of taxes already paid. 382 U.S. at 380–81, 86 S.Ct. 511. The court decided that a debtor’s NOLs, because they arise from prior losses, are “sufficiently rooted in [its] pre-bankruptcy past” that, when carried back to generate a tax refund, they “should be regarded as ‘property’ under the Code.” Id. at 380, 86 S.Ct. 511.

Subsequent cases extended the holding in *Segal* to the right to use NOLs to offset future tax liability (a “loss carryforward”). For example, in *Official Committee of Unsecured Creditors v. PSS Steamship Co. (In re Prudential Lines, Inc.).* 928 F.2d 565, 567 (2d Cir.1991), a corporate *§754* subsidiary had $74 million of NOLs attributable to its past operations when an involuntary petition for reorganization under Chapter 11 was filed against it. Its corporate parent attempted to take a $39 million “worthless stock” deduction, based on the anticipated loss of its investment in the subsidiary, which would have eliminated the value of its NOL for future use, but creditors of the subsidiary sued the parent to enjoin it from doing so. The bankruptcy court held that the NOL carryforward was property of the subsidiary’s bankruptcy estate and that the parent’s planned tax deduction would violate the automatic stay. The court thus granted the injunction. *In re Prudential Lines Inc.*, 114 B.R. 27, 32 (Bankr.S.D.N.Y.1989). The United States Court of Appeals for the Second Circuit affirmed, holding that the “right to carryforward [the] $74 million NOL to offset future income is property of the [subsidiary’s] estate within the meaning of § 541.” 928 F.2d at 571. *Accord In re Felett*, 218 F.3d at 955–56 (holding that a prepetition election to carry forward NOLs, making them unavailable to the debtor to claim a refund of past taxes, constituted a preference payment avoidable under the Code); *Gibson v. United States (In re Russell)*, 927 F.2d 413, 417–18 (8th Cir.1991) (same). The Second Circuit also held that the non-debtor parent’s proposed worthless stock deduction was barred by the automatic stay because, “where a non-debtor’s action with respect to an interest

that is intertwined with that of a bankupt debtor would have the legal effect of diminishing or eliminating property of the bankruptcy estate, such action is barred by the automatic stay.” *Prudential Lines*, 928 F.2d at 574.

*Trans–Lines West* and the decisions that follow it extended *Prudential Lines*, *§754* saying that the ability to make an S-corp election, like the ability to elect whether to carry forward or carry back NOLs, is property. We think that extension untenable, though, for several reasons.” First, in applying the NOL-as-property principle, which had been extended once already by *Prudential Lines*, see supra note 15, the decision in “Trans–Lines West” and the other S-corp-as-property cases fail to consider important differences between the two putative property interests. In holding that tax status is property, the S-corp cases reason from the premise that the “prospective ... nature [of a right] does not place it outside the definition of ‘property.’ ” *Bakersfield Westar*, 226 B.R. at 234. Even accepting that this will sometimes be the case, not all contingencies are of equal magnitude or consequence. NOLs when carried back are hardly contingent at all. In all events, a debtor in possession of NOLs has a defined amount of them at the time of the bankruptcy filing; they are a function of the debtor’s operations prior to bankruptcy and are not subject either to revocation by the shareholders or termination by the IRS. See *Segal*, 382 U.S. at 381, 86 S.Ct. 511 (noting that “[t]he bankrupts in this case had both prior net income and a[n] [NOL] when their petitions were filed”); *Prudential Lines*, 928 F.2d at 571 (noting that the subsidiary had a $74 million NOL attributable to its pre-bankruptcy operation when it filed for Chapter 11 reorganization). By contrast, the shareholders of an S-corp can terminate its pass-through status at will, regardless of how long it has been an S-corp and whatever its pre-bankruptcy operating history has been. The tax status of the entity is entirely contingent on the will of the shareholders.

NOLs also have value in a way that S-corp status does not. The value of an *§754* NOL is readily determinable as a tax refund immediately available to the bankruptcy estate to the extent that it is applied to prior years’ earnings, and it is still subject to relatively clear estimation if the debtor decides to carry it forward against future earnings. The value of the S-corp election, however, is dependent on its not being revoked, as well as the amount and timing of future earnings. Moreover, NOL carryforwards may be monetized in a manner that continuing S-corp status cannot. A corporation that does not expect to generate sufficient future earnings to use its NOLs may be purchased by another more profitable corporation which may then use the NOLs to shelter its
own income, a transaction expressly contemplated by the I.R.C. See I.R.C. § 382 (setting forth certain limitations on the use of NOL carryforwards after a change in the corporation’s ownership). By contrast, the sale of an S-corp will generally result in the termination of its tax-free status. See I.R.C. § 1361(b)(1) (setting forth the requirements for “small business corporation” status and providing that the sale of an S-corp to most corporate purchasers would terminate its “S” status). Thus, the analogy of S-corp status to NOLs is of limited validity.

A further flaw in the S-corp-as-property cases is that they presume that “once a corporation elects to be treated as an S corporation, [the I.R.C.] guarantees and protects the corporation’s right to use and enjoy that status ... [and] guarantees and protects an S corporation’s right to dispose of that status at will.” Trans–Lines West, 203 B.R. at 662. That reflects an incomplete and inaccurate understanding of the law. The I.R.C. does not, and cannot, guarantee a corporation’s right to S-corp status, because the corporation’s shareholders may elect to revoke that status “at will.” See I.R.C. § 1362(d)(1)(B) (providing for termination of S-corp status by revocation with the approval of shareholders holding more than one-half the corporation’s shares). Even if the shareholders do not vote to revoke their corporation’s S-corp status, any individual shareholder may at any time sell his interest—without hindrance by the Code or the I.R.C.—to another corporation, or to a nonresident alien, or to a number of new individuals sufficient to increase the total number of shareholders to more than 100. Any of those sales would trigger the automatic revocation of the company’s S status because the corporation would no longer qualify as a “small business corporation.” See I.R.C. § 1361(a)(1), (b)(1). Thus, the Trans–Line West line of cases is incorrect in concluding that S-corp status is a “right” that is “guaranteed” under the I.R.C.

*757* [23] [24] Perhaps recognizing those flaws, some courts holding that S-corp status is “property” have defaulted to the argument that such status must be property because it has value to the estate. See Prudential Lines, 928 F.2d at 573 (“We must consider the purposes animating the Bankruptcy Code ... [and] Congress’ intention to bring anything of value that the debtors have into the estate.” (internal quotation marks omitted)); Bakersfield Westar, 226 B.R. at 234 (“The ability to not pay taxes has a value to the debtor-corporation in this case.”). Indeed, the Bankruptcy Court in this case essentially defined the Debtors’ property interest as “the right to prevent a shifting of tax liability from the shareholders to the QSub through a revocation of the ‘S’ corporation’s status.” Majestic Star Casino, 466 B.R. at 678. But § 541 defines property only in terms of “legal or equitable interests of the debtor in property as of the commencement of the case.” 11 U.S.C. § 541(a)(1). It goes without saying that the “right” of a debtor to place its tax liabilities on a non-debtor may turn out to have some value, but that does not mean that such a right, if it exists, is property. Capacious as the definition of “property” may be in the bankruptcy context, we are convinced that it does not extend so far as to override rights statutorily granted to shareholders to control the tax status of the entity they own. “[T]he Code’s property definition is not without limitations....” Westmoreland, 246 F.3d at 256. Even accepting that an interest that is “novel or contingent” may still represent property under the Code, Segal, 382 U.S. at 379, 86 S.Ct. 511, a tax classification over which the debtor has no control is not a “legal or equitable interest [ ] of the debtor in property” for purposes of § 541.

Finally, aside from their flawed reasoning, Trans–Lines West and its progeny (and the Bankruptcy Court’s decision in this case) also produce substantial inequities. Taxes are typically borne and paid by those who derive some benefit from the income. Cf. I.R.C. § 1 (imposing taxes on “the taxable income” of the parties listed in that section). As the IRS observes in its brief, “[i]n the typical case where an S corporation or Q-sub receives income, the shareholder has the ability to extract the income from the corporation in order to pay the taxes due on that income.” (IRS Opening Br. at 29.) See also supra notes 2 and 4 (discussing the “flow-through” nature of S-corps). If a bankruptcy trustee is permitted to avoid the termination of a debtor’s S-corp or QSub status, then any income generated during or as part of the reorganization process (such as from the sale of assets) is likely to remain in the corporation, and ultimately in the hands of creditors, but the resulting tax liability must be borne by the S-corp shareholders. The Trans–Lines West decision, despite its flaws, clearly recognized that unfairness:

The Trustee’s successful challenge of the Debtor’s revocation of its Subchapter S status in the present case would have dire tax consequences to the non-consenting shareholder. Upon the Trustee’s sale of the Debtor’s real estate, the liability for any capital gain would be passed on to the shareholder. Conversely, in its present C corporation status, the Debtor’s estate will be liable for the capital gains tax.

203 B.R. at 662 n. 9. Trans–Lines West treated that inequitable outcome as indicating a problem with the
bankruptcy trustee's standing to challenge the transfer of *758 a supposed property interest in a debtor's S-corp status without the consent of the company's shareholders, *Id.* at 660. That bit of *Trans–Lines West* is true enough, but the inequity also calls into question the soundness of the court's holding that an entity's tax status is property in the first place. "Under the scheme contemplated by the Bankruptcy Code, a debtor's creditors are typically compensated to the extent possible and in as equitable a fashion as possible ... after the trustee marshals the debtor's bankruptcy property...." Westmoreland, 246 F.3d at 251. It would be impossible for a trustee (or a debtor-in-possession) to "marshal" a debtor's S-corp status and use it to compensate creditors, as that status is not controlled by the debtor and has no realizable value.

For all these reasons, we decline to follow the rationale of *Trans–Lines West* and its progeny, and we conclude that S-corp status is not "property" within the meaning of the Code.

**ii. MSC II's QSub Status as "Property"**

QSub status is an *a fortiori* case. As with S-corp status, the I.R.C. does not (and cannot) guarantee a QSub "the unrestricted right to [the] use, enjoyment and disposition" of that status, see *Trans–Lines West*, 203 B.R. at 661, because it depends on a variety of factors that are entirely outside the QSub's control. The QSub has an even weaker claim to the control of its status than does an S-corp. The use and enjoyment of its entity tax status is not only dependent on its S-corp parent's continuing to own 100 percent of its stock, see *I.R.C.* § 1361(b)(3)(B)(i), (b)(3)(C)(i), but also on the parent's decision to not revoke the QSub election, see *id.* § 1361(b)(3)(B)(ii), as well as the parent's continuing status as an S-corp, see *id.* § 1361(b)(3)(B)(i). That last contingency, in turn, depends on the S-corp contingencies already discussed. Therefore, a QSub's use and enjoyment of its tax status may be terminated by factors not only outside its control, but also outside the control of its S-corp parent.

Nor can the QSub transfer or otherwise dispose of its QSub status. "As a practical matter," rights to which a debtor asserts a property interest "must be readily alienable and assignable," Westmoreland, 246 F.3d at 250, to fulfill the equitable purpose of bankruptcy, which is to generate funds to satisfy creditors. See *id.* at 251 (holding that a license for which few entities other than the debtor would qualify was not a property interest of a bankruptcy estate because it is "dubious, as a practical matter, that any potential buyers would actually bid for that right"). QSub status itself is neither alienable nor assignable, and an S-corp that wishes to sell its QSub and preserve its tax status can only sell it to another S-corp that is willing to purchase 100 percent of its shares and to make the QSub election. See *I.R.C.* § 1361(b)(3)(B) (setting forth the requirements for QSub status). The subsidiary would no longer qualify as a QSub after any other type of sale, and the I.R.C. expressly provides for the loss of QSub status as a result of a sale of the subsidiary's stock. See *id.* § 1361(b)(3)(C)(ii). Thus, a QSub can hardly be said to control the disposition of the alleged property interest in its entity status. Again, a tax classification over which a debtor has no control and that is not alienable or assignable is not a "legal or equitable interest [of the debtor in property]." *11 U.S.C.* § 541(a)(1). We therefore hold that MSC II's QSub status *759 was not "property" and that the Bankruptcy Court's contrary conclusion was error.

**2. QSub Status as Property of the Estate**

Even if QSub status were property, it would still have to be property "of the estate" for a transfer of that status to be void under Code § 362 or avoidable under § 549. The Code defines "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)(1) (emphasis added). Notwithstanding "Congress' intention to bring anything of value that the debtors have into the estate," *Prudential Lines*, 928 F.2d at 573 (internal quotation marks omitted), the legislative history of § 541 also demonstrates that it was "not intended to expand debtor's rights against others more than they exist at the commencement of the case." S. Rep. 95–989, at 82 (1978), reprinted in 1978 U.S.C.C.A.N. 5787, 5868; see also 4 Collier on Bankruptcy ¶ 541.06 (15th ed.1996) ("Although [§ 541(a)(1)] includes choses in action and claims by the debtor against others, it is not intended to expand the debtor's rights against others beyond what rights existed at the commencement of the case.... The trustee can assert no greater rights than the debtor himself had on the date the case was commenced.").

As discussed above, whether a tax attribute is property of a corporate entity for purposes of Code § 541 is a function of the I.R.C. and related regulations. Even if it were proper to think of S-corp status in terms of "ownership," the ownership question would rightly be decided by considering the S-corp's "flow-through" treatment for tax purposes. See supra note 4. For example, an NOL may belong to a debtor that is a "C" corporation, such as in
Prudential Lines, or to an individual debtor, as in Feiler and Russell, because “when [a] C corporation and/or ... individuals file[] for bankruptcy, the estate contains all of their assets[,] [and] [h]eferred therein are[ their] tax attributes, including NOLs.” *Official Comm. of Unsecured Creditors of Forman Enters., Inc. v. Forman (In re Forman Enters., Inc.),* 281 B.R. 600, 612 (Bankr.W.D.Pa.2002). However, when an S-corp files for bankruptcy, its estate cannot contain any NOLs because “[u]nder the provisions of the [I.R.C.] ..., the NOL and the right to use it automatically passed through by operation of law to [the] ... S corporation shareholders.” Id. “Any tax benefits resulting from the NOL and the right to use it inure solely to the benefit of ... shareholders and would not be available to satisfy claims of the corporation’s creditors.” Id.

The same can be said of an S-corp’s entity tax status itself. The S-corp debtor is merely a “conduit” for tax benefits that flow through to shareholders. The 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. *See* I.R.C. § 1363(a) (providing that an S-corp is a disregarded entity for federal tax purposes and is not taxed on its income); *United States v. Tomko,* 562 F.3d 558, 576 n. 14 (3d Cir.2009) (en banc) (noting that the shareholders of an S-corp receive their individual shares of the corporation’s income, deductions, losses, and tax credits).

For its part, a QSub does not even exist for federal tax purposes. If an S-corp makes a valid QSub election with respect to an existing subsidiary, the subsidiary is deemed to have liquidated into the parent under I.R.C. §§ 332 and 337. Treas. Reg. § 1.1361–4(a)(2). As a result, a QSub is generally not treated as a corporation separate from its S-corp parent. *Id.* § 1.1361–4(a)(1). If a subsidiary ceases to qualify as a QSub—because, for example, its corporate parent is no longer an S-corp—the subsidiary is treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) from the parent S-corp immediately before termination, in exchange for stock of the new subsidiary corporation, under I.R.C. § 351. I.R.C. § 1361(b)(3)(C); Treas. Reg. § 1.1361–5(b). Lastly, a QSub that loses its S-corp status cannot return to that status for five years, at which time a new QSub election by the parent S-corp is required. I.R.C. § 1361(b)(3)(D); Treas. Reg. § 1.1361–5(c)(1). Pertinent regulations thus strongly suggest that a QSub’s tax status is not “owned” by the QSub.

If QSub status were property at all, it would be property of the subsidiary’s S-corp parent. Because “[t]he desirability of a Subchapter S election depends on the individual tax considerations of each shareholder[,] [t]he final determination of whether there is to be an election should be made by those who would suffer the tax consequences of it.” *Keen v. Comm’r,* 469 F.2d 1182, 1187 (9th Cir.1972). *Trans-Line West* was correct in that regard. It acknowledged that “[a] corporation’s election and revocation of the S corporation status under I.R.C. § 1362 is shareholder driven,” and “[a]lthough the corporation is the sole entity that makes the election or revocation under I.R.C. § 1362, both acts are contingent upon various degrees of consent by the corporation’s shareholders.” 203 B.R. at 660 (citing I.R.C. § 1362(a)(2), (d)(1)(B)).

Moreover, allowing QSub status to be treated as the property of the debtor subsidiary rather than the non-debtor parent, as the Bankruptcy Court did in this case, places remarkable restrictions on the rights of the parent, restrictions that have no foundation in either the I.R.C. or the Code. First, the corporate parent loses not only the statutory right to terminate its subsidiary’s QSub election, see I.R.C. § 1361(b)(3)(B), (D), but also its right to terminate its own S-corp election, see *id.* § 1361(d). Second, the corporate parent loses the ability to sell the subsidiary’s shares to any purchaser other than an S-corp, and would then be required to sell 100 percent of the shares, because any other sale would trigger the loss of the subsidiary’s QSub status. *See* *id.* § 1361(b)(3)(B).

Third, the S-corp parent and its shareholders lose the ability to sell the parent to a C-corporation, partnership, or other non-S-corp entity, to a nonresident alien, or to more than 100 shareholders, because any of those transactions would also trigger the loss of the subsidiary’s QSub status. *See* *id.* § 1361(b)(1)(B), (C), (A). Filing a bankruptcy petition is not supposed to “expand or change a debtor’s interest in an asset; *761* it merely changes the party who holds that interest.” *In re Sanders,* 969 F.2d 591, 593 (7th Cir.1992). But under the Bankruptcy Court’s holding in this case, a QSub in bankruptcy can stymie legitimate transactions of its parent as unauthorized transfers of property of the estate, even though the QSub would have had no right to interfere with any of those transactions prior to filing for bankruptcy. 203 B.R. 660, 674 (9th Cir.1993).

*762* The Debtors argue that “the manner in which an S-corp or QSub obtains or maintains its status is not determinative” of who holds the property right. (Debtors’ Br. in Resp. to Barden Appellants’ Opening Br. at 26). They say that “the proper focus is on the fact that, under the Internal Revenue Code, the corporation possesses and enjoys the benefits that result from such status at the time of its chapter 11 petition.” (Id.) In support of that contention, they cite *In re Atlantic Business & Community*
In re Majestic Star Casino, LLC, 716 F.3d 736 (2013)


Corp., 901 F.2d 325 (3d Cir. 1990), for the proposition that mere possession of property at the time of filing suffices to give an interest in property protected by section 362(a)(3).” (Id at 26-27 (quoting Atl. Bus. & Cmty. Corp., 901 F.2d at 328) (internal quotation marks omitted).)

There are two problems with that argument. First, the holding in Atlantic Business & Community Corp. was, by its own terms, limited to possessory interests in real property. See 901 F.2d at 328 (holding that “a possessory interest in real property is within the ambit of the estate in bankruptcy under Section 541”); id. (“[W]e hold that a debtor’s possession of a tenancy at sufferance creates a property interest as defined under Section 541, and is protected by Section 362....”). The case does not support the broad principle that any interest that “benefits” the debtor or that “the corporation possesses and enjoys” (Debtor’s Br. at 26) is necessarily property of the estate rather than property of a non-debtor. Cf. 11 U.S.C. § 541(a)(1) (limiting property of the estate to “legal or equitable interests of the debtor”). Second, the QSub’s S-corp parent—and the parent’s ultimate shareholders—have at least as strong an argument that they possess and enjoy the benefits that result from the subsidiary’s QSub status due to the pass-through of income, the pass-through of losses which may be used to shelter other income, and the elimination of entity-level tax at the QSub.

Based on the foregoing, we conclude that, even if MSC II’s QSub status were “property,” it is not properly seen as property of MSC II’s bankruptcy estate, and the contrary conclusion of the Bankruptcy Court cannot stand.

*763 C. Standing Revisited

Having determined that a debtor’s QSub status is not property of its bankruptcy estate, we return to the question of whether such a debtor has standing to challenge the revocation of that status by its corporate parent. As discussed in Part III.A, supra, an S-corp, standing alone, cannot challenge the validity of a prior Subchapter S revocation without the consent of at least those shareholders who consented to the revocation.” Trans-Line West, 203 B.R. at 660. “A trustee [or debtor-in-possession] who attempts to challenge the validity of [such] a revocation without such consent is asserting the rights of a third party,” i.e., its shareholders, and “does not have standing....” Id. By analogy, a debtor QSub that seeks to challenge the revocation of its tax status is asserting the rights of a third party, its S-corp shareholder, and can do so only if it can claim third-party standing. That, in turn, requires that the QSub plaintiff demonstrate both that its S-corp parent “is hindered from asserting its own rights and shares an identity of interests with the plaintiff.” Pu. Psychiat. Soc’y, 280 F.3d at 288.

Neither of those conditions exists in this case. Far from being “hindered,” BDI and its ultimate shareholder Barden are both parties to this suit and have effectively defended BDI’s right to revoke its own S-corp status and, by extension, the QSub status of MSC II. And far from having an “identity of interests,” the interests of MSC II and the other Debtors are diametrically opposed to those of Barden and BDI, onto whom they would like to shift substantial ongoing tax liabilities. “The extent of potential conflicts of interests between the plaintiff and the third party whose rights are asserted matters a good deal.” Amato v. Wilentz, 952 F.2d 742, 750 (3d Cir. 1991). “While it may be that standing need not be denied because of a slight, essentially theoretical conflict of interest, ... genuine conflicts strongly counsel against third party standing.” Id. We therefore hold that the Debtors lacked standing to initiate an adversary proceeding to seek avoidance of the alleged “transfer” of MSC II’s QSub status.

IV. CONCLUSION

Sections 362, 549, and 550 of the Code set forth guidelines to determine whether a voidable transfer of estate property has occurred. The Bankruptcy Court’s decision, like the S-corp-as-property cases on which it relied, was based in part on the conclusion that “a broad range of property [should] be included in the estate,” due to the “Congressional goal of encouraging reorganizations and Congress’ choice of methods to protect secured creditors.” Majestic Star Casino, 466 B.R. at 673. But, as the Supreme Court recently observed, “nothing in the generalized statutory purpose of protecting secured creditors can overcome the specific manner of that protection which the text [of the Code] contains.” RadLAX Gateway Hotel, LLC v. Amalgamated Bank, ___ U.S. ___, 132 S.Ct. 2065, 2073, 182 L.Ed.2d 967 (2012).

Given that principle, and for the reasons set forth in this opinion, we will vacate the Bankruptcy Court’s January 24, 2012 order and remand this matter with directions *764 to dismiss the complaint for lack of jurisdiction.

Parallel Citations

Footnotes

1 Don H. Barden died on May 19, 2011. His personal representative was substituted for him in this action in July 2011. For simplicity, Don H. Barden and Mr. Chase are referred to in this opinion as "Barden."

2 The Internal Revenue Code presumes that a business entity incorporated under any federal or state statute is taxable as a "C" corporation, the letter designation having reference to the subsection of the I.R.C. which governs the tax treatment of various corporate transactions and interests. See, e.g., I.R.C. §§ 331-346 (covering corporate liquidations); id. §§ 351-368 (corporate organizations and reorganizations); id. § 385 (treatment of corporate interests as stock or indebtedness); Treas. Reg. § 301.7701-2(a), (b) (defining a business entity that is "recognized for federal tax purposes"). Subchapter S of the I.R.C. creates an exception for a business entity that qualifies as a "small business corporation" and whose shareholder or shareholders elect S-corp status for that entity. See I.R.C. § 1361(a) (providing that any corporation is a taxable C-corporation unless it qualifies for, and elects, S-corp status); id. § 1362(a) (providing for the "S" election). To qualify as a small business corporation, the business entity must be a domestic corporation that does not have more than 100 shareholders, has only individual persons as shareholders, does not have a nonresident alien as a shareholder, and has only a single class of stock. Id. § 1361(b). As discussed in more detail infra, an S-corp is a "disregarded entity" for federal tax purposes and is not taxed on its income. Id. § 1363(a); see also Treas. Reg. § 301.7701-3(o)(v)(C) (providing that an entity that elects S-corp status is treated as an "association" rather than as a corporation for tax purposes so that only its shareholders are taxed on the entity's income).

3 Indiana follows the federal entity classification rules for state tax purposes, so that an entity classified as an S-corp for federal tax purposes is automatically classified as such for Indiana state tax purposes. Ind.Code Ann. § 6-3-2-2.8(2). BDI was therefore treated as a disregarded entity by Indiana tax authorities as well.

4 An S-corp is sometimes referred to as a "pass-through" or "flow-through" entity because the entity itself pays no tax but its income, deductions, losses, and credits flow-through to its shareholders, who must report those amounts in their personal income tax returns. United States v. Tomko, 562 F.3d 558, 576 n. 14 (3d Cir.2009) (en banc).

5 MSC II was a wholly-owned subsidiary of The Majestic Star Casino, LLC, which in turn was wholly-owned by Majestic Holdco, LLC. BDI owned 100 percent of the stock of Majestic Holdco, LLC. Due to the 100 percent tiered ownership of Majestic Holdco, LLC and The Majestic Star Casino, LLC, those intermediate subsidiaries are treated as "disregarded entities" for federal income tax purposes, see Treas. Reg. § 301.7701-3(b)(ii), and BDI is treated as the owner of MSC II.

6 The 1996 amendments to the I.R.C. enacted as part of the Small Business Job Protection Act of 1996, Pub.L. No. 104-188, 110 Stat. 1755, introduced QSubs as a new tax entity. An S-corp may elect QSub status for its subsidiary if (1) the S-corp parent holds 100 percent of the subsidiary's stock, (2) the subsidiary is otherwise eligible to qualify as an S-corp on its own, but for the fact that it has a corporate shareholder, and (3) the S-corp parent makes the appropriate election on IRS Form 8869. See generally The S Corporation Handbook § 2.6 (Peter M. Fass & Barbara S. Gerrard, eds.2012). Treasury regulations provide that a QSub is not treated as a corporation separate from its S-corp parent. Treas. Reg. § 1.1361-4(a)(1). If an S-corp makes a valid QSub election with respect to an existing subsidiary, as in this case, the subsidiary is deemed to have liquidated into the parent under I.R.C. §§ 332 and 337. Treas. Reg. § 1.1361-4(a)(2). If a subsidiary ceases to qualify as a QSub—for example, because its corporate parent is no longer an S-corp—the subsidiary is treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) from the parent S-corp immediately before termination, in exchange for stock of the new subsidiary corporation, under I.R.C. § 351. I.R.C. § 1361(b)(3)(C); Treas. Reg. § 1.1361-5(b).

7 Those events include the purchase of the company's stock by more than 100 shareholders, by a shareholder who is not a natural person, or by a shareholder who is a nonresident alien, I.R.C. § 1361(b)(1)(A)-(C), or the company's issuance of more than one class of stock, id. § 1361(b)(1)(D). Any of those events cause the S-corp to lose its required status as a "small business corporation."

8 Like an S-corp that elects to revoke or otherwise loses its S-corp status, see I.R.C. § 1362(q), a QSub that loses its QSub status is not eligible for that status again for five years, without the consent of the Secretary or the IRS, id. § 1361(b)(3)(D); Treas. Reg. § 1.1361-5(c)(1).

9 It is not clear from the record at what point during the pendency of the Majestic bankruptcy proceedings BDI revoked its S-corp status. However, it presumably did so before March 15, 2010, because the revocation was effective on the first day of 2010 and would otherwise have been effective on the first day of 2011. See I.R.C. § 1362(d)(1)(C) (setting forth the effective dates for revocation of S-corp status).
An LLC may opt to elect to be taxed as a partnership, see Treas. Reg. § 301.7701-3(c), so the conversion of MSC II to an LLC effectively reimitted its status as a "flow-through" entity. But the conversion of MSC II, at that time a C-corporation as a result of the Revocation, into an LLC may itself have been a taxable event to the extent the conversion could have been treated as a corporate liquidation. See I.R.C. § 336. The Debtors were aware of the possible taxable nature of the conversion to an LLC when it occurred.

Specifically, the Debtors sought "an order voiding the Avoidable Transfer under section 549 of the Bankruptcy Code, and [] pursuant to section 550 of the ... Code," orders directing all of the defendants to return any transferred property and directing the IRS and Indiana Department of Revenue to return any tax payments made by MSC II as a result of the Avoidable Transfer, an order invalidating the Revocation, and an order "voiding the Avoidable Transfer under section 362(a)(3) ... and section 362(b)(1) of the Bankruptcy Code...." (App. at 51.)

Section 548 provides, in relevant part, that "the trustee may avoid any transfer ... of an interest of the debtor in property, or any obligation ... incurred by the debtor, that was made or incurred on or within 2 years before the date of the filing of the petition...." 11 U.S.C. § 548(a)(1).

Courts that have followed Trans-Lines West have reached the same conclusion. See, e.g., Parker v. Saunders (In re Bakersfield Western, Inc.), 326 B.R. 227, 233 (9th Cir. BAP 1998) ("[A] debtor's subchapter S status is a creation of I.R.C. § 1362, and federal law therefore determines whether a debtor holds a 'property' interest in its subchapter S status.").

Net operating losses are created when the taxpayer's deductible business expenses for a given year exceed her net income for that year. [I.R.C.] § 172(c). Once NOLs are sustained, the taxpayer may carry the loss back three years and use it as a deduction in that year. NOLs that remain are applied to the next two years and deducted accordingly. Id. § 172(b)(1)(A), (b)(2). If any loss remains at the end of the three-year carryback period, it is carried forward and deducted from the taxpayer's income over the next fifteen years (or until it is exhausted), beginning with the year after the loss was initially sustained. Id. § 172(b)(1)(B).

Alternatively, the Tax Code permits the taxpayer to forego the carryback option and instead use the NOLs exclusively in future years. Id. § 172(b)(3)(C). Such an election, once made, is irrevocable for that tax year. Id.

Gibson v. United States (In re Russell), 927 F.2d 413, 415 (8th Cir. 1991). An NOL "carryback" against past earnings therefore generates a claim for a refund of taxes paid on those earnings, while an NOL "carryforward" represents the ability to shelter future income from taxation.

Although Prudential Lines and cases that followed it extended Segal's holding, the Segal Court expressly reserved judgment on whether future tax benefits, such as loss "carryforwards" (or "carryovers") would also constitute bankruptcy estate property. The Court observed that "a carryover into post-bankruptcy years can be distinguished both conceptually as well as practically" from a benefit available against past taxes because "the supposed loss-carryover would still need to be matched in some future year by earnings, earnings that might never eventuate at all." Segal, 382 U.S. at 381, 86 S.Ct. 511. Despite that dictum, the court in Prudential Lines concluded that "[t]he fact that the right to an NOL carryforward is intangible and has not yet been reduced to a tax refund ... does not exclude it from the definition of property of the estate." 928 F.2d at 372. That conclusion relied on the Segal Court's reasoning that "postponed enjoyment does not disqualify an interest as "property."" and that "contingency in the abstract is no bar" to finding that an interest is property of a bankruptcy estate. 382 U.S. at 380, 86 S.Ct. 511. But that reasoning in Segal was addressed only to the argument that an NOL carryover was not property of the estate at the commencement of the proceedings because "no refund could be claimed from the Government until the end of the year" of filing, during which "earnings by the bankrupt ... might diminish or eliminate the loss-carryback refund claim...." Id. It does not support the broad proposition that any contingent tax attribute can necessarily be labeled as "property."

We have not yet addressed the question of whether NOL carrybacks or carryforwards constitute property. The closest we have come to deciding the question was an issue arising under the Employee Retirement Income Security Act of 1974 (ERISA), 29 U.S.C. § 1001 at seq., rather than the I.R.C. In In re Frechauf Tailor Corp., 444 F.3d 203 (3d Cir.2006), a debtor made an irrevocable election to increase pension benefits that denied the bankruptcy estate the ability to recoup an accumulated surplus in plan assets. We held that "[this recoupment right is a transferrable property interest" because, "[a]lthough the right to recover [the surplus from an ERISA-qualified retirement plan] is a future estate, the reversion itself is a present, vested estate. As a result, the employer's reversionary interest falls within the broad reach of section 541(a) of the Bankruptcy Code and is considered property...." Id. at 211 (second alteration in original) (internal quotation marks omitted); see also id. ("Property of the estate includes all interests, such as ... contingent interests and future interests, whether or not transferrable by the debtor." (quoting Prudential Lines, 928 F.2d at 372) (internal quotation marks omitted)).

We are not the only ones to find the Trans-Lines West line of cases wanting. See James S. Boustic & Joel D. Kuntz, Federal Income Taxation of S Corporations § 5.08[1] (4th ed. 2001) ("These cases seem like little more than hard bankruptcy cases making bad tax law."); Camilla Berit Galesi, Shareholders' Rights Regarding Termination of a Debtor Corporation's S Status in a Bankruptcy Setting, 10 J. Bankr. L. & Prac. 157, 161–62 (2001) ("[D]ue to the Trans-Lines West court's misunderstanding of the
rules governing S election and termination [ ... the court adopts an erroneous conception of the nature of a corporation's interest in its S status];" Richard A. Shaw, *Taxing Shareholders on the Income of an S Corporation in Bankruptcy*, 1 No. 6 Bus. Emis. 40, 1999 WL 1419055, at *46 (1999) ("In its haste to provide cash for creditors, the Ninth Circuit BAP in *Bakersfield (Wester)* and the Tennessee Bankruptcy Court in *Trans-Line-West* ... arc simply creating a windfall for the bankruptcy estate at the expense of third parties who are not in the bankruptcy proceeding"); id. ("The NOL cases are somewhat easier to accept ... [but] ... the case for disrespecting the revocation of an S election is, in many ways, much more troublesome.").

The reasoning of the "NOL-as-property" cases is itself not without flaws. Those cases, in part, to Congressional intent that "property of the estate" be construed to include all interests, such as ... contingent and future interests. *Prudential Lines*, 928 F.2d at 572 (quoting H.R.Rep. No. 95–595, at 176 (1978), reprinted in 1978 U.S.C.C.A.N. 5965, 6136) (internal quotation marks omitted); see also *Feller*, 218 F.3d at 956–57 (quoting same and suggesting that "Congress affirmatively adopted the *Segal* holding when it enacted the present Bankruptcy Code"). But Code § 541 contains no reference to "contingent" or "future" interests and refers only to "legal or equitable interests of the debtor in property as of the commencement of the case."

To speak of the revocation as a "disposition," as *Trans-Line-West* does, is to assume that the tax status is a property interest, which is exactly the issue in contention.

There may, of course, be contractual agreements among the shareholders limiting the alienability of shares.

Our holding in *Freeland Trailer*, see *supra* note 16, is not to the contrary. In that case, we held that a corporate debtor's right to recoup an accumulated surplus in its pension plan was property, even though the plan trustee had the right to make an irrecoverable election under ERISA to increase pension benefits, denying the debtor the benefit of that surplus. See 444 F.3d at 211 (noting that property may be "contingent" and that "the mere opportunity to receive an economic benefit in the future is property with value under the Bankruptcy Code") (internal quotation marks omitted). But in that case the debtor had a contractual right to recover the surplus, which we found to be a "future estate, in which the reversion itself is a present, vested estate," and one that was "transferable and alienable." Id. As a result, we held that the debtor's "reversionary interest falls within the broad reach of section 541(a) of the Bankruptcy Code and is considered property of the debtor's estate." Id. An S-corp has no such contractual or otherwise "reversionary" interest in its tax status, let alone one that is "transferable and alienable."

See *supra* note 2. The S-corp parent's contingencies include preservation of its own S-corp election which, as discussed above, is controlled by its shareholders.


That is what happened in this case; MSC II was incorporated in 2005, and BDI made the QSub election in 2006.

The Debtors argue that a QSub's separate existence is "reserved for a number of ... purposes, including various tax purposes as set forth in the U.S. Treasury regulations." (Debtors' Br. in Resp. to Board of Appellants' Opening Br. at 23.) However, the purposes they cite for which a QSub's separate existence is respected (for taxes due on pre-QSub income, employment and excise taxes, and the obligation to file information returns, see Trans. Reg. § 1.1361–4(a)(6)(a)(9)) are the narrow exceptions to the general rule that a QSub has no independent status under the I.R.C., see id. § 1.1361–4(a)(1)(C).

For similar reasons, we question whether the relief that the Bankruptcy Court granted was permissible or appropriate. Code § 550, which authorizes relief for transfers avoided pursuant to § 549, places several limitations on the scope of that relief. First, the trustee may only recover "the property transferred, or, if the court so orders, the value of such property." 11 U.S.C. § 550(a). Therefore, "only net amounts diverted from, that is damages consequently suffered by the creditor body of, a debtor may be recovered" pursuant to § 550. *In re Fazmeyer Corp.*, 296 B.R. 327, 342 (Bankr.D.Del.2003) (considering a claim under Code § 548). Second, "[t]he trustee is entitled to only a single satisfaction" under § 550. 11 U.S.C. § 550(d); see also *HBE Leasing Corp. v. Frank*, 48 F.3d 622, 640 (2d Cir.1995) (prohibiting "an unjustified double recovery" in an avoidance action); *In re Skywalkers, Inc.*, 49 F.3d 546, 549 (9th Cir.1995) (applying the "single satisfaction" rule to a debtor's recovery of both a liquor license and the payments made to procure that license). Third, a debtor may avoid transfers and recover transferred property or its value only if the recovery is "for the benefit of the estate." *In re Meeusen*, 687 F.3d 74, 82–83 (3d Cir.2012) (citing 11 U.S.C. § 550(a)). A debtor is not entitled to benefit from any avoidance, id., and "courts have limited a debtor's exercise of avoidance powers to circumstances in which such actions would in fact benefit the creditors, not the debtors themselves." *In re Cybergenics Corp.*, 226 F.3d 237, 244 (3d Cir.2000). Because the rule is that the estate is dissolved upon confirmation of the plan, ... there is no post-confirmation
bankruptcy estate ... to be benefitted," and property recovered as a result of an avoidance action after a plan has been confirmed may represent an impermissibly benefit to the reorganized debtor. Horsted v. First Am. Bank, 39 F.3d 898, 904 (8th Cir.1994) (citing Code § 1141). For that reason, some courts have required a specific mechanism whereby the prepetition creditors, rather than the reorganized debtor, receive the benefit of a post-confirmation avoidance and recovery of transferred property. See In re Kroh Bros. Dev. Co., 100 B.R. 487, 498 (Bankr.W.D.Mo.1989) (authorizing relief pursuant to which creditors would receive at least one half of preference recovery); In re Jet Flights, Inc., 73 B.R. 552, 556 (Bankr.S.D.Fla.1987) (authorizing relief pursuant to which creditors would receive 80 percent of the proceeds of preference actions).

The remedy fashioned here by the Bankruptcy Court runs afield of such limitations. The Bankruptcy Court held that "[t]he revocation of Defendant [BDI]'s status as a subchapter 'S' corporation and the termination of MSC II's status as a qualified subchapter 'S' subsidiary are void and of no effect" and ordered that "[t]he Defendants ... shall take all actions necessary to restore the status of Defendant [MSC II] as a qualified subchapter 'S' subsidiary of Defendant [BDI]." Majestic Star Casino, Inc., 466 B.R. at 679-80. However, MSC II had already emerged from bankruptcy and was no longer a wholly-owned subsidiary of BDI. That meant that MSC II "recovered" only its transferred "property"—its tax-free status that was subject to BDI's claim on 100 percent of its income—but also its ability to retain all of its pre-tax earnings. That represented a double recovery and then some. Likewise, because the relief ordered by the Bankruptcy Court was of indefinite duration, it would continue to benefit MSC II long after its creditors had been compensated and sold their interests, thus impermissibly benefitting MSC II itself as the former debtor.

Relief under § 362 admittedly is not subject to the limitations of § 550 because a transfer that violates the automatic stay is void ab initio. Siciliano, 13 F.3d at 749. Nevertheless, under § 362, in order to define the relief due as a result of a void transfer, it is still necessary to identify the postpetition transfer that violated the stay. See 11 U.S.C. § 362(a)(3). The Bankruptcy Court failed to do that, and simply treated the revocations at both BDI and MSC II as void. But those revocations were themselves irrevocable, see I.R.C. §§ 1361(b)(3)(D), 1362(g); Treas. Reg. § 1.1361-5(c)(1), and the Court's treatment of them as simply void raises a question of whether § 362 "could, under the tax laws of the United States, be utilized to undo previously executed acts." Forman, 281 B.R. at 612.

Finally, MSC II no longer qualified as a QSub after the Majestic Plan was confirmed both because it was owned by its former creditors rather than being wholly-owned by an S-corp, see I.R.C. § 1361(b)(3)(B)(i), and because those creditors had converted it to an LLC, see id. § 1361(b)(3)(B) (requiring that a QSub be a "domestic corporation"). Therefore, treating the revocation of MSC II's QSub status as void pursuant to Code § 362 left that entity in violation of at least those two I.R.C. provisions. "Humphry Dumpy could not be restructured using this scenario." Forman, 281 B.R. at 612.

27 We also doubt that, even if MSC II's QSub status were property of its bankruptcy estate, the Revocation would constitute a transfer for purposes of Code §§ 549 and 550. The Code defines a "transfer" as, inter alia, "each mode, direct or indirect, absolute or unconditional, voluntary or involuntary, of disposing or parting with ... property[ ] or an interest in property." 11 U.S.C. 101(54)(D) (numbering omitted). "Congress intended this definition to be as broad as possible." Russell, 927 F.2d at 418. However, both §§ 549 and 550 presume that a "transfer" requires that there be a "transferee" that receives the property interest conveyed from the debtor. See 11 U.S.C. § 549(b) (providing that the trustee has avoidance powers "notwithstanding any notice or knowledge of the case that the transferee has"); id. § 550(a)(2) (providing for the recovery of value from "any immediate or mediate transferee of such initial transferees"). There are only two candidates for transferee in this case—Barden and BDI—and neither can be said to have been the "transferee" of MSC II's QSub status or of its "right" not to pay taxes on its income. The Revocation was itself triggered by BDI's revocation of its S-corp status, so that, far from enjoying a transfer of MSC II's tax-free status, BDI itself became a taxpayer. Likewise, Barden did not somehow become an S-corp or a QSub as a result of the revocations at BDI and MSC II. The transfer envisioned by the Bankruptcy Court thus seems very far removed from the definition set forth in 11 U.S.C. § 101(54) and suggested by the concept of a "transferee" as that term is used in §§ 549 and 550.