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Volatile Windfalls: Effects of Tax Cuts and Jobs Act for S-Corp Shareholders Warrant Strong Arm Power Limitation in Bankruptcy

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VOLATILE WINDFALLS: EFFECTS OF TAX CUTS AND JOBS ACT FOR S-CORP SHAREHOLDERS WARRANT STRONG ARM POWER LIMITATION IN BANKRUPTCY

ABSTRACT

For years, a nuanced judicial inconsistency at the intersection of the U.S. Internal Revenue and Bankruptcy Codes has percolated in bankruptcy and appellate courts, generating a judicial split and erratic outcomes for a small few of the approximately 4 million S corporations in the United States. The split concerns whether S corporation shareholder termination rights granted under § 1362 of the Tax Code constitute avoidable fraudulent transfers under § 548 of the Bankruptcy Code.

Some courts, including those in In re Trans-Lines West, Inc. and In re Bakersfield Westar, Inc., have historically permitted bankruptcy trustees to unilaterally shift the capital gains liabilities stemming from asset liquidation sales of insolvent S corporations to third parties—the business's shareholders—who are not parties to the bankruptcy proceeding, characterizing the terminations as 'fraudulent conveyances.' Recently, however, two courts, including the Third Circuit in In re Majestic Star Casino, LLC and a Fourth Circuit Bankruptcy Court in In re Health Diagnostic Lab. Inc. have restricted the liquidating trustee's nearly unlimited strong arm power to avoid S election terminations, creating inconsistent treatment in federal bankruptcy courts.

This Comment begins with a background discussion of the relevant sections of the two federal codes involved in the judicial uncertainty at issue. Second, this Comment considers potential implications of the Tax Cuts and Jobs Act on S corporation shareholders, which is likely to increase the frequency of litigation over Subchapter S elections and termination rights in the context of the Strong-Arm power. Ultimately, this Comment suggests that, at the intersection of the Tax and Bankruptcy Codes, there lies a strong argument for creating an exception to the fraudulent conveyance doctrine for S corporations.

INTRODUCTION

This Comment suggests that the enactment of Public Law 115-97 (Tax Cuts and Jobs Act),[1] first applicable for individual filer's tax returns for fiscal year 2018,[2] incentivizes a statistically significant number of the owners of over 4 million S corporations in the United States to convert their businesses into other business forms.[3] According to the Internal Revenue Service, "S corporations became the most common corporate entity type in 1997," and "continue to be the most prevalent type of corporation."[4] While the Tax Cuts and Jobs Act directly amended the Internal Revenue Code, its effects in bankruptcy courts are complicated. In particular, the Act impacts the scope of the fraudulent conveyance doctrine under the Bankruptcy Code.

Under 11 U.S.C. (Bankruptcy Code)[5] § 548 (Strong Arm power),[6] liquidating trustees possess nearly unlimited power to avoid fraudulent transfers of *property* or *interests of the debtor in property* made by debtors prior to filing for bankruptcy protection.[7] While some scholars have noted several solutions to an "issue [arising] at the intersection of federal bankruptcy and tax law" may warrant the creation of a Strong Arm clause exception,[8] courts have recently begun to adopt those suggestions, creating judicial uncertainty.[9] The uncertainty

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[1] H.R. Con. Res. 1, 115th Cong., Pub. L. No. 115-97, 131 Stat. 2054 (2017) (enacted Dec. 22, 2017).

[2] Matthew Frankel CFP, *2019 Tax Changes: Everything You Need to Know*, THE MOTLEY FOOL, (Jan. 3, 2019), https://www.fool.com/taxes/2019/01/03/2019-tax-changes-everything-you-need-to-know.aspx.

[3] *See* Bryce Welker, *The Impact of the 2018 Tax Reform on Business Owners*, FORBES (Mar. 14, 2018 9:00 A.M.), https://www.forbes.com/sites/theyec/2018/03/14/the-impact-of-the-2018-tax-reform-on-business-owners/#4C9EB9647213; J. Michael Kolk, *Another Look at C Corp. vs. S corp. in Light of Tax Reform*, THE TAX ADVISER, (Aug. 1, 2018), https://www.thetaxadviser.com/issues/2018/aug/c-corp-s-corp-tax-reform.html ("Considering that the top individual tax rate was dropped only to 37% (from 39.6%), even with the addition of a 20% deduction for qualified business income (QBI) that can effectively lower the rate to 29.6%, many passthrough taxpayers may be interested in possibly changing their businesses into C corporations.").

[4] SOI Tax Stats – S Corporation Statistics, INTERNAL REVENUE SERVICE, https://www.irs.gov/statistics/soi-tax-stats-s-corporation-statistics (last visited Jan. 26, 2019).

[5] 11 U.S.C. § 548 (2019).

[6] § 548. *See* Segal v. Rochelle, 382 U.S. 375, 379 (1966) ("The main thrust of § 70a(5) is to secure for creditors everything of value the bankrupt may possess in alienable or leviable form when he files his petition. To this end the 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.").

[7] § 548 (emphasis added).

[8] Ian Follansbee, *Is S-corp Tax Status "Property"? Two Recent Decisions Considered*, 37-APR AM. BANKR. INST. J. 26 (2018), available at WL 37-APR AMBKRIJ 26. *See* Camilla Berit Galesi, *Shareholder's Rights Regarding Termination of a Debtor Corporation's S Status in a Bankruptcy Setting*, 10 J. BANKR. L. & PRAC. 157 (2001), Westlaw 10 JBKRLP 157.

[9] *See generally* Majestic Star Casino, LLC v. Barden Dev., Inc. (*In re* Majestic Star Casino, LLC), 716 F.3d 736 (3d. Cir. 2013); Health Diagnostic Lab., Inc. v. United States (*In re* Health Diagnostic Lab. Inc.), 578

at issue, most recently addressed in *Health Diagnostic Lab., Inc. v. United States* (*In re Health Diagnostic Lab. Inc.*),[10] concerns whether termination of 26 U.S.C. (Tax Code) § 1361[11] small business corporation (S corporation) shareholder elections under § 1362 constitute avoidable fraudulent transfers under the Strong Arm power.[12] Recently, two courts restricted the liquidating trustee's nearly unlimited Strong Arm power to avoid S election terminations,[13] creating inconsistent treatment in federal bankruptcy courts with the potential to morph into a full blown circuit split.[14]

While relatively few opinions directly address the judicial uncertainty discussed in this Comment, the courts and scholars who have considered the issue sharply disagree on nuanced issues of statutory interpretation, competing policy goals, and ultimately whether shareholders or the bankruptcy estate ought to shoulder the capital gains burden arising from an S corporation's asset liquidation. This Comment suggests that the enactment of the Tax Cuts and Jobs Act[15] is likely to increase the frequency of litigation over Subchapter S elections and termination rights in the context of the Strong Arm power.[16] This Comment examines prior holdings that have addressed the issue in light of the Tax Cuts and Jobs Act's potential impact on shareholders of S corporations moving forward.

The following illustration, articulated by tax scholar Richard Shaw in *Taxing Shareholders on the Income of an S Corporation in Bankruptcy*, distinguishes

B.R. 552 (Bankr. E.D. Va. 2017).

[10] *See, e.g.*, *In re Health Diagnostic Lab., Inc.*, 578 B.R. at 560–61 ("The salient legal issue alleged is whether the Debtors' S corporation status was an interest in 'property' that was subject to transfer. If it is not, then the election is not subject to the fraudulent transfer provisions of sections 544(b) and 548(a)(1) of the Bankruptcy Code.").

[11] *See generally* 26 U.S.C. § 1361 (2018).

[12] *See, e.g.*, *In re Health Diagnostic Lab., Inc.*, 578 B.R. at 560–61 ("The salient legal issue alleged is whether the Debtors' S corporation status was an interest in 'property' that was subject to transfer. If it is not, then the election is not subject to the fraudulent transfer provisions of sections 544(b) and 548(a)(1) of the Bankruptcy Code."). *See* 26 U.S.C. § 1361.

[13] *See generally In re Majestic Star Casino, LLC*, 716 F.3d 736; *In re Health Diagnostic Lab., Inc.*, 578 B.R. 552.

[14] *Circuit Split*, WEX LEGAL DICTIONARY, LAW.CORNELL.EDU, https://www.law.cornell.edu/wex/circuit_split (last visited Feb. 22, 2018) ("When two or more circuits in the United States court of appeals reach opposite interpretations of federal law."). While only the Third Circuit Court of Appeals in *In re* Majestic Star Casino, LLC, 716 F.3d 736 (3d. Cir. 2013) has ruled on the issue at the appellate level, adoption of contrasting analysis that S corporation elections are revocable by bankruptcy trustees by another court of appeals would create a full blown "circuit split."

[15] *See* H.R. Con. Res. 1, 115th Cong., Pub. L. No. 115-97, 115-97, 131 Stat. 2054 (2017) (enacted Dec. 22, 2017).

[16] *See infra* Section III.A.

the competing treatment of S corporation tax elections as either protected or avoidable property interests in bankruptcy:

> The only asset of Corporation *X*, an S corporation, is Blackacre, which is raw land with a basis of $1 million and a fair market value of $2 million. *X* has two shareholders, *A* and *B*. *X* is in financial straits and is about to file a voluntary petition in bankruptcy to stave off its creditors. If *X* retains its status as an S corporation after going into bankruptcy, the trustee may force a sale of Blackacre for $2 million and apply the entire proceeds to satisfy the claims of creditors. Since *X* is an S corporation, recognized gain from the sale is not subject to tax at the corporate level. Instead, the gain recognized by the corporation passes through and will be taxed to *A* and *B* under IRC Section 1366. Since Subchapter S has shifted the tax obligation from the corporation to its shareholders, the federal tax resulting from the sale of Blackacre by the corporation will not be an obligation of the bankruptcy estate, and would not be paid as a first priority administrative expense of the estate under Bankruptcy Code Sections 503(a)(1)(B) and 507(a)(1). The *unfortunate effect* for the shareholders is that the $2 million proceeds from the sale have been severed for the benefit of creditors and are not made available to satisfy the $200,000 federal tax burden inherent in the recognized gain.[17]

Notably, in *Majestic Star Casino, LLC v. Barden Dev., Inc.* (*In re Majestic Star Casino, LLC*), the Third Circuit recently found that permitting such unfortunate burden shifting of tax liability to S corporation shareholders was based on incorrect logic and contradicted multiple bankruptcy policy goals.[18] The *In re Health Diagnostic Lab., Inc.* court tended to agree, asserting that "[t]he Liquidating Trustee cannot hold the shareholders 'tax hostage' by avoiding their decision to revoke the S corporation election."[19] While the *In re Majestic Star Casino, LLC* and *In re Health Diagnostic Lab., Inc.* decisions create outcomes equitable to both creditors and the S corporation's shareholders, they each rest on a number of contested statutory interpretation and policy issues which, as discussed later in this Comment, remain unresolved.

This Comment begins with a background discussion of the relevant sections of the two federal codes involved in the judicial uncertainty at issue. First, it

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[17] *See* Richard A. Shaw, *Taxing Shareholders on the Income of an S Corporation in Bankruptcy*, 1 No. 6 Bus. Entities, Nov.–Dec. 1999, at * 41, available at 1999 WL 1419055 (emphasis added).

[18] *See generally In re Majestic Star Casino, LLC*, 716 F.3d 736.

[19] Health Diagnostic Lab., Inc. v. United States (*In re* Health Diagnostic Lab., Inc.), 578 B.R. 552, 568 (Bankr. E.D. Va. 2017).

discusses the Tax Code, followed by a discussion of the related Bankruptcy Code sections in question and their relationship to the Tax Code. Next, this Comment analyzes statutory interpretation issues and a number of related conflicting Tax and Bankruptcy Code policy questions raised by courts, scholars, and experts. This Comment then considers potential implications of the Tax Cuts and Jobs Act on S corporation shareholders, which raises additional questions regarding previous court decisions.[20] Indeed, the specific effects of the Tax Cuts and Jobs Act on S corporations and their shareholders highlight policy considerations raised on both sides of this judicial uncertainty. Finally, this Comment considers whether the implementation of the Tax Cuts and Jobs Act will cause more litigation in this area in the near future, and suggests that judicial and legislative creation of a Tax Code § 1362 exception to the Bankruptcy Code Strong Arm power for S corporation election rights provides an equitable solution for both shareholders and creditors.[21] In addition, the *In re Health Diagnostic Lab., Inc.* court's examination of the issue in light of tax-specific statutory interpretation also increases its analytical value for future courts that may encounter the issue, for many of whom the question will be an issue of first impression.[22] Ultimately, these policy considerations support the conclusion that S elections pose unique challenges which should thus be excepted from the Strong Arm power under the Bankruptcy Code.

I. STATUTORY BACKGROUND AND LEGAL DOCTRINE

A. 26 U.S.C. §1361–62: The S Corporation—Overview

There are fundamental Tax Code differences between two types of corporations, C corporations[23] and § 1362 S corporations, relevant to the judicial uncertainty concerning S corporation insolvencies discussed in this Comment. The shareholders of C corporation business entities are generally not liable for the business's debts in bankruptcy.[24] The "default"[25] "C corporation" business

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[20] *See infra* Section III.A.

[21] *See, e.g.*, *In re Health Diagnostic Lab., Inc.*, 578 B.R. at 565.

[22] *See generally id.* at 563. (applying "essential property rights" federal tax property test and noting that only a small handful of courts have touched on this issue in even a cursory manner).

[23] *See* 26 U.S.C. § 1361(a)(2) (2018) ("the term 'C corporation' means, with respect to any taxable year, a corporation which is not an S corporation for such year.").

[24] *See* Follansbee, *supra* note 8, at 26 ("When a corporate entity elects to be treated as an S-corp, its income tax liability is generally shifted to its shareholders, whereas without such an election, the corporation remains liable for income taxes.").

[25] *See generally In re Health Diagnostic Lab., Inc.*, 578 B.R. at 557 ("Under the Tax Code, the '*default*' tax status for corporate entities in the United States is a subchapter C corporation status ('C corporation

structure refers to corporations generally,[26] and is subject to double taxation under the Internal Revenue Code: first at the corporate level as a tax-paying entity separate from its shareholders, and then again at the shareholder level as dividends distributed to its shareholders.[27] Although subject to double taxation, the C corporation generally shields the corporate entity's shareholders from exposure to personal liability for the entity's debts in bankruptcy[28]—that is to say that the business is a distinct legal entity from its owners.[29]

It gets more complicated for S corporations, which receive distinct corporate tax treatment under Tax Code § 1361.[30] After electing S corporation tax status, "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."[31] While the "pass-through" capital gains liabilities for the S corporation's capital gains are paid by individual shareholders, shareholders' agreements usually provide that the S corporation will reimburse each individual shareholder for capital gains taxes of the business reported individually by its shareholders.[32]

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status') . . . . The tax laws of subchapter C of Chapter 1, Title 26 of the Tax Code govern C corporation taxation. C corporations are subject to two levels of taxation, or 'double taxation,' whereby the corporation's net income is taxed, and dividends to the shareholders are taxed as well.") (citing 26 U.S.C. § 1361) (emphasis added)).

[26] *See* 26 U.S.C. § 1361(a)(2) (2018) ("C corporation. For purposes of this title, the term 'C corporation' means, with respect to any taxable year, a corporation which is not an S corporation . . . .").

[27] *See* 26 U.S.C. § 301 (2018).

[28] *See* Ann M. Tabor, *Gitlitz v. Commissioner: Windfall for Shareholders of an Insolvent S Corporation*, 46 S.D. L. REV, 648, 654–55 (2000–2001) (citing Richard A. Shaw, *S Corporations in 1994*, C892 ALI-ABA 597, 611 (Mar. 3, 1994)).

[29] *See, e.g.*, Galesi, *supra* note 8, at 159.

[30] *See* § 1361(a)(2) ("[T]he term 'C corporation' means, with respect to any taxable year, a corporation which is not an S corporation for such year.").

[31] Majestic Star Casino, LLC v. Barden Dev., Inc. (*In re* Majestic Star Casino, LLC), 716 F.3d 736, 742 n.4 (3d. Cir. 2013) (citing United States v. Tomko, 562 F.3d 558, 576 n. 14 (3d Cir. 2009) (en banc)).

[32] *See* Health Diagnostic Lab., Inc. v. United States (*In re* Health Diagnostic Lab., Inc.), 578 B.R. 552, 565 (Bankr. E.D. Va. 2017) ("The logical consequence of the shareholders' decision to elect S corporation status is their decision to enter into a shareholders' agreement requiring the corporation to make distributions from its earnings to cover the amount of tax the shareholders incur on the income that is passed through to them."); Galesi, *supra* note 8, at 158.

B. 26 U.S.C. §1362: The S Corporation—Elections and Terminations

1. Election and Shareholders' Agreement

To qualify as an S corporation, an entity must first and foremost be eligible to be a C corporation.[33] However, S corporations are bound by several additional eligibility requirements, which are codified at Tax Code §§ 1361–62.[34] S corporation status can only be implemented with a unanimous shareholder election, according to § 1362(a)(2).[35] Congress created the S corporation to promote flexibility for shareholders, "intend[ing] the election of S corporation status to limit the influence of tax considerations on choice of entity used to own a business."[36] To elect S corporation tax treatment, Tax Code § 1361(b)(1) requires that the entity first be a domestic corporation.[37] According to § 1361(b)(1), the entity may *not* "have more than 100 shareholders,"[38] or "have more than 1 class of stock."[39] In addition, each of the entity's shareholders must be an individual person who is a resident of the United States.[40]

Due to the pass-through nature of S corporations, their shareholders' agreements also usually provide for arrangements "requiring the corporation to make distributions from its earnings to cover the amount of tax the shareholders incur on the income that is passed through to them."[41] Such an arrangement "is generally neutral as to the amount of tax a corporation would otherwise pay."[42] Describing the arrangement, the court in *In re Health Diagnostic Lab. Inc.* for instance, noted that "[t]he benefit is to the shareholders—it allows them to avoid double taxation."[43] Further, the court stated: "To the extent there is value inherent in the S election, it is value Congress intended for the corporation's

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[33] 26 U.S.C. § 1361(b)(1) (2018).

[34] *See* § 1361 (2018); 26 U.S.C. § 1362 (2018); *In re Health Diagnostic Lab., Inc.*, 578 B.R. at 565 ("Congress intended the election of S corporation status to limit the influence of tax considerations on choice of entity used to own a business.").

[35] § 1362(d)(2); Galesi, *supra* note 8, at 157.

[36] *In re Health Diagnostic Lab., Inc*., 578 B.R. at 565 ("Congress intended the election of S corporation status to limit the influence of tax considerations on choice of entity used to own a business."). *See* 26 U.S.C. § 1361–62 (2018).

[37] § 1361(b)(1). *See* § 1361(b)(2), for a list of corporations that do not qualify for S status.

[38] § 1361(b)(1)(A).

[39] § 1361(b)(1)(D).

[40] § 1361(b)(1)(B)–(C).

[41] *In re Health Diagnostic Lab., Inc*., 578 B.R. at 565.

[42] *Id.*

[43] *Id.*

shareholders and not for the corporation."[44] Courts and scholars alike disagree, however, about whether the value Congress intended for shareholders in creating S corporations should be reallocated to the corporation's creditors following an asset liquidation sale in bankruptcy.[45]

2. Termination of Subchapter S Elections

The split of judicial certainty at issue focuses on the level of control shareholders possess over the continued existence of S status. One area of flexibility for shareholders electing to operate their business as an S corporation is the ability to later elect to terminate S status,[46] which can be accomplished through a simple majority shareholder vote under § 1362(d) (the "S termination").[47] However, this is not the only way S elections may be terminated. Certain courts, scholars, and experts argue that S corporation shareholders in fact lack complete control over the continued existence of the status,[48] because Tax Code § 1362(d)(2)(A) provides that the occurrence of events completely outside the control of a majority of its shareholders automatically terminate an S corporation's existence.[49]

In *In re Majestic Star Casino, LLC*, the Third Circuit, referencing Tax Code § 1361(b)(1), recognized that: "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 [Bankruptcy] Code or the [Tax Code]—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

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[44] *Id.*

[45] *See* Parker v. Saunders (*In re* Bakersfield Westar, Inc.), 226 B.R. 227, 234 (B.A.P. 9th Cir. 1988); Trans-Lines West, Inc. v. Lines (*In re* Trans-LinesWest, Inc.), 203 B.R. 661 (Bankr. E.D. Tenn. 1996). *See also* C. Chadwick Cullum, Note, *A Majestic Vacation: The Third Circuit Takes a Break From the Modern Trend of Including Subchapter S Elections in the Property of a Bankruptcy Estate*, 2 TEX. A&M L. REV. 299 (2014).

[46] *See generally* 26 U.S.C. § 1362(d) (2018).

[47] § 1362(a)(1)–(2) ("An election under this subsection shall be valid only if all persons who are shareholders in such corporation on the day on which such election is made consent to such election.").

[48] *See* Majestic Star Casino, LLC v. Barden Dev., Inc. (*In re* Majestic Star Casino, LLC), 716 F.3d 736, 756 (3d. Cir. 2013) (referencing 26 U.S.C. § 1361(a)(1); (b)(1)) ("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.").

[49] § 1362(d)(2)(A). *See also In re Majestic Star Casino, LLC*, 716 F.3d at 756 (citing 26 U.S.C. § 1361(a)(1), (b)(1)).

100."[50] Accordingly, the entity would cease to qualify as an S corporation, as stated in Tax Code § 1362(d)(2)(A).[51]

Moreover, an S corporation termination may also automatically occur—against the will of the S corporation's shareholders—if the conditions specified in §1362(d)(3) are met, when the corporation "has accumulated earnings and profits at the close of each of 3 consecutive taxable years," and "has gross receipts for each of such taxable years more than 25 percent of which are passive investment income."[52] Courts addressing the judicial split have disputed whether debtors possess the necessary "control" and "right to dispose" typical of conventional property interests considered avoidable by bankruptcy trustees under the Strong Arm power.[53]

C. Introduction to Bankruptcy Code: The Strong Arm Power

S corporation shareholders, like shareholders of C corporations, are third parties with limited liability in bankruptcy.[54] Nonetheless, in S corporation bankruptcies, the tax status has the potential to impose a massive liability on shareholders, even though its shareholders are not themselves insolvent debtors.[55] In chapter 7 or 11, a bankruptcy trustee may be appointed to liquidate certain assets of the bankruptcy estate in an effort to create value for creditors to cover outstanding debts and obligations.[56] When courts hold that S elections are property interests subject to the Strong Arm provision, shareholders remain personally liable for the S corporation's capital gains taxes assessed against liquidated property, while proceeds of the liquidation are redirected only to

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[50] *In re Majestic Star Casino, LLC*, 716 F.3d at 756.

[51] § 1362(d)(2)(A).

[52] § 1362(d)(3)(A)(i)(I)–(II).

[53] Health Diagnostic Lab., Inc. v. United States (*In re* Health Diagnostic Lab., Inc.), 578 B.R. 552, 564 (Bankr. E.D. Va. 2017). *Cf.* Parker v. Saunders, (*In re* Bakersfield Westar, Inc., Inc.), 226 B.R. 227, 236 (B.A.P. 9th Cir. 1988). *See generally* § 1362(d)(1)(A)–(D).

[54] *See* Ann M. Tabor, *Gitlitz v. Commissioner: Windfall for Shareholders of an Insolvent S Corporation*, 46 S. D. L. REV, 648, 654–55 (2000–2001) (citing Richard A. Shaw, *S Corporations in 1994*, C892 ALI-ABA 597, 611 (Mar. 3, 1994)).

[55] *See* Galesi, *supra* note 8, at 159 ("The inequity for the shareholders lies in the fact that they are liable for the capital gains tax, yet do not receive the income from which to pay the tax. Such a tax is tantamount to an income tax that purports to tax an individual's income when the individual has no income."). *See also* Shaw, *supra* note 17, at 46 ("In its haste to provide cash for creditors, the Ninth Circuit BAP in Bakersfield [Westar] and the Tennessee Bankruptcy Court in . . . *In re Trans–Lines West* . . . are simply creating a windfall for the bankruptcy estate at the expense of third parties who are not in the bankruptcy proceeding.").

[56] *See generally* 11 U.S.C. Chapter 7, 11 (2019). Chapter 7 typically refers to liquidation, and chapter 11 refers to reorganization.

creditors and the estate free and clear of tax liability.[57] The relationship between the Tax and Bankruptcy Codes is discussed in Sections C(1)–(3) of this Comment, which follow.

1. 11 U.S.C. § 541: Broad Property of the Estate Interests

The language of Bankruptcy Code § 541, which establishes the bankruptcy estate, is broad. Section 541(a) provides: "The commencement of a [bankruptcy case] creates an estate. Such estate is comprised of all the following property, wherever located and by whomever held."[58] Outside of the exceptions listed in §§ 541(b)–(c),[59] the estate includes "all legal or equitable interests of the debtor in property as of the commencement of the case."[60] Section 541's broad language presents a challenge to a court's ability to limit the trustee's avoidance power for equitable purposes, such as preventing the trustee from holding shareholders "tax hostage."[61] Courts have determined that the definition of "property" includes tangible and intangible property,[62] although "property" is not defined by the Bankruptcy Code.[63] In *Segal v. Rochelle*,[64] the Supreme Court interpreted § 541's statutory predecessor to include the "mere *opportunity to receive* an economic benefit in the future" as property of the estate under the Code,[65] noting that "the 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."[66]

Whether an S corporation's election fits these sweeping § 541 interpretations largely influences whether the election is subject to the bankruptcy trustee's avoidance power under *Butner* and Bankruptcy Code § 548.[67] An important

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[57] Galesi, *supra* note 8, at 181.

[58] 11 U.S.C. § 541(a) (2019).

[59] § 541(b)–(c).

[60] § 541(a)(1).

[61] *See* Health Diagnostic Lab., Inc. v. United States (*In re* Health Diagnostic Lab., Inc.), 578 B.R. 552, 568 (Bankr. E.D. Va. 2017).

[62] § 541(a); *In re Health Diagnostic Lab., Inc.*, 578 B.R. at 561 (citing *In re* Kane, 628 F.3d 631, 637 (3d. Cir. 2010)).

[63] For an exhaustive list of terms which *are* defined by the Bankruptcy Code, *see* 11 U.S.C. § 101 (2019).

[64] *See generally* Segal v. Rochelle, 382 U.S. 375 (1966).

[65] Majestic Star Casino, LLC v. Barden Dev., Inc. (*In re* Majestic Star Casino, LLC), 716 F.3d 736, 750 (3d. Cir. 2013) (quoting *Segal*, 382 U.S. at 379) (emphasis added); *In re* Fruehaul Trailer Corp., 444 F.3d 203, 211 (3d. Cir. 2006)).

[66] *Segal*, 382 U.S. at 379 (alterations added) (internal citations omitted).

[67] *See infra* Sections (B)(2–3).

class of exceptions contained in § 541(b)[68] concern Employee Retirement Income Security Act (ERISA) employee benefit plans and Tax Code § 414(d) government plans.[69] This Comment ultimately suggests that Tax Code § 1362 elections and Congress's intended goals in enacting Subchapter S are similar to ERISA benefit plans in many ways, warranting treatment as an exception to the Strong Arm power in the Bankruptcy Code.

2. The Butner Principle: Countervailing Federal Interests

In *Butner v. United States*,[70] the Supreme Court held that bankruptcy encompasses all pre-petition debtor property rights according to state laws, unless federal law requires a different result. The *Butner* court reasoned that Congress "ha[d] generally left the determination of property rights in the assets of a bankrupt's estate to state law,"[71] by omitting a definition of "property" in the Bankruptcy Code. According to the Court, a debtor ought to be "afforded in federal bankruptcy court the same protection he would have had under state law if no bankruptcy case had ensued."[72]

The *Butner* principle suggests that equivalent state and federal interpretations of what constitutes property of the estate are proper in furtherance of the following principles: "Uniform treatment of property interests by both state and federal courts within a State serves to reduce uncertainty, to discourage forum shopping, and to prevent a party from receiving a windfall merely by reason of the happenstance of bankruptcy."[73]

Additionally, the *Butner* Court also highlighted the principle that: "[f]iling for bankruptcy does not create new property rights or value where there previously were none."[74] For instance, the *In re Majestic Star Casino, LLC* court concluded that "the [Tax Code], rather than state law, governs the characterization of entity tax status as a property interest for purposes of the

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[68] *See* § 541(b)(7)(B).

[69] *Id.*

[70] *See generally* Butner v. United States, 440 U.S. 48 (1979).

[71] Majestic Star Casino, LLC v. Barden Dev., Inc. (*In re* Majestic Star Casino, LLC), 716 F.3d 736, 751 (3d. Cir. 2013) (citing *Butner*, 440 U.S. at 54).

[72] *Butner*, 440 U.S. at 56 (articulating underlying policy consideration for application of state law in defining property interests).

[73] *Id.* at 55. (internal citation omitted).

[74] *In re Majestic Star Casino, LLC*, 716 F.3d at 750 (citing *In re* Messina, 687 F.3d 74, 82 (3d Cir. 2012) and *Butner*, 440 U.S. at 54).

Bankruptcy Code," due to the existence of a countervailing federal interest.[75] The *In re Health Diagnostic Lab., Inc.* court reached a similar conclusion.[76]

3. 11 U.S.C. § 548: The "Strong Arm" Provision—Actual Fraudulent Transfers

While § 541 and the *Butner* principle define the bankruptcy estate, Bankruptcy Code § 548 provides the trustee with avoidance powers to protect the bankruptcy estate and its creditors from unlawful property transfers.[77] Section 548 allows the avoidance of property transfers made with: (a) actual fraudulent intent; and (b) constructively fraudulent intent.[78] The judicial split discussed in this Comment concerns actual fraudulent intent, not constructive fraudulent intent.

a. 11 U.S.C. § 548(a)(1)(A): Actual Fraudulent Intent

One question arising in the area of judicial uncertainty at issue in this Comment, whether termination of Tax Code §1361 elections constitute avoidable fraudulent transfers under the Strong Arm power, concerns whether S terminations amount to property transfers indicative of actual fraudulent intent under § 548.[79] Section 548(a)(1)(A) provides that "[t]he trustee may avoid any transfer . . . of an interest of the debtor in property, or any obligation . . . incurred by the debtor" within two years of filing for bankruptcy relief, "with actual intent to hinder, delay, or defraud . . . ."[80] Under § 101(54), the term "transfer" means "each mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with (i) property; or (ii) an interest in property."[81] In determining if the shareholder's election of the S corporation asset and its subsequent revocation prior to filing its bankruptcy petition is a fraudulent conveyance, the initial inquiry concerns whether the

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[75] *In re Majestic Star Casino, LLC*, 716 F.3d at 752.

[76] *See* Health Diagnostic Lab., Inc. v. United States (*In re* Health Diagnostic Lab., Inc.), 578 B.R. 552, 563 (Bankr. E.D. Va. 2017) ("In this case, federal tax law governs any purported property right at issue. Under the *Butner* principle, there is clearly a countervailing federal interest because S corporation status is a creature of federal law under subchapter S of the Tax Code.").

[77] *See* C. Chadwick Cullum, *Note: A Majestic Vacation: The Third Circuit Takes a Break From the Modern Trend of Including Subchapter S Elections in the Property of a Bankruptcy Estate*, 2 TEX. A&M L. REV. 299, 305 (2014).

[78] 11 U.S.C § 548(a)(1) (2019).

[79] *See, e.g., In re Health Diagnostic Lab., Inc.*, 578 B.R. at 557.

[80] § 548(a)(1)(A).

[81] Cullum, *supra* note 77, at 305 (citing 11 U.S.C § 101(54) (2019)).

election and termination amount to a transferable property interest.[82] Next, if the S election is a property interest, the inquiry turns to whether the termination of an S election amounts to a transfer of that property interest which a bankruptcy trustee may revoke as a fraudulent conveyance made with "actual intent to hinder, delay, or defraud."[83]

The actual fraudulent requirement in § 548(a)(1)(A) is normally proven through common law badges of fraud, with bankruptcy courts generally requiring the liquidating trustee to prove more than one badge of fraud.[84] In *Corzin v. DiGiammarino* (*In re Maglione*), the Bankruptcy Court for the Northern District of Ohio found actual fraudulent intent where a debtor had transferred $30,000 in cash to his mother just before a divorce.[85] The transfer also occurred within two years of filing a petition for bankruptcy relief.[86] The court rejected the debtor's contention that the purpose of the $30,000 transfer was to satisfy an "antecedent debt," because the evidence he offered could only show the debt "would have been discharged more than a decade ago in a prior bankruptcy, and would only have shown a remaining balance of less than $6,000 even if perfectly documented and never discharged."[87] Therefore the trustee could avoid the transfer due to the presence of actual fraudulent intent to hinder, delay, or defraud the bankruptcy estate and its creditors.[88]

D. Contentious Comparison: Are S Elections Similar to Net Operating Loss Carry-forward/Carry-back Elections?

The judicial uncertainty examined in this Comment has been largely debated based upon the question of whether S corporation terminations are analogous to net operating losses (NOLs).[89] NOLs, generally, "are created when the

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[82] *See In re Health Diagnostic Lab., Inc.*, 578 B.R. at 570 (declining to address whether conveyance amounted to a transfer because property inquiry was dispositive). *Cf.* Trans-Lines West, Inc. v. Lines (*In re* Trans-Lines West, Inc.), 203 B.R. 661 (Bankr. E.D. Tenn. 1996).

[83] *See In re Trans-Lines West, Inc.*, 203 B.R. 661; Majestic Star Casino, LLC v. Barden Dev., Inc. (*In re* Majestic Star Casino, LLC), 716 F.3d 736, 757–58 (3d. Cir. 2013); *In re Health Diagnostic Lab., Inc.*, 578 B.R at 570 (declining to address whether conveyance amounted to a transfer because property inquiry was dispositive).

[84] Corzin v. DiGiammarino (*In re* Maglione), 559 B.R. 489, 495 (Bankr. N.D. Ohio 2016).

[85] *Id.* at 501.

[86] *Id.*

[87] *Id.*

[88] *Id.*

[89] *See, e.g.*, Majestic Star Casino, LLC v. Barden Dev., Inc. (*In re* Majestic Star Casino, LLC), 716 F.3d 736, 754–55, n.17 (3d. Cir. 2013) ("*Trans-Lines West* and the decisions that follow it extended *Prudential Lines*, saying that the ability to make an S-corp election, like the ability to elect whether to carry forward or carry back

taxpayer's deductible business expenses for a given year exceed her net income for that year[,]"[90] but allow tax elections where "[c]arry[ing] the amount back . . . and apply[ing] it against any taxable income . . . can generate an immediate tax rebate."[91] In *Segal*, the Supreme Court held that elections to carry-back net operating losses were property of the estate.[92] The *Segal* Court, "conceding the question to be close,"[93] largely relied on the bankruptcy principles that neither postponed enjoyment of property's value, nor a contingency to realization of the property's value, could prevent NOL's from becoming property of the estate.[94] The Court further reasoned that:

> Unlike a pre-bankruptcy promise of a gift or bequest, passing title to the trustee does not make it unlikely the gift or bequest will be effected. Nor does passing the claim hinder the bankrupt from starting out on a clean slate, for any administrative inconvenience to the bankrupt will not be prolonged, . . . and the bankrupt without a refund claim to preserve has more reason to earn income rather than less.[95]

In *Gibson v. United States* (*In re Russell*),[96] the Eighth Circuit extended the *Segal* decision,[97] holding that carry-forward elections are also revocable property interests.[98] In *In re Russell*, the Court reasoned that carry-forward elections similarly created value to creditors, making otherwise permanent elections avoidable by liquidating trustees.[99] The tax scholar Richard Shaw,[100] noted that the *In re Russell* Court "emphasized that these avoidance powers are exclusively geared toward protecting the rights of creditors and are so broad that

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NOLs, is property. We think that extension untenable, though, for several reasons.") ("We are not the only ones to find the *Trans-Lines West* line of cases wanting.") (internal citations omitted)).

[90] *In re Majestic Star Casino, LLC*, 716 F.3d at 753 n.14 (internal citations omitted); Gibson v. United States (*In re* Russell), 927 F.2d 413, 415 (8th Cir. 1991).

[91] *See, e.g.*, *The Net Operating Loss Carryback and Carryforward*, ACCOUNTING TOOLS (Aug. 11, 2017) https://www.accountingtools.com/articles/2017/5/15/the-net-operating-loss-carryback-and-carryforward.

[92] Segal v. Rochelle, 382 U.S. 375, 380 (1966).

[93] *Id.* at 379.

[94] *Id.*

[95] *Id.* at 380 (internal citation omitted).

[96] Gibson v. United States (*In re* Russell), 927 F.2d 413, 415 (8th Cir. 1991).

[97] *See* Majestic Star Casino, LLC v. Barden Dev., Inc. (*In re* Majestic Star Casino, LLC), 716 F.3d 736, 753–54 (3d. Cir. 2013) (internal citations omitted) (citing *In re Russell*, 927 F.2d at 417–18).

[98] *In re Majestic Star Casino, LLC*, 716 F.3d at 753–54; *In re Russell*, 927 F.2d at 415.

[99] *See In re Russell*, 927 F.2d at 417–18; *See* Shaw, *supra* note 17, at 44 ("It emphasized that these avoidance powers are exclusively geared toward protecting the rights of creditors and are so broad that they even enable the trustee to avoid transfers otherwise considered irrevocable under the tax laws.").

[100] *See* Shaw, *supra* note 17, at 40.

they even enable the trustee to avoid transfers otherwise considered irrevocable under the tax laws."[101]

II. BACKGROUND CIRCUIT SPLIT/JUDICIAL UNCERTAINTY

First, this Comment examines judicial disputes on issues of statutory interpretation and policy inconsistencies in the Tax and Bankruptcy Codes.[102] One issue concerns § 548 and whether the S corporation tax attribute is valuable property or a valuable interest of the debtor in property.[103] If it is a property interest, the second question concerns whether the shareholders' ability to terminate S corporation tax treatment amounts to a fraudulent "transfer" of a property interest subject to avoidance under the Strong Arm power.[104] The courts in *Parker v. Saunders* (*In re Bakersfield Westar, Inc.*)[105] and *Trans-Lines West, Inc. v. Lines* (*In re Trans-Lines West, Inc.*),[106] found the Subchapter S tax attributes to be revocable property interests. Rejecting possible shareholder inequality concerns, the *In re Bakersfield Westar, Inc.* and *In re Trans-Lines West, Inc.* courts opted to treat S terminations as avoidable property interests.[107] As a result, the Courts permitted liquidating trustees to create value for creditors by distorting the economics of bankruptcy to shift capital gain liability from asset liquidation to shareholders, who, because they are not parties to the bankruptcy proceeding, otherwise would not be liable.[108] In contrast, the courts in *In re Majestic Star Casino, LLC*[109] and *In re Health Diagnostic Lab., Inc.*[110]

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[101] Shaw, *supra* note 17, at 44 (citing *In re Russell*, 927 F.2d 413).

[102] *See* discussion *infra* ANALYSIS Section A.

[103] *See* Trans-Lines West, Inc. v. Lines (*In re* Trans-Lines West, Inc.), 203 B.R. 653, 661 (Bankr. E.D. Tenn. 1996); *In re Majestic Star Casino, LLC*, 716 F.3d at 757–58; Health Diagnostic Lab., Inc. v. United States (*In re* Health Diagnostic Lab., Inc.), 578 B.R. 552, 570 (Bankr. E.D. Va. 2017) (declining to address whether conveyance amounted to a transfer because property inquiry was dispositive).

[104] 11 U.S.C. § 548 (2019). *See, e.g.*, *In re Health Diagnostic Lab., Inc.*, 578 B.R. at 565. Although a U.S. Circuit Court has not addressed pre-petition S elections directly, the Third Circuit departed from years of precedent and found a post-petition revocation of S classification of a subsidiary was not property of the estate. *In re Majestic Star Casino, LLC*, 716 F.3d 736. On the other hand, the Ninth Circuit Bankruptcy Appellate Panel previously held that the election was property of the debtor-corporation which could be avoided by the Trustee. Parker v. Saunders (*In re* Bakersfield Westar, Inc.), 226 B.R. 227, 239 (B.A.P. 9th Cir. 1998).

[105] *In re Bakersfield Westar, Inc.*, 226 B.R. at 235.

[106] *In re Trans-Lines West, Inc.*, 203 B.R. at 663.

[107] *See generally In re Bakersfield Westar, Inc.*, 226 B.R. at 230; *In re Trans-Lines West, Inc.*, 203 B.R. at 660.

[108] *See, e.g.*, *In re Majestic Star Casino, LLC*, 716 F.3d at 757–58; *In re Trans-Lines West, Inc.*, 203 B.R. at 661; *In re Health Diagnostic Lab., Inc.*, 578 B.R. at 570 (declining to address whether conveyance amounted to a transfer because property inquiry was dispositive). *See* Shaw, *supra* note 17, at 46.

[109] *See generally In re Majestic Star Casino, LLC*, 716 F.3d at 763.

[110] *See generally In re Health Diagnostic Lab., Inc.*, 578 B.R. at 570.

disagreed, concluding that S termination rights were not 'property' interests that could have been transferred; nor were the S terminations subject to avoidance under the fraudulent conveyance doctrine.[111] The *In re Majestic Star Casino, LLC* and *In re Health Diagnostic Lab., Inc.* opinions remedy a number of inequalities for shareholders and promote the *Butner* principles more effectively in consideration of the Tax Cuts and Jobs Act, as discussed later in this Comment.

A. Decisions Finding S Corporation Elections Within Strong Arm Power

The *In re Trans-Lines West, Inc.* and *In re Bakersfield Westar, Inc.* courts each found that shareholder termination of S elections fit the definition of "property of the estate" under § 541 of the Bankruptcy Code subject to the trustee's avoidance under § 548 as fraudulent conveyances.[112] The *In re Trans-Lines West, Inc.* court held that S-elections were property rights, much like Net Operating Losses.[113] The *In re Bakersfield Westar, Inc.* court adopted the same NOL analogy and found actual fraudulent intent in "taxpayer manipulation of the Tax Code."[114]

1. U.S. Bankruptcy Court for the Eastern District of Tennesee: *In re Trans-Lines West, Inc.*

The first court to address whether a trustee could avoid shareholder S-election termination was the United States Bankruptcy Court for the Eastern District of Tennessee in the case of *Trans-Lines West, Inc., v. Lines. (In re Trans-Lines West, Inc.).*[115] The debtor and Internal Revenue Service contended that the "revocation of its Subchapter S status does not constitute a 'transfer of an interest of the debtor in property' under . . . § 548(a) or a fraudulent conveyance under [state law]."[116] First, the court initially considered whether an S corporation

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[111] *See In re Health Diagnostic Lab., Inc.*, 578 B.R. at 570; *In re Majestic Star Casino, LLC*, 716 F.3d at 757.

[112] *See In re Bakersfield Westar, Inc.*, 226 B.R. at 236 ("Thus, the decision to revoke the debtor's subchapter S status appears to reflect careful tax planning, and the Revocation appears to represent an effort by the Saunders to manipulate the bankruptcy system to their personal advantage under the guise of professional tax planning."); *In re Trans-Lines West, Inc.*, 203 B.R. at 663 ("Given the Bankruptcy Code's broad definition of 'transfer' and the Eighth Circuit's holding in *Russell*, this court holds that the Debtor's prepetition revocation of its Subchapter S status constitutes a 'transfer' under § 548(a).").

[113] *See id*. at 661–62.

[114] *In re Bakersfield Westar, Inc.*, 226 B.R. at 235–36.

[115] *See generally In re Trans-Lines West, Inc.*, 203 B.R. 653.

[116] *Id.* at 660–61 (alterations in original).

election was a property interest. Only then would the court consider whether that property interest had been fraudulently conveyed.[117]

To decide the initial question of what constitutes property, the *In re Trans-Lines West, Inc.* court relied upon the following dictionary definition of property:

> As a matter of legal definition, "property" refers not to a particular material object but to the right and interest or domination rightfully obtained over such object, with the unrestricted right to its use, enjoyment and disposition. In other words, [in] its strict legal sense "property" signifies that dominion or indefinite *right of use*, *control*, and *disposition* which one may lawfully exercise over particular things or objects; thus "property" is nothing more than a collection of rights.[118]

The court found that S termination rights under Tax Code § 1362 "affords a corporation which has elected the Subchapter S status a guaranteed, indefinite right to use, enjoy, and dispose of that status[,]" making it a property interest.[119] Section 1362(c) of the Tax Code provides that an S-election continues indefinitely unless it is terminated under any of the three termination possibilities articulated in § 1362(d).[120] Regarding the first two elements—the right to "use" and to "enjoy"—the *In re Trans-Lines West, Inc.* court reasoned that "once a corporation elects to be treated as an S corporation, [Tax Code] § 1362(c) guarantees and protects the corporation's right to use and enjoy that status until it is terminated . . . ."[121] Regarding the third element in the dictionary definition, "disposition," the court found that the shareholder's right to terminate the S corporation under § 1362(d)(1)(A), "guarantees and protects an S corporation's right to dispose of that status at will[,]" providing the unilateral control necessary to be considered property.[122]

After initially finding that S corporation terminations under Tax Code § 1362 were property interests, the court examined whether the elections were 'transferrable' to third parties within the meaning of the fraudulent conveyance

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117 *Id.* at 661.

118 *See id*. (alteration in original) (emphasis added) (citing 63A AM. JUR. 2d Property § 1 (1984); *Property*, BLACK'S LAW DICTIONARY (6th ed. 1990) (internal citations omitted)).

119 *See In re Trans-Lines West, Inc.*, 203 B.R. at 661; *Property*, BLACK'S LAW DICTIONARY 1216 (6th ed. 1990) (internal citations omitted).

120 26 U.S.C. § 1362(c)–(d) (2018).

121 *In re Trans-Lines West, Inc.*, 203 B.R. at 662.

122 *Id.* at 661–62.

doctrine.[123] The court analogized the majority vote to terminate S elections to elections to carryforward NOLs, much like in *In re Russell*.[124] The court concluded that S elections are transferrable property interests, because they each effectively: "[A]chieved the same purpose: the potential increase of the debtor's tax liability."[125]

Where the *In re Trans-Lines West, Inc.* court reasoned that Tax Code § 1362 "affords a corporation which has elected the Subchapter S status a guaranteed, indefinite right"[126] of unilateral control over S status, future courts should reach a different conclusion.[127] One expert, Richard Pope observed:

> No such guarantee exists in Subchapter S, nor can it be reasonably inferred from any language in Subchapter S . . . . Most importantly, none of the Subchapter S sections constitute, or define, any limitations or restrictions upon the shareholders of the S corporation, in acting or failing to act as to the entity's S corporation status.[128]

Another expert, Camila Galesi, author of *Shareholders' Rights Regarding Termination of a Debtor Corporation's S Status in a Bankruptcy Setting*, remarked:

> [I]t is clear that the nature of a corporation's interest in its S status is dependent upon, and subordinate to, the tax considerations of the shareholders. The implications of the nature of the corporation's interest in S status for the S status termination issue is that the debtor S corporation does not have the requisite property interest in its S status to mandate inclusion of the S status in the bankruptcy estate under the provisions of the Bankruptcy Code.[129]

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123 *Id.* at 663.

124 *See id*. at 662–63 (citing Gibson v. United States (*In re* Russell), 927 F.2d 413 (8th Cir. 1991) (holding an election to carry forward net operating losses was a transfer under Bankruptcy Code § 548(a))).

125 *Id.* at 663.

126 *Id.* at 661; *see* Galesi, *supra* note 8, at 162 (referring to the *Trans-West* decision as an "erroneous conception"); Wm. Robert Pope, *S Corporation Federal Tax Status—Property of the Bankruptcy Estate?*, 2013 NORTON BANKR. L. ADVISER 1, 5 (7th ed. 2013) ("Most importantly, none of the Subchapter S sections constitute, or define, any limitations or restrictions upon the shareholders of the S corporation, in acting or failing to act as to the entity's S corporation status.").

127 *See In re Trans-Lines West, Inc.*, 203 B.R. at 661; *see also* Galesi, *supra* note 8; Pope, *supra* note 126.

128 Pope, *supra* note 126.

129 Galesi, *supra* note 8.

2. 9th Cir. B.A.P.: *In re Bakersfield Westar, Inc.*

Two years later, in *Parker v. Saunders*, (*In re Bakersfield Westar, Inc.*), the United States Bankruptcy Appellate Panel for the Ninth Circuit considered whether termination of S corporation treatment thirteen days[130] prior to filing a bankruptcy petition amounted to a fraudulent transfer.[131] The court also relied on the *Trans-Lines West* court's dictionary definition of "property," allowing the trustee to avoid the shareholders' employment of a § 1362 S termination option as a fraudulently transferred property interest rightfully belonging to the bankruptcy estate.[132]

The court relied on *Segal v. Rochelle*,[133] which "declin[ed] to exclude the right to NOL carry forwards from [the] definition of property merely because [the] right was intangible and not yet reduced to a tax refund."[134] In *In re Bakersfield Westar, Inc*., if the shareholders of an S corporation, Bakersfield Westar, Inc., had been permitted to terminate its prior election to be taxed as an S corporation, creditors of the bankruptcy estate would have been liable for the $400,000 of capital gain liability arising from the liquidation of Bakersfield Westar, Inc.'s assets. [135] However, the court held that the revocation created value and therefore was an avoidable property interest,[136] permitting the trustee to "Strong Arm" the company back into an S corporation with pass-through tax characteristics, which shifted the $400,000 capital gain liability to the corporation's two individual shareholders.[137]

Having found a property interest, the *In re Bakersfield Westar, Inc.* court also held that the revocation of an S election was a transfer, making it an avoidable fraudulent transfer made within two years of filing for bankruptcy.[138] The court found actual fraudulent intent, reasoning that the shareholders of the debtor, Bakersfield Westar, Inc., had revoked the election in an apparent "effort by the [shareholders] to manipulate the bankruptcy system to their personal

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130 *See* Parker v. Saunders (*In re* Bakersfield Westar, Inc.), 226 B.R. 227, 229 (B.A.P. 9th Cir. 1988) (noting that the debtor submitted its revocation on Feb. 1, 1994 and filed a bankruptcy petition on Feb. 14, 1994).

131 *In re Bakersfield Westar, Inc.*, 226 B.R. at 229.

132 *Id*. at 233–34.

133 Segal v. Rochelle, 382 U.S. 375 (1966).

134 *In re Bakersfield Westar, Inc.*, 226 B.R. at 234 (citing *Segal*, 382 U.S. at 379).

135 *In re Bakersfield Westar, Inc*., 226 B.R. at 234 (citing *Segal*, 382 U.S. at 379).

136 *In re Bakersfield Westar, Inc.*, 226 B.R. at 234 (citing *Segal*, 382 U.S. at 379).

137 *In re Bakersfield Westar, Inc.*, 226 B.R. at 234 (citing *Segal*, 382 U.S. at 379).

138 *Id.* at 236.

advantage under the guise of professional tax planning."[139] The court indicated that "careful tax planning," such as conferring with an accountant before revoking the election, was a badge of a § 548 conveyance with actual fraudulent intent.[140]

B. Decisions Finding S Corporation Elections Are an Exception to Strong Arm Power

Recognizing the inequity to shareholders created by decisions that permit liquidating trustees to hold S corporation shareholders tax-hostage, the courts in *In re Health Diagnostic Lab., Inc.*[141] and *In re Majestic Star Casino, LLC*[142] each carved out Strong Arm power exceptions for S corporation elections.[143] Tax Code § 1362 effectively allows shareholders to terminate Subchapter S tax treatment any time by either: (i) outright revocation or (ii) transferring ownership to a disqualified party under § 1361(b), such as a non-resident alien or a corporate entity, thereby disqualifying the entity as an S-corporation.[144] By creating Strong Arm power exceptions and allowing S corporation shareholders to exercise Tax Code § 1362 termination rights to block capital gain taxes from liquidation sales from passing through to shareholders, each opinion has the effect of preventing trustees from unlawfully holding shareholders 'tax hostage.'[145]

1. Third Circuit: *In re Majestic Star Casino, LLC*

In *In re Majestic Star Casino, LLC*,[146] the Third Circuit directed sharp criticism at the opinions of the *In re Trans-Lines West, Inc.* and *In re Bakersfield Westar, Inc.* courts, which assumed that electing S corporation tax treatment guaranteed shareholders unilateral control over a property interest.[147] The Court

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139 *Id.*; *see also* Shaw, *supra* note 17, at 45.

140 *In re Bakersfield Westar, Inc.*, 226 B.R. at 236–37.

141 Health Diagnostic Lab., Inc. v. United States (*In re* Health Diagnostic Lab. Inc.), 578 B.R. 552 (Bankr. E.D. Va. 2017).

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

143 *In re Health Diagnostic Lab., Inc.*, 578 B.R. at 565; *In re Majestic Star Casino, LLC*, 716 F.3d at 757; *cf.* 11 U.S.C. § 548(c) (2019).

144 Galesi, *supra* note 8, at 157 (internal citation omitted).

145 *See In re Health Diagnostic Lab., Inc.*, 578 B.R. at 568; *see also* Galesi, *supra* note 8, at 157 (internal citation omitted).

146 *See In re Majestic Star Casino, LLC*, 716 F.3d at 736.

147 *Id.* at 756–57.

ultimately found that wholly-owned subsidiaries of S corporations, ("Q subs")[148] are neither property of the estate[149] nor within the scope of the Strong Arm power of bankruptcy trustees.[150] In contrast with the *In re Trans-Lines West, Inc.* and *In re Bakersfield Westar, Inc.* opinions (which held that Subchapter S election and termination rights fell within the Strong Arm power due to their similarity to NOL's), the *In re Majestic Star Casino, LLC* Court noted several critical distinctions between NOL's and S elections, ultimately excepting S elections from avoidance.[151]

First, where the *In re Bakersfield Westar, Inc.* court determined that the contingent nature of a property right "does not place it outside the definition of '*property*,'"[152] the *In re Majestic Star Casino, LLC* Court found that S corporation elections were too contingent to amount to estate property, reasoning that: "Even accepting that this will sometimes be the case, not all contingencies are of equal magnitude or consequence."[153] Therefore, the Court found that, relatively, NOLs "are hardly contingent at all,"[154] because only one contingency exists in the election to carry forward or carry back NOLs, while elections for S corporation tax treatment are "entirely contingent on the will of the shareholders[,]" placing them outside the definition of estate property.[155]

Second, the Court determined that the ability to elect S corporation tax treatment was not a valuable property interest like an election to carry forward and carry back NOLs, because NOLs can actually be valued and monetized in bankruptcy through the physical sale of the NOL, conferring value to the purchasing organization, while Subchapter S tax treatment cannot.[156]

Third, the Court disagreed with the *Trans-Lines West* court's assumption that electing S corporation tax treatment guaranteed shareholders unilateral

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148 *See* 26 U.S.C. § 1361(b)(3)(B) (2018); *see also In re* Majestic Star Casino, LLC, 716 F.3d at 743 n.6, for discussion of historical background concerning enactment of Q Subs, statutory requirements and regulatory implications.

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

150 *See id.* at 755–58. While the case tangentially concerned 11 U.S.C. § 549 post-petition transfers, the majority of the analysis concerns whether S-corps and Q-subs constitute property, which it determined to be the dispositive issue. *Id*. at 752–63.

151 *Id.* at 755–58.

152 *Id.* at 755 (citing Parker v. Saunders, (*In re* Bakersfield Westar, Inc., Inc.), 226 B.R. 227, 234 (B.A.P. 9th Cir. 1988)) (emphasis added).

153 *Id.*

154 *Id.*

155 *Id.*

156 *Id.* at 755–56 .

control to exercise termination rights.[157] While the *Trans-Lines West* court reasoned that "once a corporation elects to be treated as an S corporation, [the Tax Code] guarantees and protects the corporation's right to use and enjoy that status . . . [as well as the] right to dispose of that status at will," the *In re Majestic Star Casino, LLC* Court described the statement as an "incomplete and inaccurate understanding of the law."[158] The Court reasoned that the right to use the S election tax asset was not guaranteed, because, in addition to outright revocation, the occurrence of multiple events may cause S corporations to terminate entirely against the will of its shareholders, such as a single shareholder's sale of their interest to a corporate entity or to a nonresident alien.[159]

Fourth, the limited value created by shifting tax liability to the non-debtor shareholders is insufficient to "override rights statutorily granted to shareholders to control the tax status of the entity they own."[160]

Fifth, the court recognized that treating S elections like NOL carry forward elections produces substantial inequities to shareholders, as well as a windfall for creditors which would not otherwise be available but for the happenstance of an S corporation entering bankruptcy.[161]

2. U.S. Bankruptcy Court for the Eastern District of Virginia: *In re Health Diagnostic Lab., Inc.*

In *In re Health Diagnostic Lab., Inc.*,[162] recognizing that neither the Bankruptcy Code nor applicable case law provided a sufficient definition to either include or exclude elections for S corporation tax treatment from the Strong Arm power, the United States Bankruptcy Court for the Eastern District of Virginia deferred to the *Butner* principle for guidance.[163] Ultimately, the court determined that, because the salient question concerned an inconsistency

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[157] *Id.* at 756 (referencing Trans-Lines West, Inc. v. Lines (*In re* Trans-LinesWest, Inc.), 203 B.R. 662 (Bankr. E.D. Tenn. 1996)).

[158] *Id.*

[159] *Id.* at 755–56.

[160] *Id.* at 757.

[161] *Id.* at 757–58.

[162] Health Diagnostic Lab., Inc. v. United States (*In re* Health Diagnostic Lab., Inc.), 578 B.R. 552 (Bankr. E.D. Va. 2017).

[163] *Id.* at 562 (applying Butner v. United States, 440 U.S. 48, 55 (1979)).

between the Tax and Bankruptcy Codes, two federal statutes, a countervailing federal interest indeed existed.[164]

The *In re Health Diagnostic Lab., Inc.* court applied a new federal property test, previously applied by the Fourth Circuit in contested Tax Code property questions relating to the Bankruptcy Code, to determine whether S corporation terminations under the Tax Code should amount to avoidable property interests in bankruptcy.[165] The test is based on the Fourth Circuit's recognition "that certain interests constitute 'property' for federal tax purposes when they embody 'essential property rights . . . .'"[166] The Fourth Circuit's property rights test (Essential Property Rights Test) consists of six factors, as opposed to the three-factor dictionary test applied in *Trans-Lines West*.[167] The Essential Property Rights Test notably includes the breadth of control which the taxpayers may actually exercise, in addition to the rights to receive income for the S status as elements, which the *Trans-Lines West* decision's three-part dictionary test failed to address.[168] The *In re Health Diagnostic Lab., Inc.* court's Essential Property Rights Test is comprised of six factors:

> (1) the right to use; (2) the right to receive income produced by the purported property interest; (3) the right to exclude others; (4) the breadth of the control the taxpayer can exercise over the purported property; (5) whether the purported property right is valuable; and (6) whether the purported right is transferable . . . . A reviewing court must weigh those factors in order to determine whether the interest in S corporation status constitutes "property" for federal tax purposes.[169]

The court found that only the first element, the "right to use," leaned in favor of characterizing S elections as property.[170]

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164 *Id.* at 563 (quoting Butner, 440 U.S. at 55).

165 *Id.*

166 *Id.*

167 *See id.*; *cf.* Trans-Lines West, Inc. v. Lines (*In re* Trans-Lines West, Inc.), 203 B.R. 653, 661 (Bankr. E.D. Tenn. 1996) (alteration in original) (emphasis added) (citing 63A AM. JUR. 2D Property § 1 (1984); *Property*, BLACK'S LAW DICTIONARY (6th ed. 1990) (internal citations omitted)).

168 *See generally In re Health Diagnostic Lab., Inc.*, 578 B.R. at 566–67.

169 *Id.* at 563 (citing Va. Historic Tax Credit Fund 2001 LP v. Comm'r, 639 F.3d 129, 140 (4th Cir. 2011) (citing United States v. Craft, 535 U.S. 274, 278 (2002) (internal citations to *Va. Historic Tax Credit Fund* and *Craft* omitted).

170 *See id.* at 565–66 ("[T]he Liquidating Trustee contends that there is postpetition value to this ability of the Debtors to avoid directly paying taxes on their own income. The Trustee argues that it is this value that makes the Debtors' S corporation status an interest in property. But this rationale runs afoul of the prohibition against creating in bankruptcy 'new property rights or value where there previously were none.'") (quoting *In re* Messina, 687 F.3d 74, 82 (3d Cir. 2012)).

However, the court explained that the "right to use" element, standing alone, was not enough to justify classifying S elections and their revocations as property.[171] The court reasoned that "the 'right to use' is the weakest of the 'essential property rights.' Without the rights of control and disposition, the right to use is devoid of any meaningful property interest . . . ."[172] The court explained that the "right to use," in absence of the rights to control and disposition, is not meaningful, much like "the right to use a tool borrowed from a neighbor[,]"[173] quoting the Fifth Circuit decision *TMT Procurement Corp. v. Vantage Drilling Co., (In re TMT Procurement)*.[174] In *In re TMT Procurement*, the Fifth Circuit similarly "reject[ed] the debtor's argument that shares of stock it had been allowed to use to establish adequate collateral were 'property of the estate,'" when the debtor had neither the right to control or retain those shares.[175]

The court similarly reasoned that the shareholders of S corporations indeed possessed the "right to use" the S status.[176] However, unlike the prior *In re Trans-Lines West, Inc.* and *In re Bakersfield Westar, Inc.* decisions, the *In re Health Diagnostic Lab., Inc.* court found that S corporation shareholders lacked control rights and disposition rights for the S corporation tax status.[177] Accordingly, the right to control the tax asset existed when the shareholders initially elected the S corporation status up until the shareholders revoked it; at that point, the shareholders, who are non-debtors and therefore not parties to the bankruptcy proceeding, no longer possessed control of the contested property status.[178] The court found that the other factors in the Essential Property Rights Test weighed against bringing the election into the bankruptcy estate.[179] Therefore, the court reasoned that the corporation could "use the S corporation tax status to pass their tax liability through to their shareholders."[180]

While demanding the return of the shareholders' tax refunds could create value for the estate, the court rejected that element's determinativeness, instead

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171 *In re Health Diagnostic Lab., Inc.*, 578 B.R. at 563–64.

172 *Id.*

173 *See id.* at 564 (citing *In re* TMT Procurement Corp. v. Vantage Drilling Co., 764 F.3d 512, 523–26 (5th Cir. 2014)).

174 *See generally id.* (referencing *In re* TMT Procurement Corp., 764 F.3d 512 (5th Cir. 2014)).

175 *See id.* (quoting *In re* TMT Procurement Corp., 764 F.3d 512, 523–26 (5th Cir. 2014)).

176 *In re Health Diagnostic Lab., Inc.*, 578 B.R. at 564.

177 *Id.*

178 *Id.* at 565.

179 *See id.* at 564 ("Only one of the factors identified by the Fourth Circuit leans in favor of classifying S corporation tax status as property. That is the Debtors' ability to use the S corporation tax status to pass their tax liability through to their shareholders.").

180 *Id.* at 565.

reasoning that that value did not create a property right in the tax attribute.[181] The court analogized the situation to *Wornick v. Gaffney*, a Second Circuit case which held that "a beneficiary of a life insurance policy 'has no legal or equitable interest in the policy that could be made part of the property of the beneficiary's bankruptcy estate.'"[182] In the Second Circuit, for instance "[i]t has long been the law that '[t]he beneficiary of a life insurance policy, who may at any time be removed from the benefited position by the insured and against the beneficiary's will, cannot have a vested interest.'"[183] Thus, not each and every single item of value must necessarily fall within the "property" definition subject to avoidance under § 548 of the Bankruptcy Code.

This Comment suggests that future courts addressing S terminations in the context of the Strong Arm Power should apply the Essential Property Rights Test. Courts would do well to apply this test because, in response to the Tax Cuts and Jobs Act, a statistically significant number of S corporation elections are likely to be terminated in favor of treatment as standard C corporations. As a result of the Act, the amended Tax Code uniformly assesses tax rates upon C corporation shareholders similar to, if not lower than, the tax rates assessed on S corporation shareholders, without the risk of being held tax hostage in bankruptcy.[184] Thus, the certainty and consistency offered by the Essential Property Rights Test warrants wider consideration by future courts outside the Fourth Circuit, for many of whom these questions will be an area of first impression.

III. ANALYSIS

A. 2017 Tax Cuts and Jobs Act: Implications for S Corporations and Shareholders

The 2017 Tax Cuts and Jobs Act (TCJA), first applicable for individual filer's in the spring tax returns of fiscal year 2018,[185] is likely to the increase frequency of litigation over Subchapter S elections and termination rights in the context of the Strong Arm power. The TCJA impacts S corporations and shareholders in unique ways, magnifying inequalities to S corporation

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181 *Id.*

182 *Id.* (citing Wornick v. Gaffney, 544 F.3d 486, 490 (2d Cir. 2008)).

183 *Wornick*, 544 F.3d at 490 (citing *In re* Greenberg, 271 F. 258, 259 (2d Cir. 1921)).

184 *See In re Health Diagnostic Lab., Inc.*, 578 B.R. at 563 n.19.

185 Matthew Frankel CFP, *2019 Tax Changes: Everything You Need to Know*, THE MOTLEY FOOL (Jan. 3, 2019), https://www.fool.com/taxes/2019/01/03/2019-tax-changes-everything-you-need-to-know.aspx.

shareholders in bankruptcy courts declining to adopt an exception to the trustees' avoidance power for Subchapter S termination rights.

The Tax Cuts and Jobs Act, which cut corporate income tax rate from thirty-five percent[186] to a permanent twenty-one percent flat rate for C corporations,[187] in many instances, has decreased corporate income tax to a level lower than the individual rates assessed against shareholders of S corporations.[188] Since individual tax rates under the Tax Cuts and Jobs Act have remained assessed on a temporary graduating scale ranging from ten to thirty-seven percent, this Comment reasons that the Tax Cuts and Jobs Act is likely to cause a statistically significant portion of S corporation shareholders to terminate Subchapter S elections for legitimate tax planning purposes.[189]

For pass-through businesses like S corporations, which are not otherwise subject to the corporate income tax,[190] the Tax Cuts and Jobs Act allows individual shareholders to deduct up to twenty percent from personal tax filings for Qualified Business Income (QBI Deductions) under 26 U.S.C. § 199A, to compensate for the balance of corporate income tax liability now incurred at individual rates.[191] However, a number of usage limitations on QBI Deductions, such as dollar cap limitations and limitations on the business activities which pass-through entities may conduct, will likely lead shareholders of S corporations to reach agreements revoking elections for Subchapter S tax treatment in order to revert entities to C corporations.[192] Moreover, while the

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[186] *Summary: H.R.1 — 115th Congress (2017–2018)*, CONGRESS.GOV (2017), https://www.congress.gov/bill/115th-congress/house-bill/1 ("This section reduces the corporate tax rate from a maximum of 35% under the existing graduated rate structure to a flat 21% rate for tax years beginning after 2017."); *see also* Alistair M. Nevius, *How Tax Overhaul Would Change Business Taxes*, J. OF ACCT., (Oct. 23, 2018, 11:38 PM), https://www.journalofaccountancy.com/news/2017/dec/tax-reform-bill-changes-for-businesses-201718071.html.

[187] 26 U.S.C. § 11(b) (2018) ("The amount of the tax imposed by subsection (a) shall be 21 percent of taxable income.").

[188] *See* Welker, *supra* note 3; J. Michael Kolk, *Another Look at C Corp. vs. S corp. in Light of Tax Reform*, THE TAX ADVISER (Aug. 1, 2018), https://www.thetaxadviser.com/issues/2018/aug/c-corp-s-corp-tax-reform.html ("Considering that the top individual tax rate was dropped only to 37% (from 39.6%), even with the addition of a 20% deduction for qualified business income (QBI) that can effectively lower the rate to 29.6%, many passthrough taxpayers may be interested in possibly changing their businesses into C corporations.").

[189] *Summary: H.R.1 — 115th Congress (2017–2018)*, CONGRESS.GOV (2017), https://www.congress.gov/bill/115th-congress/house-bill/1 ("Unless otherwise specified, provisions referred to in this summary as temporary or as a suspension of an existing provision apply for taxable years beginning after December 31, 2017, and before January 1, 2026.").

[190] Scott Greenberg, *Reforming the Pass-Through Deduction*, TAX FOUNDATION (June 21, 2018), https://taxfoundation.org/reforming-pass-through-deduction-199a/.

[191] *See* Welker, *supra* note 3. *See generally* 26 U.S.C. § 199A (2018) (allowing the deduction to compensate for the balance of corporate income tax liability now incurred at individual rates).

[192] *See* Welker, *supra* note 3; Kolk, *supra* note 188.

lowered corporate income tax rate of twenty-one percent for C corporations is permanent, the availability of the QBI Deduction for pass-through entities will expire in 2025 pursuant to the terms of § 199A(2)(i),[193] raising additional questions regarding the longevity of the S corporation's usefulness.[194]

Furthermore, according to CPA J. Michael Kolk of the Tax Adviser, even where S corporations are not disqualified by QBI Deduction usage limitations, "[c]onsidering that the top individual tax rate was dropped only to 37% (from 39.6%), even with the addition of a 20% [QBI Deductions] that can effectively lower the rate to 29.6%, many pass-through taxpayers may be interested in possibly changing their businesses into C corporations[,]" despite double taxation implications.[195] The resulting increase in shareholders terminating S corporations may require either legislators or courts to craft an exception to the Bankruptcy Code Strong Arm power for Tax Code § 1362 S terminations.[196]

B. Policy Considerations Support Creation of S Corporation Exception to Strong Arm Power

This Comment suggests that the *In re Majestic Star Casino, LLC* and *In re Health Diagnostic Lab., Inc.* opinions, which concluded that Tax Code § 1361 elections and § 1362 S terminations should be excepted from the § 548 Strong Arm power to avoid fraudulent conveyances under the Bankruptcy Code, more effectively promote Congress's intent in enacting both the Tax and Bankruptcy codes.[197] In addition, the *In re Health Diagnostic Lab., Inc.* court's application of the Essential Property Rights Test provides an especially persuasive analysis of Subchapter S Tax Code elections in bankruptcy[198] in consideration of the

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193 § 199A(i).

194 *See* Tabor, *supra* note 28, at 654 ("gained popularity in 1986 when federal income tax rates on corporations were higher than for individuals.") (referencing Richard A. Shaw, *S Corporations in 1994*, C892 ALI-ABA 597, 611 (Mar. 3, 1994)); *cf.* Kolk, *supra* note 188.

195 *See* Kolk, *supra* note 188.

196 *See* H.R. Con. Res. 1, 115th Cong. (2017) (enacted); Pub. L. No. 115-97, 115-97, 131 Stat. 2054 (2017) (enacted); Health Diagnostic Lab., Inc. v. United States (*In re* Health Diagnostic Lab. Inc.), 578 B.R. 552 (Bankr. E.D. Va. 2017); Majestic Star Casino, LLC v. Barden Dev., Inc. (*In re* Majestic Star Casino, LLC), 716 F.3d 736 (3d Cir. 2013). *See generally Third Circuit Narrowly Construes Doctrine of Equitable Mootness*, AKIN GUMP STRAUSS HAUER & FELD LLP (Aug. 10, 2012), https://www.akingump.com/en/news-insights/third-circuit-narrowly-construes-doctrine-of-equitable-mootness.html (referring to "the bankruptcy-influential United States Court of Appeals for the Third Circuit").

197 *See In re Majestic Star Casino, LLC*, 716 F.3d 736 (deciding that S corporation status is not revocable by the Liquidating Trustee in context of deciding that Qsubs are not revocable).

198 *See In re Health Diagnostic Lab., Inc.*, 578 B.R. at 563 n. 19 ("The Fourth Circuit in *Virginia Historic Tax Credit Fund* utilized the analysis from United States v. Craft to determine whether the interest at issue classified as 'property' for section 707 of the Tax Code . . . . While *Virginia Historic Tax Credit Fund* concerned

sweeping changes ushered in by the Tax Cuts and Jobs Act. The decisions of the *In re Majestic Star Casino, LLC* and *In re Health Diagnostic Lab., Inc.* courts are also consistent with the *Butner* principle, among other principles, from which the *Trans-Lines West* and *In re Bakersfield Westar, Inc.* courts either substantially departed or declined to address.[199]

First, "careful tax planning" is not penalized in either the Tax or Bankruptcy Codes and should not be penalized moving forward in light of changes to the tax landscape ushered by the TCJA. Second, preventing trustees from revoking S terminations as fraudulent conveyances serves to reduce uncertainty in an area where a countervailing federal interest in uniformity exists, by both mitigating inequality to non-debtor shareholders of insolvent S corporations in addition to allowing creditors to recover. Third, an exception to the Strong Arm provision allowing shareholders to terminate S elections prevents a windfall to creditors merely by the coincidence of an S corporation's bankruptcy. Fourth, Congress's intent in creating the S corporation, as well as the terms of §§ 1361–62 of the Tax Code, suggest that S corporations are similar enough to an enumerated exception to the Strong Arm power, ERISA retirement plans, to warrant a similar exception for S corporation election and termination rights. Fifth, the application of the Essential Property Rights Test to tax-specific disputes in bankruptcy presents a useful analytical tool for courts moving forward, serving to prevent uncertainty, forum shopping, and prohibited creditor windfalls, warranting greater adoption by courts outside the Fourth Circuit.

1. Careful Tax Planning is Not Penalized in Other Areas Within the Bankruptcy Code

The sweeping changes to the taxation of corporations and pass-through entities in the Tax Cuts and Jobs Act, at the very least, call the *In re Bakersfield Westar, Inc*. court's characterization of "careful tax planning" as indicative of actual fraudulent intent into question.[200] In consideration of the present

section 707 of the Tax Code, the Court finds the analysis and balancing test applicable to this case. Courts have repeatedly applied the *Craft* analysis to several different federal statutes.") (citing Greene v. Savage (*In re* Greene), 583 F.3d 614, 620 (9th Cir. 2009) (applying the *Craft* analysis to 11 U.S.C. § 522(p)(1)); Wallace v. Rogers (*In re* Rogers), 513 F.3d 212, 223–24 (5th Cir. 2008) (applying the *Craft* analysis to 11 U.S.C. § 522(p)(1)); *In re* Conrad, 544 B.R. 568, 571–73 (Bankr. D. Md. 2016) (applying the *Craft* analysis to 11 U.S.C. § 522(b)(3)(B)); United States v. Towne, 406 F.Supp.2d 928, 935 (N.D. Ill. 2005) (applying the *Craft* analysis to 26 U.S.C. § 6321)).

[199] *See In re Health Diagnostic Lab., Inc.*, 578 B.R. at 565–70; *see infra* notes 208, 225, 228, 234, 260, 261 and accompanying text.

[200] *See* Kolk, *supra* note 188; *c.f.* Parker v. Saunders (*In re* Bakersfield Westar, Inc.), 226 B.R. 227, 236

uncertainty surrounding tax changes, especially concerning the indeterminate viability of QBI Deductions, careful tax planning appears not only perfectly legitimate, but also necessary for many businesses concerned about the declining usefulness of the S corporation business organization.[201] Since C corporation shareholders could ultimately pay less income tax than shareholders of S corporations despite double-taxation,[202] preventing trustees from strong-arming shareholders of small business corporations into a tax hostage scenario seems to appropriately promote consistency and fairness in an area of federal interest.[203]

In creating the S corporation, "Congress intended the election of S corporation status to limit the influence of tax considerations on choice of entity used to own a business."[204] One expert, Camila Berit Galesi, remarked that: "Of course, no shareholder would elect S status for the corporation if it meant that only the tax liability would be passed through to the shareholders, but that the cash would never be received by them."[205] Ultimately, the *In re Trans-Lines West, Inc.* and *In re Bakersfield Westar, Inc.* courts permitted trustees to avoid S terminations as "careful tax planning," or a similar maneuver to defraud creditors.[206] However, those characterizations are inconsistent with the amended Tax Code, which arguably incentivizes shareholders to abandon Subchapter S in its entirety.[207] As a result, excepting S terminations from the Strong Arm

(B.A.P. 9th Cir. 1998) (finding "careful tax-planning" as actual fraudulent intent).

[201] *See* 26 U.S.C. § 199A (2018); Welker, *supra* note 3; *see also* Kolk, *supra* note 188 ("Considering that the top individual tax rate was dropped only to 37% (from 39.6%), even with the addition of a 20% deduction for qualified business income (QBI) that can effectively lower the rate to 29.6%, many passthrough taxpayers may be interested in possibly changing their businesses into C corporations."); *cf.* Tabor, *supra* note 28, at 654 (noting that the S corporation tax attribute "gained popularity in 1986 when federal income tax rates on corporations were higher than for individuals.") (referencing Richard A. Shaw, *S Corporations in 1994*, C892 ALI-ABA 597, 611 (Mar. 3, 1994)).

[202] *See* 26 U.S.C. § 11(b) (2018) ("The amount of the tax imposed by subsection (a) shall be 21 percent of taxable income."); *Summary: H.R.1 — 115th Congress (2017–2018)*, CONGRESS.GOV (2017), https://www.congress.gov/bill/115th-congress/house-bill/1. ("This section reduces the corporate tax rate from a maximum of 35% under the existing graduated rate structure to a flat 21% rate for tax years beginning after 2017."); Nevius, *supra* note 187.

[203] *See In re Bakersfield Westar, Inc.*, 226 B.R. at 236 ("Thus, the decision to revoke the debtor's subchapter S status appears to reflect careful tax planning, and the Revocation appears to represent an effort by the Saunders to manipulate the bankruptcy system to their personal advantage under the guise of professional tax planning").

[204] *In re Health Diagnostic Lab., Inc.*, 578 B.R. at 565 ("Congress intended the election of S corporation status to limit the influence of tax considerations on choice of entity used to own a business.").

[205] Galesi, *supra* note 8, at 181.

[206] *See In re Bakersfield Westar, Inc.*, 226 B.R. at 236; Trans-Lines West, Inc. v. Lines (*In re* Trans-Lines West, Inc.), 203 B.R. 653 (Bankr. E.D. Tenn. 1996).

[207] *See* Welker, *supra* 3; Kolk, *supra* note 188 ("Considering that the top individual tax rate was dropped only to 37% (from 39.6%), even with the addition of a 20% deduction for qualified business income (QBI) that

power may indeed be the only path consistent with Congress's original goal of providing owners of S corporation's with more freedom.[208]

Long before the corporate income tax became lower than that for individual taxpayers, tax scholar Richard Shaw[209] noted that:

> The revocation of the S election in connection with the bankruptcy merely assures that during the bankruptcy, the tax burden from the sale of assets or from the operation of a business during bankruptcy will follow and be applied to the entity recognizing the gain or earning profits from the business.[210]

Where many taxpaying shareholders of S corporations would benefit from changing their businesses into C corporations,[211] the characterization of "careful tax planning" as indicative of the type of fraud opening the door to avoidance under the Strong Arm power appears to be, as Shaw described, a "misnomer."[212]

To the contrary, many tax advisory and financial service providers indeed advise S corporation owners to consult tax planning advisors.[213] Therefore, the *In re Majestic Star Casino, LLC* and *In re Health Diagnostic Lab., Inc*. holdings are likely more consistent with Congress's intended purposes of creating greater flexibility for the owners of small business corporations. These create an unusual limitation on the Strong Arm power for S corporation election rights as well as promoting the reorganization of debtors, as discussed in the following section.

2. Congress Intended to Create Equitable Outcomes in Both the Bankruptcy and Internal Revenue Codes

The principal agenda in Chapter 11 bankruptcy proceedings is to

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can effectively lower the rate to 29.6%, many passthrough taxpayers may be interested in possibly changing their businesses into C corporations.").

[208] *See In re Health Diagnostic Lab., Inc*., 578 B.R. at 565 ("Congress intended the election of S corporation status to limit the influence of tax considerations on choice of entity used to own a business."); Shaw, *supra* note 17, at 47. *See generally* 26 U.S.C. §§ 1361–62 (2019).

[209] Shaw, *supra* note 17, at 40, n.aa.

[210] *Id.* at 47.

[211] *See id.*

[212] *Id.*

[213] *See, e.g.*, Kathy Pickering, *How the Tax Cuts and Jobs Act Impacts U.S. Tax Returns*, H&R BLOCK, (Oct. 24, 2018), https://www.hrblock.com/tax-center/irs/tax-reform/tax-cuts-and-jobs-act/) ("One taxpayer's situation will be different from the next. If you're curious to find out how tax reform will affect you, get an estimate from our tax return and tax reform calculator and make an appointment to visit with a tax professional. He or she will help you navigate the new tax laws.").

successfully reorganize the debtor.[214] That agenda is comprised of two objectives: (i) to rehabilitate the debtor, and (ii) to minimize forfeitures of creditors.[215] While those objectives are often at odds with one another, the Bankruptcy Code tends to balance competing interests by "entrust[ing] bankruptcy courts with 'broad, equitable powers to balance the interests of the affected parties . . . .'"[216] In enacting Subchapter S of the Tax Code, "Congress intended the election of S corporation status to limit the influence of tax considerations on choice of entity used to own a business."[217] A bankruptcy expert, Ian Follansbee, clarified that "outside of bankruptcy, dominion and control over [S-corporation status] belongs not to the corporate entity but to its shareholders, who were Congress's intended beneficiaries in allowing the entity and its shareholders to utilize pass-through tax treatment."[218]

The decisions on both sides of the area of judicial uncertainty discussed in this Comment, whether or not termination of Tax Code § 1361 elections constitute avoidable fraudulent transfers under the Strong Arm power, each conflict with Congress's intended Tax and Bankruptcy purposes in some aspects.[219] However, the consequence of forcing shareholders to shoulder the pass-through capital gains taxes arising from asset liquidation sales in bankruptcy, while the bankruptcy estate realizes the entirety of those very capital gains free and clear of tax liability, has been consistently recognized as especially severe.[220] The question of which adversarial party, either the debtor or the creditors of the bankruptcy estate, must shoulder the burden remains open to dispute. Nonetheless, the implementation of the Tax Cuts and Jobs Act should encourage future courts to adopt the holdings of the *In re Majestic Star Casino*,

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214 Joshua M. Silverstein, *Hiding in Plain View: A Neglected Supreme Court Decision Resolves the Debate Over Non-Debtor Releases in Chapter 11 Reorganizations*, 23 EMORY BANKR. DEV. J. 13, 15 (2006).

215 *Id.*

216 *See id.* (quoting *Pioneer Inv. Serv. Co. v. Brunswick Assoc. Ltd. P'ship*, 507 U.S. 380, 389 (1993)).

217 Health Diagnostic Lab., Inc. v. United States (*In re* Health Diagnostic Lab., Inc.), 578 B.R. 552, 565 (Bankr. E.D. Va. 2017) ("Congress intended the election of S corporation status to limit the influence of tax considerations on choice of entity used to own a business.").

218 Follansbee, *supra* note 8, at 79.

219 *See, e.g.*, Majestic Star Casino, LLC v. Barden Dev., Inc. (*In re* Majestic Star Casino, LLC), 716 F.3d 736, 755 n.17 (3d. Cir. 2013).

220 *Id.* at 757 ("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.") (citing Trans-Lines West, Inc. v. Lines (*In re* Trans-LinesWest, Inc.), 203 B.R. 653, 660 (Bankr. E.D. Tenn. 1996)).

LLC and *In re Health Diagnostic Lab., Inc.* decisions, which will serve to promote uniformity and clarity.[221]

Prior to the passage of the Tax Cuts and Jobs Act, the tax scholar Richard Shaw highlighted the conflicts between the *In re Trans-Lines West, Inc.* and *In re Bakersfield Westar, Inc.* decisions and the underlying policies of both the Tax Code.[222] Shaw stated: "It is well-founded tax policy that the function of the capital gains tax is to impose a tax burden on appreciation recognized on disposition of the property by the owner."[223] Shaw also recognized the problematic tax-related effects of *In re Trans-Lines West, Inc.* and *In re Bakersfield Westar, Inc.* particularly in the context of bankruptcy proceedings:

> The inequity of treating an S corporation different from a C corporation or an individual owner is evident in the Bankruptcy Code itself. If the bankrupt entity is a C corporation, the tax obligation arising from a sale is treated as a direct administrative expense of the estate under Bankruptcy Code Section 503(a)(1)(B), and must be paid from corporate properties before settling claims of creditors. Likewise, if the debtor in bankruptcy is an individual, the tax burden from the sale of the property is also an administrative expense that must be paid out of the bankruptcy estate before satisfying the claims of creditors.[224]

The bankruptcy courts' decisions in the *In re Trans-Lines West, Inc.* and *In re Bakersfield Westar, Inc.* produce an inconsistency that Shaw describes as "abus[ing] the economics of both the tax and the bankruptcy systems by taking advantage of the S election to distort the economics of bankruptcy proceedings."[225] Similarly, in *Sery v. Federal Business Centers, Inc.*, the United States District Court for the District of New Jersey, arrived at a similar conclusion, determining that a "shareholder is bound forever by the decision to elect Subchapter S status is a bridge too far and not something that can reasonably be read into the Subchapter S IRS election forms."[226] The *Sery* court noted that "considering the very limited market for minority shares of close corporations, shareholders in closely held S corporations would effectively be held hostage if the Court were to find that Subchapter S election contractually bound a shareholder to preserve the tax favored status."[227] Therefore, the *In re*

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221 *See In re Health Diagnostic Lab., Inc.*, 578 B.R. at 569.
222 Shaw, *supra* note 17, at 46–47.
223 *Id.* at 46.
224 *Id.* at 46–47.
225 *Id.* at 47.
226 Sery v. Fed. Bus. Ctrs, Inc., 616 F.Supp.2d 496, 505 (D.N.J. 2008).
227 *Id.* at 505 n.3.

Majestic Star Casino, LLC and *In re Health Diagnostic Lab., Inc.* outcomes may be more consistent with Congress's intent in the Tax and Bankruptcy Codes by largely mitigating that inequity to the shareholders, in addition to allowing creditors to recover.[228]

The Tax Cuts and Jobs Act has raised additional questions regarding whether S-status is actually "valuable," making it a revocable property interest subject to the fraudulent conveyance doctrine,[229] since the corporate income tax rate for C corporations, despite double-taxation, may ultimately be less than the individual income tax rates on pass-through shareholders.[230] While the *In re Trans-Lines West, Inc.* and *In re Bakersfield Westar, Inc.* courts found financial value for creditors sufficient to justify permitting liquidating trustees to "Strong Arm" shareholders into shouldering an anomalous burden,[231] much of the pass-through tax value of the status has been called into question by the Tax Cuts and Jobs Act.[232] Therefore, the most equitable result in future litigation may be to prevent trustees from nullifying revoked S elections because the current tax landscape undermines the value in an S election or S termination, a large component of the *In re Trans-Lines West, Inc.* and *In re Bakersfield Westar, Inc.* decisions. Therefore, the potential reduction of uncertainty for shareholders of insolvent S corporations across jurisdictions justifies the implementation of a uniform exception to the Strong Arm power.

3. Creditors Benefit from a Windfall at the Expense of Inequalities to Non-Debtor Shareholders; The Standing Question Prevents a Suggested Solution

The creation of an exception to the Strong Arm power for S corporation elections would resolve the prohibited windfall to creditors which would not otherwise be available, but for the coincidence of an S corporation entering

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[228] *See* Majestic Star Casino, LLC v. Barden Dev., Inc. (*In re* Majestic Star Casino, LLC), 716 F.3d 736, 756–57 (3d. Cir. 2013); Health Diagnostic Lab., Inc. v. United States (*In re* Health Diagnostic Lab., Inc.), 578 B.R. 552, 564 (Bankr. E.D. Va. 2017).

[229] *Cf.* Tabor, *supra* note 28, at 654–55 (2001) (referencing Richard A. Shaw, *S Corporations in 1994*, C892 ALI-ABA 597, 611 (Mar. 3, 1994) (noting that the S corporation tax attribute "gained popularity in 1986 when federal income tax rates on corporations were higher than for individuals")).

[230] *Cf. id.*

[231] *See* Parker v. Saunders (*In re* Bakersfield Westar, Inc.), 226 B.R. 227, 234 (B.A.P. 9th Cir. 1988) ("The ability to not pay taxes has a value to the debtor-corporation in this case.").

[232] *See id.* ("The ability to not pay taxes has a value to the debtor-corporation in this case."); *cf. In re Health Diagnostic Lab., Inc.*, 578 B.R. at 565 ("The fact that something confers value to the estate does not necessarily create a property right in it."). *But see supra* notes 199, 200, and accompanying text.

bankruptcy.[233] In contrast with shareholders, who foot a potentially astronomical capital gains tax liability, Galesi emphasized that:

> The most glaringly obvious equitable reason for allowing termination is that, if termination is avoided, the tax on the capital gain generated by the sale of the corporation's assets by the trustee for the benefit of the creditors will not be paid out of that income. As a result, the creditors are unjustly enriched . . . .[234]

Such an unjust enrichment is exactly the prohibited windfall the *Butner* Court aimed to eliminate with uniform property of the estate definitions across state and federal courts.[235] The *In re Majestic Star Casino, LLC* Court, which did create such an exception, noted that, "[i]n its haste to provide cash for creditors, the Ninth Circuit BAP in *Bakersfield [Westar]* and the Tennessee Bankruptcy Court in . . . *Trans–Lines West* . . . [were] simply creating a windfall for the bankruptcy estate at the expense of third parties who are not in the bankruptcy proceeding."[236]

The *In re Bakersfield Westar, Inc.* opinion provides a useful illustration of the inequality caused by holdings permitting trustees to avoid shareholder termination of S elections under the Strong Arm provision. In *In re Bakersfield Westar, Inc*., if the shareholders of Bakersfield Westar, Inc. had been permitted to terminate its prior election to be taxed as an S corporation, creditors of the bankruptcy estate would have been liable for the $400,000.00 of capital gain liability arising from the liquidation of Bakersfield Westar, Inc.'s assets.[237] However, because the Court held that the revocation therefore created value and therefore was an avoidable property interest,[238] permitting the trustee to "Strong Arm" the company back into an S corporation with pass-through tax characteristics, the trustee shifted the $400,000 capital gain liability to the corporation's two individual shareholders.[239]

Shaw recognized that the decisions in In re *Trans-Lines West* and *In re Bakersfield Westar, Inc.* effectively "creat[ed] a windfall for the bankruptcy estate at the expense of third parties who are not in the bankruptcy

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233 *See, e.g., In re Majestic Star Casino, LLC*, 716 F.3d at 757–58.

234 Galesi, *supra* note 8, at 180.

235 *See* Butner v. United States, 440 U.S. 48, 55 (1979).

236 *In re Majestic Star Casino, LLC*, 716 F.3d at 755 n.17 (citing Richard A. Shaw, Taxing Shareholders on the Income of an S Corporation in Bankruptcy, 1 NO. 6 BUS. ENTITIES 40, 1999 WL 1419055, at *46 (1999)).

237 *In re Bakersfield Westar, Inc.*, 226 B.R. at 234.

238 *Id.*

239 *Id.*

proceeding."[240] Further, Shaw explained, the *In re Trans-Lines West* and *Bakersfield* decisions also contravene bankruptcy principles:

> Because the shareholders of an S corporation have elected to follow a tax structure created by Congress for the purpose of applying a single tax instead of a two-tier tax, the Ninth Circuit BAP in *Bakersfield* has decided that the trustee can arbitrarily place the tax burden resulting from the future sale of bankruptcy assets or future operation of the debtor's business on third parties (shareholders of the S corporation who are not parties to the pending bankruptcy proceeding), without their consent. This abuses the economics of both the tax and the bankruptcy systems by taking advantage of the S election to distort the economics of bankruptcy proceedings. It separates the tax burden on the property from the ownership of the property.[241]

These arguments were eventually recognized by the Third Circuit in *In re Majestic Star Casino, LLC*, which cited Shaw, Galesi and Pope, [242] and ultimately held that shareholders should have the ability to convert S corporations to C corporations by exercising Tax Code § 1362(d)(1)(B) termination rights without fearing that a bankruptcy trustee will impose an inequitable tax burden in bankruptcy.[243] Therefore, creation of an exception preventing liquidating trustees from strong-arming owners into retaining S corporation tax treatment in bankruptcy would prevent a prohibited windfall by the mere coincidence of being a creditor of an S corporation, as opposed to a creditor of some other entity like a C corporation, LLC, or LLP.

Underlying the creation of a prohibited windfall for creditors is a substantial standing problem in preventing termination. The standing issue concerns the distinction between the insolvent S corporation, an entity, and its shareholders, who are individuals.[244] Tax Code § 1362(a)(2) states that "[a]n election under this subsection shall be valid only if *all persons who are shareholders* in such corporation on the day on which such election is made consent to such election."[245] The court in *In re Health Diagnostic Lab., Inc.* noted that "the plain language of the statute makes abundantly clear that the shareholders elect S

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[240] Shaw, *supra* note 17, at 46.

[241] Shaw, *supra* note 17, at 47.

[242] *See* Majestic Star Casino, LLC v. Barden Dev., Inc. (*In re* Majestic Star Casino, LLC), 716 F.3d 736, 755 fn.17 (3d. Cir. 2013).

[243] *See id.* at 756.

[244] *See* Follansbee, *supra* note 8, at 79.

[245] 26 U.S.C. § 1362(a)(2) (2018) (emphasis added); *see also* Health Diagnostic Lab., Inc. v. United States (*In re* Health Diagnostic Lab., Inc.), 578 B.R. 552, 566 (Bankr. E.D. Va. 2017).

corporation status—not the corporate entity—and that any interest in electing S corporation status belongs to the shareholders."[246] Shaw noted "more inappropriate implications" concerning opinions permitting avoidance by liquidating trustees:

> If a trustee is in a position to treat the right to revoke the S election as property of the estate, which the trustee can control without the consent of the shareholders, then it is only a minor step for a trustee to assert that this property right includes authority for the trustee to make an affirmative election for a small business corporation to become an S corporation under Subchapter S without the consent of the shareholders. Technically, under Section 1362, an S election can be made only by the corporation with the unanimous consent of all the shareholders. Therefore, the trustee would need authority to take affirmative action to make the election, in lieu of merely preventing the shareholders from revoking the S status in derogation of the corporate status quo.[247]

That conclusion is bolstered by the fact that usage limitations on QBI Deductions are likely to drive shareholders to terminate S elections to avoid personally incurring corporate income taxes (at personal rates).[248] In the event that the entity might later become insolvent within two years of doing so, failure to create an exception to the Strong Arm power would permit liquidating trustees to force shareholders into shouldering capital gain taxes from an asset liquidation. However, the purpose of termination, in most instances, should properly be attributed to efforts made in order to take advantage of a federal tax incentives made available by the implementation of the TCJA. Moreover, since the availability of the QBI Deduction for pass-through entities will expire in 2025 pursuant to the terms of § 199A(2)(i),[249] here, too, the liquidating trustee could foreseeably avoid terminations of S elections, perpetuating the existence of unnecessary windfalls in the absence of an exception to the Strong Arm power.[250] Therefore, in consideration of the TCJA's creation of new incentives for owners of small business corporations to terminate Subchapter S elections, decisions which create an exception to the § 548 Strong Arm power for S

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246 *In re Health Diagnostic Lab., Inc.*, 578 B.R. at 567.

247 Shaw, *supra* note 17, at 64 (emphasis added).

248 *See* Welker, *supra* note 3; Kolk, s*upra* note 188.

249 26 U.S.C. § 199A(2)(i) (2018).

250 *See* Tabor, *supra* note 28, at 654 ("gained popularity in 1986 when federal income tax rates on corporations were higher than for individuals") (referencing Richard A. Shaw, *S Corporations in 1994*, C892 ALI-ABA 597, 611 (Mar. 3, 1994)); *cf.* Kolk, *supra* note 188 ("Considering that the top individual tax rate was dropped only to 37% (from 39.6%), even with the addition of a 20% deduction for qualified business income (QBI) that can effectively lower the rate to 29.6%, many passthrough taxpayers may be interested in possibly changing their businesses into C corporations").

elections and terminations appear much more likely to effectively and equitably prevent prohibited windfalls in consideration of the terms of the TCJA.

4. Tax Code § 1362 S Corporation Elections: Analogy to Bankruptcy Code § 541 ERISA Property of the Estate Exception

Unlike the *In re Trans-Lines West, Inc.* and *In re Bakersfield Westar, Inc.* decisions, which analogized S-elections to NOL's, S corporation elections might be more analogous to ERISA pension plans, an enumerated § 541 exception. For example, in *Patterson v. Shumate*, the Supreme Court recognized an exception to the general rule that interests of the debtor become estate property.[251] The Court held that: "a restriction on the transfer of a beneficial interest of the debtor in a trust that is enforceable under applicable nonbankruptcy law is enforceable in a case under [this title]."[252] Furthermore, the Court ruled that ERISA pension plans were not revocable by the trustee.[253] The Court reasoned that "Section 206(d)(1) of ERISA, which states that '[e]ach pension plan shall provide that benefits provided under the plan may not be assigned or alienated,' 29 U.S.C. § 1056(d)(1), clearly imposes a 'restriction on the transfer' of a debtor's 'beneficial interest' in the trust."[254] Therefore, the Court held that, in bankruptcy, ERISA's anti-alienation requirement created an exception to the trustee's avoidance power.[255]

While the Court noted that, under ERISA, pension plans might contain enforceable provisions that specifically restrict the transfer of a financial interest, S corporation elections are also somewhat limited in their transferability by the language of IRC Section 1362.[256] The *In re Health Diagnostic Lab., Inc.* court noted that:

> Shareholders have the overwhelming ability to control the tax status of their corporation. Election of S corporation status may be achieved by one method—unanimous shareholder consent. The federal tax statute governing the election of S corporation status states that "[a]n election under this subsection shall be valid only if *all persons who are shareholders* in such corporation on the day on which such election is made consent to such election." . . . The plain language of

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251 Patterson v. Shumate, 504 U.S. 753, 756 (1992).
252 *Id.* at 757; 11 U.S.C. 541(c)(1)–(2) (2019).
253 *Patterson*, 504 U.S. at 759–60.
254 *Id.* at 759.
255 *See id.* at 759–60.
256 *See generally* 26 U.S.C. § 1362 (2018).

> the statute makes abundantly clear that the shareholders elect S corporation status—not the corporate entity—and that any interest in electing S corporation status belongs to the shareholders.[257]

Therefore, the *In re Health Diagnostic Lab., Inc.* court's holding is consistent with *Patterson*'s analysis in the sense that Subchapter S limits the transferability of that tax-attribute with respect to bankruptcy trustees.[258]

More importantly, the *Patterson* court noted a number of policy considerations, which may be similar to S elections.[259] First, the Court noted that its "decision . . . ensures that the treatment of pension benefits will not vary based on the beneficiary's bankruptcy status."[260] The Court noted that it was important to maintain that ERISA pension plans were non-transferrable in bankruptcy proceedings, "minimiz[ing] the possibility that creditors will engage in strategic manipulation of the bankruptcy laws in order to gain access to otherwise inaccessible funds."[261] Outside of bankruptcy, the imposition of capital gains taxes to indirectly satisfy creditor claims would otherwise be inaccessible to creditors and the bankruptcy estate.[262] The Supreme Court's creation of an exception in *Patterson* suggests the S elections might deserve similar treatment.

The *In re Majestic Star Casino, LLC-Star* and *In re Health Diagnostic Lab., Inc.* holdings, much like the Supreme Court's holding in *Patterson*, protect, in bankruptcy proceedings, the property interests and transfer restrictions created under other federal laws. While in the case of ERISA, each plan must state that the pension plans are not assignable,[263] there is no such requirement in the Tax Code.[264] The *In re Majestic Star Casino, LLC* and *In re Health Diagnostic Lab., Inc.* decisions are consistent in their treatment of other federal laws regardless of bankruptcy since any interest in electing S corporation status belongs to the

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[257] Health Diagnostic Lab., Inc. v. United States (*In re* Health Diagnostic Lab., Inc.), 578 B.R. 552, 566 (Bankr. E.D. Va. 2017) (emphasis in original) (citing 26 U.S.C. § 1362(a)(2)).

[258] *See supra* note 257 and accompanying text.

[259] *See Patterson*, 504 U.S. at 764.

[260] *Id.* (citing Butner v. United States, 440 U.S. 48, 55 (1979)).

[261] *Id.*

[262] *Cf. id.* (citing Seiden, *Chapter 7 Cases: Do ERISA and the Bankruptcy Code Conflict as to Whether a Debtor's Interest in or Rights Under a Qualified Plan Can be Used to Pay Claims?*, 61 AM. BANKR. L. J. 301, 317 (1987) (noting inconsistency if "a creditor could not reach a debtor-participant's plan right or interest in a garnishment or other collection action outside of a bankruptcy case but indirectly could reach the plan right or interest by filing a petition . . . to place the debtor in bankruptcy involuntarily")).

[263] *See supra* notes 254, 255, and accompanying text.

[264] Galesi, *supra* note 8, at 157.

shareholders.[265] For instance, the *In re Health Diagnostic Lab., Inc.* court remarked: "The mere filing of the tax form does not confer control over the S corporation status. It is unrealistic to suggest that a corporation could ever revolt against its shareholders by refusing to file the revocation form."[266] As a result, bankruptcy courts should allow an exception for S corporation termination rights, which are arguably made inalienable by the Tax Code.

Protecting Subchapter S election and termination rights prevents the risk of strategic manipulation, which the *Patterson* Court also sought to prevent when it created a Strong Arm power exception for ERISA pension plans.[267] Shaw noted that the "purpose of the revocation of an S election is not to defraud creditors but simply to ensure that the tax obligation arising from the sale is tied to the proceeds from the sale[,]" consistent with tax principles.[268] Therefore, allowing shareholders to revoke an S election might already sufficiently mitigate exposure to risk of strategic manipulation for access to funds otherwise inaccessible, in a manner consistent with *Patterson*. In light of the foreseeably increased quantity of Subchapter S terminations, the creation of a Bankruptcy Code § 541 property of the estate exception, preventing trustees from asserting § 548 avoidance powers on terminated S corporations, may warrant an exception to the fraudulent conveyance doctrine in a manner similar to ERISA pension plans.

5. The In re Health Diagnostic Lab., Inc. Court Correctly Applied Judicially Created Essential Property Rights Test in Absence of Intervening Code Guidance

The *In re Health Diagnostic Lab., Inc.* court correctly applied the Supreme Court's Essential Property Rights Test, which "recognize[s] that certain interests constitute 'property' for federal tax purposes . . . ."[269] The *In re Health Diagnostic Lab., Inc.* court recognized that: "The Fourth Circuit in *Virginia Historic Tax Credit Fund* utilized the analysis [from the Supreme Court case] *United States v. Craft* to determine whether the interest at issue classified as

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[265] Health Diagnostic Lab., Inc. v. United States (*In re* Health Diagnostic Lab., Inc.) 578 B.R. 552, 566 (Bankr. E.D. Va. 2017); and Majestic Star Casino, LLC v. Barden Dev., Inc. (*In re* Majestic Star Casino, LLC)., 716 F.3d 736 (3d Cir. 2013).

[266] *In re Health Diagnostic Lab., Inc.*, 578 B.R at 567.

[267] *See Patterson*, 504 U.S. at 764.

[268] *See* Shaw, *supra* note 17, at 47.

[269] *In re Health Diagnostic Lab., Inc.*, 578 B.R. at 563 (citing Virginia Historic Tax Credit Fund 2001 LP v. Comm'r of Internal Revenue, 639 F.3d 129, 141 (4th Cir. 2011); United States v. Craft, 535 U.S. 277, 283 (2002)).

'property' for *section 707 of the Tax Code*."[270] The *In re Health Diagnostic Lab., Inc.* court also noted a number of instances where the Tax Code Essential Property Rights Test was applicable to Bankruptcy Code issues.[271] In addition to the Essential Property Rights Test's applicability in the Fourth Circuit, the *In re Health Diagnostic Lab., Inc.* court referenced the applicability of the *Craft* analysis to tax issues in bankruptcy across a number of jurisdictions and courts, including the Ninth Circuit, the Fifth Circuit, and the United States Bankruptcy Court for the District of Maryland.[272] Therefore, the *In re Health Diagnostic Lab., Inc.* court's application of the Essential Property Rights Test between two bodies of federal law—the Tax and Bankruptcy Codes—may promote clarity in an area of federal interest. As the *In re Health Diagnostic Lab., Inc.* court noted, application of the Essential Property Rights Test to the Bankruptcy Code is, at minimum, "bolstered by the fact that the courts that have extensively analyzed this issue have all concluded that federal law controls."[273] As a result, "there is no risk of inconsistent treatment of this choice of law issue."[274]

Since a range of federal courts have successfully applied the Essential Property Rights Test across circuits in considering what constitutes a § 522 Exemption in the Bankruptcy Code, an area which federal law controls, there lies a strong argument for the uniform application of the Essential Property Rights Test for § 541 property of the estate exceptions, which define the scope of the trustee's Strong Arm power.[275] Since each of the courts addressing the issue have agreed that federal law should apply in determining whether S

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[270] *In re Health Diagnostic Lab., Inc.*, 578 B.R. at 563 n.19 (emphasis added).

[271] *See id.* (citing Virginia Historic Tax Credit Fund 2001 LP v. Comm'r of Internal Revenue, 639 F.3d 129, 141 (4th Cir. 2011); United States v. Craft, 535 U.S. 277, 283 (2002)).

[272] *See id.* (referencing Greene v. Savage (*In re* Greene), 583 F.3d 614, 620 (9th Cir. 2009) (applying the *Craft* analysis to 11 U.S.C. § 522(p)(1)); Wallace v. Rogers (*In re* Rogers), 513 F.3d 212, 223–24 (5th Cir. 2008) (applying the *Craft* analysis to 11 U.S.C. § 522(p)(1)); *In re* Conrad, 544 B.R. 568, 571–73 (Bankr. Md. 2016) (applying the *Craft* analysis to 11 U.S.C. § 522(b)(3)(B)); United States v. Towne, 406 F. Supp. 2d 928, 935 (N.D. Ill. 2005) (applying the *Craft* analysis to 26 U.S.C. § 6321).

> The Fourth Circuit in *Virginia Historic Tax Credit Fund* utilized the analysis from *United States v. Craft* to determine whether the interest at issue classified as "property" for section 707 of the Tax Code. 639 F.3d at 140–41. While *Virginia Historic Tax Credit Fund* concerned section 707 of the Tax Code, the Court finds the analysis and balancing test applicable to this case. Courts have repeatedly applied the Craft analysis to several different federal statutes.

While none of the aforementioned cases concerned the applicability of United States. v. Craft, 535 U.S. 277 (2002) to the breadth of "Property of the estate" under 11 U.S.C. § 541 or 11 U.S.C. 548, they do concern bankruptcy "exemptions" under 11 U.S.C. § 522. *In re Health Diagnostic Lab., Inc.*, 578 B.R. at 563 n.19.

[273] *Id.* at 563.

[274] *Id.*

[275] *See id.*

elections are property moving forward,[276] the *In re Health Diagnostic Lab., Inc.* court's application of the Essential Property Rights Test offers clarity within an uncertain area of federal interest which may soon see more attention, and supports a conclusion that creating an exception to the Bankruptcy Code's Strong Arm power for S corporation's may be necessary. The implementation of the Fourth Circuit Essential Property Rights Test indeed results in an exception to the Strong Arm Power, serving to prevent uncertainty, forum shopping, and prohibited windfalls by producing a uniform outcome.

CONCLUSION

This Comment suggests that the *In re Majestic Star Casino, LLC* and *In re Health Diagnostic Lab., Inc.* decisions, which hold that Tax Code §§ 1361–62 elections and terminations fall outside the scope of the Bankruptcy Code § 548 Strong Arm Power, are likely to more effectively further Tax and Bankruptcy Code policies than the alternative solution, which imposes a disproportionately large tax liability on shareholders of S corporations.[277] In addition to addressing a nuanced statutory interpretation problem within the split discussed in this Comment, whether termination of Tax Code § 1361 elections constitute avoidable fraudulent transfers under the Strong Arm power, these decisions are consistent with the essential policy goals of both federal codes.

First, preventing trustees from revoking S terminations as fraudulent conveyances is consistent with Congress's intent concerning Subchapter S of the Tax Code as well as the Strong Arm power of the Bankruptcy Code. Second, "careful tax planning" is not penalized in other areas of the Bankruptcy Code and should not be penalized in light of recent tax changes of particular consequence to Subchapter S corporations. Third, an exception to the Strong Arm provision allowing shareholders to terminate S elections prevents a windfall to creditors merely by the happenstance of an S corporation's bankruptcy. Fourth, Congress's intent in creating the S corporation, as well as the terms of §§ 1361–62 of the Tax Code, suggest that S corporations are similar enough to ERISA retirement plans, an enumerated exception to the Strong Arm power, to warrant a similar exception for S corporation election and termination rights. Fifth, the application of the Essential Property Rights Test to tax-specific

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[276] *Id.* ("This conclusion is bolstered by the fact that the courts that have extensively analyzed this issue have all concluded that federal law controls. Thus there is no risk of inconsistent treatment on this choice of law issue.").

[277] *See* Majestic Star Casino, LLC v. Barden Dev., Inc. (*In re* Majestic Star Casino, LLC), 716 F.3d 736 (3d Cir. 2013) (deciding that S corporation status is not revocable by the Liquidating Trustee in cont*ext of deciding that Q subs are not revocable).

disputes in bankruptcy presents a useful analytical tool for courts moving forward, serving to prevent uncertainty, forum shopping, and prohibited creditor windfalls. Therefore, courts outside of the Fourth Circuit would do well to adopt the Essential Property Rights Test. Moreover, at the intersection of the Tax and Bankruptcy Codes, there lies a strong argument for creating an exception to the fraudulent conveyance doctrine for S corporations.

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