Emory Bankruptcy Developments Journal

Volume 39 | Issue 3

2023

# Status Check: Should the Federal Tax Status of a Disregarded Debtor Be Property of the Estate?

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## Recommended Citation

J. B. Ward, *Status Check: Should the Federal Tax Status of a Disregarded Debtor Be Property of the Estate?*, 39 EMORY BANKR. DEV. J. 629 (2023).
Available at: https://scholarlycommons.law.emory.edu/ebdj/vol39/iss3/8

# STATUS CHECK: SHOULD THE FEDERAL TAX STATUS OF A DISREGARDED DEBTOR BE PROPERTY OF THE ESTATE?


ABSTRACT

*This Comment focuses on whether the tax status of a debtor constitutes "property" of the debtor's estate under 11 U.S.C. § 541(a). The answer to this question ultimately determines whether a bankruptcy trustee has the power to avoid a "check-the-box" tax status change made by the owner of a debtor entity from a "pass-through" to a separately taxed C Corporation. This issue normally arises when the parent corporation or individual owner of a debtor subsidiary corporation or disregarded entity (to the individual owner) elects to transform the status of the debtor by "checking the box" on the proper federal tax form.*

*This Comment utilizes a hypothetical scenario involving an individual who owns a pass-through entity which holds a completely depreciated piece of real property. The individual decides to leverage the piece of real property but, through a series of misfortunes, is subsequently forced to place the entity holding that real property into bankruptcy. In bankruptcy, the distressed property is sold in a forced sale that is a taxable event. The individual owner of the debtor entity is motivated to make a prepetition or post-petition tax status change in entity type to a C Corp because the tax obligation resulting from the gain on sale of the real estate no longer "passes through" to the owner's tax return once the change is made. Instead, the tax gain remains with the newly-transformed C Corp and the bankruptcy estate. In effect, the change in tax status allows the owner of a debtor entity to shift the tax burden normally flowing to the owner as a pass-through gain to instead be paid by the bankruptcy estate simply by making a change on a tax form. Check-the-box changes can also tangibly affect other kinds of tax attributes, such as the ability to use NOLs.*

*Courts are split on whether the debtor entity's tax status constitutes property. This Comment advocates for the position taken by the Third Circuit, that ultimate control of the debtor's tax status is contingent on the will of the parent-owner of the debtor and is therefore, not property. This Comment argues against courts within the Sixth and Ninth Circuits, which have held that tax attributes of a debtor are property of the debtor's estate protected by the automatic stay under 11 U.S.C. § 362(a) and are therefore subject to the trustee's avoidance powers under sections 544, 548, and 549 of the Bankruptcy Code.*

TABLE OF CONTENTS

INTRODUCTION .......... 631
I. SCENARIO & BACKGROUND LAW .......... 637
A. *Three Potential Buddies: Choosing Between an SMLLC, a C Corp, and an S Corp* .......... 637
B. *Buddy LLC in Distress: The Capitol Hill Land Purchase* .......... 639
C. *Buddy in Bankruptcy* .......... 641
D. *Checking the Box* .......... 645
E. *Fraudulent Transfer & Avoidance Powers* .......... 646
II. PROPERTY OF THE ESTATE IN BANKRUPTCY .......... 648
A. *Section 541 and the Text of the Bankruptcy Code* .......... 648
B. *The* Butner *Principle: Looking to State Law* .......... 650
C. Chicago Board of Trade*: Intangible Rights* .......... 651
III. THE DISFAVORED APPROACH AND THE FAVORED APPROACH .......... 652
A. *The Disfavored Approach* .......... 653
1. In re Trans-Lines West *and* In re Bakersfield Westar .......... 654
2. *The NOL Cases* .......... 658
B. *The Favored Approach* .......... 663
1. In re Majestic Star Casino, LLC .......... 663
2. *A Continuation of the Move in the Right Direction:* In re Health Diagnostic Laboratory .......... 667
3. *Why It Matters: The Fresh Start Policy* .......... 670
4. *An Exceedingly Simple Solution* .......... 673
CONCLUSION .......... 674

## INTRODUCTION

For at least the last century, bankruptcy and other federal courts have struggled to define what qualifies as "property" under section 541 of the Bankruptcy Code.[1] The Supreme Court determined that Congress declined to provide a complete definition of the term specifically to enable a bankruptcy trustee to draw as many of a debtor's rights and interests as possible into the bankruptcy estate[2]—because a larger estate benefits the debtor's creditors. As the congressional record to section 541 details, legislators envisioned "property" as "includ[ing] . . . all interests such as . . . contingent and future interests."[3] Under such a broad definition, section 541 empowers a trustee to rake a comprehensive array of a debtor's property rights into the estate, leading to a more thorough distribution of the debtor's assets.[4] Though a debtor is unlikely to enjoy a trustee turning over every proverbial stone to locate valuable property rights, this sometimes-invasive process allows the debtor to walk away from the bankruptcy proceedings with a cleaner and more thorough fresh start at discharge, because a greater number of assets with monetary value will be available to settle outstanding debts.

However, there are logical limits to what should be brought under the definition of property. Despite congressional intent, issues arise when a trustee attempts to draw exotic property interests into the estate, especially those interests that are difficult to administer because they are novel, uncommon, and hard to value.[5] One area in which courts struggle to reach a concrete definition for the word "property" is where the Bankruptcy Code intersects with the Internal Revenue Code (the "IRC") concerning the "tax attributes" derived from the IRC, specifically the tax status of an entity.[6] Friction exists at this

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1 *See, e.g.*, Bd. of Trade v. Johnson, 264 U.S. 1, 10 (1924) (holding that a seat on the board of directors is property of the estate); *see also, e.g.*, United States v. Whiting Pools, Inc., 462 U.S. 198, 204–05 (1983) (contemplating the brevity of what can be considered an interest in property covered under section 541(a)(1)); Majestic Star Casino, LLC v. Barden Dev., Inc. (*In re* Majestic Star Casino, LLC), 716 F.3d 736, 749–63 (3d Cir. 2013) (considering tax status as property under section 541(a)).

2 *See Whiting Pools*, 462 U.S. at 203–04 ("Although these statutes [sections 542(a), 363, and 541(a)] could be read to limit the estate to those 'interests of the debtor in property' at the time of the filing of the petition, we view them as a definition of what is included in the estate, rather than as a limitation.").

3 Off. Comm. of Unsecured Creditors v. PSS S.S. Co. (*In re* Prudential Lines, Inc.), 928 F.2d 565, 572 (2d Cir. 1991) (quoting H.R. REP. NO. 95-595, at 176 (1978), *as reprinted in* 1978 U.S.C.C.A.N. 5963, 6136) (internal quotation marks omitted); *Whiting Pools*, 462 U.S. at 204.

4 *See generally* 11 U.S.C. §§ 726, 524 (2022); Butner v. United States, 440 U.S. 48 (1979).

5 *See, e.g.*, *Johnson*, 264 U.S. 1 (contemplating the exotic property right of a seat on a board of directors for a trade association).

6 *See, e.g.*, *Majestic Star Casino*, 716 F.3d at 747–48 (addressing the "question of whether a debtor subsidiary's entity tax status is "property" under section 541(a)).

intersection because the term "property" for purposes of the Bankruptcy Code does not mean, at every instance, the same thing as it does for the IRC.[7]

Specifically, courts have developed two major approaches to help determine whether a certain tax attribute of a taxpayer, that of tax status, is considered "property" of the bankruptcy estate under section 541(a). The approach adopted by a given court ultimately determines the ability of a bankruptcy trustee to use its avoidance powers under sections 544, 548, and 549 of the Bankruptcy Code. These avoidance powers permit the trustee to reverse a modification of the debtor entity's tax status outside of the bankruptcy process.[8] Courts are split on whether to characterize the modification to tax status as an allegedly fraudulently transfer of "property" out of the bankruptcy estate.[9]

The first approach, adopted by the Ninth Circuit's Bankruptcy Appellate Panel and the Bankruptcy Court for the Eastern District of Tennessee, among others,[10] has its roots in a line of net operating loss ("NOL") cases out of the Second, Eighth, and Ninth Circuit Courts of Appeals.[11] This approach considers tax status to be "property" of the bankruptcy estate by embracing an all-encompassing definition of the term. The primary reason these courts consider tax status to be property of the bankruptcy estate is that a non-debtor taxpayer's tax attributes can be so "intertwined with that of a bankrupt debtor [that allowing a taxpayer to manipulate the tax attribute in question] would have the legal effect of diminishing or eliminating property of the bankrupt estate."[12] The practical effect of including tax status in the definition of property is that non-debtor taxpayers who own entities undergoing bankruptcy are barred by the Bankruptcy Code from arranging their tax affairs in a manner prescribed by the IRC. If a

[7] *Compare* 11 U.S.C. § 541(a) (governing what types of "property" comprise the property of the bankruptcy estate in a broad, largely unenumerated manner), *with* 26 U.S.C. § 317(a) (defining "property" for federal income tax purposes to mean "money, securities, and any other property" except certain kinds of stock and rights to stock). Note, however, that the IRC nowhere provides a *general* definition of property, cabining its occasional definitions to certain subparts. *See id.* ("For purposes of this part, the term "property" means . . . .").

[8] *See* 11 U.S.C. §§ 544(a)–(b), 548(a)(1), 549(a)–(b).

[9] *See, e.g.*, Guinn v. Lines (*In re* Trans-Lines W., Inc.), 203 B.R. 653, 656 (Bankr. E.D. Tenn. 1996) (finding the tax status change to be a fraudulent transfer); *Majestic Star Casino*, 716 F.3d at 750 (finding tax status change to not be a fraudulent transfer).

[10] *See Trans-Lines W.*, 203 B.R. at 656; Parker v. Saunders (*In re* Bakersfield Westar, Inc.), 226 B.R. 227, 234 (B.A.P. 9th Cir. 1998); *see also* Halverson v. Funaro (*In re* Funaro), 263 B.R. 892, 898 (B.A.P. 8th Cir. 2001); Hanrahan v. Walterman (*In re* Walterman Implement Inc.), No. 05-07284, 2006 WL 1562401, at *4 (Bank. N.D. Iowa May 22, 2006).

[11] *See* Off. Comm. of Unsecured Creditors v. PSS S.S. Co. (*In re* Prudential Lines, Inc.), 928 F.2d 565, 571–73 (2d Cir. 1991); Gibson v. United States (*In re* Russell), 927 F.2d 413, 419 (8th Cir. 1991); United States v. Sims (*In re* Feiler), 218 F.3d 948, 956 (9th Cir. 2000).

[12] *Prudential Lines*, 928 F.2d at 574.

non-debtor owner attempts to manipulate the debtor's tax status in such a manner, the owner is found to have committed a transfer reversible by the trustee's avoidance powers, and faces revocation of these otherwise lawful actions concerning the tax status.[13] Revocation leads to cascading negative consequences which cut directly against "the principal purpose of the Bankruptcy Code,"—namely, "to grant a fresh start" to the debtor.[14]

Though judges who employ this approach may have good intentions in attempting to realize one of the goals of bankruptcy (an equitable distribution of property to creditors), their approach is nonetheless mistaken. The approach accomplishes this goal, but at the cost of creating judge-made rules that unjustifiably cram an increasing number of tax attributes into the definition of property. In so doing, these courts show a lack of careful consideration of the juxtaposition of the IRC with the Bankruptcy Code, creating real inequities for debtors. These tax status cases also extrapolate from the shallow logic of cases that have reckoned NOLs as property of the estate, thereby creating a dangerous precedent that could allow future courts to glom onto such logic to extend "property of the estate" to encompass other tax attributes. This wrongheaded approach endangers bankruptcy's promise of a fresh start by taking tax liabilities (such as those arising from foreclosure sales of real property occurring before or during bankruptcy from the debtor's estate) and forcing them upon the non-debtor owners of the troubled entities.[15] This reassignment undercuts the IRC, which explicitly allows for tax status changes at the will of the owner.[16] In these jurisdictions, there is no true "discharge" of the respective debtor liabilities as required by the Bankruptcy Code.[17]

This side-stepping of the IRC is done in open defiance of the plain meaning of the language present in section 541 of the Bankruptcy Code. Because Congress did not intend for shadow-reading in its approach to defining property, tax status can and should be easily excluded from the reach of section 541.[18]

13 *See, e.g.*, *Russell*, 927 F.2d at 417–19 (showing that success of the chapter 11 trustee's argument in favor of revoking the taxpayer's carryforward of NOLs would mean the taxpayer had committed a fraudulent transfer under sections 548 and 549, despite being allowed to elect to carry them forward under 26 U.S.C. § 172(b)(3)(c)). *See generally* 11 U.S.C. §§ 362(a), 548(a), 549(a).

14 Marrama v. Citizens Bank of Mass., 549 U.S. 365, 367 (2007) (citing Loc. Loan Co. v. Hunt, 292 U.S. 234, 244 (1934)).

15 *See* Majestic Star Casino, LLC v. Barden Dev., Inc. (*In re* Majestic Star Casino, LLC), 716 F.3d 736, 746 (3d Cir. 2013).

16 *See* Treas. Reg. § 301.7701-3(c)(1)(i).

17 *See generally* 11 U.S.C. §§ 548(a), 549(a), 727, 1141(d).

18 *See, e.g.*, RadLAX Gateway Hotel, LLC v. Amalgamated Bank, 566 U.S. 639, 649 (2012) ("[N]othing in the generalized statutory purpose of protecting secured creditors can overcome the specific manner of that

Greenlighting the slippery rules created by these courts goes against the goals of bankruptcy: predictability, consistency, and equity for both debtors and creditors in arranging affairs before and during a bankruptcy proceeding.[19]

The second approach, adopted by the Third Circuit and championed by this Comment, offers a more recent interpretation of "property" relating to tax status.[20] The Third Circuit rejected what this comment refers to as the "Disfavored Approach," finding no rational basis to include tax status under section 541's definition of property.[21] The Third Circuit instead found that a debtor entity's tax status existed at the will of its non-debtor owner,[22] that tax status has no discernible value,[23] and that tax status is not a right or a guarantee of any party (let alone a right or guarantee belonging to the debtor in bankruptcy).[24] The Third Circuit further recognized that major inequities result if income remains in a bankruptcy estate but liabilities flow out to the non-debtor owner by operation of the trustee's avoidance powers.[25] To further drive home the shortcomings of the Disfavored Approach, the court took the extra step of assuming, contrary to the main thrust of its analysis, that tax status *could* be considered property,[26] and *still* concluded that a bankruptcy estate could have no possible interest in the tax status of a debtor because ultimate control of that status belongs to the shareholders of an entity instead of to the entity itself.[27]

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protection which the text [of the Code] contains."); *see also, e.g.*, United States v. Whiting Pools, Inc., 462 U.S. 198, 205 n.8 (1983) ("Similar statements to the effect that § 541(a)(1) does not expand the rights of the debtor in the hands of the estate were made in the context of describing the principle that the estate succeeds to no more or greater causes of action against third parties than those held by the debtor.").

19 *See, e.g.*, Butner v. U.S., 440 U.S. 48, 55 (1979) (citing Lewis v. Mfr.'s Nat'l Bank, 364 U.S. 603, 609 (1961) ("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.'"); Grogan v. Garner, 498 U.S. 279, 286 (1991) ("[A] central purpose of the Code is to provide a procedure by which certain insolvent debtors can reorder their affairs, make peace with their creditors, and enjoy a new opportunity in life and a clear field for future effort, unhampered by the pressure and discouragement of preexisting debt." (internal quotation marks omitted)); *In re* Kontrick, 295 F.3d 724, 732 (7th Cir. 2002) ("[T]he Bankruptcy Code's goal [is] promoting certainty and finality for debtors."); Bank of Am. Nat'l Tr. & Sav. Ass'n v. 203 N. Lasalle St. P'ship, 526 U.S. 434, 453 (1991) (A goal of Chapter 11 is "preserving going concerns and maximizing property available to satisfy creditors.").

20 *See Majestic Star Casino*, 716 F.3d at 758–59; *see also* Arrowsmith v. United States (*In re* Health Diagnostic Lab'y, Inc.), 578 B.R. 552, 554 (Bankr. E.D. Va. 2017) (adopting the Third Circuit's approach).

21 *See Majestic Star Casino*, 716 F.3d at 758.

22 *See id.* at 755.

23 *See id.* at 756.

24 *See id.*

25 *See id.* at 757.

26 *Id.* at 758.

27 *See id.*

I advocate for the adoption of the Third Circuit's interpretation of "property" as it relates to tax attributes (the "Favored Approach"). As the Third Circuit highlights, the courts employing the Disfavored Approach have overextended themselves by applying the logic of the net-operating-loss-is-property cases to an unrelated tax attribute: tax status.[28] Copy-and-pasting the logic from NOL cases in this haphazard manner does not demonstrate in a fundamental way *why* tax status and NOLs should be considered, on the same basis, to be property. The broad proposition that NOLs and tax status should be treated the same is not supported by the underlying logic presented in the NOL cases. As I explain, the IRC permits taxpayers to arrange their affairs with respect to tax status even when doing so reduces the funds available to pay unsecured creditors.[29] This result may be to the chagrin of the courts championing the Disfavored Approach, but only because these courts mischaracterize the interrelationship between the IRC and the Bankruptcy Code to reach what they perceive to be an equitable result for unsecured creditors.

Although the advocates of the Disfavored Approach might hand-wring over the fate of creditors "left holding the bag" once a non-debtor owner changes a debtor's tax status, I argue that accepting the Third Circuit's alternative approach leads to a more perfect achievement of several principal aims of bankruptcy—those of predictability and consistency. Following the Third Circuit's approach creates greater predictability for creditors; it enables them to make more careful and comprehensive lending decisions because they are given greater certainty on another aspect of lending risk. If a lender is aware a potential debtor could change its tax status, the level of risk then assigned to the borrower will better reflect the economics of the deal; the lender knows it may be less likely to recover on its loan in bankruptcy if the loan is issued to a disregarded entity.

Specifically excluding tax status from the definition of property also streamlines the bankruptcy process for the trustee. If courts consistently rule in the same manner on tax status, interested parties and the courts forgo additional costs and wasted time in determining if status should be included in the estate. Consistency and predictability assist borrowers and taxpayers in arranging their

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28 *See id.* at 753–54.

29 The Constitution gives Congress the exclusive power to legislate laws, including promulgation of the IRC. *See* U.S. CONST. art. 1 § 1; U.S. CONST. amend. XVI. The Department of the Treasury has the exclusive power to regulate the IRC (with small exceptions to the Attorney General). *See* 26 U.S.C. § 7801(a). The Internal Revenue Service was organized to administer the IRC, under the control of the Treasury. No other branch of government, then, has the primary authority to determine the application of the IRC or its accompanying Treasury regulations, meaning no court has the authority to undo the lawful actions of a taxpayer under the IRC, including arranging his affairs according to the directives of the IRC. *See* 26 U.S.C. § 7805(a), (c).

affairs at the outset of a business transaction. These aims also make for better economies of scale as borrowers and lenders can more knowledgeably negotiate risk.

Foes of the Favored Approach might argue that the same predictability and consistency could be achieved by uniformly including tax status in the definition of property—that the *Third Circuit* is the court introducing uncertainty. However, widespread adoption of the Disfavored Approach would violate the respect due to the Treasury and the Internal Revenue Service (the "IRS")—the agencies blessed by Congress to administer the IRC—which have historically asserted that tax attributes are not property for tax purposes and should not be so in bankruptcy.[30] The Disfavored Approach recklessly overlooks these agencies' interpretations of the IRC. This usurpation damages public faith in both the judiciary and the administrative state and goes against one of the basic rules of jurisprudential interpretation: judicial deference to agency opinion.

Section I of this Comment provides background on the tax implications associated with various corporate entities, especially as they manifest in the bankruptcy context, and introduces the hypothetical scenario used to explain complex contexts throughout the Comment. Section II analyzes the conflicting definitions of "property" provided by the Bankruptcy Code and the Supreme Court and explores the inclusion of tangible rights as property of the bankruptcy estate. Finally, in Section III, this Comment argues that the Disfavored Approach is contrary to the Bankruptcy Code's fresh-start policy.

This Comment concludes by proposing (1) that the IRC be amended to read that tax status cannot be considered property in bankruptcy and (2) that the Bankruptcy Code be amended to enumerate tax status as a facet of the federal income tax schema outside of the Bankruptcy Code's definition of property. Although it intentionally errs on the side of inclusivity by encompassing more assets into the definition of property,[31] section 541 partially enumerates a list of items *not* considered property of the estate.[32] By adding tax status to this list, lawmakers could arrive at a simple and effective solution that addresses the inadequate judge-made rules of the Disfavored Approach.

[30] *See generally* Gibson v. United States (*In re* Russell), 927 F.2d 413, 417 (8th Cir. 1991).

[31] *See* Jack F. Williams, *Tax and Fraudulent Transfers*, *presented at* ASS'N OF INSOLVENCY & RESTRUCTURING ADVISORS 34TH CONF., at 24–25 (June 13, 2018) (on file with author).

[32] 11 U.S.C. § 541(b).

## I. SCENARIO & BACKGROUND LAW

It's easy for discussions of the interplay between the IRC and the Bankruptcy Code to feel remote and abstract. Hypothetical scenarios are useful here because they allow us to fix our attention on a discrete cast of characters and to highlight the human impact that underlies these sometimes clinical discussions. To aid in understanding the underlying issue, let's introduce Joe Zapatos, a successful commercial real estate broker and taxpayer in Seattle, Washington. In addition to brokering, Joe has built a successful side business developing, owning, and managing a handful of high-end commercial retail properties in the greater Seattle area.

### *A. Three Potential Buddies: Choosing Between an SMLLC, a C Corp, and an S Corp*

In 1987, Joe acquired an undeveloped parcel of land located within the parking lot of a high-end shopping center in Seattle's exclusive Capitol Hill neighborhood. A savvy investor, Joe took the advice of his legal counsel during the acquisition phases of his properties and placed each into a special type of limited liability company ("LLC") called a single-member limited liability company ("SMLLC").

An SMLLC limits the liability of its single owner (known as a member) to the amount of capital the member invests in the SMLLC—much like any other LLC where the member assumes no personal liabilities for the activities of the entity.[33] The practical effect of organizing each enterprise as an SMLLC is that Joe only risks losing the value of the investments he made into his SMLLCs if any of them ever faces litigation or bankruptcy.

What makes an SMLLC special in comparison to a standard LLC is that a freshly-minted SMLLC is automatically classified as a "disregarded entity" for federal income tax purposes by the IRS.[34] When an entity's tax status is classified as disregarded, any income generated, losses incurred, gains experienced, and other tax items attributed to the business activities of the SMLLC are directly reflected on the income tax return of the single member-

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[33] *See* Heather Huston, *Single-Member LLC vs. Sole Proprietorship: Advantages & Disadvantages*, WOLTERS KLUWER: EXPERT INSIGHTS (Nov. 22, 2022), http:// www.wolterskluwer.com/en/expert-insights/singlemember-llc-vs-sole-proprietorship.

[34] Treas. Reg. § 301.7701-3(b)(1)(ii) ("[A] domestic eligible entity is . . . . [d]isregarded as an entity separate from its owner if it has a single owner.").

owner.[35] Put another way, an SMLLC is not required to file a tax return with the IRS separate from its owner because the entity does not exist in the eyes of the IRS for tax purposes.[36] Rather, the SMLLC's owner tracks the taxable activities of the entity and reports them on the owner's individual return.[37] Each year, then, Joe aggregates the business activities he tracks in the separate books of each of his SMLLCs and reports these on his Form 1040 individual tax return. The tax consequences flowing from each SMLLC impact the amount of tax Joe personally owes to the IRS.

Before we go further, it is worth highlighting the relationship between different types of corporations. When an entity is formed as a corporation, its "default" tax status with the IRS is as a Subchapter C Corporation ("C Corp").[38] C Corps are subject to "double taxation," meaning both the corporation and its owners (known as shareholders) are separately subject to income tax on the income from the corporation's activities: The C Corp is first taxed on income from business and passive activities and the shareholders are then taxed on their dividend income.[39] A C Corp, then, is a wholly-contained universe where only dividends flow to the owner-shareholders, and all items of business income, gain, loss, and other tax attributes remain within the walls of the C Corp's tax return, unlike LLCs and SMLLCs. If Joe organizes Buddy as a C Corp ("BuddyCorp"), he would effectively pay tax twice on any income BuddyCorp earned: once at the C Corp level and again on a personal level any time BuddyCorp made a distribution in the form of dividends.[40]

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35 *See* Treas. Reg. § 301.7701-2(a).

36 Treas. Reg. § 301.7701-2(a) ("[I]f the entity is disregarded, its activities are treated in the same manner as a sole proprietorship, branch, or division of the owner.").

37 *See* Treas. Reg. § 301.7701-3(b)(1)(ii); Treas. Reg. § 301.7701-2(a). An SMLLC is also different from a traditional partnership for federal income tax purposes. Although both SMLLCs and partnerships are "flow-through" entities in the sense that that neither organization is double taxed, partnerships are *not* disregarded by the IRS. A partnership tracks its business activities over the course of its fiscal year, memorializing those activities by filing its own, separate informational tax return with the IRS. *See* Treas. Reg. § 1.6031(a)-1(a)(1) ("Every domestic partnership must file a return of partnership income under section 6031 (partnership return) for each taxable year on the form prescribed for the partnership return."). The partnership itself does not pay income tax to the IRS, but instead issues each of its partners a document known as a Schedule K-1 which reflects items of partnership income, loss, gains, and other tax activities. 26 U.S.C. §§ 6031(b), 7805(c); DEPT. OF THE TREASURY, INTERNAL REVENUE SERV., PARTNER'S INSTRUCTIONS FOR SCHEDULE K-1 (FORM 1065), CAT. NO. 11396N, at 1 (Jan. 17, 2023), *available at* https://www.irs.gov/pub/irs-pdf/i1065sk1.pdf ("The partnership uses Schedule K-1 to report your share of the partnership's income, deductions, credits, etc."). The partners then use the Schedule K-1 to compile their own individual tax returns and to determine their own separate tax liabilities. *See* 26 U.S.C. § 6031(b).

38 26 U.S.C. § 1361(a)(2).

39 26 U.S.C. §§ 11(a), 301(a).

40 26 U.S.C. §§ 11(a), 301(a).

In further contrast, an S Corp is a special entity type into which its owner must elect with the IRS.[41] An entity must meet a handful of requirements to qualify for S Corp status.[42] If qualified, an entity achieving S Corp status has its income and other tax items flow-through to the S Corp's owner, with tax items appearing on the shareholder's individual return—although the S Corp must still file an informational return with the IRS.[43]

Joe had the option to form Buddy as a C Corp, an S Corp, or an SMLLC. Given the complexity and double taxation associated with a C Corp and the additional filing costs and accountant fees connected to producing S Corp informational tax returns, Joe ultimately chose to found Buddy as an SMLLC. "Buddy LLC" is born.

### *B. Buddy LLC in Distress: The Capitol Hill Land Purchase*

Wasting no time after entity formation, Joe uses his own funds to purchase the land for $100,000, placing it into Buddy LLC. Joe personally finances out loans to Buddy LLC and then uses the funds to develop a 6,000 square foot, stand-alone retail building on the land at a cost of $600,000. Mere weeks after construction begins, PayMore Shoes, an international luxury shoe retailer, contacts Joe about leasing the building. PayMore signs a ten-year lease with Buddy LLC for the entire building, with several options to renew. Joe, happy with the building and his tenant, kicks back to enjoy the new income stream.

For the years Joe holds his interest in Buddy LLC, he takes an annual depreciation deduction related to the building on his personal tax return, slowly

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41 26 U.S.C. §§ 1362(a)(1); 1361(a)(2).

42 To qualify for S Corp status, an entity must be a small business corporation. A small business corporation is defined as a domestic (U.S.) corporation with no more than 100 shareholders that issues only a single class of stock. S Corp shareholders themselves cannot be corporations, partnerships, or non-resident aliens. Each shareholder must also consent to S Corp status with the IRS. Revocation of S Corp status (i.e., return to C Corp status) may be accomplished by: (1) majority consent of shareholders and the entity itself; (2) ceasing to meet the definition of a small business corporation; or (3) attaining passive investment income in excess of 25% of gross receipts for each of three consecutive tax years with consideration of accumulated earnings and profits. *See* 26 U.S.C. §§ 1361(b)(1), 1362(d).

43 *See* Treas. Reg § 301.7701-2(a); DEPT. OF THE TREASURY, INTERNAL REVENUE SERV., INSTRUCTIONS FOR FORM 1120-S, CAT. NO. 11515K, at 2 (Jan. 27, 2023), *available at* https://www.irs.gov/pub/irs-pdf/i1120s.pdf ("Use Form 1120-S to report the income, gains, losses, deductions, credits, and other information of a domestic corporation or other entity for any tax year covered by an election to be an S corporation."). This is similar to a traditional partnership.

reducing his tax basis in the property.[44] A taxpayer who acquires a piece of property is said to have "basis" in the property in an amount equal to the cost of the property to the taxpayer on the date of acquisition.[45] The government forces a taxpayer to reduce the basis in owned property for tax purposes, where basis is reduced by an amount equal to the yearly depreciation deduction.[46] Once the property's basis is equal to zero dollars, no further deductions are allowed and the property is considered fully depreciated.[47] The IRC details the annual depreciation deduction associated with a piece of property, which is used to reduce a taxpayer's gross income on their tax return in an amount roughly equal to the diminishment (or economic loss) in value of the property.[48] For nonresidential real property, the value of the building and of improvements (such as parking lot lights and landscaping) has a basis reduced by depreciation, but this basis reduction does not include the value of the underlying land.[49] For Joe, the cost of the PayMore building is divided equally over a period of thirty-nine years, where in each calendar year Joe reduces his gross income on his federal income tax return by the amount of the depreciation deduction.[50]

In December 2021, Joe receives bad news. Due to severe online competition undercutting traditional big-box sales and the pandemic, his tenant PayMore Shoes is entering voluntary chapter 7 bankruptcy. From what Joe reads in the financial newspapers, a hedge fund acquired PayMore about five years ago at a large discount. The fund has slowly but systematically stripped the company of assets in a run-up to forcing the entity into bankruptcy. PayMore can offer Joe three months' rent in settlement of the remaining five-year lease PayMore has on the building or, alternatively, Joe can file a claim as a creditor in PayMore's bankruptcy. If the latter is chosen, Joe risks receiving nothing once PayMore's limited assets are liquidated. Joe, looking for a quick out, takes the three months' rent as settlement, and PayMore vacates the building.

It is now November 2022. The real estate market, reacting to the pandemic's fallout, has seen a spike in default notices, scheduled auctions, and bank

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[44] *See* 26 U.S.C. § 1012(a) (explaining that tax basis is equal to the cost of an asset at the time it is purchased); 26 U.S.C. § 1011(a) (explaining that adjusted basis is the tax basis of an asset which has been materially changed upwards or downwards by certain events during ownership, like depreciation).

[45] 26 U.S.C. § 1012(a).

[46] *See* 26 U.S.C. §§ 1012(a), 167(a) (describing a depreciation deduction as "a reasonable allowance for the exhaustion, wear and tear").

[47] 26 U.S.C. § 1011(a); INTERNAL REVENUE SERV., U.S. DEP'T OF THE TREASURY, PUB. NO. 946, HOW TO DEPRECIATE PROPERTY 7 (2022).

[48] *See* 26 U.S.C. §§ 167(a), 168(b)(3)(A).

[49] *See* 26 U.S.C. §§ 167(a), 168(b)(3)(A).

[50] 26 U.S.C. § 168(b)(3)(c); 168(c).

repossessions in an amount 34% higher than the previous quarter, with no signs of slowing.[51] Buddy LLC finds itself in deep distress. The entity goes without any income for a year and a half after losing the PayMore lease, because Joe was unable to secure tenants for the building. To ride out the storm, Joe, as Buddy LLC's sole and managing member, has the entity take out a secured loan from SeaFirst Bank for $300,000 to meet operating costs, which include a $53,000 capitalized expense to cover the costs of roof repairs made a few months prior. Unfortunately, although the roof was fixed, the entity racked up an additional $300,000 in unpaid miscellaneous and unsecured bills, including missed payments to the roof contractor, utility charges, common area maintenance costs for the shopping center, and others.

Worse still, the commercial real estate market in Capitol Hill, a densely packed urban neighborhood, has seen unprecedented flight from the area as the tech-heavy sector located there went remote. Tech employees and persons in supporting industries moved to more rural abodes to enjoy lower rental prices and the outdoors, in effect pulling down Capitol Hill property values. The building, never renovated but for the roof, was appraised last year at $800,000—down from an estimated pre-pandemic valuation of $1.2 million, made before PayMore's vacation from the building. Joe, now retired and tired of dealing with Buddy LLC, decides he does not want to personally guarantee the loan with SeaFirst when the bank begins sending default notices for nonpayment. Joe simply refuses to make payments from his personal funds to keep Buddy LLC solvent and heads down to warmer climes to enjoy his retirement, indifferent to the fate of the SMLLC.

### *C. Buddy in Bankruptcy*

Before the end of 2022, Buddy LLC's creditors, including SeaFirst, gather and place Buddy LLC into bankruptcy by filing an involuntary chapter 7 petition with the local bankruptcy court.[52] Although Buddy LLC does not meet the definition of "individual" under the Bankruptcy Code,[53] Buddy LLC's creditors can file a chapter 7 bankruptcy because an SMLLC is considered an

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[51] Jordan Gice, *Year-End Outlook: A 'Tick to Torrent' of Foreclosures Expected in 2022*, RISMEDIA (Oct. 20, 2021), https://www.rismedia.com/2021/10/19/year-end-outlook-a-tick-to-torrent-of-foreclosures-expected-in-2022/.

[52] *See* 11 U.S.C. § 303(b) (explaining that a business entity might be forced into bankruptcy under chapter 11 if the entity's creditors decide to commence a case against the debtor); *see also* 11 U.S.C. §301(a) (explaining that, in contrast to an involuntary bankruptcy, a debtor can file a petition with the bankruptcy court to commence a bankruptcy proceeding without action on the part of creditors).

[53] 11 U.S.C. § 109(c); *see also* 11 U.S.C. § 101(41).

"unincorporated association," an entity eligible to file.[54] Filing is possible even if the SMLLC is not considered a corporation under state law or the IRC.[55] The property of Buddy LLC's bankruptcy estate includes all of Buddy LLC's assets: namely, the land and the PayMore building.[56] None of Joe's assets are included in Buddy's bankruptcy estate, because Joe limited his liability by setting the entity up as an SMLLC back in 1987.[57]

SeaFirst, being a creditor with a security interest in the building, successfully petitions the court to lift the automatic stay for the PayMore building, removing it from the bankruptcy proceedings.[58] SeaFirst then auctions the property at a foreclosure sale for $850,000, remitting the difference between the loan and the auction proceeds to the bankruptcy trustee to be doled out first to administrative creditors and then to the SMLLC's general unsecured creditors. The foreclosure sale of the PayMore property is considered a taxable event by the IRS because a foreclosure sale meets the definition of a "sale or other disposition of property" for recognizing gain or loss for tax purposes.[59] Since Seafirst's loan was secured by the PayMore building, the resulting tax gain from the sale equals the outstanding debt on the building (or the amount garnered from the sale) less Buddy LLC's adjusted basis in the property.[60] In a nonrecourse secured loan scenario like this one, the fair market value of the building is not relevant for calculating the resulting gain from the sale.[61]

The gain amount is important to Buddy LLC as a debtor and to the entity's secured and unsecured creditors. The amount of tax liability resulting from the sale of the PayMore property is extremely high because Buddy LLC owes a significant amount of debt on the building and has a low adjusted tax basis. Buddy LLC had been depreciating the building since 1987, resulting in a basis reduced by nearly 90% of the original cost. It may be helpful here to see the numbers at play in chart form, with an explanation to follow.

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54 11 U.S.C. § 101(9)(a); *see also* 11 U.S.C. § 101(9)(A)(iv).
55 11 U.S.C. § 109(c); *see also* 11 U.S.C. § 101(41).
56 *See* 11 U.S.C. § 541(a)(1).
57 *See id.*
58 11 U.S.C. § 362(d).
59 See 26 U.S.C. § 1001(a), (c); Crane v. Comm'r, 331 U.S. 1, 9 (1947).
60 Comm'r v. Tufts, 461 U.S. 300, 317 (1983).
61 *Id.*

*Table 1: Buddy LLC's Basis in the PayMore Building as of 2022*

| **Year** | **Item** | **Amount** |
|---|---|---|
| 1987 | Cost of Undeveloped Land Parcel | $100,000 |
| 1987 | PayMore Building Original Cost | 600,000 |
| 35 years | Accumulated Depreciation | (538,000) |
| 2021 | Capitalized Roof Membrane Repair[62] | 53,000 |
| 2022 | Buddy LLC's Remaining Basis in PayMore Building | **$215,000** |

*Table 2: SeaFirst's Foreclosure Sale of PayMore* Property

| **Item** | **Amount** |
|---|---|
| Foreclosure Sale Price | $850,000 |
| Reduction for Buddy LLC's Remaining Basis in PayMore Building | (215,000) |
| Sale Price Amount Subject to Capital Gains Tax | 635,000 |
| Estimated Capital Gain Tax Due on Sale Price (20% rate)[63] | (127,000) |
| SeaFirst's Collection on the Secured 2020 Buddy LLC Loan | (300,000) |
| Amount Remaining and Available to Unsecured Creditors | **$208,000** |

62 For simplicity, assume no depreciation has been taken on the capitalized roof cost.

63 As another simplifying assumption, we use a 20% capital gains rate. *See* 26 U.S.C. § 1(h) (assuming the maximum long term capital gains rate an individual would pay at 20%, given that the long-term capital gains rate is graduated based on the taxpayers income per the tables in sections 1(b) and 1(c)).

*Table 3: Summation of Debt & Payments in Buddy LLC's Bankruptcy*

| **Item** | **Amount** |
|---|---|
| Amount Remaining from Payment of Capital Gains Tax and Secured Loan Collection by Seafirst | $208,000 |
| Debt Payable to Buddy LLC's Unsecured Creditors (Roofer, Utility Companies, Shopping Center CAM Charges, Other Misc Bills) | (300,000) |
| Unrecoverable Amount Owed to Buddy LLC's Remaining Creditors if Buddy LLC absorbs the Capital Gains Tax Payment | ($92,000) |

Examining the tables above, the first shows Buddy LLC's adjusted basis in the PayMore building in 2022. The initial basis was $700,000: the $100,000 basis in the underlying land, plus the $600,000 purchase price for the building. The basis in the building was reduced over thirty-five years by depreciation deductions on the property (totaling $538,000) but increased slightly by the capitalization of the roof repair ($53,000) for a remaining total basis of $215,000.[64] The second table reflects the impact that the capital gains tax ($127,000) has on the pot of funds available to Buddy LLC's unsecured creditors after the $850,000 foreclosure sale, reducing the overall amount available to $208,000, after Buddy LLC's adjusted basis of $215,000 is factored out.

The third table shows that the debt owed to the unsecured creditors ($300,000) is $92,000 greater than the amount in the pot of available funds (at $208,000). Notice that this $92,000 disparity between what is owed to Buddy LLC's unsecured creditors and what amount remains after the sale of the PayMore building almost certainly means the unsecured creditors will not be paid in full.

The crux of the issue in this Comment revolves around *who* should pay the $127,000 tax due on the foreclosure sale. The answer to that question ultimately depends on the definition of property under section 541. The tax on this gain, as we will see, must be paid by someone.

[64] Recall that there is no depreciation for land basis, but the $100,000 land purchase price *is* included in the total adjusted basis.

### *D. Checking the Box*

Without any action on Joe's part, the tax resulting from the gain on disposition of the PayMore building through SeaFirst's foreclosure sale would be his responsibility to pay.[65] Recall Buddy LLC is an SMLLC and is disregarded for tax purposes; normally, all items of income, loss, and gain flow through from Buddy LLC's business activities directly to Joe's tax return.[66] This flow-through mechanism means he is responsible for the gain on the foreclosure sale of the PayMore property.

However, let's imagine that Joe, the ever-savvy and well-counseled business owner, decides to cease payments on the SeaFirst loan, months before Buddy LLC's creditors force the company into bankruptcy. Joe makes an election with the IRS to change the tax status of Buddy LLC from an SMLLC to a C Corp: the traditional corporate structure discussed above.[67] Buddy LLC suddenly becomes BuddyCorp at Joe's election.

To effect this election with the IRS, Joe "checked the box" on the IRS Form 8832.[68] By checking the box and filing the form with the IRS, Joe effectively changed Buddy LLC's entity tax status, thereby altering the tax ramifications of BuddyCorp's business activities. [69] Transforming Buddy LLC from an SMLLC to a C Corp means all items of income, loss, gain, or other tax attributes previously flowing through to Joe's individual tax return when BuddyCorp was an SMLLC are now restricted to the C Corporation by the nature of the entity type.[70] Where previously Joe was personally responsible for the tax consequences of Buddy's activities because the entity was an SMLLC, he is now shielded from personal tax liability. Before, Joe stood to lose his interest in Buddy LLC *and* remain on the hook for its tax bill.[71] Now that he's checked the box, Joe only stands to lose his interest in the business, and is now in a similar

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65 *See* Treas. Reg. §§ 301.7701-2(a), 301.7701-3(b)(1).

66 Treas. Reg. §§ 301.7701-2(a), 301.7701-3(b)(1).

67 *See* Treas. Reg. § 301.7701-3(c).

68 *See* Treas. Reg. § 301.7701-3(c)(1). Line 6 of Form 8832 permits qualifying entities to choose their classification from a "menu" of six entity types—including different types of partnerships and corporations. DEPT. OF THE TREASURY, INTERNAL REVENUE SERV., FORM 8832: ENTITY CLASSIFICATION ELECTION, CAT. NO. 22598R, at line 6 (Dec. 2013), *available at* https://www.irs.gov/pub/irs-pdf/f8832.pdf. To make this election, Joe, as principal of Buddy LLC, literally checks box 6(a) and submits the form to the IRS. *See id.* at line 3 ("You can elect to be classified as an association taxable as a corporation or to be disregarded as a separate entity. Go to line 4.").

69 *See* Treas. Reg. § 301.7701-3(c)(1).

70 *See id.*

71 *Id.*; Treas. Reg. § 301.7701-3(b)(1)(ii); 26 U.S.C § 11(a) (explaining that "[a] tax is hereby imposed for each taxable year on the taxable income of every corporation").

position to any other shareholder of a C Corp in bankruptcy.[72] In other words, after this shuffling, Joe is shielded from the tax liability resulting from the gain on sale of the PayMore building.[73] BuddyCorp instantly became responsible for filing its own tax returns with the IRS and paying its own tax liabilities, including the taxable gain resulting from the sale of the PayMore property.[74]

### *E. Fraudulent Transfer & Avoidance Powers*

Let's turn back to the bankruptcy process—recall that BuddyCorp's creditors had filed an involuntary chapter 7 case to bring BuddyCorp into bankruptcy. A bankruptcy trustee is charged with handling property of the estate.[75] In chapter 7 liquidation cases, the trustee collects and sells all of the debtor's assets and disburses the proceeds to creditors in order of priority, and in chapter 11 reorganization cases, the trustee administers the estate under court supervision.[76]

In order to preserve the estate for the benefit of unsecured creditors, the Bankruptcy Code endows the trustee with avoidance powers, which permit the trustee to avoid a transfer of the debtor's property to a third party—thereby recovering the property for the benefit of the estate.[77] Avoidance of a prepetition transfer of property is appropriate if the transfer occurred within two years of the petition date.[78] The trustee can also avoid postpetition transfers when these are not authorized by the bankruptcy court."[79] Additionally, section 544(b)(1) authorizes a trustee to avoid any transfer that could otherwise be avoided by an unsecured creditor with an allowable claim under state fraudulent transfer law.[80]

One key purpose of the avoidance powers is to permit the trustee to reverse transfers of property made under fraudulent circumstances, whether actual or constructive.[81] An actual fraudulent transfer requires a showing that the debtor

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72 *See generally* Treas. Reg. § 301.7701-3(c)(1), (b)(1)(ii).

73 26 U.S.C. § 11(a).

74 Treas. Reg. § 1.6012-2(a)(1).

75 *See* 11 U.S.C. § 323 (discussing the role of the bankruptcy trustee generally).

76 *See* 11 U.S.C. § 704 (detailing the duties of the trustee in a chapter 7 case); 11 U.S.C. §§ 1106, 1107 (explaining that in a typical chapter 11 case, the debtor takes on trustee duties and administers the business and the estate as debtor in possession); 11 U.S.C. § 1104 (but if there is good reason to remove the debtor in possession from control of the estate, the court may order the appointment of a chapter 11 trustee to oversee the estate and manage the business).

77 *See* 11 U.S.C. § 541(a)(3); 11 U.S.C. § 544(b)(1).

78 11 U.S.C. § 548(a)(1).

79 11 U.S.C. § 549; *see also* 11 U.S.C. § 550(a).

80 *See* 11 U.S.C. § 544(b)(1).

81 Henkel v. Green (*In re* Green), 268 B.R. 628, 650 (Bankr. M.D. Fla. 2001) ("Section 548(a)(1)(A) of the Bankruptcy Code provides the criteria for determining whether transfers made prior to bankruptcy constitute

intended to hinder, delay, or defraud creditors by the transfer.[82] To determine if a constructive fraudulent transfer subject to avoidance occurred, a bankruptcy court focuses on (1) whether a debtor received less than reasonably equivalent value in exchange for a transfer and (2) whether the debtor was in a precarious financial situation at the time of transfer.[83] Importantly, the debtor's intent is not an element in this consideration.[84] The exercise of avoidance powers allows a trustee to reach a more complete and equitable distribution of property for unsecured creditors by reversing any debtor attempts to hide or remove property and thereby manipulate the bankruptcy estate.[85] In order to permit a trustee to exercise her avoidance powers with respect to tax attributes, the court must find that those tax attributes are "property" of the estate. To foreshadow the analysis in Section III of this Comment, the courts employing the Disfavored Approach are happy to make the finding that tax status is property, which empowers the trustee to undo changes to a debtor's tax status. The courts employing the Favored Approach find otherwise.

Let's turn back to our hypothetical with Joe and BuddyCorp: Can the trustee use her avoidance powers under section 548 to shift the tax liability resulting from the gain on the sale of the PayMore building back to Joe?[86] Prior to filing Form 8832**,** Joe would have had to pay that tax liability from his personal funds because the foreclosure sale is considered a taxable event under the IRC.[87] However, Joe changed the tax status of BuddyCorp before its involuntary chapter 7 filing and before SeaFirst's foreclosure sale—meaning the change places the tax burden on the debtor, and therefore, on the estate. In other words, in the eyes of the IRS, BuddyCorp's C Corp status at the moment of foreclosure sale means that only BuddyCorp, and not Joe, is responsible for the tax bill. As discussed earlier, without any hampering by the Bankruptcy Code or bankruptcy courts, the tax liability resulting from the gain on sale of the PayMore building will no longer flow through BuddyCorp to Joe.

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actual fraud, and Section 548(a)(1)(B) provides the criteria for determining whether transfers made prior to bankruptcy constitute constructive fraud.").

82 *See* 11 U.S.C. § 548(a)(1).

83 11 U.S.C. § 548(a)(1)(B); *see, e.g.*, *Green*, 268 B.R. at 650 (Bankr. M.D. Fla. 2001) (noting that "the Trustee must demonstrate" all of the elements of section 548(a)(1)(B)).

84 *Green*, 268 B.R. at 650 ("A finding of actual fraud necessitates an examination of the debtor's intent, while a finding of constructive fraud can be made without regard to the transferor's intent and is determined by examining the circumstances surrounding the transfer.").

85 11 U.S.C. § 548(a)(1).

86 *See* 26 U.S.C. § 1001(a), (c); Crane v. Comm'r, 331 U.S. 1, 5–6, 12 (1947).

87 *See* 26 U.S.C. § 1001(a), (c); *Crane*, 331 U.S. at 5–6, 12.

Further, the tax liability resulting from the PayMore building gain cannot be discharged by the bankruptcy court or avoided by the trustee.[88] The foreclosure sale occurred within three years of filing the petition for bankruptcy, and the tax due is considered an unavoidable administrative expense that must be paid in cash and in full at the time of the confirmation of BuddyCorp's bankruptcy plan because of the priority of claims.[89] The payment of the tax liability must then occur before any property of the estate can be distributed to BuddyCorp's unsecured creditors, who hope the proceeds forwarded by SeaFirst to the trustee from the sale of the PayMore building will be enough to cover the amounts owed to them by BuddyCorp.[90] As calculated earlier, if the tax is paid by the estate, there will be a $92,000 shortfall that will have to be absorbed as a loss by BuddyCorp's unsecured creditors. If this happens, Joe walks away from the bankruptcy only losing his interest in BuddyCorp and is not responsible for the tax liability from the foreclosure sale.

The lynchpin for Joe, BuddyCorp, BuddyCorp's creditors, and the trustee in determining who pays the tax due on the PayMore gain is to determine whether the tax status change made by Joe to transform Buddy LLC from an SMLLC to a C Corp was somehow a fraudulent act subject to avoidance by the trustee. Under the IRC, however, Joe's actions were perfectly legal.[91] The trustee's only recourse is to attempt to construe BuddyCorp's prior tax status as property of the estate to attempt to reverse the change in status. To explore this possibility, we must examine the definition of property under both the text of the Bankruptcy Code and under two seminal Supreme Court cases interpreting what it means for something to be property of the estate.

## II. PROPERTY OF THE ESTATE IN BANKRUPTCY

### A. *Section 541 and the Text of the Bankruptcy Code*

The bankruptcy estate is created automatically at time of filing.[92] Other than the exceptions enumerated at sections 541(b) and (c), the bankruptcy estate includes "all legal or equitable interests of the debtor in property as of the

88 *See* 11 U.S.C. §§ 507(a)(2), 507(a)(8)(A), 503(b)(1)(B).

89 *See* 11 U.S.C. §§ 507(a)(2), 507(a)(8)(A), 503(b)(1)(B).

90 *See* 11 U.S.C. §§ 507(a)(2), 507(a)(8)(A), 503(b)(1)(B).

91 *See* Treas. Reg. § 301.7701-3(c)(1)(i) (sanctioning the changing of entity type, resulting in a change to tax status, with no bar on election dependent on whether the taxpayer is in bankruptcy).

92 11 U.S.C. § 541(a).

commencement of the case."[93] The language establishing the bankruptcy estate under the Bankruptcy Code at section 541 is liberal in its definition, written with the purpose of creating a large "pot of gold" for distribution through the bankruptcy proceedings.[94]

Courts have established that the definition of "property" includes both tangible and intangible things, although "property" itself has no full definition within the Code.[95] Reflecting the broad scope of section 541, the Supreme Court in *Segal v. Rochelle* determined (for section 541's precursor statute) 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."[96] Other courts have gone so far as to say that property of the estate under section 541 includes even the "mere *opportunity to receive* an economic benefit in the future . . . ."[97]

A general analytical framework is helpful to determine whether tax status meets the definition of "property" under the Bankruptcy Code. Section 541(a) says that a debtor's bankruptcy estate includes, with some exceptions, "all legal or equitable interests of the debtor in property as of the commencement of the case."[98] The application of section 541, then, requires courts to answer three questions:

(1) Is object in question "property" under applicable law?

(2) If the object is in fact property, did the debtor have an "interest" in that property?[99]

(3) If yes to (1) and (2), did the debtor hold this interest in property at the "commencement of the case"?[100]

Two Supreme Court cases help us answer these three questions.

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93 11 U.S.C. § 541(a)(1).

94 *See id.*

95 Kane v. Kane (*In re* Kane), 628 F.3d 631, 637 (3d. Cir. 2010).

96 Segal v. Rochelle, 382 U.S. 375, 379 (1966).

97 *E.g.*, Mellon Bank N.A. v Off. Comm. of Unsecured Creditors of R.M.L., Inc. (*In re* R.M.L., Inc.), 92 F.3d 139, 148 (3d. Cir 1996) (emphasis added; internal quotation marks omitted).

98 11 U.S.C. § 541(a)(1) (excepting certain interests listed at section 541(b), which covers variety of interest held by the debtor, and at section 541(c)(2) which convers certain beneficial interests of the debtor in a trust).

99 Section 541(a)(1) reaches the debtor's "interest in property" rather than simply the debtor's property. *See id.*

100 *See id.*

### B. *The* Butner *Principle: Looking to State Law*

A steppingstone to determining if an item is included as a property interest under section 541 is understanding the principle established in *Butner v. United States*. In *Butner*, the Supreme Court ruled that a bankruptcy estate includes all of a debtor's prepetition property rights afforded under state law as well as restrictions on those rights (for example, restrictions on transfer) except where a strong federal interest demands a different result.[101] The Court noted that Congress, by neglecting to include a definition of "property" in the Bankruptcy Act,[102] "ha[d] generally left the determination of property rights in the assets of a bankrupt's estate to state law."[103] A debtor in bankruptcy should be "afforded in federal bankruptcy court the same protection he would have had under state law if no bankruptcy case had ensued."[104] In essence, the *Butner* principle allows bankruptcy courts to fashion property rights in the federal arena from state law, especially in circumstances in which federal law has not contemplated a certain property interest because of its rarity or novelty.[105]

The emergence of the *Butner* principle, then, allowed courts to use state law to broaden section 541, in accord with the section's legislative history.[106] Federal law prevails only in circumstances where a strong federal interest calls for the usurpation of a state's definition of property, since a bankruptcy court retains ultimate discretion over the proceedings and administration of the estate.[107] In sum, what constitutes property *of the estate* is determined by federal law (section 541) but the more general question of what qualifies as property is guided by state law. Thus, common law and state law principles are integral to determining if certain tax attributes can be considered property of the estate.[108]

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

102 Although "[t]echnically speaking, *Butner* is a decision rendered under the former Bankruptcy Act; and the Bankruptcy Code has superseded its specific holding. Nonetheless . . . *Butner* provides a valid rule of decision . . . because it deals with the nature and extent of property interests." *In re* Pruitt, 401 B.R. 546, 564 (Bankr. D. Conn. 2009).

103 Butner v. United States, 440 U.S. 48, 54 (1979).

104 *Id.* at 56.

105 *Id.* at 55 (quoting Lewis v. Mfrs. Nat'l Bank, 364 U.S. 603 (1961)).

106 *Id.*

107 *See id.*

108 *See* Majestic Star Casino, LLC v. Barden Dev., Inc. (*In re* Majestic Star Casino), LLC, 716 F.3d 736, 750 (3d Cir. 2013) ("Filing for bankruptcy does not create new property rights or value where there previously were none." (citing Messina v. Neuner (*In re* Messina), 687 F.3d 74, 82 (3d Cir. 2012))); *see also id.* at 752 ("[T]he [IRC], rather than state law, governs the characterization of entity tax status as a property interest for purposes of the Bankruptcy Code" because of an offsetting federal interest.); *Butner*, 440 U.S. at 54.

However, examining state and common law precedent does not work for tax attributes. As a bookend to the expansive concept of including state property rights under the federal bankruptcy umbrella, *Butner* also stood for the notion that "[f]iling for bankruptcy does not create new property rights or value where there previously were none."[109] Tax attributes are inventions of the federal government, for use in calculating federal tax obligations regulated by the IRC. State law is useless in this analysis because it does not speak to the federal tax scheme.[110] Although the *Butner* principle empowers a trustee to pursue property claims available under state law that may not be present in or reflected by federal law,[111] the opposite problem occurs with tax attributes. A trustee has no ability to utilize state law to assume federal tax attributes create actionable state law claims, as courts using the Disfavored Approach discussed later wrongly assume.[112] State law cannot serve as a basis for the property classification of federal tax attributes, since these are fictions of the tax code meant to facilitate the administration of federal income tax.

### *C.* Chicago Board of Trade*: Intangible Rights*

*Board of Trade of Chicago v. Johnson* explored the inclusion of intangible rights as property of the bankruptcy estate.[113] At issue in the case was whether an individual debtor's membership position on the Chicago Board of Trade could properly be included in the debtor's estate.[114] Several of the debtor's creditors (other members of the Board of Trade) argued that membership on the

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[109] *Messina*, 687 F.3d at 82 (citing *Butner*, 440 U.S. at 54).

[110] Except where state tax law ties to federal calculations, an issue beyond the scope of this Comment. *See generally* Timothy Vermeer, *State Individual Income Tax Rates and Brackets for 2023*, TAX FOUND. (Feb. 21, 2023), http://taxfoundation.org/publications/state-individual-income-tax-rates-and-brackets/ ("[M]any states use the federal tax code as the starting point for their own standard deduction and personal exemption calculations.").

[111] *See Butner*, 440 U.S. at 55 (reflecting that "[p]roperty interests are created and defined by state law").

[112] *See* Guinn v. Lines (*In re* Trans-Lines W., Inc.), 203 B.R. 653, 662 (Bankr. E.D. Tenn. 1996) (finding that the IRC, "guarantees and protects an S corporation's right to dispose of [S Corp] status at will," in effect creating a property right includable in the bankruptcy estate); Parker v. Saunders (*In re* Bakersfield Westar, Inc.), 226 B.R. 227, 234 (B.A.P. 9th Cir. 1998) (citing *Trans-Lines W.*'s logic to find that "[a] corporation's right to use, enjoy and dispose of its subchapter S status has been held to fall within this broad definition of 'property'"). *But see Majestic Star Casino*, 716 F.3d at 756 (citing 26 U.S.C. § 1362(d)(1)(B)) (stating that the IRC "does not, and cannot, guarantee a corporation's right to S-corp status [because] the corporation's shareholders may elect to revoke that status 'at will'" and holding that "a tax classification over which the [QSub] debtor has no control is not a 'legal or equitable interest of the debtor in property' for purposes of § 541").

[113] Bd. of Trade v. Johnson, 264 U.S. 1, 6 (1924). The Supreme Court in *Chicago Board of Trade* foreshadowed its later decision in *Butner*, because it similarly acknowledged state laws respecting property rights are generally followed unless there is a greater federal interest in drawing rights into the estate as property. *See id* at 10.

[114] *Id.* at 6.

Board could not be considered property of the bankruptcy estate,[115] because a chair position was subject to the Board's discretionary rules to admit or reject members. This meant, argued the creditors, that the debtor's claim to the chair seat was essentially worthless as a right because it could not be freely transferred and sold.[116]

The Court reasoned that the Bankruptcy Code, with respect to the debtor's disputed board position, "vest[s] in the trustee title to powers which the bankrupt might exercise for his own benefit."[117] Because the debtor could *control* the disposition of his membership rights, the Court held that "[the Board seat] is a continuously enjoyed 'incorporeal right.'"[118] An "incorporeal right" is one that is "in a way attached to the . . . bankrupt and disposable only by his will," meaning it is properly included in the bankruptcy estate.[119] The Court then concluded that because the Board seat was attached to the debtor's person, "[i]t follows him . . . into the bankruptcy court . . . to be administered by it as part of his estate."[120]

The Court further explained that an intangible right is, "a right in some respects similar to the typical lien of the common law . . . ."[121] Elaborating that intangible rights like a board seat can be analogized to a lien, the Supreme Court opened the door to the inclusion of "incorporeal rights" in the bankruptcy estate.[122] The takeaway from *Chicago Board of Trade* is that, for property to be included in the debtor's estate, the *debtor* must be able to *control* the final disposition of the underlying piece of property.[123] Ultimately, intangible rights attach to the person (read: the debtor) entering bankruptcy, if and only if the debtor can maintain control over the rights.[124]

## III. THE DISFAVORED APPROACH AND THE FAVORED APPROACH

Courts have formed two distinct approaches to determining whether Joe checking the box to change Buddy LLC's tax entity type is permissible (and

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115 *Id.* at 8.
116 *Id.* at 7–8.
117 *Id.* at 10.
118 *Id.* at 12.
119 *Id.*
120 *Id.* at 13.
121 *Id.* at 11.
122 *See id.* at 12.
123 *See id.* at 11 (citing Peck v. Jenness, 48 U.S. 612, 620 (1849)).
124 *See id.* at 13.

hence immune to trustee clawback) in the bankruptcy context. Both approaches contemplate whether Buddy LLC's tax entity status is considered property of the bankruptcy estate under section 541.[125] However, the approaches yield two different results. Under the Disfavored Approach, the trustee characterizes the debtor's tax status change as a fraudulent transfer wrongly taken by the non-debtor-owner.[126] If successful under this approach, a debtor's tax status becomes subject to a trustee's avoidance powers because these courts determine that tax status meets the definition of property of the bankruptcy estate.[127] Under the Favored Approach, a trustee is unable to reverse a status change[128] because the court does not consider tax status to satisfy the definition of property.[129] As a result, the entity's non-debtor-owner's choice to change the debtor-entity's tax status is immune from disturbance by the trustee's avoidance powers.

### A. *The Disfavored Approach*

The Disfavored Approach has been adopted by Ninth Circuit's Bankruptcy Appellate Panel and the Bankruptcy Court for the Eastern District of Tennessee. It argues the tax status of a debtor is property of the bankruptcy estate under section 541 and is therefore subject to the trustee's avoidance powers under sections 548(a) and 544(a). The general theory adopted by these courts, however, is built upon a line of cases out of the Second, Eighth, and Ninth Circuit Courts of Appeals that focused on NOLs, a type of tax attribute,[130] and which posited that NOLs are property of the estate because they allow the debtor (and by operation, the trustee) to use losses to offset taxable income arising from the activities of the debtor in bankruptcy.[131] The courts employing the Disfavored Approach also determined that a non-debtor-owner's tax status is considered property because status is too closely "intertwined" with the owner-debtor, where manipulation of the status by the non-debtor-owner has the wrongful effect of diminishing or eliminating the bankruptcy estate.[132]

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125 *See, e.g.*, Guinn v. Lines (*In re* Trans-Lines W., Inc.), 203 B.R. 653, 661 (Bankr. E.D. Tenn. 1996); Parker v. Saunders (*In re* Bakersfield Westar, Inc.), 226 B.R. 227, 232 (B.A.P. 9th Cir. 1998); Majestic Star Casino, LLC v. Barden Dev., Inc. (*In re* Majestic Star Casino, LLC), 716 F.3d 736, 747 (3d Cir. 2013); Arrowsmith v. United States (*In re* Health Diagnostic Lab'y, Inc.), 578 B.R. 552, 554 (Bankr. E.D. Va. 2017).

126 *See, e.g.*, *Trans-Lines W.*, 203 B.R. at 656; *Bakersfield Westar*, 226 B.R. at 229.

127 *See, e.g.*, *Trans-Lines W.*, 203 B.R. at 662; *Bakersfield Westar*, 226 B.R. at 234.

128 *See, e.g.*, *Majestic Star Casino*, 716 F.3d at 750; *Health Diagnostic Lab'y*, 578 B.R. at 567–68.

129 *See, e.g.*, *Majestic Star Casino*, 716 F.3d at 755; *Health Diagnostic Lab'y*, 578 B.R. at 570.

130 *See* Off. Comm. of Unsecured Creditors v. PSS S.S. Co. (*In re* Prudential Lines, Inc.), 928 F.2d 565, 571–73 (2d Cir. 1991); Gibson v. United States (*In re* Russell), 927 F.2d 413, 419 (8th Cir. 1991); United States v. Sims (*In re* Feiler), 218 F.3d 948, 956 (9th Cir. 2000).

131 *See Russell*, 927 F.2d at 418.

132 *Prudential Lines*, 928 F.2d at 574.

As will be seen, if the Disfavored Approach were followed in the case of BuddyCorp, Joe would be stuck paying the tax resulting from the foreclosure sale, despite the permissibility of his choice under the IRC to make such an election.

### *1.* In re Trans-Lines West *and* In re Bakersfield Westar

The United States Bankruptcy Court for the Eastern District of Tennessee was the first court to explore whether tax status is property by considering S Corp status in *In re Trans-Lines West*.[133] Donald Lines was the sole shareholder of Trans-Lines West, an S Corp.[134] In his capacity as the entity's sole shareholder, Lines submitted a Statement of Consent along with a revocation statement of S Corp status to the IRS one month prior to his filing for chapter 11 on behalf of the entity.[135] The IRS accepted the revocation, and the trustee then commenced an adversary proceeding to avoid that revocation under sections 544(b) and 548(a).[136]

To determine if the revocation constituted a fraudulent conveyance avoidable by the trustee, the court found it necessary to determine whether the debtor entity had a property interest in its S Corp status, stating that "an essential element of an action to avoid a particular transaction as fraudulent is that there ha[s] in fact been a 'transfer' of an interest of the debtor in property."[137] With no definition of "interest in property" present in the Bankruptcy Code, the court turned to a general law treatise and *Black's Law Dictionary*, finding that these sources provide "property" can be more than a physical object.[138] Property is essentially a collection of rights because it includes anything over which a person has a "right and interest or domination rightfully obtained" that can be used, enjoyed, or disposed in an "unrestricted" manner.[139] Holding up this broad definition of property, the court immediately concluded that the debtor's tax status was also property because the IRC "guarantees and protects an S corporation's right to dispose of [S Corp] status at will," where the right exists until the election is terminated.[140]

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133 *See* Guinn v. Lines (*In re* Trans-Lines W., Inc.), 203 B.R. 653 (Bankr. E.D. Tenn. 1996).
134 *Id.* at 656.
135 *Id.* at 656.
136 *Id.*
137 *Id.* at 661.
138 *Id.*
139 *Id.* (citing *Property*, BLACK'S LAW DICTIONARY 1216 (6th ed. 1990)).
140 *Id.* at 662.

The Ninth Circuit's Bankruptcy Appellate Panel in *In re Bakersfield Westar* relied heavily on the reasoning from *Trans-Lines West*.[141] Bakersfield Westar was a California S Corp owned jointly by a husband and wife.[142] The husband filed a Statement of Revocation with the IRS thirteen days before the entity entered chapter 7 bankruptcy.[143] The trustee then sought to avoid the revocation of S Corp status as a fraudulent transfer of property under sections 544(b) and 548(a) using the same theory used by the trustee in *Trans-Lines West*: namely, that the definition of "property" included some illusory right to entity status found neither in the IRC nor in the Bankruptcy Code.[144] The Ninth Circuit's Bankruptcy Appellate Panel concluded that "the debtor therefore possessed a property interest, 'i.e., a guaranteed right to use, enjoy, and dispose of that interest' in its subchapter S status,"[145] adopting the idea that tax status is "an interest of the debtor in property."[146]

Both *Trans-Lines West* and *Bakersfield Westar* took a substantial leap in logic in going from vague and loose statements about property rights to arrive at the conclusion that tax status is property. As such, the bedrock fault with the courts' logic is that they relied on a series of cases that determined that another incorporeal tax attribute—NOLs—were properly included as property of the estate and therefore subject to the trustee's avoidance powers.[147] I revisit the NOL cases in more detail following this initial walkthrough *Trans-Lines West* and *Bakersfield Westar*.

There are three dovetailing issues in these cases beyond their faulty reliance on the NOL cases. First, the *Trans-Lines West* court made poor use of a common judicial tool—that of looking for meaning in a law dictionary and general treatise covering many aspects of law—to immediately arrive at a highly technical

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141 *See* Parker v. Saunders (*In re* Bakersfield Westar, Inc.), 226 B.R. 227 (B.A.P. 9th Cir. 1998).
142 *Id.* at 229.
143 *Id.*
144 *Id.* at 234.
145 *Id.* (quoting Guinn v. Lines (*In re* Trans-Lines W., Inc.), 203 B.R. 653, 661 (Bankr. E.D. Tenn. 1996)).
146 *Id.* at 234.
147 *See* Segal v. Rochelle, 382 U.S. 375 (1966); Off. Comm. of Unsecured Creditors v. PSS S.S. Co. (*In re* Prudential Lines, Inc.), 928 F.2d 565, 572 (2d Cir. 1991) (citing *Segal*, 382 U.S. 375); Gibson v. United States (*In re* Russell), 927 F.2d 413, 415 (8th Cir. 1991) (citing *Prudential Lines, Inc.*, 928 F.2d 565); *Trans-Lines W.*, 203 B.R. at 663 (citing *Russell*, 927 F.2d 413); *Bakersfield Westar, Inc.*, 226 B.R. at 234, 235 (citing *Trans-Lines W.*, 203 B.R. 653); *see also* Majestic Star Casino, LLC v. Barden Dev., Inc. (*In re* Majestic Star Casino, LLC), 716 F.3d 736, 754–55 (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 NOLs, is property.").

answer in a niche area of tax.[148] Starting its analysis with *Black's* and the treatise, the court in *Trans-Lines West* took the general maxims about property it found therein and used them to demonstrate (conclusively, in the court's mind) that the IRC's rules related to entity status change reflected the creation of an owned property right.[149] Because the dictionary and treatise talk about general property rights being "unrestricted" in nature for the ultimate enjoyment of their holder, the *Trans-Lines West* court drew what it saw as a linear conclusion that the IRC "guaranteed" a corporation's status change once elected.[150] Drawing a precise conclusion about the meaning of a provision of the IRC through the use of a basic judicial tool, completely ignoring the context and purpose of the check-the-box regulations,[151] is an improper use of general treatises and legal dictionaries.[152] These resources should only be consulted as authoritative as a last resort, after all other sources of interpretation are exhausted.[153] Because there were more salient judicial tools of interpretation available, the court in *Trans-Lines West* should not have started with these general guides, but instead with deference to the IRS's authoritative position on the issue.

The IRC does not define tax status as "property" in any provision and no global definition of property is present in any IRS rule or regulation.[154] In fact, the IRS has repeatedly filed briefs and disseminated opinions asserting tax status is not property.[155] In cases involving technical matters such as tax status, it is poor practice to ignore a more relevant tool of judicial interpretation—agency deference—in favor of reverting to dictionaries[156] and ignoring the IRS's subject-matter expertise. It is not hard to imagine a scenario where the same

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148 *Trans-Lines W.*, 203 B.R. at 661.

149 *See generally id.*

150 *See id.* at 661.

151 *See* Treas. Reg. § 301.7701-3(c)(1); *see also* Nat'l Tax Credit Partners, L.P. v. Havlik, 20 F.3d 705, 707 (7th Cir. 1994) (When considering the text of a statute, "[k]nowing the purpose behind a rule may help a court decode an ambiguous text," meaning ignoring the purpose of the check-the-box regulations in favor of using general judicial tools of interpretation is disfavored.).

152 Nix v. Hedden, 149 U.S. 304, 307 (1893) ("[D]ictionaries are admitted, not as evidence, but only as aids to the memory and understanding of the court.")

153 *See, e.g.*, Yates v. United States, 574 U.S. 528, 536–37 (2015) (rejecting the use of *Webster's Dictionary* and *Black's Law Dictionary* to define a word broadly when other tools of interpretation are available to discern a definition for the word).

154 Williams, *Tax and Fraudulent Transfers*, *supra* note 31, at 12.

155 *See* I.R.S. Gen. Litig. Couns. Mem. 199927037 (April 26, 1999); *see also* Parker v. Saunders (*In re* Bakersfield Westar, Inc.), 226 B.R. 227, 230 (B.A.P. 9th Cir. 1998); Guinn v. Lines (*In re* Trans-Lines W., Inc.), 203 B.R. 653, 661 (Bankr. E.D. Tenn. 1996).

156 I acknowledge that this is not a question of administrative law, but given the novel nature of the question relating to a specialized area of law, there remains a glaring question why the stated position of the agency administering the IRC was completely ignored.

definitional reaching employed by this court could be applied to any intangible "thing" appearing to have the qualities of a right and some tangential impact on the bankruptcy estate. A court utilizing this logic could lasso almost any concept into the definition of property.

There does not appear to be any substantial reason for the court in *Trans-Lines West* to take this approach other than to achieve some policy goal unattached to deductive legal reasoning. As the Supreme Court observed, "nothing in the generalized statutory purpose of protecting secured creditors can overcome the specific manner of that protection which the text [of the Code] contains."[157] Just as here, where a specific manner of protection is lacking for unsecured creditors harmed by a debtor's tax status change, the fabrication of tax status as a property right under section 541 serves no equitable purpose.

Second, even if we were to accept that tax status is property, the court in *Trans-Lines West* misconstrued who has the right to control an S Corp election. According to the IRC, only shareholders may consent to the election of S Corp status and only shareholders can consent to revocation; the S Corp has no independent means to do so itself.[158] The relevant parts of the statute covering S Corp status read: "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" and "[a]n election may be revoked only if shareholders holding more than one-half of the shares of stock of the corporation on the day on which the revocation is made consent to the revocation."[159] Because entity status is controlled by the S Corp's shareholders when the entity *qualifies* for S Corp status, the conclusion reached in *Trans-Lines West* that the IRC "guarantees and protects *an S corporation's right* to dispose of [S Corp] status at will" is wholly inaccurate.[160] If control of status designation lies solely in the hands of the *qualifying shareholders*, it was never under the debtor's control, and could not be property of the bankruptcy estate.[161] Nor could the debtor S Corp be considered to have an "interest in property" in

157 RadLAX Gateway Hotel, LLC v. Amalgamated Bank, 566 U.S. 639, 649 (2012).

158 26 U.S.C. § 1362(a)(2), (d)(1)(B).

159 26 U.S.C. § 1362(a)(2, (d)(1)(B).

160 *Trans-Lines W.*, 203 B.R. at 662 (emphasis added).

161 Majestic Star Casino, LLC v. Barden Dev., Inc. (*In re* Majestic Star Casino, LLC), 716 F.3d 736, 757 (3d Cir. 2013) ("Capacious as the definition of 'property' may be in the bankruptcy context, we are convinced that it does not extend so far as to override rights statutorily granted to shareholders to control the tax status of the entity they own."). To note, because an S Corp is not a qualifying shareholder in itself, it has no right to control any aspect of its destiny. *See supra* notes 41 through 43 and accompanying text for the qualifications of an S Corp.

its own tax status because the status of the entity exists at the will of its owner-shareholder. The same can be said about a trustee: A trustee is not a qualifying shareholder of an S Corp and cannot control its status. Alignment is found between this reasoning and the reasoning given by the court in *Chicago Board of Trade* as it related to the Board seat: Incorporeal rights follow the debtor into bankruptcy only if the debtor has the means to control those rights.[162]

Third, nothing in the IRC creates a "guaranteed right" to S Corp status as the court in *Bakersfield Westar* claimed.[163] S Corp status is automatically revoked via a handful of scenarios.[164] If any of these events occur, S Corp status is rescinded by operation of the law.[165] Automatic revocation reflects a lack of any sort of "guarantee" or "right" in the entity to possession of its tax status.[166]

The exception swallows the rule in courts that choose to follow *Trans-Lines West* and *Bakersfield Westar*. These courts would be inclined to order a revocation of a tax status change made by the non-debtor-owners, fabricating the appearance of a guarantee or right to tax status by advent of a court order. Such a practice is not derived from an underlying principle embedded in the law that would need to clearly state that tax status belongs to the debtor. As one bankruptcy court put it: "[W]e are reluctant to believe that a post-bankruptcy revocation of S status could, under the tax laws of the United States, be utilized to undo previously executed acts. Humpty Dumpty could not be restructured using this scenario."[167]

### 2. *The NOL Cases*

As mentioned earlier, the bedrock error in including tax status in the definition of property under section 541, made by both courts discussed above, is premised on a succession of precedents that determined that NOLs should also

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162 *See* Board of Trade v. Johnson 264 U.S. 1, 12 (1924) (citing Hyde v. Woods, 94 U.S. 523, 524 (1886)).

163 Parker v. Saunders (*In re* Bakersfield Westar, Inc.), 226 B.R. 227, 234 (B.A.P. 9th Cir. 1998).

164 Including where shareholders in the corporation suddenly exceed 100; where the entity becomes internationally chartered; where the entity obtains a partnership, corporation or non-resident alien shareholder; where the entity issues more than a single class of stock; or where the entity attains passive investment income in excess of 25% of gross receipts for each of 3 consecutive tax years with accumulated earnings and profits. 26 U.S.C. § 1362(d)(1)–(3).

165 *Id.*

166 *Id.*

167 Off. Comm. of Unsecured Creditors v. Forman (*In re* Forman Enters., Inc.), 281 B.R. 600, 612 (Bankr. W.D. Pa. 2002).

be included in property of the estate.[168] Essentially, the courts in *Trans-Lines West* and *Bakersfield Westar* copy-and-pasted the shaky logic of these NOL-as-property cases to tax status without solid substantiation justifying why two tax attributes should be treated the same—thereby expanding the reach of section 541 by improper means.[169] Courts adopting the Favored Approach have recognized and attacked this failure to appreciate the difference[170] and even questioned the underlying logic of the inclusion of NOLs in the definition of property.[171] An NOL is tax attribute that is a loss that a taxpayer experiences in a given tax year, when a taxpayer's deductions from income exceed its taxable income in a given tax year. This dollar amount of loss can be carried back to applied backwards to previous tax years or forwards to future tax years, depending on the circumstances.

The court in *Segal v. Rochelle* was the first to determine that NOLs should be included in property of the estate.[172] The court in *Segal* found that an NOL carryback is property of the debtor because that debtor can receive a refund for previously paid taxes.[173] The Court gave the reasoning that NOLs should be considered property because they are "sufficiently rooted in [the debtor's] pre-bankruptcy past" and "should be regarded as 'property' under [the Bankruptcy Code]" once carried back to create a refund.[174] As discussed further later, the court in *Segal* specifically refrained from making a judgement as to whether NOL carryforwards (which it called "carryovers") should be considered property of the estate, stating that "a carryover into post-bankruptcy years can be distinguished both conceptually as well as practically [from carrybacks because] the supposed loss-carryover would still need to be matched in some future year by earnings, earnings that might never eventuate at all."[175]

Notwithstanding the reservation by the court in *Segal* to include NOL carryforwards in property of the estate, the court in *In re Prudential Lines*,

168 *See* Off. Comm. of Unsecured Creditors v. PSS S.S. Co. (*In re* Prudential Lines, Inc.), 928 F.2d 565 (2d Cir. 1991); Gibson v. United States (*In re* Russell), 927 F.2d 413 (8th Cir. 1991); United States v. Sims (*In re* Feiler), 218 F.3d 948 (9th Cir. 2000). For more information regarding NOLs and their treatment under the IRC, see M.L. Cross, *"Net Operating Loss" and Its Carry-Back and Carry-Over as a Deduction Under Internal Revenue Code*, 9 AM. L. REPS. 2D 330 (1950).

169 Majestic Star Casino, LLC v. Barden Dev., Inc. (*In re* Majestic Star Casino, LLC), 716 F.3d 736, 753 (3d Cir. 2013).

170 *See id.* at 753–54 & n.17.

171 *See id.* at 754–55 & nn.15, 18.

172 *See* Segal v. Rochelle, 382 U.S. 375, 381 (1966).

173 *See id.* at 380–81.

174 *Id.* at 380.

175 *Id.* at 381.

decided to ignore that reservation.[176] A non-debtor parent corporation attempted to take a $39 million worthless stock deduction on its federal income tax return after its wholly owned subsidiary corporation entered an involuntary chapter 11 bankruptcy.[177] The troubled subsidiary possessed a $74 million NOL from previous business operations. The parent attempted to take the stock deduction with the knowledge it was about to lose its investment in the subsidiary through the bankruptcy.[178]

The parent contended the NOL generated by its debtor-subsidiary was not "property" within the meaning of section 541[179] and that the IRC gave the parent the right to use the NOL because the subsidiary's status as an "affiliated corporation filing a consolidated tax return abolished any interest it had in the right to use its NOL to offset its income."[180] The court rejected the parent's argument, instead finding Congress intended section 541 "to be interpreted broadly."[181] The court concluded that the Bankruptcy Code, and not the IRC, determined "whether that interest is included in the property of the debtor's estate"[182] The court noted "where a non-debtor's action with respect to an interest that is intertwined with that of a bankrupt debtor would have the legal effect of diminishing or eliminating property of the bankrupt estate, such action is barred by the automatic stay."[183]

One of the major issues with the *Prudential Lines* decision is the lack of traceable logic between the evidence cited by the court and its overall conclusion about NOLs. The court fixated on what it perceived to be the Congressional intent surrounding the meaning of property under section 541.[184] The court drew the conclusion that NOLs must be "property" because the Bankruptcy Code's legislative history for section 541 indicates Congress' desire to broaden the word's definition to "include [] all interests such as . . . contingent and future interests."[185] However, the disconnect between the court's conclusion about

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[176] Off. Comm. of Unsecured Creditors v. PSS S.S. Co. (*In re* Prudential Lines, Inc.), 928 F.2d 565, 572 (2d Cir. 1991).

[177] *Id.* at 567.

[178] *Id.*

[179] *Id.* at 566.

[180] *Id.* at 569.

[181] *Id.*

[182] *Id.* (citing Crysen/Montenay Energy Co. v. Esselen Assocs., Inc. (*In re* Crysen/Montenay Energy Co.), 902 F.2d 1098, 1101 (2d Cir. 1990)).

[183] *Id.* at 574.

[184] *Id.* at 572 (quoting H.R. REP. NO. 95-595, at 176 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6136) (internal quotation marks omitted).

[185] *Id.*

Congressional intent and the reality of the enacted law in the Bankruptcy Code is apparent when the text of section 541 is considered, because it does not contain the words "contingent" or "future" or any other forward-looking qualification in its definition of "property of the estate."[186] Section 541(a)(1) provides that property includes only "legal or equitable interests of the debtor in property as of the commencement of the case" and nothing more.[187] In this line of cases, NOL carryforwards are (questionably) considered to be property of the estate because their future use is *contingent* on the earning of taxable income, an event not certain or readily ascertainable.[188] As another court put it, "the crucial analytical key [is] not . . . an abstract articulation of the statute's purpose, but . . . an analysis of the nature of the asset involved in light of those principles."[189]

Admittedly, a House Report indicated that when interpretating section 541, property of the estate should be broadly construed.[190] It is also significant that the House's discussion of that code section included consideration of "future" and "contingent" interests.[191] However, "future" and "contingent" do not appear in section 541 *as enacted*. This absence indicates Congress did not intend for "property" to be so broadly defined so every thinkable conception of property should be included in the definition of the term, especially future or illusory benefits. Really, only those definite, quantifiable, and present interests existing at the inception of the case should be included in the estate.

What is more, the court in *Prudential Lines* cited the previously discussed *Segal* decision as authoritative to its conclusion that NOL carryforwards are property of the estate.[192] The court pointed to language in *Segal* reading "postponed enjoyment does not disqualify an interest as 'property,'" and "contingency in the abstract is no bar" to supporting the idea that NOL carryforwards are property.[193] Also discussed later in this Comment, the problem with relying on this reasoning is the court in *Segal* concluded that only

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186 11 U.S.C. § 541(a)(1).

187 *Id.*

188 *See id.*; *see also* Majestic Star Casino, LLC v. Barden Dev., Inc. (*In re* Majestic Star Casino, LLC), 716 F.3d 736, 754 n.15 (3d Cir. 2013) ("The reasoning of the 'NOL-as-property' cases is itself not without flaws.").

189 Kokoszka v. Belford, 417 U.S. 642, 646 (1974).

190 *See* H.R. REP. NO. 95-595, at 176 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6136.

191 *See* H.R. REP. NO. 95-595, at 176 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6136.

192 Off. Comm. of Unsecured Creditors v. PSS S.S. Co. (*In re* Prudential Lines, Inc.), 928 F.2d 565, 572 (2d Cir. 1991) (citing Segal v. Rochelle, 382 U.S. 375, 380 (1966)).

193 *Id.*

NOL *carrybacks* are property of the estate.[194] As the court in *Majestic Star Casino* observed, "NOLs when carried back are hardly contingent at all."[195] The court in *Segal* specifically refrained from making a judgment about the impact of the *future* use of NOLs, observing "a [NOL carryforward] into post-bankruptcy years can be distinguished conceptually as well as practically" from an NOL carryback because "the supposed loss-carryover would still need to be matched in some future year by earnings, earnings that might never eventuate at all."[196] The court in *Prudential Lines* got it wrong: It does not follow from *Segal* that NOL carryforwards are property of the estate.[197]

Further, *Prudential Lines* stands in part for the notion that choices made by a taxpayer that may affect the property of a debtor-subsidiary's future bankruptcy estate should be disallowed as a fraudulent transfer, because those choices could undesirably affect the debtor's creditors at some future date.[198] The court in *In re Russell* considered *Prudential Lines* in its decision,[199] feeding into the holdings that tax status should be subject to a trustee's avoidance powers in in *Trans-Lines West* and *Bakersfield Westar.* [200]

Applying the disfavored approach to Joe and Buddy, a judge would determine that Joe's choice to change the tax status of Buddy LLC from an LLC to BuddyCorp, a C Corp, (as allowed by the IRC[201]), could be avoided by the trustee as a fraudulent transfer because the court considers that tax status to be property of Buddy LLC's estate.[202] Joe would be forced to personally shoulder the entire tax bill resulting from the foreclosure sale of the PayMore Building, which this Comment argues is unfair. Briefly, Joe made the decision to form Buddy LLC as a limited liability company thereby shielding himself from personal liability for the business activities of the entity. Joe then made a choice

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194 *Segal*, 382 U.S. at 380 ("[N]o refund could be claimed from the Government until the end of the [filing] year" during which "earnings by the bankrupt . . . might diminish or eliminate the loss carryback refund claim . . . .").

195 Majestic Star Casino, LLC v. Barden Dev., Inc. (*In re* Majestic Star Casino, LLC), 716 F.3d 736, 755 (3d Cir. 2013).

196 *Segal*, 382 U.S. at 381.

197 *Prudential Lines*, 928 F.2d at 572.

198 *See id.*

199 Gibson v. United States (*In re* Russell), 927 F.2d 413, 417–18 (8th Cir. 1991) (citing *Prudential Lines*, 928 F.2d at 572).

200 Guinn v. Lines (*In re* Trans-Lines W., Inc.), 203 B.R. 653, 663 (Bankr. E.D. Tenn. 1996) (citing *Russell*, 927 F.2d 413); Parker v. Saunders (*In re* Bakersfield Westar, Inc.), 226 B.R. 227, 234, 235 (B.A.P. 9th Cir. 1998) (citing *Trans-Lines W.*, 203 B.R. 653).

201 *See* Treas. Reg. § 301.7701-3(c).

202 *See* 11 U.S.C. §§ 541(a)(3), 544(b)(1); *see also Trans-Lines W.*, 203 B.R. 653.

to change Buddy LLC to a C Corp, further insulating Joe from liability resulting from BuddyCorp's taxable events that may have occurred after Joe checked the box. Because a C Corp is not disregarded in the same way an as SMLLC, it is unfair to unwind Joe's choice of entity type, a choice allowed by the IRC at the time it was made.

### *B. The Favored Approach*

#### *1. In re Majestic Star Casino, LLC*

The correct resolution to whether tax status is property of the estate was proffered by the Third Circuit in *In re Majestic Star Casino*.[203] Don Barden was the sole shareholder of Barden Development, Incorporated ("BDI").[204] BDI owned 100% of the stock of Majestic Star Casino II ("MSC II"), a subsidiary involved in casino operations on floating barges in Indiana.[205] At the time of the filing of the petition for bankruptcy for MSC II under chapter 11, both BDI and MSC II were S Corps, with MSC II qualifying as a QSub.[206] Less than two months after the filing of the petition, BDI "abandon[ed] its classification as an S Corp, thus forfeiting the pass-through tax benefits."[207]

By revoking its own S Corp tax status and becoming a C Corp, BDI and its single individual shareholder, Don Barden, were able to avoid the continuing income tax obligations arising from the activities of the reorganized MSC II.[208] MSC II was still generating income but (because of the bankruptcy) was being owned and operated by MSC II's creditors.[209] BDI and Barden were able to avoid payment of taxes because of the automatic revocation of MSC II's

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

[204] *Id.* at 742.

[205] *Id.*

[206] *Id.* at 743. A parent corporation organized as an S Corp with 100% ownership of a domestic subsidiary corporation can, for tax purposes, elect to treat its wholly-owned subsidiary as a "qualified subchapter S subsidiary"—also known as a QSub. *See* 26 U.S.C. § 1361(b)(3). A QSub for tax purposes is treated as a disregarded entity, similar to how an owner-member treats an SMLLC. *Id.* This means once an election is filed with the IRS, the subsidiary becomes a QSub, where all items of income, loss, gain, and other tax attributes flow up (and pass through) to the parent corporation's federal income tax return. *See* 26 U.S.C. § 1361(b)(3)(A)(ii). QSub status can be revoked when the basic requirements for this special entity status are not met (including the parent S Corp reverting back to a C Corp) or when the parent corporation voluntarily revokes the QSub's status. *See* 26 U.S.C. § 1361(b)(3)(C). An owner-entity cannot re-elect QSub status for its subsidiary for at least five years following revocation. *Id.*

[207] *Majestic Star Casino*, 716 F.3d at 741.

[208] *Id.*

[209] *Id.* at 742.

disregarded entity status as a QSub.[210] By losing S Corp status and transforming into a C Corp, MSC II and its owner-creditors became responsible for paying the tax liabilities resulting from current and future taxable activities.[211]

The bankruptcy court held MSC II's tax status constituted property and voided BDI's revocation of its parental S Corp status, in effect restoring MSC II's status as a disregarded QSub.[212] The bankruptcy court's ruling reflects another attempt to expand the definition of property, where the court took the expansive and egregious step of including a non-debtor's own tax status.[213] The court's sole justification for drawing a non-debtor-parent's affairs into the estate was that its status was tied, downstream, to the debtor-subsidiary.[214] The court arrived at the conclusion the status changes for both BDI and MSC II were avoidable under section 549 by adopting the courts' logic in *Trans-Lines West* and *Bakersfield Westar*, stating "property" under section 541 should be interpreted broadly.[215]

However, the Third Circuit, in a novel departure from prior courts, reversed the bankruptcy court's ruling.[216] By parsing and examining the "property" and "of the bankruptcy estate" language in section 541, the Third Circuit concluded revocation of BDI's S Corp status did not empower the trustee to avoid the alleged transfer.[217]

Dealing with the definition of "property," the Third Circuit explored the potential for S Corp status and QSub status to be property of the bankruptcy estate.[218] For S Corp status, the court came to four conclusions—the fourth of which I save for the end of the Comment. First, the court distinguished the S Corp cases of *Trans-Lines West* and *Bakersfield Westar* from the NOL case of *Prudential Lines* by highlighting that the S Corp cases "fail to consider important differences between the two putative property interests," namely, that tax status is entirely contingent by its nature and NOLs are generally fixed and certain.[219] The court pointed out that, "[i]n holding that tax status is property, the

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210 *Id.* at 743–44.
211 *Id.* at 744.
212 Majestic Star Casino, LLC v. Barden Dev., Inc. (*In re* Majestic Star Casino, LLC), 466 B.R. 666, 676–77 (Bankr. D. Del. 2012).
213 *Id.*
214 *Id.*
215 *Id.* at 676, 678.
216 *Majestic Star Casino*, 716 F.3d at 763–64.
217 *Id.* at 750.
218 *See id.* at 752.
219 *Id.* at 755–56.

[disfavored] S-corp cases reason from the premise that the 'prospective . . . nature of a right does not place it outside the definition of property.'"[220] In other words, the court in *Majestic Star Casino* felt that the contingent nature of a prospective right was not a concept that could be discounted as irrelevant.[221] The court emphasized that "not all contingencies are of equal magnitude or consequence. NOLs when carried back are hardly contingent at all. In all events, a debtor in possession of NOLs has a defined amount of them at the time of the bankruptcy filing."[222] Further, NOLs "are a function of a debtor's operation prior to bankruptcy and are not subject either to revocation by the shareholders or termination by the IRS."[223] Because NOLs by their nature are utilized to cover tax losses and have a definite, readily identifiable dollar value, they enter bankruptcy predetermined and non-contingent.[224] Tax status, on the other hand, exists at the will of an entity's shareholders and is entirely contingent in nature.[225]

Further, the court in *Majestic Star Casino* found the inclusion of S Corp tax status in the definition of property faulty because S Corp status is "contingent" and based on future events.[226] As previously discussed in the same context as the NOL cases,[227] the court explained: "[b]y contrast [to NOLs], the shareholders of an S-corp can terminate its pass-through status at will, regardless of how long it has been an S-corp and whatever its pre-bankruptcy operating history has been. The tax status of the entity is entirely contingent on the will of the shareholders," making a comparison of NOLs to S Corp status invalid.[228] In other words, the existence of NOLs in the hands of a taxpayer is definite and non-deniable; the taxpayer cannot change the existence or dispose of NOLs in the same way the taxpayer could modify its tax status (if the taxpayer qualified to do so), even if the taxpayer had some irrational fear or phobia of NOLs. NOLs exist with definite certainty in a way tax status does not.

Second, NOLs are not only less contingent than tax status, but their value is more readily calculable. As the court noted, "NOLs also have value in a way

[220] *Id.* at 755 (quoting Parker v. Saunders (*In re* Bakersfield Westar, Inc.), 226 B.R. 227, 234 (B.A.P. 9th Cir. 1998)).
[221] *Id.*
[222] *Id.*
[223] *Id.*
[224] *See id. See generally* 26 U.S.C. § 172.
[225] *See Majestic Star Casino*, 716 F.3d at 755. *See generally* 26 U.S.C. § 1362(d)(1)–(3).
[226] *Majestic Star Casino*, 716 F.3d at 755.
[227] *See* discussion *supra* Section III(A)(2).
[228] *See Majestic Star Casino*, 716 F.3d at 755.

that S-Corp status does not" because the "value of an NOL is readily determinable as a tax refund immediately available to the bankruptcy estate."[229] According to the court, NOLs are monetized and valuable because it is common practice for primary entities with large and known tax liabilities to target and acquire secondary entities because the secondaries have several years of accumulated losses evidenced by large NOLs, where the primaries utilize the NOLs to reduce their tax liabilities (effectively creating tax discounts).[230] In contrast, noted the court, S Corp status has no inherent value.[231] Moreover, the court correctly noted "the sale of an S-corp will generally result in the termination of its tax-free status," meaning that S Corp status has no monetizable value on the open market.[232]

Third, and consistent with its conclusion that QSub status is not property, the court in *Majestic Star Casino* reasoned S Corp status as a concept cannot produce a "right" or guarantee to the entity's owner.[233] The court in *In re Trans-Lines West* and its sister courts presumed "once a corporation elects to be treated as an S corporation, [the IRC] guarantees and protects the corporation's right to use and enjoy that status [and] guarantees and protects an S corporation's right to dispose of that status at will."[234] The court in *Majestic Star Casino* correctly pointed out this kind of logic reflects "an incomplete and inaccurate understanding of the law" and stated the IRC "does not, and cannot, guarantee a corporation's right to S-corp status [because] the corporation's shareholders may elect to revoke that status 'at will.'"[235] The court further noted, even if an S Corp's shareholders do not vote to revoke S Corp status, a number of things can occur (such as losing the qualification of a "small business corporation") which would force the loss of S Corp status and any QSub status by operation of law.[236] The court's conclusion is accurate; there is nothing in the IRC ensuring tax status to an entity.

The court in *Majestic Star Casino* also explored QSub status as potential property of the estate (a consideration separate from BDI's S Corp status as non-debtor-parent), but ultimately rejected that QSub status could be property because a QSub debtor's tax status "depends on a variety of factors that are

[229] *Id.* at 755–56.
[230] *Id.* at 756; *see also* 26 U.S.C. § 382 (setting forth limits on the utilization of NOLs).
[231] *Majestic Star Casino*, 716 F.3d at 755–56.
[232] *Id.* at 756.
[233] *Id.*
[234] Guinn v. Lines (*In* re Trans-Lines W., Inc.), 203 B.R. 653, 662 (Bankr. E.D. Tenn. 1996).
[235] *Majestic Star Casino*, 716 F.3d at 756 (citing 26 U.S.C. § 1362(d)(1)(B)).
[236] *Id.* at 756–57 (citing 26 U.S.C. § 1361(b)(1)).

outside the QSub's control," an important theme to this court.[237] The court noted a QSub's "use and enjoyment of its entity tax status is not only dependent on its S-corp parent's continuing to own 100 percent of its stock . . . but also on the parent's decision to not revoke the QSub election . . . as well as the parent's continuing status as an S-corp."[238] The absence of these qualities in an entity could lead to revocation of QSub status and demonstrate there is no "guarantee" or "right" to tax status.[239] This demonstration by the court in *Majestic Star Casino* directly refutes the courts' decisions in *Trans-Lines West* and *Bakersfield Westar* that tax status creates rights and guarantees.[240]

The court in *Majestic Star Casino* rightly concluded that "a QSub's use and enjoyment of its tax status may be terminated by factors not only outside its control, but outside the control of its S-corp parent."[241] The QSub at issue in the case had a tax status that was "entirely contingent on the will of the shareholders" who own the debtor entity: the will of BDI and Don Barden.[242] In the court's view, the S Corp status of parent entity BDI was terminable by Don Barden without the authorization or consent of the underlying QSub-debtor, MSC II. This meant that MSC II was two steps removed from control of its own destiny.[243] The court further determined "a tax classification over which the debtor [QSub] has no control is not a 'legal or equitable interest of the debtor in property' for purposes of § 541."[244] Effectively, the court in *Majestic Star Casino* drew a line in the sand, shrinking the definitional reach of "property" at section 541 away from the ever-expanding vision of courts like those in *Trans-Lines West* and *Bakersfield Westar*.[245]

### 2. *A Continuation of the Move in the Right Direction: Health Diagnostic Laboratory*

Happily, the Third Circuit's approach appears to be catching on. In *In re Health Diagnostic Laboratory*, a bankruptcy court in the Eastern District of Virginia, in the Fourth Circuit, adopted the correct approach in rejecting tax

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237 *Id.* at 758.

238 *Id.*

239 26 U.S.C. § 1361(b)(1).

240 Guinn v. Lines (*In re* Trans-Lines W., Inc.), 203 B.R. 653, 662 (Bankr. E.D. Tenn. 1996); Parker v. Saunders (*In re* Bakersfield Westar, Inc.), 226 B.R. 227, 234 (B.A.P. 9th Cir. 1998).

241 *Majestic Star Casino*, 716 F.3d at 758–59.

242 *Id.* at 755.

243 *See id.* at 756.

244 *Id.*

245 *Id.* at 758.

status as property, following the court in *Majestic Star Casino*'s logic.[246] Health Diagnostic Laboratory, Inc. ("HDL") violated federal law by remitting kickback payments to doctors in a scheme involving its blood testing.[247] As a result, the company lost its ability to borrow with its primary lender.[248] When funds ran out, HDL entered voluntary chapter 11 bankruptcy.[249] Six years prior to filing the bankruptcy petition, HDL, qualifying as a small business corporation, elected into S Corp status,[250] but terminated its S Corp status six months before bankruptcy.[251] Three months post-petition, a bankruptcy court ordered HDL to sell all of its assets to a separate buyer, where the trustee in the case was responsible for paying the resulting capital gains tax on the sale of the assets.[252] The trustee filed suit against HDL's owners and against the IRS, requesting an injunction on and reversal of the change in HDL's tax status, arguing HDL's tax status was property that had been fraudulently transferred out of the estate.[253]

The court heard the case and began its legal analysis by giving a fair and comprehensive review of prior case law.[254] Zeroing in on whether S Corp status is property for purposes of sections 544(b) and 548(a)(1) (the avoidance provisions), the court determined tax status was not property because "federal law governs any purported property right at issue."[255] The court explained its decision by turning to the elephant in the room—the *Butner* principle.[256] Although a bankruptcy court "must consider the purposes animating the Bankruptcy Code, which includes the intention to bring anything of value that the debtors have into the estate,"[257] the court reasoned that "[n]o Bankruptcy Code provision 'answers the threshold questions of whether a debtor has an interest in a particular item of property and, if so, what the nature of that interest is.'"[258] Seeing that the Bankruptcy Code has no supremacy in the determination of property interests, the court reasoned "once it has been determined that state

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246 Arrowsmith v. United States (*In re* Health Diagnostic Lab'y, Inc.), 578 B.R. 552, 554 (Bankr. E.D. Va. 2017).

247 *Id.*

248 *Id.*

249 *Id.* at 554–55.

250 *Id.* at 555.

251 *Id.* at 556.

252 *Id.*

253 *Id.*

254 *Id.* at 558–60.

255 *Id.* at 563.

256 *Id.*

257 *Id.* at 562 (quoting Off. Comm. of Unsecured Creditors v. PSS S.S. Co. (*In re* Prudential Lines, Inc.), 928 F.2d 565, 573 (2d Cir. 1991)).

258 *Id.* (quoting Universal Coops., Inc. v. FCX, Inc. (*In re* FCX, Inc.), 853 F.2d 1149, 1153 (4th Cir. 1988)).

law creates sufficient interests in the [taxpayer] to satisfy the requirements of [the statute], state law is inoperative, and the tax consequences thenceforth are dictated by federal law."[259] Because federal law is operative and the Bankruptcy Code does not specifically define tax status as property, the court in *Health Diagnostic Laboratory* held that *Butner* dictates that "federal tax law governs any purported property right at issue" in this case.[260]

Ultimately, the court in *Health Diagnostic Laboratory* drew the correct conclusion using the tools created under *Butner* to explain that "there is clearly a countervailing federal interest because S corporation status is a creature of federal law under subchapter S of the Tax Code."[261] State law created "sufficient interests" in HDL for S Corp status by provision of incorporation statutes, but, beyond that threshold, became "inoperative" and therefore subservient to federal tax statutes.[262] Most important in the court's determination was the notion that "a corporation has very little control over S corporation status. The right to exercise dominion and control over an interest is an essential characteristic defining property."[263] Further, the court noted section 1362(a)(2) reads "[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."[264] The "plain language of 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."[265]

The court in *Health Diagnostic Laboratory* continued the correct lines of reasoning the court in *Majestic Star Casino* crafted for exclusion of tax status as property of the bankruptcy estate. A trustee should not be able to "hold the shareholders 'tax hostage' by avoiding their decision to revoke the S corporation election" just because doing so serves the ends of the trustee and unsecured creditors.[266] At the end of the day, neither the Bankruptcy Code nor the IRC explicitly allow a trustee to choose the tax status of an entity in bankruptcy. For tax purposes, if a shareholder makes an election under the IRC with respect to an entity's status, the trustee is stuck with the election. Attempts by a trustee to

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259 *Id.* (quoting United States v. Nat'l Bank of Comm., 472 U.S. 713, 722 (1985)).
260 *Id.* at 563.
261 *Id.*
262 *Id.*
263 *Id.* at 566.
264 *Id.* (quoting 26 U.S.C. § 1362(a)(2)).
265 *Id.*
266 *Id.* at 568 (citing Sery v. Fed. Bus. Ctrs., Inc., 616 F. Supp. 2d 496, 505 (D.N.J. 2008)).

use the fraudulent transfer provisions of the Bankruptcy Code—no matter how inequitable the results may be for a debtor-entity's creditors— wrongfully ignores the tenets of the IRC.

### 3. *Why It Matters: The Fresh Start Policy*

The courts' reasoning from *Majestic Star Casino* and *Health Diagnostic Laboratory* in restricting a trustee's ability to avoid tax status change may seem patently unfair to partisans of the Disfavored Approach, since it deprives creditors of value. However, there is a countervailing consideration that these proponents ignore: that allowing a trustee to obviate a shareholder's option to tax status change could cause the taxpayer, and ultimately the non-debtor-owner of the taxpayer, to endure a continued obligation to pay taxes after they have made a conscious choice to enter bankruptcy. That is the inequitable result that BDI and its owner Don Barden would have faced had the trustee in *Majestic Star Casino* gotten its way with respect to MSC II and its QSub status.[267] Don Barden, as the sole owner of the casino enterprise, made a decision to place his ailing business into bankruptcy—a decision that cannot be taken lightly.[268]

When a debtor enters bankruptcy, vendors, customers, and the community in which the debtor is involved inevitably find out about the proceeding, potentially damaging the business relationships of the debtor and the personal reputation of any non-debtor owners.[269] Non-debtor-owners who voluntarily plunge their businesses into bankruptcy have one overarching goal in mind when filing a petition—that of a fresh start after bankruptcy.[270] Looking to the basic goals of the bankruptcy process, the trustee's ambition to treat tax status as property is diametrically opposed to the interests of a debtor: "The principal purpose of the Bankruptcy Code is to grant a 'fresh start' to the 'honest but unfortunate debtor.'"[271] In a situation where a trustee is successful in reversing a prepetition election to C Corp status, and where the trustee sells the assets of

[267] *See* Majestic Star Casino, LLC v. Barden Dev., Inc. (*In re* Majestic Star Casino, LLC), 716 F.3d 736, 741 (3d Cir. 2013).

[268] *See id.* at 742.

[269] *See, e.g.*, 11 U.S.C. § 342.

[270] Jack F. Williams, *The Tax Consequences of Abandonment Under The Bankruptcy Code*, 67 TEMPLE L. REV. 13, 14 (1994) ("To an individual debtor contemplating relief under the Bankruptcy Code . . . nothing appears as precious as the right to discharge. . . . [T]he right to discharge ensures that an honest but unfortunate debtor has a fresh start to begin anew his or her economic life.").

[271] Marrama v. Citizens Bank of Mass., 549 U.S. 365, 367 (2007) (citing Grogan v. Garner, 498 U.S. 279, 287 (1991)).

the debtor-entity, the non-debtor shareholders could be stuck with the tax bill, possibly driving the shareholders into bankruptcy.

The IRC itself, however, recognizes, in certain cases, that a debtor in bankruptcy deserves a new beginning. This is seen, for example, in section 1398 of the IRC,[272] which acknowledges the bankruptcy estate as a separate, taxable entity from an individual debtor when that debtor files a bankruptcy petition, such that "the bankruptcy estate . . . may incur and should pay its own tax liabilities."[273] Section 1398 in effect allows the debtor, at their election, to "shift at least some of his or her tax liability for current year's taxes to the estate," because the taxable income of the estate is computed separately from the debtor's income once the election is filed.[274] I believe section 1398 works in concert with the tax status change provisions and regulations to paint a complete picture of a fresh start for debtors and non-debtor owners. Tax debt should not leave the perimeter of the bankruptcy estate, especially through strongarming by a trustee, given that section 1398 splits the tax impacts of the bankruptcy estate from the debtor once the election is filed.[275] This is further driven home by the point that section 1398 specifically notes that the estate succeeds to the tax attributes of the debtor, although tax status is not specifically mentioned.[276]

Just as has occurred with the tax status change, trustees have tried to combat the benefits conferred to individual debtors that take advantage of section 1398.[277] For instance, in *In re A.J. Lane & Co.*, the trustee in a series of consolidated chapter 11 cases petitioned the court to abandon several pieces of real property so as to "avoid the substantial income tax liability that would be incurred by the bankruptcy estates should the estates be considered owners at the time of the foreclosure sales."[278] The debtor did not want the properties abandoned because doing so would shift the tax gain resulting from the

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[272] *See* 26 U.S.C. § 1398.

[273] *See* Williams, *Tax Consequences of Abandonment*, *supra* note 270, at 15, 21.

[274] *See* 26 U.S.C. § 1398(d)(2)(A), 1398(e); Williams, *Tax Consequences of Abandonment*, *supra* note 270, at 15.

[275] *See* 26 U.S.C. § 1398(c)(1), (e).

[276] *See* 26 U.S.C. § 1398(g)(8). While tax status is not mentioned, section 1398 does highlight that the bankruptcy estate succeeds to "[o]ther tax attributes of the debtor, to the extent provided in regulations prescribed by the Secretary as necessary or appropriate to carry out the purposes of this section." Tax status could and should be included because the IRS issued Treas. Reg. 301.7701-3 (the check the box regulations) which can be argued as appropriate to carrying out the purposes of section 1398, a fresh start for the debtor.

[277] Beyond the discussion of *In re* A.J. Lane & Co. that immediately follows, see also Erickson v. United States (*In re* Bentley), 916 F.2d 431 (8th Cir. 1990), and Samore v. Olson (*In re* Olson), 930 F.2d 6 (8th Cir. 1991).

[278] *In re* A.J. Lane & Co., 133 B.R. 264, 266 (Bankr. D. Ma. 1991).

foreclosure sales from the estates to the debtor.[279] Shifting these tax consequences "would destroy the Debtor's opportunity for a fresh start" by forcing the debtor to pick up the gain after the closure of the bankruptcy estate.[280]

To that end, the court in *A.J. Lane* noted that, because section 1398 transfers tax attributes (including NOLs) to the estate once the election to split tax years is made, "if [the estate] incurs a taxable gain in the disposition of the property he can use the net operating loss carryover to offset the gain [upon foreclosure]."[281] If the trustee were to get its way by abandoning the properties, "abandonment would destroy this symmetry" and the debtor would be forced to shoulder the gain after the closure of the estate without the benefit of the net operating losses to cover the tax. The court reasoned that such a thing "would be particularly unfair here" and went on to find that "the foreclosure following this proposed abandonment creates a clear burden on the Debtor's fresh start, and there is no countervailing policy which overrides this consideration" such that section 1398's "clear" design would otherwise be violated.[282]

Congress's enactment of section 1398 drives home the point that tax status should not be weaponized by a trustee to penalize a non-debtor-owner by forcing tax status reversal, because doing so would saddle the non-debtor-owner with the tax burden from the gain on a taxable sale. The court in *A.J. Lane* noted that the trustee unsuccessfully "attempt[ed] to place form over substance by substituting a different seller in a pending sales transaction," in much the same way that a trustee would attempt to substitute in a non-debtor owner to absorb the tax from a foreclosure sale in a case where the debtor's tax status was changed. Allowing a trustee to reverse a tax status change allowed by the check-the-box regulations goes against the fresh start policy—just like allowing a trustee to go against the tenets of section 1398 and abandon property in an individual debtor case does.

It is not hard to imagine a scenario where Joe, like the couple in *In re Bakersfield Westar*,[283] poured his personal funds into his small S Corp business, attempting to keep it afloat. If, instead of involuntary bankruptcy, Joe voluntarily places Buddy into bankruptcy because he has no more funds to keep the entity afloat, it approaches absurdity to then ask him to shoulder the burden of paying

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[279] *Id.*
[280] *Id.*
[281] *Id.* at 272.
[282] *Id.* at 272, 274.
[283] *See* Parker v. Saunders (*In re* Bakersfield Westar, Inc.), 226 B.R. 227, 229 (B.A.P. 9th Cir. 1998).

a large capital gains tax on the sale of the entity's assets because the S Corp is disregarded for tax purposes. This is an even more ridiculous result considering that, had Joe otherwise organized Buddy as a C Corp, he would have no obligation to pay the tax because the entity is a wholly-contained universe for tax purposes.

Worse still, as happened in *Majestic Star Casino*, is a situation where the debtor-entity's creditors take over the debtor and generate new income through the entity.[284] If a trustee were successful in revoking a debtor's tax status change, the debtor "(and its new equity holders) will continue to enjoy its tax-free status, while [the former non-debtor owner] retains liability for [the debtor's] income taxes, even though [the former owner] has no access to [the debtor's] income and cash flow to fund the tax payments."[285] If this were to happen to Joe, he would be held in perpetual financial servitude to Buddy and its creditors, where "substantial inequities" exist for the non-debtors who are forced to foot the tax bill for an entity in which they no longer enjoy a stake.[286]

Ultimately, the Favored Approach leads to a simple solution for Joe and Buddy LLC: Joe's choice to check the box on Form 8832, changing Buddy LLC to BuddyCorp, would be respected by the courts. If his choice to change his business to a C Corp were challenged, the trustee would, under the Favored Approach, fail to reverse Joe's entity choice through on a fraudulent transfer argument because the court would not consider tax status to fall under the definition of property within the meaning of section 541. The gain from the sale of the PayMore building would still be payable as an administrative expense by the estate and Joe would walk away from BuddyCorp, free and clear.

### *4. An Exceedingly Simple Solution*

To solve this quandary and achieve consistent results in all circumstances, a simple solution is within reach. To resolve the differences between the Disfavored and Favored Approaches and provide clarity, consistency, and predictability to debtors, creditors, trustees, and courts alike, the Bankruptcy Code and the IRC should be amended to explicitly exclude federal tax entity status from the definition of property of the estate. The IRC and associated regulations should be updated to reflect the notion that in no bankruptcy

284 *See* Majestic Star Casino, LLC v. Barden Dev., Inc. (*In re* Majestic Star Casino, LLC), 716 F.3d 736, 746 (3d Cir. 2013).

285 *Id.* at 742.

286 *See id.* at 757.

proceedings are these tax attributes considered property and that they are not otherwise subject to the fraudulent transfer powers of a trustee. Section 541(b) of the Bankruptcy Code should be updated to enumerate tax attributes among those interests excluded from the definition of property. Congress should follow this two-pronged approach instead of only amending the IRC or relying on rule-making authority vested in the IRS and the Treasury, because these cases show that some bankruptcy trustees and judges are unwilling to defer to the repeatedly stated position of the IRS.

Updating both the IRC and the Bankruptcy Code to exclude tax status from the definition of property leads to predictability, consistency, and equity for both debtors and creditors in arranging their affairs before and during a bankruptcy case.

Enhancing predictability allows creditors to make comprehensive lending decisions based on risk. If Buddy LLC's lenders such as the roofer or SeaFirst had been aware the entity had been structured as an SMLLC, they could have built better contractual protections into their loans or working agreements. They could also have required a higher return on principal in order to equitably reflect the heightened level of lending risk. Consistently treating tax status as excluded from the definition of property also streamlines the bankruptcy process because interested parties and the courts will not waste time and energy litigating the issue. A streamlined bankruptcy process leads to a less stressful experience for debtors and creditors and a more expeditious arrival at a fresh start. As Buddy LLC's creditors learned the hard way, there can be financial consequences from lending to an SMLLC with substantially depreciated real property.

## CONCLUSION

"Property" of the bankruptcy estate, as described in section 541, should not include the federal tax status of an entity. Tax status is not specifically enumerated in the Bankruptcy Code or in the IRC as "property." The Second, Eighth, and Ninth Circuits' tortured path to the determination that these "rights" are property subject to a trustee's avoidance powers wrongly obviates the steps taxpayers take to arrange affairs in accordance with the IRC. The judge-made rules improperly rely on general treatises and brief dictionary entries to somehow arrive at a definitive answer to a technical federal tax question. These courts wrongly ignore IRS agency expertise, as well as the plain meaning of the IRC, by focusing on how "intertwined" tax status is with a debtor's affairs. This is little more than thinly-veiled policymaking, carried out by bankruptcy courts, trying to favor creditors beyond what the law permits.

Instead, the Third Circuit's interpretation of "property" in *Majestic Star Casino* should be followed to exclude tax status, because, as the court correctly highlights, control of an entity's tax status belongs with the non-debtor-owner of the entity, not the entity itself. This finding is consistent with the earliest bankruptcy case approaching intangible rights, *Chicago Board of Trade*, and is in line with Congress's treatment of the interaction of the IRC and Bankruptcy Code when it comes to tax matters. Congress should amend the IRC to explicitly provide that tax status is not property of the bankruptcy estate, and should update the Bankruptcy Code's exclusions from property at section 541(b).

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