CHM Co. v. Commissioner, 68 T. C. 31 (1977)

Filing for bankruptcy under Chapter XI or XII by shareholders does not terminate a corporation’s Subchapter S election.

Summary

In CHM Co. v. Commissioner, the U. S. Tax Court ruled that the filing of Chapter XI and XII bankruptcy petitions by two shareholders of CHM Co. did not affect its status as a Subchapter S corporation. CHM Co. had elected Subchapter S status in 1961, and the IRS argued that the subsequent bankruptcy filings created new taxable entities that disqualified the corporation from Subchapter S treatment. The court rejected this view, holding that neither the filings nor the appointment of a receiver created separate entities from the debtors. This decision emphasized the rehabilitative nature of Chapter XI and XII and aligned with the purpose of Subchapter S to support small businesses.

Facts

CHM Co. , a California corporation, elected Subchapter S status in 1961. In 1963, shareholder M. W. Hull filed for bankruptcy under Chapter XI, and in 1969, shareholder J. E. Harbinson filed under Chapter XII. Both listed their CHM Co. shares as assets in their bankruptcy petitions. Hull remained a debtor in possession, while a receiver was appointed for his estate. Harbinson also remained a debtor in possession, with no receiver or trustee appointed. The IRS challenged CHM Co. ‘s Subchapter S status for the tax years ending March 31, 1969, 1970, and 1971, asserting that the bankruptcy filings created new entities that were not qualified shareholders under Subchapter S.

Procedural History

The IRS determined deficiencies in CHM Co. ‘s Federal income tax for the fiscal years ending March 31, 1969, 1970, and 1971, arguing that the bankruptcy filings by shareholders terminated the Subchapter S election. CHM Co. petitioned the U. S. Tax Court, which issued its decision on April 11, 1977, ruling in favor of CHM Co. and maintaining its Subchapter S status.

Issue(s)

1. Whether the filing of a Chapter XI or XII bankruptcy petition by a shareholder of a Subchapter S corporation terminates the corporation’s Subchapter S status.

Holding

1. No, because the filing of such petitions does not create a separate entity from the debtor that would disqualify the corporation from Subchapter S treatment.

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Court’s Reasoning

The court reasoned that neither the filing of a Chapter XI or XII petition nor the appointment of a receiver creates a separate taxable entity from the debtor. The court relied on IRS regulations and prior case law to support this view, emphasizing that the debtor remains the actual taxpayer even when a receiver or trustee manages the property. The court also highlighted the rehabilitative purpose of Chapters XI and XII, which aims to help debtors reach satisfactory agreements with creditors rather than creating new entities. Furthermore, the court noted that the underlying purpose of Subchapter S is to assist small businesses, and terminating the election due to a shareholder’s unrelated financial difficulties would be contrary to this intent.

Practical Implications

This decision provides clarity for Subchapter S corporations facing shareholder bankruptcies under Chapters XI and XII. It ensures that such filings do not automatically jeopardize the corporation’s tax status, allowing small businesses to maintain their Subchapter S election despite individual shareholder financial issues. The ruling encourages a more stable and predictable tax environment for small businesses, aligning with the legislative intent of Subchapter S. Subsequent cases and IRS guidance have followed this precedent, further solidifying the protection of Subchapter S status in similar situations.

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