UNITED STATES COURT OF APPEALS

FOR THE FIRST CIRCUIT

ALPHONSE MOURAD, Petitioner - Appellant,	)	
-V-	)	DOCKET NO. 03-2367
COMMISSIONER OF INTERNAL REVENUE Respondent - Appellee.	)	

September 16, 2004

Boston, Massachusetts

Before:

JUAN R. TORRUELLA, Circuit Judge
FRANK M. COFFIN, Senior Circuit Judge
SANDRA L. LYNCH, Circuit Judge

For the Petitioner:

LESTER E. RIORDAN, III, ESQ.

For the Respondent:

TERESA E. MCLAUGHLIN, ESQ.

Proceedings recorded by electronic sound recording, transcript produced by Apex Reporting.

P R O C E E D I N G S

THE CLERK: The next case will be 03-2367. Alphonse Mourad vs. Commissioner of Internal Revenue.

THE COURT: Mr. Riordan, good morning.

MR. RIORDAN: Good morning. May it please the Court, Less Riordan representing Alphonse Mourad.

Your Honors, let me say at the outset, this case involves of questioned first impression, not just in this Circuit, but in this nation. In light of that, I would request brief rebuttal time, given the importance of the issues, if it pleases the Court.

THE COURT: I think we could hear your argument but if there's some need for additional time, we'd consider it, but --

MR. RIORDAN: All right. Thank you, Your Honor.

Your Honor, the main issue presented here is whether the conduct of bankruptcy terminated S-Corporation status. That, in fact, is the question which hasn't been issued by an appellate court.

What happened in this case was --

THE COURT: When you say the conduct of the bankruptcy, what do you mean? That it terminates --

MR. RIORDAN: What I mean by --

THE COURT: -- on the filing of the bankruptcy petition? On the confirmation? What do you mean?

MR. RIORDAN: I think that the issue about whether the filing was terminated the bankruptcy and the Chapter 11 is a subsidiary issue. And I think in many cases, it will.

THE COURT: Well, yes. But I'd like to know at what point you say the bankruptcy terminates the sub-chapter S election.

MR. RIORDAN: I believe in this case, it terminated at the point in which the trustee was appointed, which was somewhat into the bankruptcy and in which the trustee began to operate the debtor for the benefit of the creditors.

Now, in this case, it comes to a head during the hearing in which Alphonse Mourad is denied standing. And it's my view and I think it's -- Your Honor, the record -- Mr. Mourad, represented himself pro se in the Tax Court so the record is very difficult to follow.

But what happened was is that a tax credit was applied for by the trustee, even though it's a pass through item, which should have been the property of the shareholder, not of the debtor, to prospectively qualify the buyer for it.

The trustee made a decision not to represent the interest of the shareholders in that regard. The shareholder, Mr. Mourad, went to oppose the plan and this Court affirmed a ruling that he had no standing to oppose

that. He had no equity interest.

THE COURT: But he had the opportunity himself, in his personal return, to claim the credit.

MR. RIORDAN: No, I don't believe he did. I believe --

THE COURT: The government has asserted so, and your client made no effort to do so.

MR. RIORDAN: I don't -- my client didn't view -- he was told that he was no longer an owner of the corporation and that he had no standing. My client didn't file a tax return. My client didn't believe that he owed any debt. And what has happened here is that the court denied him the ability to seek that credit. Now --

THE COURT: No. How does that follow?

MR. RIORDAN: Because he attempted -- the credit was applied for for the benefit of the creditor. I don't think there's any --

THE COURT: The credit was applied for going forward and isn't most of your argument about an earlier period of time?

MR. RIORDAN: My belief on the primary argument is that once the trustee started to operate the business, which the tax credit issue is indicative of or evidence of the fact that he was doing it for the creditors; that it no longer became a small business corporation and that it

terminated based on two principles. One, that you can't have shareholders who are not individuals; and No. 2 that it was no longer a small business corporation.

I believe it's appropriate and I think the Foreman case points to this that it terminates on Chapter 11. On the Stadler Case is -- which I'm sure the Court is aware, it indicates that in Chapter 7, in which tax returns over several years are ratified by the shareholders, would not constitute an automatic termination. But a Chapter 11, where you have a trustee appointed, seems to be of a different type of issue.

And in this case, I think the facts show that the --

THE COURT: And how do you get around that statute, which very clearly says there are three ways of terminating?

MR. RIORDAN: Well, Your Honor, we're --

THE COURT: This is tax law, and we're not usually free to invent additions to specified lists, which look like exclusive lists.

MR. RIORDAN: Well, and the first point of that, Your Honor, is, is that we argue that one of the points in that list was violated and that this terminated its status in small business. But there's a couple other --

THE COURT: Yes, but is there anything in the

bankruptcy code that says that sub-chapter S is no longer a small business on the filing of the petition?

MR. RIORDAN: No, there's nothing expressed, either way. So one would have to make a decision the bankruptcy policy would trump this. But look what happened. I mean look at the basic policy of the case that you're addressing for the first time. The creditors receive the property tax-free, and an indigent was burdened with the tax and lost his tax credit, completely lost his tax credit.

Now, in regards -- to follow up on finishing to your question, Your Honor. We believe that it terminated S status. And there's a provision in the code, and I believe it's 1362(f), which says there (unintelligible) terminations. There are terminations that happen as a matter of course. The shareholders have a right to reverse those terminations. That's why I believe the ratification in Stadler is so important.

Mr. Mourad could have certainly voted or consented to continuing S status, but there is no indication that that was done and he certainly would have opposed it. It wouldn't have been to his benefit.

The point being, I think, is that ultimately, what you're looking for is creating S corporations for benefits to the shareholder, providing incentive that the shareholder open the corporation. I think that's what Gietler says very

clearly. Beauford says that, as well, as does the Durango case.

What's being done here is that he's being stripped of a tax credit, because it goes with the property and at the same time, the trustee is qualifying it, while the S corporation allegedly still exists for the benefit of someone else.

THE COURT: I don't understand your answer to Judge Coffin's question about the way the S status can be terminated. Specifically, Section 1362(d), talks about three ways you can do it.

MR. RIORDAN: I agree and --

THE COURT: Which one does this fall under?

MR. RIORDAN: I believe that this terminated its small business corporation status, which is one of those three ways, through the fact that beneficial shareholders were not individuals. Clearly, some of the creditors here were corporations. And in addition to that, we believe it terminated its status because -- because --

THE COURT: By filing the bankruptcy, it automatically terminates a small business corporation status?

MR. RIORDAN: I believe, Your Honor, that the proper rule here is that when you have reorganization -- and think this is relatively clear from the Foreman case. That

when you have a reorganization and it's a real reorganization at the outset that the S corporation status is violated. What Foreman says, where it went from 11 to 7, it says we're going to treat this as an S corporation because the 11 wasn't really intended to reorganize, but was to liquidate.

And in that case it says -- the tax side, the NRL is clearly not property of -- of the corporation. It's the property of the shareholder. And our position is that Mr. Mourad was clearly divested of that. I think you get to this point on the main issue. Mr. Gray, as trustee, had an obligation to the shareholders to apply for that credit, for the benefit of the shareholders. He chose not to do it. He went to a bankruptcy judge and asked for the judge's blessing.

The judge -- I can properly take away Mr. Mourad's shares. But once she does it, it becomes a C corporation.

THE COURT: Let me ask you. When you filed for bankruptcy, did the bankrupt -- did he cease to own 100 percent of the stock?

MR. RIORDAN: Well, I think he ceased owning 100 percent of the stock --

THE COURT: That's a yes or no answer. I --

MR. RIORDAN: But it's no at the filing of the bankruptcy. You have to remember, Mr. Mourad was running

the corporation upon filing. It was taken away from him. But there's no doubt that in the Fall of 1998, the court said you have no equity value. And we know that he must've had some equity value, if he was a shareholder, because he had a right to a credit. And this Court will find itself facing an issue in where this man had no standing to oppose a plan based on known value.

THE COURT: The I.R.S. says that regardless of what happened, he could have filed, as he did every other year, his individual return, taking account of any income and any credits that he received from the sub-chapter S. Your case depends on the proposition that that's not true and that based on equitable principles, we ought to read in a new gloss to the small business corporation language of the statute.

If you're incorrect on the first proposition, you don't even have an equitable argument.

MR. RIORDAN: Judge Lynch, I think -- with all do respect, I think you're absolutely wrong.

THE COURT: Okay. Why?

MR. RIORDAN: The fact of the matter --

THE COURT: Am I correct that that's the I.R.S. position?

MR. RIORDAN: I believe it's the I.R.S. position, but it's a bizarre position, because everyone knows that

under the facts of this case that the property was sold.

THE COURT: That filing of a bankruptcy petition excuses the person who gets the benefit of the sub-chapter S election from filing a tax return?

MR. RIORDAN: No, I don't. I don't believe that's the case.

THE COURT: All right.

MR. RIORDAN: But he doesn't have to file a tax return, if it's no longer a sub-chapter S. And the fact of the matter here --

THE COURT: Then you've become quite circular.

MR. RIORDAN: Well, I don't think it does. Because I think what you have to -- you have to -- this Court affirmed the decision that he had no stock; that he had no equity.

THE COURT: That he had no standing to object to the --

MR. RIORDAN: Based on the fact that he had no equity, Your Honor. And we --

MR. TORRUELLA: You equate that to a transfer of ownership?

MR. RIORDAN: I have to, because we all --

MR. TORRUELLA: No, you don't have to. Legally --

MR. RIORDAN: Legally, I think we have to under the facts. And this is my point. If he had to have equity,

if he was entitled or potentially entitled to a tax credit at the moment this occurred. If he had no equity, if he wasn't entitled to the tax credit -- and if it was an S corporation, he was entitled to the tax credit. So that ruling by this Court in that case implicitly implied that he wasn't entitled to the tax credit.

And we all know that the tax credit was transferred, essentially, to the buyer. That they qualified for it in the S corporation, period, simply to be able to transfer, for the benefit of the creditors.

I think ultimately what you have to decide is at what point does a bankruptcy do damage on what Congress is trying to accomplish in 1362(d)(1) and 1361(b). And really, the question then becomes one of at what point does a small business corporation cease to act like a small business. Clearly, bankruptcy has a lot of the incidences of where that might occur. And I think your ruling that that couldn't occur, would essentially create a preemption of bankruptcy law over federal tax law. I don't think that's the appropriate argument.

In any event, there is no way Mr. Mourad could have applied for the tax credit and I mean as the argument indicates, he never applied for it. Why did he never apply for it? Because the trustee didn't apply for it on his behalf. The trustee applied for it on the behalf of the

people who were buying the property.

Mr. Mourad loses an $11 million tax credit and is saddled with $250,000.00 in taxes. I don't think it's a matter of equity.

THE COURT: I thought the deficiency here was about $150,000.00.

MR. RIORDAN: Well, I mean we have state tax issues I believe, as well, Your Honor. I mean --

THE COURT: Yes. But aren't I correct? What is this $4 million? We're talking about $150,000.00 - $190,000.00.

MR. RIORDAN: Oh, no, the tax credit. The tax credit, which was traded away.

THE COURT: The tax deficiency.

MR. RIORDAN: The -- I said -- I said approximately a quarter million of tax. I think if you take the federal and state tax, that's a good approximation. In any event, the tax credit was worth a significant amount of money and it was stripped away from him.

So what this Court would be then doing is permitting the stripping out of a tax benefit, which court decisions have said are the property of the shareholder. And I think you have to square your decision that says he doesn't have any interest sufficient to be able to argue against this plan and try to reorganize his corporation.

I think then, you're just reading that ruling as being he doesn't have any value in the corporation. And I would suggest that can't be true, if he can potentially apply for a million dollar tax credit. So you're permitting the trustee to cause the shareholders to lose the only benefit they have and then a forced infusion of capital to pay the taxes and allowing the creditors to receive that benefit. Certainly, from a tax question -- standpoint, in this case, the beneficial rule for the FISK would be to find that the corporation terminated.

To follow -- to just briefly go back to the question regarding the basis, I would also point out that the Farmer's Gin case says that there are not -- there are other ways, other than the exclusion provisions listed in 1361(b). In that case, that involved a specific provision relating to a change of ownership in the correct tax year. So it's clear that there are other ways to terminate it.

In that provision, I think it was implicit that the corporation would terminate, if it didn't follow the rules on -- it wasn't expressed. But certainly, that's not the only way. I think that this -- that the policy behind the tax law -- as I think was said by (Unintelligible) in Gillis, which Congress listened to, because they went and corrected it -- says you've got to look to the benefits behind the policy to S corporations. Justice Byron said

exactly the opposite in his dissent; that you should look to tax collection.

I think in this case, tax collection and benefits to the shareholders fall on the side of my client, on the second issue regarding the tax credit, I would submit. Thank you.

THE COURT: Ms. McLaughlin, good morning.

MS. MCLAUGHLIN: Good morning.

May it please the Court, my name is Theresa McLaughlin and I represent the Commissioner. And the Commissioner's position is that the Tax Court was right in deciding that this S corporation status did not terminate, either on the filing of the petition or on the appointment of a trustee.

The Bankruptcy Code, Section 346(C)(1) provides that the commencement of a case under this title, Title 11, concerning a corporation or a partnership does not affect a change in status of such corporation or partnership for purposes of any federal or state income tax law.

The Internal Revenue Code says in Section 1399 that except as provided in Section 1398, a corporate -- a taxpayer's tax status does not change. No separate entity is created by virtue of the filing of a petition in bankruptcy.

Section 1398 is not applicable here. It applies

only to debtors who are individuals who are in Chapter 7 or Chapter 11. And here, the S corporation is the debtor, not an individual. So we're remitted back to the code's provisions regarding termination of S corporation status, which are highly articulated. And to be an S corporation, you have to be an eligible corporation and you have to have an election in effect.

There's no question that going into bankruptcy this corporation was an s corporation. It was eligible and it had an election in effect. Once you have an election in effect, the code expressly provides in Section 1362(c) that the election is in effect, until it is revoked. And there are only three ways in the statute that the election can be revoked.

Two of them clearly don't apply. One is where the shareholders revoke it. And that clearly did not happen here. The second inapplicable one involves three consecutive years of gross receipts, 25 percent of which are passive income. And that clearly is inapplicable.

So the only way that the statute provides that this S corporation election can terminate is if the corporation becomes an ineligible corporation. For instance, if it gets more than 75 shareholders; if any shareholder is a non-resident alien. And there's on that escapes me right now, but it doesn't apply. And the one

that the taxpayer invoked was that an S corporation lose its status, if it has more than one class of stock.

So the way we understand the taxpayer's argument is that once the trustee in bankruptcy was appointed, there's somehow -- or that somehow created more than one class of stock. Now, we don't think that that's the case.

When the code is talking about more than one class of stock, it's -- the plain meaning of that is are rights to share in any dividends equal. Are voting rights equal? Are rights to share in any liquidation proceeds equal? And that's where an S corporation can run afoul of this requirement, if they create preferred stock; if the classes don't have equal voting rights. That simply doesn't apply here.

Now, any theory that the creditors somehow have become stockholders is -- that doesn't work either. Now, conceivably, there could be a recapitalization at some point in the Chapter 11, but that didn't happen here. And as it happens, the creditors are ahead of the shareholders. So that simply --

MR. COFFIN: What about his argument that our prior decision, in effect, said he had no equity; i.e. he no longer had any right in that.

MS. MCLAUGHLIN: Well, that came up later when after the bankruptcy, he tried to set aside the plan of

confirmation on the basis that his lawyer had an undisclosed conflict of interest.

Now, by the time the bankruptcy is over, you know, it's clear when you walk away what happened. But you know, as it happened during it, I mean if the corporation buys a lottery ticket, you know, everything could come up roses. And debtors in Chapter 11 sometimes do emerge, you know, with equity interests.

So while it may have happened that in the event the way things wound up, he wound up with nothing, it certainly didn't -- you know, during it, you know, before everything happened he still had had an equity interest, even if it was worth nothing. And the creditors didn't, because they had a creditors interest. Now, I also briefly --

THE COURT: Ms. McLaughlin, could we go back a couple of steps?

MS. MCLAUGHLIN: Sure.

THE COURT: You said that once the election is made, it is in effect until it has been revoked?

MS. MCLAUGHLIN: Yes.

THE COURT: Is revocation a term of art, which is to say, does the I.R.S. have to accept information from the corporation, and the I.R.S. determines that it has been revoked?

MS. MCLAUGHLIN: Well, if --

THE COURT: Is there -- does there have to be an application to revoke?

MS. MCLAUGHLIN: No, there doesn't have to be. You can lose status, even inadvertently, if your corporation becomes ineligible. For instance, if you got a 76th shareholder. That's once you have an election in effect.

THE COURT: Right.

MS. MCLAUGHLIN: You can lose your status. And the way the statute works, it calls it -- it's either revocation or revoked, in Section -- and the terminology is that the election is in effect, until it is revoked. And then --

THE COURT: But what is the usual mechanism by which the revocation of a small business corporation's status is determined?

MS. MCLAUGHLIN: Well, the way it's determined? I think the shareholders all have to -- the corporation has to elect -- and this is addressed in Section 1361. The corporation has to elect. The shareholders have to consent. And I believe there is a form for that.

THE COURT: The corporation has to elect to no longer be a sub-chapter S?

MS. MCLAUGHLIN: Oh, oh, no. Initially --

THE COURT: No? Well, let's start here with they

have elected to be a sub-S.

MS. MCLAUGHLIN: Yes.

THE COURT: How does one get out of being a sub-S in the normal course of things?

MS. MCLAUGHLIN: In the normal course, where you're not losing your election by -- by having too many shareholders or something like that. You would revoke the election and that's in Section 1362(d)(1). And the statute, itself, doesn't say much, Your Honor.

THE COURT: But usually the taxpayer takes an affirmative step to revoke the election?

MS. MCLAUGHLIN: Yes. And termination, one, by revocation; a, in general an election under sub-section (a) may be terminated by revocation; (b) more than 1/2 of shares must consent to the revocation.

THE COURT: Okay.

MS. MCLAUGHLIN: So then I would also like to touch upon the low income housing credit. And basically, I wanted to clear up the fact that what happened here is that the trustee, on behalf of the estate, sold the estate's main assets, which was a low income housing complex in the Mandela Apartments.

And the buyers of the complex applied to get an allocation of housing credits. And they obtained credits -- an allocation from the state or local housing authority for

the next taxable year, 1998. So it was not the taxpayer who ever applied. And this is a threshold requirement.

There would be questions on the merits, whether the credit would be allowable to V&M Corporation, the taxpayer, because -- but you know, I won't get into that, but there would be questions. But it is clear that V&M never applied for an allocation of credits, which is a prerequisite to the allowance, because there are only a certain number of credits allowed for each state.

THE COURT: You have to apply first to the state and --

MS. MCLAUGHLIN: Yes.

THE COURT: -- and get an allocation from the state, before you can apply for the federal tax credit.

MS. MCLAUGHLIN: Exactly, Your Honor.

THE COURT: And nobody for the tax year '97 ever applied to the state, a necessary prerequisite?

MS. MCLAUGHLIN: Right. And the application was granted for the year 1998, for the buyer of the complex. And this is when the taxpayer, S&M Corporation, didn't own the complex anymore.

THE COURT: Right, right, right. So there's a mismatch in time. But the argument he's making is he used to control the corporation. Had he still controlled it, he could've applied for a tax credit. He lost control. The

trustee comes in. The trustee does not apply for the tax credit for the year '97, and that leaves him in a difficult position.

MS. MCLAUGHLIN: Right. But just as an aside, the low income housing credit came in, in 1986, for property placed in service after 1986. These --

THE COURT: Did V&M ever apply?

MS. MCLAUGHLIN: Not to my knowledge. It's not in the record, but they place it in service in 1981. So I don't think they were eligible for it, anyway.

THE COURT: Oh, okay. Okay.

MS. MCLAUGHLIN: I don't think V&M was eligible for it, anyway. And you have to buy it -- you have to substantially rehab it --

THE COURT: Why was it not eligible earlier, but when the sale is made, it's eligible?

MS. MCLAUGHLIN: Well, a new buyer who buys it and places it in service is eligible.

THE COURT: Okay, because it's a new buyer?

MS. MCLAUGHLIN: Right. And you can only turn over the -- the credit is very complex, but you can't turn it over more than every ten years and get a credit. That's one of the provisions.

THE COURT: Mm-hmm.

MS. MCLAUGHLIN: So and we think it's not unfair

for this income to be passed back. Even aside from everything, a point of fairness has been raised. But the taxpayer enjoyed single level taxation. There was no double tax here. He got the benefit of the depreciation of this apartment complex. And so --

THE COURT: What does that mean? You said he got the benefit of a lower depreciation.

MS. MCLAUGHLIN: He got the benefit on his --

THE COURT: You mean --

MS. MCLAUGHLIN: And this is the way sub-chapter S works and it's perfectly legitimate. But he was able to write off the depreciation of these buildings on his personal income tax returns. And so now that it's sold and the depreciation is recaptured -- and that was a big part of the gain here -- it's really not unfair for the shareholder also to be charged with the income. And in fact, there would be a question whether the corporation should be stuck with that tax to the detriment of the creditors.

So unless the Court has any other questions, I'll rest my --

THE COURT: The tax liability only goes up to the point of the sale, which occurs in late '97, I think?

MS. MCLAUGHLIN: Yes. Well, it's the whole year 1997. And basically, I think that -- there may be other items of income I -- conceivably, such as rent, I suppose.

But once the property is sold, I don't think there would be --

THE COURT: Any further income.

MS. MCLAUGHLIN: Odds and ends.

THE COURT: Okay.

MS. MCLAUGHLIN: Thank you.

MR. RIORDAN: Will the Court permit a rebuttal? A brief one.

THE COURT: All right.

MR. RIORDAN: Your Honor, I can make --

THE COURT: You've got to get a very brief --

MR. RIORDAN: It's going to be very brief. The statement by the I.R.S. as to what happened here is incorrect. What happened is, is V&M had to apply for the credit, because the buyer couldn't qualify. The application for the credit was made while Mr. Mourad was allegedly that and I submitted a reply brief. If the buyer could not have qualified the credit, unless they held the property for ten years or unless it was transferred by a qualified buyer.

There is no doubt --

THE COURT: We'll look at the record.

MR. RIORDAN: All right. Thank you.

(Whereupon, the hearing was concluded.)

CERTIFICATE OF TRANSCRIBER

This is to certify that the attached proceedings before: U.S. COURT OF APPEALS FOR THE FIRST CIRCUIT in the Matter of:

ALPHONSE MOURAD, Petitioner - Appellant,	)	
-V-	)	DOCKET NO. 03-2367
COMMISSIONER OF INTERNAL REVENUE Respondent - Appellee.	)	

Place: Boston, Massachusetts

Date: September 16, 2004

Were held as herein appears, and that this is the true, accurate and complete transcript prepared from the recordings taken of the above entitled proceeding.

J. Mocanu — 05/23/05
Transcriber — Date