

## ‘Disregarding’ a Liquidation: The Bizarre *Browning-Ferris* Case

By Robert A. Clary II and Kevin J. Feeley

Robert A. Clary II is an associate and Kevin J. Feeley is a partner in the tax practice of McDermott Will & Emery LLP in Chicago. The authors would like to acknowledge Martin L. Milner for his efforts in the development of this article. Martin’s insights cannot be “disregarded.” The authors would also like to thank George W. Benson, a partner at McDermott Will in Chicago, for his helpful comments.

In this special report Clary and Feeley examine the Federal Circuit’s recent decision in *Browning-Ferris Industries, Inc.* The report focuses on the seemingly odd conclusion of the court that a conversion by a corporation to limited liability company status under state law does not result in a liquidation for tax purposes.

Copyright 2008 Robert A. Clary II and Kevin J. Feeley.  
All rights reserved.

### Table of Contents

<b>I.</b>	<b>Background</b> . . . . .	1155
	A. Procedural History . . . . .	1155
	B. <i>Coltec</i> II — Time for a Change of Scenery . . . . .	1156
	C. Claims Court Escape Hatch . . . . .	1156
<b>II.</b>	<b>Absentee Parents</b> . . . . .	1157
<b>III.</b>	<b>Entity Classification Regulations</b> . . . . .	1157
<b>IV.</b>	<b>The Claims Court Decision</b> . . . . .	1157
<b>V.</b>	<b>The Arguments on Appeal</b> . . . . .	1158
<b>VI.</b>	<b>Show Me the Regulation</b> . . . . .	1158
<b>VII.</b>	<b>Conclusion: Wounded While Dragon Slaying</b> . . . . .	1159

**(A) A corporation means a business entity organized under federal or state statute . . . and an association;**

**(B) A business entity that has a single owner and is not a corporation is disregarded as an entity separate from its owner.**

What happens for U.S. federal tax purposes when an entity starts out as (A) and as a result of a state law conversion becomes (B)? To this seemingly simple question, most tax practitioners will respond: The corporate

entity liquidates by distributing all of its assets and liabilities to its owner, and the entity becomes a sole proprietorship, branch, or division of its owner. Recently, the U.S. Court of Appeals for the Federal Circuit wrestled with this question in *Browning-Ferris Industries, Inc. & Subsidiaries v. United States* (the *BFI* case).<sup>1</sup> The issue arose in the context of trying to determine whether the former parent of a consolidated group that converted to a limited liability company properly filed an administrative claim for refund. The Federal Circuit reached a most surprising conclusion that will perplex any practitioner who happens on the decision. Even more puzzling is why the court addressed this settled issue at all when the case could have been decided on genuine disputed issues submitted by the parties.<sup>2</sup> A review of the oral arguments<sup>3</sup> in the *BFI* case does little to alleviate this confusion.<sup>4</sup>

A unique set of facts coupled with a role reversal (the government arguing that the petitioner’s refund claims were valid) had all the makings of a strange decision. It did not help that at the background of this odd decision lies the controversial *Coltec* decision — a case that goes to the heart of the government’s attack on what it perceives as artificial loss-generating transactions (a species of tax shelter).

### I. Background

#### A. Procedural History

In tax years 1997 and 1998, Browning-Ferris Industries Inc. (BFI Inc.) was the parent of a group of corporations that joined in the filing of a U.S. consolidated return (the BFI Group).<sup>5</sup> BFI Inc. filed timely returns for tax years 1997 and 1998 on behalf of the BFI Group.<sup>6</sup> Although not

<sup>1</sup>2008 WL 1743903 (Fed. Cir. 2008), *Doc* 2008-8560, 2008 TNT 75-17.

<sup>2</sup>Taxpayers seeking deemed liquidation treatment will argue that the *BFI* case is nonprecedential and limited to refund claims of former common parents on behalf of a consolidated group. As discussed below, however, the *BFI* case may have an unintended impact in other contexts regarding deemed liquidations resulting from state law conversions.

<sup>3</sup>The oral arguments can be accessed by entering case number 2007-5144 at [http://www.cafc.uscourts.gov/oral\\_arguments/searchscript.asp](http://www.cafc.uscourts.gov/oral_arguments/searchscript.asp) (referred to herein as the oral arguments). While this article reproduces portions of the oral arguments where appropriate, space constraints preclude a full discussion of the fascinating and colorful 50-minute oral argument.

<sup>4</sup>On May 15, 2008, the taxpayer petitioned the Federal Circuit for a rehearing of the *BFI* case. That petition is pending.

<sup>5</sup>*Browning-Ferris Industries & Subs., Inc. v. United States*, 75 Fed. Cl. 591 (2007), *Doc* 2007-5635, 2007 TNT 43-17.

<sup>6</sup>*Id.*

described in the opinion, it appears the original returns for those years reflected deductions for substantial capital losses.

On July 30, 1999, Allied Waste North America Inc. (AWNA), a wholly owned subsidiary of Allied Waste Industries Inc. (Allied), acquired BFI Inc. (and its subsidiaries). Allied was the parent of a group of corporations that joined in the filing of a U.S. consolidated group (the Allied Group). As a result of the acquisition, BFI Inc. became a wholly owned subsidiary of AWNA, and BFI Inc. and its subsidiaries became members of the Allied Group.

On October 29, 2004, the U.S. Court of Federal Claims issued its taxpayer-favorable opinion in *Coltec Industries, Inc. v. United States (Coltec I)*.<sup>7</sup> In *Coltec I* the claims court held that Coltec could use the capital loss deductions from its contingent liability transaction because the losses were permissible under a plain reading of the code<sup>8</sup> and no common law-doctrine, including the economic substance doctrine, applied to disrupt the tax consequences mandated by the code.<sup>9</sup>

On December 31, 2004, BFI Inc. converted under the laws of the state of Delaware from a corporation to an LLC known as Browning-Ferris Industries LLC (BFI LLC). Before the conversion, BFI LLC made deficiency payments of roughly \$19 million and \$3.5 million for BFI Group's tax years 1997 and 1998, respectively (presumably following an IRS audit). On May 5, 2005, BFI LLC sought a refund of those taxes. Specifically, it filed administrative claims for refund (Forms 1120X) in the name of BFI Inc. with the IRS for the same years.

On May 10, 2005, the IRS issued a notice disallowing BFI Group's administrative claims for refund. According to the IRS, BFI Inc. based its refund claim on a capital loss generated by a contingent liability tax shelter similar to the one at issue in *Coltec I*.

With the taxpayer's victory in *Coltec I* in the background, Browning-Ferris, Inc. & Subsidiaries filed a refund suit in the same court on July 8, 2005. The complaint alleged that BFI Inc. was a Delaware corporation and the authorized agent for BFI Group for the tax years at issue (1997 and 1998) under the consolidated return regulations.

<sup>7</sup>62 Fed. Cl. 716 (2004), *Doc 2004-21316*, 2004 TNT 214-16.

<sup>8</sup>All references to the code are to the Internal Revenue Code of 1986, as amended.

<sup>9</sup>The prototypical contingent liability transaction involved a corporation with significant contingent liabilities (such as asbestos liabilities). In general terms, this corporation would form a new corporation for the purported purposes of handling the potential claims and litigation. The corporation contributed property to the new subsidiary, and the subsidiary assumed the contingent liabilities. The corporation took the position that the contingent liabilities did not reduce the corporation's basis in its subsidiary stock, and therefore the corporation was able to claim a loss on the sale of the subsidiary stock.

## B. *Coltec II* — Time for a Change of Scenery

On July 12, 2006, the Federal Circuit issued its opinion in *Coltec Industries, Inc. v. United States (Coltec II)*.<sup>10</sup> In *Coltec II* the Federal Circuit disallowed the capital loss deduction on the sale of subsidiary stock because, in the court's view, the taxpayer inappropriately inflated the basis of the stock to generate the capital loss. Specifically, the Federal Circuit held the transaction lacked economic substance and stated that it saw "nothing indicating that the transfer of liabilities in exchange for the note effected any real change in the 'flow of economic benefits,' provided any real 'opportunity to make a profit,' or 'appreciably affected' Coltec's beneficial interests aside from creating a tax advantage."<sup>11</sup> On this basis, the Federal Circuit vacated the decision of the claims court and remanded the case.

*Coltec II* was a complete departure from the decision of the claims court in *Coltec I*. Whereas *Coltec II* undertook an in-depth analysis of the economic substance of each underlying transaction in light of the language and purpose of the applicable code provisions, *Coltec I* challenged the constitutionality of the judicially created economic substance doctrine.

As a result of the Federal Circuit's opinion in *Coltec II*, the taxpayer in the *BFI* case found itself in a federal jurisdiction with an established precedent that an arguably similar contingent liability transaction lacked economic substance. Of the three possible judicial forums to litigate the taxes at issue, the taxpayer's selected forum went from best to worst.

## C. Claims Court Escape Hatch

On June 30, 2006, for no obvious reason, the taxpayer in the *BFI* case engaged the services of new legal counsel. New counsel promptly identified a potential jurisdictional defect for the case that prior counsel had initiated. This defect could be used (opportunistically) to deprive the claims court of jurisdiction, allowing the taxpayer to avoid the binding precedent of *Coltec II*. The jurisdictional question, in short, was how could BFI LLC, an entity that was disregarded (or so one would suppose) for U.S. federal tax purposes as of the date of its conversion (December 31, 2004), file a refund claim with the IRS on behalf of the BFI Group on May 5, 2005? As discussed in more detail below, reg. section 1.1502-77A(a) (effective as of the date of the tax years at issue, 1997 and 1998) provides that the common parent remains the sole agent for a consolidated group until the common parent's existence terminates.

The taxpayer filed a motion to dismiss the *BFI* case without prejudice for lack of proper subject matter jurisdiction.<sup>12</sup> Under the taxpayer's theory, the claims court lacked jurisdiction if a proper administrative claim for refund had not been filed, and a proper administrative

<sup>10</sup>*Coltec Industries, Inc. v. United States*, 454 F.3d 1340 (Fed. Cir. 2006), *Doc 2006-13276*, 2006 TNT 134-10.

<sup>11</sup>*Id.*

<sup>12</sup>In the same time frame, BFI Waste Systems (as a substitute agent for the BFI Group) filed corrected refund claims for years 1997 and 1998 in the same amounts as the refund claims previously filed on May 5, 2005.

claim for refund had not been filed, if (1) under the entity classification regulations, BFI Inc.'s existence had terminated for all U.S. federal tax purposes (including for purposes of filing a refund claim), and (2) the consolidated return regulations provided that a parent's agency ceases when its existence terminates.

The government was not impressed. It viewed this filing as a "ploy" to engage in further forum shopping. It asserted that as a matter of Delaware law, BFI LLC retained group agent status, and that even if BFI LLC was not the right party in interest, the court could approve a party substitution to avoid the waste of resources that would result from an outright dismissal. Of course, the government found itself in the unfamiliar position of arguing that a taxpayer properly filed an administrative refund claim.

Had the taxpayer not filed a motion to dismiss, the government, or the court *sua sponte*, could have asserted this issue as a basis for dismissal on grounds of subject matter jurisdiction. If either had done so successfully after the statute of limitations for the refunds closed, the taxpayer may not have had recourse in any forum. Having discovered the issue first, taxpayer's counsel had to protect its client's rights. That said, a simple protective refund claim in the name of the "correct" successor agent may have sufficed.

## II. Absentee Parents

The common parent of a consolidated group generally serves as the group's sole agent for all U.S. federal income tax purposes, including making administrative claims for refund.<sup>13</sup> The agency of the common parent continues until the existence of the corporation terminates.<sup>14</sup> Under the consolidated return regulation applicable to tax years beginning on or after June 28, 2002, the "existence of a corporation is deemed to terminate if (1) its existence terminates under applicable law, or (2) for Federal tax purposes it becomes either an entity that is disregarded as an entity separate from its owner, or an entity that is reclassified as a partnership."<sup>15</sup>

Unfortunately, the consolidated return regulations that apply to the BFI Group's tax years in question do not explicitly define when the existence of the common parent terminates.<sup>16</sup> As briefed by both the taxpayer and the government and discussed by the claims court, the primary issue thus became whether the existence of BFI Inc. terminated for purposes of reg. section 1.1502-77A when it converted into an LLC.

<sup>13</sup>See reg. section 1.1502-77 (for tax years beginning on or after June 28, 2002) and reg. section 1.1502-77A (for tax years beginning before June 28, 2002). If, however, a member pays a deficiency as a result of its several liability, the member may make a refund claim for the collected amount without regard to reg. section 1.1502-77. See reg. section 1.1502-6(b).

<sup>14</sup>Reg. section 1.1502-77 and 1.1502-77A.

<sup>15</sup>Dubroff et al., *Federal Income Taxation of Corporations Filing Consolidated Returns*, section 14.01 FN 21 (2007) (citing reg. section 1.1502-77(e)).

<sup>16</sup>See reg. section 1.1502-77A.

## III. Entity Classification Regulations

Treasury promulgated the entity classification regulations in 1996 to lessen the uncertainty that existed under the *Kintner* regulations.<sup>17</sup> These regulations provide that:

The Internal Revenue Code prescribes the classification of various organizations for federal tax purposes. Whether an organization is an entity separate from its owners for federal tax purposes is a matter of federal tax law and does not depend on whether the organization is recognized as an entity under local law.<sup>18</sup>

Under the entity classification regulations, a business entity with one owner is classified as either a corporation or a disregarded entity.<sup>19</sup> The default classification of a domestic LLC with one owner is a disregarded entity.<sup>20</sup> If an entity is disregarded, its activities are treated in the same manner as a sole proprietorship, branch, or division of the owner.<sup>21</sup> However, the entity classification regulations contain exceptions to disregarded status. Specifically, reg. section 301.7701-2(c)(2)(iii)(A) provides that an entity that is otherwise disregarded as separate from its owner is treated as an entity separate from its owner for purposes of (1) federal tax liabilities of the entity with respect to any tax period for which the entity was not disregarded;<sup>22</sup> (2) federal tax liabilities of any other entity for which the entity is liable;<sup>23</sup> and (3) *refunds or credits of federal tax*.<sup>24</sup>

## IV. The Claims Court Decision

The claims court's analysis focused on the consolidated return regulations that determine an entity's ability to act as an agent for a consolidated group, specifically reg. section 1.1502-77A. Finding that BFI Inc.'s existence terminated for all purposes on its conversion to an LLC in 2004, the court ruled that BFI Inc.'s existence terminated for purposes of the consolidated return regulations, and thus BFI Inc. could not have filed a proper administrative refund claim with the IRS in 2005. Specifically, the claims court stated:

By converting from a corporation into what became a disregarded entity for tax purposes, BFI, Inc. was deemed to have distributed 'all of its assets and liabilities to its single owner in liquidation.' Treas. Reg. Section 301.7701-3(g)(1)(iii); see also Rev. Rul. 2004-59, 2004-1 C.B. 1050 (effect of conversion of a partnership into a corporation pursuant to state conversion statute is determined by Treas. Reg. §

<sup>17</sup>See T.D. 8697, 61 *Fed. Reg.* 66,584 (1996). For a full discussion of the treatment of LLCs under the entity classification regulations, see Mark J. Silverman, Lisa M. Zarlenga, and Derek E. Cain, "Use of Limited Liability Companies in Corporate Transactions," *Tax Notes*, Sept. 21, 1998, p. 1469, *Doc 98-28524*, 98 *TNT* 182-95.

<sup>18</sup>Reg. section 301.7701-1(a)(1).

<sup>19</sup>See reg. section 301.7701-1(a)(4).

<sup>20</sup>See reg. section 301.7701-3(b)(1)(ii).

<sup>21</sup>See reg. section 301.7701-2(a).

<sup>22</sup>Reg. section 301.7701-2(c)(2)(iii)(A)(1).

<sup>23</sup>Reg. section 301.7701-2(c)(2)(iii)(A)(2).

<sup>24</sup>Reg. section 301.7701-2(c)(2)(iii)(A)(3).

301.7701-3(g)(1)). BFI, Inc. therefore liquidated for federal tax purposes as a result of the conversion into BFI, LLC under Delaware law. This liquidation of BFI, Inc. constituted a termination of its existence as the common parent of the BFI Group for federal tax purposes. Due to the liquidation, BFI, Inc. ceased to be the parent of the BFI Group.<sup>25</sup>

The decision evidenced no suspicion relative to the taxpayer's motivations for seeking the dismissal. It also showed no sympathy to the government's complaint that it had expended substantial resources in responding to the claims for refund. In the claims court's view, those considerations cannot influence a determination that goes to the court's subject matter jurisdiction.

### V. The Arguments on Appeal

The government promptly appealed the *BFI* case to the Federal Circuit. The government argued that the third carveout in reg. section 301.7701-2(c)(2), which treats a disregarded entity as regarded for purposes of "refunds or credits of federal tax," enabled BFI LLC to file the refund claims at issue. During oral arguments, the parties briefly addressed the carveout regulation, which was referred to as the "overlooked regulation" because the claims court failed to address it.<sup>26</sup> Ironically, as discussed below, the Federal Circuit's opinion also overlooked the "overlooked regulation."

The government's second principal argument was that even if BFI Inc. did terminate for all tax purposes, reg. section 1.1502-77A required a state law dissolution, and thus BFI LLC retained agency authority for tax years 1997 and 1998.<sup>27</sup>

In response, the taxpayer argued that BFI LLC lacked the authority to file the administrative refund claim. Specifically, the taxpayer argued that (1) the overlooked regulation does not apply, because the regulation speaks only to receiving refunds or credits, and not to qualification for filing a valid claim for refund<sup>28</sup>; and (2) that a termination of a corporation for agency purposes under reg. section 1.1502-77A could be accomplished by way of becoming disregarded for tax purposes. That is, the taxpayer equated disregarded status with terminated status.

Without commenting on the relative merits of each party's contentions, the parties clearly clashed on their interpretation of the applicable regulations, providing the Federal Circuit two avenues for reversal: (1) the Federal Circuit could apply the "overlooked regulation" and hold that BFI Inc. was not disregarded for purposes of filing the administrative refund claims for 1997 and 1998; or (2) the Federal Circuit could disagree with the claims court and hold that a termination under reg. section

1.1502-77A required a state law dissolution. Unfortunately, the Federal Circuit chose neither, and detoured into an analysis on whether the conversion was a deemed liquidation under reg. section 301.7701-3(g)(1). Deciding it was not, it held that the claims court erred in finding that BFI Inc. liquidated for U.S. federal tax purposes.

### VI. Show Me the Regulation

A comprehensive treatment of the issues raised by the parties would have entailed determinations on (1) whether BFI Inc. ceased to exist (that is, did BFI Inc. liquidate?) for U.S. federal tax purposes as a result of its conversion to an LLC; (2) assuming Issue 1 is answered in the affirmative, whether filing a refund claim with the IRS is a U.S. federal tax purpose for which BFI Inc. is disregarded under reg. section 301.7701-2(c)(2) (the application of the so-called overlooked regulation); and (3) if BFI Inc. did cease to exist for U.S. federal tax purposes, whether its existence terminated for purposes of reg. section 1.1502-77A, such that it could not act as the agent for the BFI Group.

The Federal Circuit did not address inquiries (2) and (3) above but rather focused solely on whether BFI Inc. "liquidated" on its conversion to an LLC. Before the BFI case, most would have regarded this as the simplest question of the three presented above. Doesn't it go without saying that when a corporation converts under local law to an LLC, that corporation is deemed to distribute all its assets to its shareholders in liquidation? If not, what alternative characterization could possibly apply? Unfortunately, pointing to a specific section of the code or regulations that explicitly provides for a deemed liquidation when the change in classification occurs under the default rules is more difficult than one may think.

During oral arguments and as reflected in its opinion, the Federal Circuit dutifully searched for the tax mechanics for a liquidation of BFI Inc. Specifically, the Federal Circuit stated:

In order for [BFI] Inc.'s motion to dismiss to succeed, [BFI] Inc. had to convince the Court of Federal Claims that [BFI] Inc. ceased to exist before the refund claims for 1997 and 1998 were filed. Because [BFI] Inc. continued to exist under Delaware law after its conversion to [BFI] LLC, [BFI] Inc.'s failure to exist had to be demonstrated under federal tax law.<sup>29</sup>

Similarly, during oral arguments, Circuit Judge Raymond C. Clevenger III posed the following question to the taxpayer's counsel:

What provision of law terminated [BFI] Inc. as of the date of the conversion?<sup>30</sup>

Underlying these questions is the assumption that establishing that an entity is disregarded does not suffice to deprive a corporation of its agent status for consolidated return purposes. It had to liquidate in a manner recognized by the code or regulations. Accordingly, if the

<sup>25</sup>See note 5 *supra*.

<sup>26</sup>Oral arguments.

<sup>27</sup>In at least one other tax area, an entity born from a conversion is treated as a continuation of the former entity. See LTR 200315001 (April 11, 2003) (conversion does not result in new obligor under the debt modification regulations); LTR 200630002 (July 28, 2006) (same).

<sup>28</sup>See taxpayer's brief, 2007 WL 4739083, at p. 17.

<sup>29</sup>See note 1 *supra*.

<sup>30</sup>Oral arguments.

taxpayer (or government, for that matter) had pointed to a provision of the regulations that explicitly provided liquidation treatment on a conversion from a corporation to LLC, the case could have come out differently.

So why was an answer so hard to find? Everyone knows that when a corporation converts to a single-member LLC, it is deemed to distribute all of its assets, provided it does not simultaneously “check the box” to be classified as an association. In support of this obvious outcome, taxpayer’s counsel pointed to reg. section 301.7701-3(g)(1)(iii).<sup>31</sup> Circuit Judge Clevenger skeptically responded:

If the federal law said when a corporation converts to an LLC then we will treat the transaction as a deemed liquidation of the corporation, then that’s so easy to say, if somebody wanted to say that in this very, very precise set of regulations, I mean my God, they are precise, they would have written it. . . . My problem sir is that you don’t fit in my judgment in what I call little (iii), there’s just no way you can get [BFI] Inc. in there literally. . . . You have to get [BFI Inc] deemed liquidated and you have only cited one provision of the vast tax code in which there could be a deemed liquidation that could apply to this case.<sup>32</sup>

To be sure, reg. section 301.7701-3(g)(1)(iii) does not apply to cause a liquidation in the *BFI* case, because *BFI* Inc. was not an eligible entity and did not elect to be treated as a disregarded entity. Nevertheless, this regulation is frequently cited by commentators for that exact proposition.<sup>33</sup> Perhaps it is so cited because no other provision in the entity classification regulations explicitly describes the treatment of a conversion from corporate to LLC status and resultant change in classification under the default rules.

So is this a genuine issue that the entity classification regulations leave open? Not according to the government’s own rulings that make clear that a conversion to LLC status results in a liquidation.<sup>34</sup> Further, there is no ruling (published or private) suggesting that the government disputes that a deemed liquidation occurs for tax purposes when a corporation converts to LLC status.

The claims court recognized that the entity classification regulations did not explicitly treat a conversion as a

liquidation. To bridge this gap, the claims court cited Rev. Rul. 2004-59.<sup>35</sup> In that ruling, the IRS held that the conversion of a partnership to a corporation under a formless state law conversion statute is treated the same as an election by a partnership to be treated as a corporation under reg. section 301.7701-3(g)(1)(i). The analogy seemed apt, making it easy for the claims court to find that the conversion by a corporation to an LLC under a formless conversion statute should be treated the same as an election for an association to be treated as a disregarded entity under reg. section 301.7701-3(g)(1)(iii). While it is doubtful the government would take issue with this finding, it did little during the oral arguments to expound on what was and was not the federal tax treatment of a conversion. For the most part it remained silent on the matter.

Accordingly, the taxpayer had to satisfy the court that a conversion of a corporation to an LLC results in a deemed liquidation of the corporation. Circuit Judge Clevenger was explicit on the petitioner’s burden:

You have to kill [BFI Inc]. You have to slay the dragon so to speak. You have to liquidate it. You have to get it deemed liquidated. And you have only cited one provision of the vast tax code in which there could be a deemed liquidation that would apply to this case.<sup>36</sup>

Both parties acknowledged that Delaware law left the dragon unscathed. Tax law had to deliver the decisive blow. In the Federal Circuit’s view, it did not, thus obviating an analysis of whether a disregarded agent retained agent status for purposes of filing for refunds and credits:

The Court of Federal Claims erred in its belief that the above-cited [reg. section 301.7701-3(g)(1)(iii)] deemed liquidation regulation applies to the facts of this case. It does not, and in the absence of any other authority cited to produce the hypothetical demise of [BFI] Inc. for purposes of filing the tax refund requests for 1997 and 1998, we must reverse the ruling that [BFI] Inc. ceased to exist as of the date of its conversion to LLC.

Following oral argument, the taxpayer’s counsel probably felt a sense of dismay, realizing that the Federal Circuit was taking issue with what it may have considered a noncontroversial position — that is, that a conversion necessarily results in a liquidation for tax purposes. How can an entity survive the event that causes it to be disregarded? Apparently the court discovered a new realm of tax existence — a state of limbo in which converted entities roam.

## VII. Conclusion: Wounded While Dragon Slaying

The Federal Circuit’s insistence on finding an explicit authority that would deem a liquidation of *BFI* Inc. undoubtedly stemmed from the emphasis that the claims

<sup>31</sup>See taxpayer’s brief, 2007 WL 4739083 (“When a corporation becomes a disregarded entity, it is deemed for federal tax purposes to distribute all of its assets and liabilities to its single owner in ‘liquidation.’ Treas. Reg. Section 301.7701-3(g)(1)(iii)”). See also oral arguments.

<sup>32</sup>Oral arguments.

<sup>33</sup>See Bittker and Eustice, *Federal Income Taxation of Corporations and Shareholders*, 7th Ed., para. 2.02[3][b] (citing reg. section 301.7701-3(g)(1)(iii) for the proposition that a liquidation occurs when an entity changes from “corporate to noncorporate status”).

<sup>34</sup>See e.g., LTR 200720010 (May 18, 2007), *Doc* 2007-12200, 2007 TNT 98-22; LTR 200709013 (Mar. 2, 2007), *Doc* 2007-5483, 2007 TNT 43-32; LTR 200708015 (Feb. 23, 2007), *Doc* 2007-4715, 2007 TNT 38-89; LTR 200701018 (Jan. 5, 2007), *Doc* 2007-528, 2007 TNT 5-16; LTR 200645012 (Nov. 10, 2006), *Doc* 2006-22962, 2006 TNT 219-29.

<sup>35</sup>Rev. Rul. 2004-59, 2004-1 C.B. 1050, *Doc* 2004-11176, 2004 TNT 102-6.

<sup>36</sup>Oral arguments.

court placed on reg. section 301.7701-3(g)(1)(iii) as a predicate for its holding that BFI Inc. had terminated on its conversion to a single-member LLC. Overturning the claims court based solely on the inapplicability of this regulation to a conversion transaction does not reveal the Federal Circuit's thinking on the tax consequences of a conversion. The Federal Circuit may have believed that the deemed distribution of assets on a conversion fell just short of a liquidation. Or it may not have understood that a conversion resulted in a deemed distribution of all of BFI Inc.'s assets for tax purposes.

Returning to our initial question, what occurs for U.S. federal tax purposes when a corporation converts under local law into an LLC? Despite the Federal Circuit's decision, the answer is a deemed liquidation. It was the taxpayer's burden in the *BFI* case to convince the Federal Circuit that this was the correct outcome. When it became clear during oral argument that the petitioner was not meeting this burden, the government chose not to intercede in defense of the deemed liquidations described in its numerous rulings. Specifically, Circuit Judge Clevenger asked counsel for the government the following question:

How could there be a deemed liquidation of BFI Inc. under [reg. section 301.7701-3(g)(3)(iii)] if you read it literally?<sup>37</sup>

<sup>37</sup>Oral arguments.

The following response by counsel for the government suggests that conceding this rather basic point was not worth the risk of potentially letting the taxpayer escape *Coltec II*:

If you read it literally there wasn't.<sup>38</sup>

In the end, the government could have been more fulsome in explaining the tax effect of a conversion. Its arguments did not depend on proving that BFI Inc. did not liquidate for tax purposes. A more principled approach would have conceded (in brief or on rebuttal) the deemed liquidation, arguing instead that such a result does not divest the continuing entity of its group agent status (under state law or under the "overlooked regulation"). Silence on this point in the face of a confused court raises the question whether, in litigating high-profile tax shelter (or so described by the government) cases, the government is willing to compromise on broader and more fundamental principles of tax law? If so, it risks greater uncertainty in the law. To make amends, the government should make clear that it rejects any suggestion that a corporation does not liquidate when it converts to a single-member LLC. Whether the *BFI* case will result in collateral damage to the relative certainty of entity classification regulations remains to be seen.

<sup>38</sup>Oral arguments.

#### SUBMISSIONS TO TAX NOTES

*Tax Notes* welcomes submissions of commentary and analysis pieces on federal tax matters that may be of interest to the nation's tax policymakers, academics, and practitioners. To be considered for publication,

articles should be sent to the editor's attention at [taxnotes@tax.org](mailto:taxnotes@tax.org). A complete list of submission guidelines is available on Tax Analysts' Web site, <http://www.taxanalysts.com/>.