RUCHELMAN

the next generation of tax

INSIGHTS

EXCHANGES OF INFORMATION IN TAX MATTERS AND FUNDAMENTAL RIGHTS OF TAXPAYERS – E.C.J. DELIVERS LANDMARK RULING IN THE AFTERMATH OF BERLIO

WATCH OUT WHIRLPOOL: THE I.R.S. HAS PUT 50 MILLION WRINKLES IN YOUR PERMANENT PRESS CYCLE

WAIT NO LONGER, THE OTHER SHOE WON'T DROP IN DENMARK

AND MORE

Insights Vol. 7 No. 6

TABLE OF CONTENTS

EDITORS' NOTE

In this month's edition of *Insights*, our articles address the following:

- **Exchanges of Information in Tax Matters and Fundamental Rights of Taxpayers – E.C.J. Delivers Landmark Ruling in the Aftermath of *Berlioz*.** In a post B.E.P.S. world, tax transparency is a mantra among stakeholders in government, media, and nongovernmental organizations. The taxpayer may own the funds, but the stakeholders wish to ensure that a chunk of the funds are spent as they deem appropriate. In this environment, governments have a stake in obtaining information on where taxpayers hold their funds and exchanges of information between governments has become a regular occurrence. In the European Union, questions arise as to whether an information request violates a taxpayer's fundamental rights, and in the event of a fishing expedition, whether the taxpayer has an effective remedy. In a recent decision issued by the E.C.J., the court held that financial institutions holding information have rights to intervene, but not taxpayers must wait until a tax authority assesses tax. Werner Heyvaert, a partner in the Brussels Office of AKD Benelux Lawyers and Vicky Sheikh Mohammad, an associate in the Brussels Office of AKD Benelux Lawyers, explain the rationale of the court and question the validity of its conclusion.

- **Watch Out Whirlpool: The I.R.S. Has Put 50 Million Wrinkles in Your Permanent Press Cycle.** As 2020 comes to a close, Subpart F is approaching its 59th anniversary as part of the Internal Revenue Code. During that period of time, various portions have been revised, but by and large, the branch rule has remained untouched. Under that rule, a C.F.C. based in a country that exempts income of a permanent establishment can be treated as two companies where manufacturing takes place in one country and selling activity takes place in a different country. From a U.S. viewpoint, the same abusive tax planning can be undertaken between the head office and the branch as can be undertaken between brother-sister or parent-subsidiary C.F.C.'s. Nonetheless, no taxpayer ever lost a case brought by the I.R.S. until this year. In *Whirlpool Financial Corp. v. Commr*., Whirlpool Corporation determined that the branch rule regulations were invalid when manufacturing operations were conducted by the branch and selling activities were conducted by the head office. Arguing that the law permitted the loophole because a single corporation conducted the manufacturing operations, Whirlpool became the first U.S. Shareholder to lose a case in which the I.R.S. asserted the application of the branch rule to a manufacturing branch. Gianluca Mazzoni, S.J.D. 2020 and L.L.M.2016 International Tax, University of Michigan Law School, explains the plan that was adopted, the argument presented by the taxpayer, the decision of the court, and the likely issues that will be addressed on appeal.

- **Final Regs Implement Changes to Source-of-Income Rules for Inventory Sales.** In late 2019, the I.R.S. proposed regulations modifying rules for determining the source of income from sales of inventory property produced by a taxpayer outside the U.S. and sold within the U.S., or produced by the taxpayer within and sold without the U.S. Final regulations were published in

October. The regulations implement changes made by the Tax Cuts and Jobs Act provide guidance under Code §865(e)(2) regarding sales of inventory through a U.S. office or fixed place of business. In her article, Léa Verdy, an attorney admitted to practice in New York and Paris, presents the sourcing rules for sales of inventory before the T.C.J.A, the changes implemented by the T.C.J.A., the guidance offered by the I.R.S., and the consequences of the regulations for taxpayers.

- **With Great Power (Control) Comes Great Responsibility – Form 5471 Category 4 Filer.** Like Spiderman, it is imperative that controlling shareholders of foreign corporations must recognize that if they have the power to control a foreign corporation, they face a greater responsibility when filing Form 5471, the reporting form for ≥10% shareholders. Neha Rastogi and Galia Antebi take a deep dive into the reporting obligations of a Category 4 Filer. Must read for those U.S. persons that reside outside the U.S. and operate through owner managed businesses.

- **Wait No Longer, the Other Shoe Won't Drop in Denmark.** It seems in the world of transfer pricing litigation, a pattern of mutual expectations has emerged. Companies expect tax authorities to take revenue-maximizing positions and expect courts see the issue more clearly and vacate or substantially vary the assessment of the tax authority. At the same time, tax authorities expect that courts will uphold audit findings of material transfer pricing income adjustments using methods and data overlooked or ignored by companies. In October, the Danish Tax Agency received a decision from the Western High Court concerning an appeal originating from a transfer pricing audit commenced in 2006. Michael Peggs explains the reasons for the 14-year marathon and ponders whether transfer pricing norms in a post-B.E.P.S. world will put an end to this type of examination.

- **Don't Let Your I.T.I.N. Expire.** Individual Taxpayer Identification Numbers ("I.T.I.N.'s") are required by any individual who has a U.S tax filing obligation but is not eligible to be issued a Social Security Number. Without affixing an I.T.IN to a document filed with the I.R.S., it is extremely difficult for the document to be tracked by I.R.S. computers. When used on documents, an I.T.I.N. expires every five years. Otherwise, it expires after three consecutive years of non-use. In a series of F.A.Q.'s, Galia Antebi and Samantha Benenson address important questions. When do I.T.I.N.'s expire? Should you renew your I.T.I.N. if you are issued an S.S.N.? What are the implication of an expired I.T.I.N.? Can an I.T.I.N. be renewed before it is set to expire?

Enjoy the read!

- The Editors

EXCHANGE OF INFORMATION IN TAX MATTERS AND FUNDAMENTAL RIGHTS OF TAXPAYERS – E.C.J. DELIVERS LANDMARK RULING IN THE AFTERMATH OF *BERLIOZ*

Authors
Werner Heyvaert
Vicky Sheikh Mohammad

Tags
A.E.O.I.
Berlioz
E.C.J.
Exchange of Information
Foreseeably Relevant Information
Sabou

Werner Heyvaert is a senior international tax lawyer based in Brussels (Belgium) and a partner with AKD Benelux Lawyers. He combines a transactional and advisory practice with tax litigation before all Belgian courts. Earlier in his career, he was based in Amsterdam, Luxembourg and New York.

Vicky Sheikh Mohammad is a tax lawyer at AKD Benelux Lawyers. His practice combines a transactional and advisory practice with tax litigation.

BACKGROUND FOR NON-EUROPEAN READERS

The Court of Justice of the European Union ("C.J.E.U.") is the European Union's judicial arm. When people talk about the C.J.E.U., they are usually referring to the European Court of Justice ("E.C.J."). However, the C.J.E.U. includes the General Court and the European Civil Service Tribunal in addition to the E.C.J. They all serve different purposes.

Two additional sources of confusion may exist, as well. First, the E.C.J. is often confused with the European Court of Human Rights ("E.C.H.R."). The E.C.J. rules on E.U. law, while the E.C.H.R. rules on the European Convention on Human Rights, which covers the 47 Member States of the Council of Europe. Second, an Advocate General ("A.G.") assists the E.C.J.. The job of the A.G. is to provide an independent opinion on each case. These opinions offer impartial advice to the judges to help them reach their decision and are not binding – even where the E.C.J. reaches the same conclusion as the A.G., it may do so for different reasons. The tricky thing is that, too often, the A.G.'s opinion is either presented as a judgment of the E.C.J. or as something the E.C.J. will almost certainly follow. Neither assertion is true.

INTRODUCTION

On October 6, 2020, the European Court of Justice ("E.C.J.")[1] delivered a landmark ruling in Joined Cases C-245/19 and C-246/19[2] about the fundamental right to an effective remedy in the context of cross-border exchange of information between Member States of the European Union ("E.U.") in application of Directive 2011/16/EU on Administrative Cooperation in the Field of Taxation ("D.A.C.").[3] In contrast with the Opinion of its A.G.,[4] the E.C.J. ruled that, when *indirect* remedies are available, Member States can deny the taxpayer under investigation and other third parties concerned the right to a *direct* judicial remedy.

1. Reported at https://curia.europa.eu.
2. E.C.J., 6 October 2020, Joined Cases C-245-19 and C-246/19, *Luxembourg v B and Others*, ECLI:EU:C:2020:795 ("Ruling").
3. Council Directive 2011/16/EU of 15 February 2011 on Administrative Cooperation in the Field of Taxation and Repealing Directive 77/799/ EEC, OJ L 64, 11 March 2011, pp. 1-12 ("D.A.C.").
4. Opinion of A.G. Kokott, 2 July 2020, Joined Cases C-245/19 and C-246/19, *Luxembourg v B and Others*, ECLI:EU:C:2020:516 ("Opinion A.G.").

In the aftermath of *Sabou* in 2013 (C-276/12)[5] and *Berlioz* in 2017 (C-682/15),[6] the decision sets new standards for fundamental rights in the era of information exchange.[7]

---

5 E.C.J., 22 Oct. 2013, Case C-276/12, *Jiří Sabou v. Finanční ředitelství pro hlavní město Prahu*, ECLI:EU:C:2013:678 ("*Sabou*"); For a detailed analysis of this case, see: J. Calderon and A. Quintas, "The Taxpayer's Right of Defence in Cross-Border Exchange-of-Information Procedures," *Bulletin for International Taxation*, 2014, Vol. 68, Issue 9, pp. 498-507; G. Zeyen, "*Affaire Sabou: en route vers un droit à l'information garanti à l'échelle européenne du contribuable,*" *Revue générale du contentieux fiscal*, 2014, Issue 3-4, pp. 234-241; C.-G. Fernlund, "*Quelques réflexions sur la jurisprudence de la Cour de justice de l'UE en matière d'échanges d'informations dans le domaine des impôts directs,*" in *Liber Amicorum Vassilios Skouris*, Brussels, Bruylant, 2015, pp. 215-225.

6 E.C.J., 16 May 2017, Case C-682/15, *Berlioz Investment Fund SA v. Directeur de l'administration des Contributions directes*, ECLI:EU:C:2017:373 ("*Berlioz*"); For a detailed analysis of this case, see: E.C.J. Taskforce, "CFE Opinion Statement ECJ-TF 3/2017 on the Decision of the Court of Justice of the European Union of 16 May 2017 in Berlioz Investment Fund SA (Case C-682/15)," *European Taxation*, 2018, Vol. 58, Issue 2-3, pp. 93-96; J. Frey, A. Jupp and F.-M. Schwarz, "The CJEU's Berlioz Judgment: A New Milestone on Procedural Rights in EU Audits," *Tax Notes International*, 2017, pp. 679-689; L. Neve, "The Berlioz-decision of the CJEU provides legal protection for concerned persons in transnational setting, but will it hold in the international area?" *Review of European administrative law*, 2017, Vol. 10, Issue 2, pp. 95-119; P. Malherbe, "*Arrêt Berlioz: Contester la pertinence vraisemblable des renseignements fiscaux à échanger,*" *Journal de droit européen*, 2017, Issue 9, pp. 361-363; C. Docclo, "*La pertinence, vraisemblable ou non, des informations échangées entre administrations fiscales et la perspective des déclarations de dispositifs transfrontaliers prévues par DAC 6,*" *Journal de droit fiscal*, 2018, Issue 7-8, pp. 242-253; A. Maitrot de la Motte, "*Cour de justice, gde ch., 16 mai 2017, Berlioz Investment Fund SA c/ Directeur de l'administration des contributions directes, aff. C 682/15, ECLI:EU:C:2017:373, Jurisprudence de la CJUE 2017,*" in *F. Picod (dir.), Jurisprudence de la CJUE 2017 – Décisions et commentaires*, Brussels, Bruylant, 2018, pp. 450-466; D. Berlin, "*Souveraineté et protection des droits fondamentaux,*" *Revue des affaires européennes*, 2017, Issue 2, pp. 307-320; S. De Raedt, "*De reikwijdte van de rechtsbescherming bij internationale uitwisseling van fiscale inlichtingen verder toegelicht,*" *Tijdschrift voor Fiscaal Recht*, 2017, Vol. 18, Issue 530, pp. 853-857.

7 On this topic, see B. Gangemi, "General Report," in I.F.A., *Cahiers de Droit Fiscal International. Vol 75b – International Mutual Assistance through Exchange of Information*, Deventer, Kluwer Law and Taxation Publishers, 1990; X. Oberson, "General Report," in I.F.A., *Cahiers de Droit Fiscal International. Vol. 98b – Exchange of information and cross-border cooperation between tax authorities*, The Hague, I.B.F.D., 2013 ; J.M. Calderón, "Taxpayer Protection within the Exchange of Information Procedure Between State Tax Administrations," *Intertax*, 2000, Vol. 28, Issue 2, pp. 462-475; T. Schenk-Geers, *International Exchange of Information and the Protection of Taxpayers*, Zuidpoolsingel, Kluwer Law International, Coll. Eucotax, 2009, 344 pp.; N. Diepvens and F. Debelva, *op. cit.*, pp. 210-219; F. Debelva, "*Internationale fiscale gegevensuitwisseling op basis van artikel 26 DBV's en de vraag naar rechtsbescherming,*" *Algemeen Fiscaal Tijdschrift,* 2015, Issue 1, pp. 5-32; N. Diepvens and F. Debelva, "The Evolution of the Exchange of Information in Direct Tax Matters: The Taxpayer's Rights under Pressure," *EC Tax Review*, 2015/4, pp. 210-219; P. Baker and P. Pistone, "The Practical Protection of Taxpayers' Fundamental Rights: General Report," in I.F.A., *Cahiers de droit fiscal international. Vol. 100B – The Practical Protection of Taxpayers' Fundamental Rights*, The Hague, I.B.F.D., 2015, pp. 17-68; P. Baker and P. Pistone, "BEPS Action 16: The Taxpayers' Right to an Effective Legal Remedy Under European Law in Cross-Border Situations," *EC Tax Review*, 2016, Vol. 25, Issue 5-6, pp. 335-345; S. André Rocha, "Exchange of Tax-Related Information and the Protection of Taxpayer Rights: General Comments and the Brazilian Perspective," *Bulletin for International Taxation*, 2016, Vol. 70, Issue 9, pp. 502-516; M. G. De Flora, "Protection of the Taxpayer in the Information Exchange Procedure," *Intertax*, 2017, Vol. 45, Issue 6-7, pp. 447-460.

BACKGROUND AND ISSUES: FUNDAMENTAL RIGHTS IN THE ERA OF EXCHANGE OF INFORMATION

Since the Great Recession,[8] the international exchange of information in direct tax matters has evolved considerably.[9] This reflects the growing awareness among tax authorities, progressive journalists, and non-governmental organizations ("N.G.O.'s") that wealthy individuals and large multinational corporations engage expert advisers to fashion effective tax plans resulting in the payment of little or no taxes. Think of the investigations carried out by the International Consortium of Investigative Journalists that revealed the *Lux Leaks, Swiss Leaks*, and *Panama Papers*. Given the pressure of mass media and the indignation of public opinion, the Organization for Economic Co-operation and Development ("O.E.C.D."), the E.U., and the U.S. committed for international tax coordination to effectively counter Base Erosion and Profit Shifting ("B.E.P.S.") in a framework of global tax transparency.

The underlying rationale is simple: national tax authorities collect income taxes based on information received from taxpayers themselves. Where appropriate, they conduct inquiries into the taxpayers' activities or request information from third parties, such as banks. While this system works reasonably well for taxpayers involved in purely domestic activities and transactions, difficulties arise for resident taxpayers earning some or most of their income in other countries. When national tax authorities investigate foreign-source income, their investigative authority stops at the national border, which serves as the outer limit of sovereignty. This fact pattern is viewed as an invitation for tax evasion or avoidance on one hand, but also can lead to international double taxation when authorities in two states each claim the primary right to impose tax. Cross-border cooperation between domestic tax authorities is viewed as a means of ensuring effective taxation for global investors and a means of relieving double taxation.[10]

In this "Brave New World" of tax transparency, two international standards ensure cross-border cooperation: the automatic exchange of information ("A.E.O.I.") and

---

8 The "Great Recession" is the global economic downturn from 2007 to 2009 that devastated world financial markets as well as the banking and real estate industries. The crisis led to increases in home mortgage foreclosures worldwide and caused millions of people to lose their life savings, their jobs, and their homes. Even though its effects were global, the Great Recession mostly struck the U.S., where it originated in the subprime mortgage crisis, and Western Europe.

9 Similarly, see S. Gadzo and I. Klemencic, "Effective International Information Exchange as a Key Element of Modern Tax Systems: Promises and Pitfalls of the OECD's Common Reporting Standard," *Public Sector Economics*, Vol. 1, Issue 2, 2017, pp. 208-226. For an overview of the main EOI instruments, see N. Diepvens and F. Debelva, "The Evolution of the Exchange of Information in Direct Tax Matters: The Taxpayer's Rights under Pressure," *EC Tax Review*, 2015, Vol. 24, Issue 4, pp. 210-219, spec. 210-214; R. Biebel and J. Voje, "EU Report" in I.F.A., *Cahiers de droit fiscal international. Vol. 105B – Exchange of information: issues, use and collaboration*, The Hague, I.B.F.D., 2020, pp. 65-93.

10 This is all the more true in the current global economic environment, characterized by high mobility of capital and labor across national borders. On this topic, see M. Stewart, "Transnational Tax Information Exchange Networks: Steps towards a Globalized, Legitimate Tax Administration," *World Tax Journal*, 2012, Vol. 4, Issue 2, pp. 152-179.

the exchange of information on request ("E.O.I.R"). In the annotated cases, the E.C.J. reviews the E.O.I.R. standard, which enables one State to request from another State any foreseeably relevant information for the administration or enforcement of its domestic tax laws, such as ownership, accounting or banking information. Numerous legal instruments provide for an E.O.I.R., for instance: the 2002 O.E.C.D. Model Agreement on Exchange of Information on Tax Matters and its commentary; Article 26 of the O.E.C.D. Model Tax Convention and its commentary; and Article 26 of the United Nations Model Double Taxation Convention and its commentary.[11]

"Currently, E.U. Member States are sharing unprecedented levels of tax information. Between 2013 and 2017, Member States sent between 8.200 and 9.400 requests for information per year, based on D.A.C."

Within the E.U., the provisions of D.A.C. also enter into play. Currently, E.U. Member States are sharing unprecedented levels of tax information.[12] Between 2013 and 2017, Member States sent between 8.200 and 9.400 requests for information per year, based on D.A.C.[13] This represents a substantial increase compared to the period between 2008 and 2012, when the figures ranged between 4.000 and 5.800 per year under the predecessor of D.A.C., namely the E.U. Mutual Assistance Directive.[14] The rising figures inevitably raise the question of a balance between administrative efficiency for tax authorities and respect for taxpayers' fundamental rights.[15] In the words of Schaper:

> There is a clear contrast between the speed at which the powers of tax administrations have been increased through Union legislation in the last years and the apparent lack of urgency on the side of the Union legislator to balance this with taxpayers' rights grounded in EU law. The Union legislator appears reluctant to regulate data protection rights through Union legislation and seems to prefer to leave the matter to the Member States.[16]

This delicate equation lies at the heart of the recent decision in the E.C.J. cases.

---

[11] For further details, see T. Falcão and A. Lara Yaffar, "General Report Subject 2," in IFA, *Cahiers de Droit Fiscal International. Vol 105b – Exchange of Information: Issues, Use and Collaboration*, The Hague, I.B.F.D., 2020, pp. 17-62.

[12] See N. Diepvens, *De grensoverschrijdende administratiefrechtelijke gegevensuitwisseling op verzoek in de inkomstenbelastingen vanuit Belgisch standpunt*, Gent, Larcier, 2018, pp. 395-396.

[13] See R. Biebel and J. Voje, "EU Report" in IFA, *Cahiers de droit fiscal international. Vol. 105B – Exchange of information: issues, use and collaboration*, The Hague, I.B.F.D., 2020, p. 70.

[14] Council Directive 77/799/EEC of 19 December 1977 concerning Mutual Assistance by the Competent Authorities of the Member States in the Field of Direct Taxation, OJ L 336, 27 December 1977, pp. 15-20.

[15] For further details on (i) the origin of the administrative cooperation between tax authorities of different States for the correct establishment of income taxes, (ii) the tension between the procedure of cross-border administrative exchange of information on request, and (iii) judicial protection of the taxpayer and the procedural safeguards necessary for the taxpayer, see the doctoral thesis of N. Diepvens (*op. cit.*).

[16] M. Schaper, "Data Protection Rights and Tax Information Exchange in the European Union: An Uneasy Combination," *Maastricht Journal of European and Comparative Law*, Vol. 23, Issue 3, pp. 514-530, spec. p. 530.

JOINED CASES C-245/19 AND C-246/19

Facts

In the context of an investigation of the tax position of a Spanish tax resident ("Taxpayer"), Spanish tax authorities ("Requesting Tax Authorities") sent two requests for information to their Luxembourg counterparts ("Requested Tax Authorities") based on D.A.C. and the Luxembourg-Spain Income Tax Treaty.[17] Since the Requested Tax Authorities did not possess the requested information, they addressed information orders to a Luxembourg based company and a Luxembourg based bank ("Addressees"). As each Addressee faced a possible fine of up to €250,000 for non-compliance, significant incentives existed for compliance. The company was asked to provide copies of contracts involving the Taxpayer[18] and the bank was ordered to share information concerning accounts, account balances, and other financial assets held or beneficially owned by the Taxpayer.[19]

The Addressees, the Taxpayer and other third parties concerned disputed the orders before the *Tribunal Administratif* (Luxembourg Administrative Court),[20] which partly annulled them.[21] The Luxembourg tax authorities then lodged an appeal before the *Cour Administrative* (Luxembourg Higher Administrative Court, "Referring Court").[22] The latter stayed the proceedings and referred two preliminary questions to the E.C.J.

The "preliminary reference" mechanism under Article 267 of the Treaty on the Functioning of the European Union ("T.F.E.U.") constitutes one of the cornerstones of the E.U. judicial system as it ensures the uniform interpretation and application of E.U. law in the Member States. It is designed as a noncontentious mechanism through which a national judge asks guidance from the C.J.E.U. regarding the interpretation of E.U. law or the validity of E.U. acts. The C.J.E.U.'s preliminary ruling strongly influences the outcome of the national procedure, as it is binding for the national courts. The preliminary reference procedure, however, is not a remedy available to the parties since individuals cannot make use of it and it is within national judges' power to decide whether to refer a question.[23]

Regarding the first question, the Referring Court asked whether the Luxembourg legislation that precluded a direct judicial remedy against information orders violated a fundamental right of the Addressees, the Taxpayer and other parties concerned under Article 47 (right to an effective remedy and to a fair trial) of the Charter of Fundamental Rights of the E.U. ("Charter"), as well as Articles 7 (right to privacy), 8 (right to protection of personal data), and 52(1) (restriction of fundamental rights in specific circumstances).[24] Regarding the second question, the Referring Court

---

17 Ruling, § 24; Opinion A.G., § 29.

18 Ruling, § 26; Opinion A.G., §§ 30-33.

19 Ruling, § 36; Opinion A.G., §§ 34-36.

20 Ruling, §§ 28 and 38; Opinion A.G., § 37.

21 Ruling, §§ 29 and 39; Opinion A.G., § 38-40.

22 Ruling, §§ 30-31 and §§ 40-41.

23 See C. Lacchi, *Preliminary References to the Court of Justice of the European Union and Effective Judicial Protection*, Brussels, Larcier, 2020, 348 pp.

24 Ruling, § 44; Opinion A.G., § 46.

asked how one should interpret the term "foreseeably relevant information" within the meaning of Article 5 of D.A.C., read in conjunction with Article 1(1) thereof.[25]

Analysis and Ruling of the E.C.J.

The Direct or Indirect Right to an Effective Remedy

In *Berlioz*, the E.C.J. ruled that, under Article 47 of the Charter, an Addressee of an Information Order that was fined for noncompliance has the right to challenge the order's legality when disputing the fine ("indirect judicial remedy").[26] However, the ruling did not address the right to an effective remedy where no fine was imposed for a compliance failure ("direct judicial remedy"). In addition, the decision in *Berlioz* focused exclusively on the Addressees of Information Orders without addressing the fundamental rights of the Taxpayer under investigation and third parties concerned. In the cases at hand, the Referring Court asked the E.C.J. to address the two open questions.

"In her Opinion, A.G. Kokott . . . evaluated the procedural safeguards available for each of the Addressees, the Taxpayer, and the third parties."

In her Opinion, A.G. Kokott positioned herself in favor of taxpayers' rights and explained that the Addressees, the Taxpayer, and the third parties concerned should each have a right to a direct judicial remedy against information orders.[27] The E.C.J., however, took a different approach. It separately evaluated the procedural safeguards available for each of the Addressees, the Taxpayer, and the third parties.

- **Rights of the Addressees of Information Orders.**[28] The E.C.J. explained that Article 47 of the Charter guarantees the right of the Addressee to an effective remedy, without having to infringe any legal rule and await to receive a penalty for such an infringement.[29] The E.C.J. found that the Luxembourg law applicable to Addressees provides a remedy only when the Addressee does not comply with the order and receives a fine. Only then can the Addressee challenge the order indirectly by challenging the penalty.[30] Consequently, the Luxembourg law is incompatible with Article 47 and Article 52(1) of the Charter, read together.[31]

---

25 Ruling, § 107; Opinion A.G., § 109.

26 See Berlioz, §§ 49, 51, 55, 56, and 59.

27 Opinion A.G., §§ 58, 82, and 108.

28 For the E.C.J.'s position about the Addressees, see Ruling, §§ 56-69.

29 Ruling, § 66 (and case-law cited therein); See, similarly, Opinion A.G., § 57 (and case-law cited therein):

> In a country based on the rule of law and in a union based on the rule of law, it is unreasonable to require a person concerned to violate an administrative order in order to be able to review the legality of the order indirectly. This applies all the more so if […] the decision as to whether to initiate proceedings for an administrative penalty is within the discretion of the tax authority. This is because, in such cases, the tax authority would be able to prevent a review of the legality of the request for information by refraining from initiating proceedings for an administrative penalty.

30 Ruling, § 67.

31 Ruling, § 69.

- **Rights of the Taxpayer under investigation.**[32] The E.C.J. explained that Article 47 of the Charter applies to the Taxpayer since the disclosure of the Taxpayer's personal data[33] to a public authority affects the fundamental rights to privacy and the protection of personal data guaranteed by Articles 7 and 8 of the Charter.[34] Nevertheless, the E.C.J. departed from the view of the A.G. and ruled that the right to an effective remedy does not necessarily mean that the Taxpayer must have a direct action against information orders. The Taxpayer could challenge the tax assessment note established at the end of the Spanish investigation and, in that context, indirectly dispute the information order. Therefore, the Luxembourg law – which prevented the Taxpayer from lodging a direct action against information orders – does not frustrate the right to an effective remedy under Article 47 of the Charter. The restriction imposed by the Luxembourg law meets an objective of general interest, *viz.*, combating international tax evasion or avoidance and strengthening cooperation between the Member States, and is proportional to that interest.

- **For third parties concerned.**[35] Article 47 of the Charter guarantees the right to an effective remedy to third parties.[36] However, in contrast with the Addressees, third parties are not under the threat of a fine in case of noncompliance.[37] Therefore, like the Taxpayer under investigation, national law can exclude their right to a direct judicial remedy against information orders when they can obtain the effective respect of their fundamental rights through other actions, such as an action to ascertain liability.[38]

The Foreseeably Relevant Information Test

Pursuant to Article 1 of D.A.C., Member States are obligated to cooperate with each other with a view to exchanging information that is foreseeably relevant to the administration and enforcement of the domestic tax laws of the Member States. In particular, Recital 9 of the Preamble to D.A.C. states:

> Member States should exchange information concerning particular cases where requested by another Member State and should make the necessary enquiries to obtain such information. The standard of 'foreseeable relevance' is intended to provide for exchange of information in tax matters to the widest possible extent and, at the same time, to clarify that Member States are not at liberty to engage in 'fishing expeditions' or to request information that is unlikely to be relevant to the tax affairs of a given taxpayer.

---

[32] For the E.C.J.'s position about the Taxpayer, see Ruling, §§ 70-93.

[33] See Opinion A.G., §63 and case-law cited therein:

> Personal data is all information relating to an identified or identifiable person. Information regarding the amount of income received is personal data. The same applies to information about bank details.

[34] Ruling, §§ 72-75 and case law cited therein; Opinion A.G., §§ 61-67.

[35] For the E.C.J.'s position about third parties, see Ruling, §§ 94-105.

[36] Ruling, §§ 94-97.

[37] Ruling, § 99.

[38] Ruling, §§ 99-102.

This serves to ensure that Requesting Tax Authorities do not carry out investigations on a speculative basis, without having any concrete suspicions.[39]

In *Berlioz*, the E.C.J. interpreted the foreseeably relevant standard as enabling the Requested Tax Authorities to obtain any information that seems to it to be justified for the purpose of its investigation, while not authorizing it manifestly to exceed the parameters of that investigation nor to place an excessive burden on the Requested Tax Authorities.[40] In other words, Requesting Tax Authorities choose the information they need for their investigations, but Requested Tax Authorities can refuse to provide information when the request is manifestly devoid of any foreseeable relevance, having regard to the taxpayer, the information holder and the tax purpose pursued by the request.[41]

In the subject cases, A.G. Kokott went a step further, and held that in order for the Requested Tax Authorities to ascertain that the requested information is foreseeably relevant, the Requesting Tax Authorities must indicate the facts they wish to investigate or, at least, concrete suspicions surrounding those facts and their relevance for tax purposes.[42] Put otherwise, the request must provide concrete evidence of the facts or transactions that are relevant for tax purposes, to rule out any fishing expedition.[43]

Building on the analysis held in *Berlioz*, the E.C.J. ruled that the requested information is not manifestly devoid of foreseeably relevance when:[44]

- The request states (i) the identity of the Addressees of the Information Order, (ii) the identity of the Taxpayer subject to the investigation giving rise to the request for exchange of information, and (iii) the period covered by that investigation.
- The request relates to contracts, invoices, and payments that are defined by personal, temporal, and material criteria establishing their links with (i) the investigation, and (ii) the Taxpayer subject to that investigation, even though not expressly identified in the request.

---

[39] Opinion A.G., § 134.

[40] Berlioz, § 68.

[41] Berlioz, § 82; The scope of the Requested Tax Authorities' review is however limited (§ 76). They must indeed trust the Requesting Tax Authorities and assume that the request for information complies with both the domestic law of the Requesting Tax Authorities and is necessary for the purposes of its investigation. Furthermore, the Requested Tax Authority does not have extensive knowledge of the factual and legal framework prevailing in the Requesting State. Hence, the Requested Tax Authorities cannot substitute their own assessment of the possible usefulness of the information sought for that of the Requesting Tax Authorities (§ 77).

[42] Opinion A.G., § 138.

[43] Opinion A.G., § 146.

[44] Ruling, § 124.

CONCLUSION

After making an important step forward in the protection of taxpayer rights within the framework of cross-border tax disputes[45] with Berlioz, the E.C.J. seems to have taken a step or two backward[46] with its annotated preliminary ruling. Clearly, the E.C.J.'s statement is welcome because it recognizes that Addressees of information orders have the right to seek direct judicial review against information orders. However, the absence of an equivalent right for the Taxpayer under investigation seems unreasonable. Indeed, a Taxpayer subject to an investigation will have to wait until the Requesting Tax Authorities issue a tax assessment note to take action, and then seek a review of the legitimacy of the information order. The E.C.J.'s position proves, yet again, that Taxpayers are perceived as "the object" of the exchange of information, and not as holders of rights requiring adequate and timely protection.[47]

"After making an important step forward in the protection of taxpayer rights within the framework of cross-border tax disputes with Berlioz, the E.C.J. seems to have taken a step or two backward with its annotated preliminary ruling."

The E.C.J. should have followed the A.G. Opinion which pointed out that the requested information contained personal data. Consequently, the request could affect the fundamental rights to privacy and protection of personal data, both of which are fundamental rights that belong to the Taxpayer. Applying these rights indirectly, only when the Requesting Tax Authorities issue a tax assessment note, provides inadequate protection. How does a taxpayer protect against fishing expeditions when the Taxpayer has no procedural avenue available? One might wonder whether, in the eyes of the judges, the political considerations surrounding the importance of exchange of information in tax matters took over the technical legal analysis.[48]

Regarding the foreseeably relevant information test, the E.C.J. correctly followed Berlioz and ruled that the Requested Tax Authorities may deny the provision of information where a request is devoid of any foreseeable relevance. This time, however, the E.C.J. enumerated a combination of criteria establishing the personal, temporal and material criteria establishing their links with the investigation and the taxpayer subject to that investigation. We believe that the threshold remains insufficient to effectively secure the protection of the Taxpayer's rights and offer protection against fishing expeditions[49] or shots in the dark.[50]

To conclude, the words of Baker and Pistone are appropriate when evaluating the position of the E.C.J.:

> The BEPS and tax transparency projects strengthened the powers of tax authorities across the borders, but kept silent on the protection of taxpayers' rights, which has become almost a taboo word for international tax coordination under the erroneous assumption that honest taxpayers have nothing to worry about this development and may anyway seek for legal protection at the national level in each country. However, silence won't lead the protection of fundamental

---

45 E.C.J. Taskforce, *op. cit.*, p. 95.

46 M. Van Herksen and Gary Barnett, "Judicial review of exchange of information requests," *Tax Journal*, 23 October 2020, pp. 11-12.

47 M. G. De Flora, *op. cit.*, p. 460.

48 M. Van Herksen and Gary Barnett, *op. cit.*, p. 12.

49 Opinion AG, § 146.

50 Opinion AG, § 132.

> rights of taxpayers to oblivion. Global tax law cannot ignore them for long, since it would otherwise severely undermine the natural correspondence with legal remedies that is the quintessence of the rule of law."[51]

They propose a two-tier system for the conciliation and settlement of cross-border tax disputes with the involvement of taxpayers at all stages. The procedure should be supplemented by notification requirements in respect of all forms of international mutual assistance between tax authorities, subject to specific carve-outs where this would undermine effective tax auditing prerogatives.[52]

Solutions, therefore, are available, but require political consensus and courage on a sensitive topic. For the time being, and in contrast with the Latin maxim, *Ubi jus, ibi remedium*, the recent decision of the E.C.J. show that where there is a right, not always is there a remedy.

51 P. Baker and P. Pistone, *op. cit.*, p. 345 ; In the same light, see P. Pistone, "Co-ordinating the Action of Regional and Global Players during the Shift from Bi-lateralism to Multilateralism in International Tax Law," *World Tax Journal*, 2014, Vol. 6, Issue 4, pp. 4-5:

> Stronger powers for tax authorities to cooperate in cross-border scenarios worldwide should march hand-in-hand with a stronger protection of taxpayers' basic rights. The plea for an effective and timely protection of human rights across borders in this field is even more obvious insofar as one considers that taxpayers are, after all, human beings! Besides, the need to sharpen the fight against fraudsters should not turn into a disproportionate bonfire of all basic values that constitute the bulk of customary international law and the legal background of civilized nations across the world in the protection of persons.

52 *Ibid.*

WATCH OUT WHIRLPOOL: THE I.R.S. HAS PUT 50 MILLION WRINKLES IN YOUR PERMANENT PRESS CYCLE

Author
Gianluca Mazzoni

Tags
Foreign Base Company Sales Income
Foreign Branch Rule
Subpart F Income

Gianluca Mazzoni, S.J.D. '20 and L.L.M.'16 International Tax, University of Michigan Law School.

INTRODUCTION

On May 5, 2020, the U.S. Tax Court held that income earned by Whirlpool Financial Corp.'s Luxembourg controlled foreign corporation ("C.F.C.") from the sales of products manufactured in Mexico should be treated as foreign base company sales income ("F.B.C.S.I.") under the branch rule of Code §954(d)(2) and taxable to Whirlpool Financial Corp. as Subpart F income under Code §951(a).[1]

Although the Whirlpool case concerns a tax year prior to the Tax Cuts and Jobs Act of 2017 ("T.C.J.A.") that significantly changed the U.S. international tax regime by introducing a new anti-deferral direct tax, initially at an effective 10.5% rate, on global intangible low-tax income ("G.I.L.T.I.") earned by foreign subsidiaries, it remains relevant for a variety of reasons. First and foremost, this is the first time the I.R.S. managed to overcome planning involving check-the-box regulations[2] by relying on Code §954(d)(2). Historically, the I.R.S. has never won a Subpart F sales or services case. Courts have always and consistently rejected government's arguments to expansively apply the definition of Subpart F sales income in order to carry out asserted Congressional intent.[3]

---

1 *Whirlpool Financial Corp. v. Commr.*; No. 13986-17; No. 13987-17; 154 T.C. __, No. 9 (2020).

2 Treas. Reg. §301.7701-3, Classification of certain business entities.

3 See *Ashland Oil Inc. v. Commr.*, 95 T.C. 348 (1990); *Vetco, Inc. v. Commr.*; 95 T.C. 579 (1990); *Brown Group, Inc. v. Commr.*, 77 F.3d 217 (8th Cir. 1996), *rev'g* 104 T.C. 105, 111 (1995); *Dave Fischbein Manufacturing Co. v. Commr.,* 59 T.C. 338 (1972), *acq.* 1973-2 C.B. 2; *Bausch & Lomb, Inc. v. Commr.*, 71 T.C.M. 2031 (1996); *The Cooper Companies Inc. v. Commr.*, T.C. No. 14816-11 (settlement order entered Feb. 2, 2012). For example, in *Vetco Inc. v. Commr.,* a Swiss C.F.C. entered into a contract manufacturing arrangement with its wholly owned U.K. subsidiary. whereby the U.K. subsidiary assembled oil and gas drilling equipment, from parts and designs provided by its parent corporation, the Swiss C.F.C., in exchange for a fixed fee. At all relevant times, title to the materials was held by the Swiss C.F.C., which bore the full risk of loss. The Swiss C.F.C. did not have any employees, but contracted with various affiliates to handle certain functions, such as purchasing raw materials and components. The U.K. subsidiary earned a fixed fee for its manufacturing services. The Swiss C.F.C. sold the fined products to unrelated purchasers. The I.R.S. contended that Vetco used the Swiss C.F.C. and the U.K. subsidiary to avoid U.S. tax by splitting their sales and manufacturing operations in order to take advantage of Switzerland's lower tax rate. The I.R.S. urged the Tax Court to look past Vetco's "contractual wizardry" and to apply the branch rule as a *loophole-closing device*. The Tax Court rejected the I.R.S.'s argument and agreed with Vetco, who argued that a branch should be distinguished from a wholly owned subsidiary. The Tax Court noted that branches or similar establishments could be established in a foreign country without the stock ownership required of a separately incorporated subsidiary. Accordingly, the branch rule was intended to prevent C.F.C.s from avoiding 954(d)

Secondly, on September 10, 2018, the I.R.S. Large Business and International division ("L.B.&I.") announced the approval of five compliance campaigns, one of them being F.B.C.S.I. and manufacturing branch rules. According to the I.R.S., the goal of this campaign is, 'to identify and select for examination returns of U.S. shareholders of C.F.C.'s that may have underreported subpart F income based on certain interpretations of the manufacturing branch rules. The treatment stream for the campaign will be issue-based examinations.' Practitioners and taxpayers should note that this campaign is still currently active in 2020.[4] Thirdly, Whirlpool case is also important for the court's application of the regulations' tax disparity test and for the court's rejection of Whirlpool's arguments that the operative regulations are invalid.

This article discusses Whirlpool court's analysis and conclusions focusing on whether Whirlpool's position was consistent with the legislative history and the purposes of Subpart F. It is divided in four parts. The first part summarizes the facts. The second part analyzes Whirlpool's foreign tax treatment under the Mexican *maquiladora* program[5] and the Mexico-Luxembourg tax treaty.[6] It will be shown how the 2009 revised structure led to the creation of stateless income. The third part carefully assesses the main issues considered by the Tax Court. The fourth and final part concludes.

BACKGROUND INFORMATION

Operations Before 2009

("Whirlpool") is a Delaware corporation with its principal place of business in Michigan. Whirlpool manufactures and distributes major household appliances, including refrigerators and washing machines, in the U. S. and abroad. Whirlpool owned

---

(1) because there would be no transaction with a related person within the meaning of 954(d)(3). In examining the structure of 954(d) and its legislative history, the Tax Court concluded that only specified related-person transactions give rise to F.B.C.S.I. As in *Ashland Oil, Inc. v. Commr.*, the Tax Court rejected I.R.S.'s assertion that the branch rule was intended as a broad *loophole-closing device* to prevent the use of multiple foreign countries to take advantage of lower tax rates in those countries, noting, instead, that legislative history suggests that the term branch should be interpreted narrowly. For a discussion of *Vetco* and those other cases, see Lowell D. Yoder, "The I.R.S. Has Never Won a Subpart F Sales or Services Case," 46 *Tax Mgmt. Int'l J.* 636 (Oct. 13, 2017), Howard J. Levine & Allen J. Littman, "Contracting Out, Not Branching Out: Manufacturing Revisited," 22 *Tax Mgmt. Int'l J.* 343 (July 1993); Richard A. Gordon et al., "Foreign Branches After Ashland Oil," 20 *Tax Mgmt. Int'l* 24 (Jan. 1991); see also Kathleen Matthews, "U.S. Official Discusses Subpart F Rules on Contract Manufacturing," 93 *TNI* 157-4 (Aug. 16, 1993).

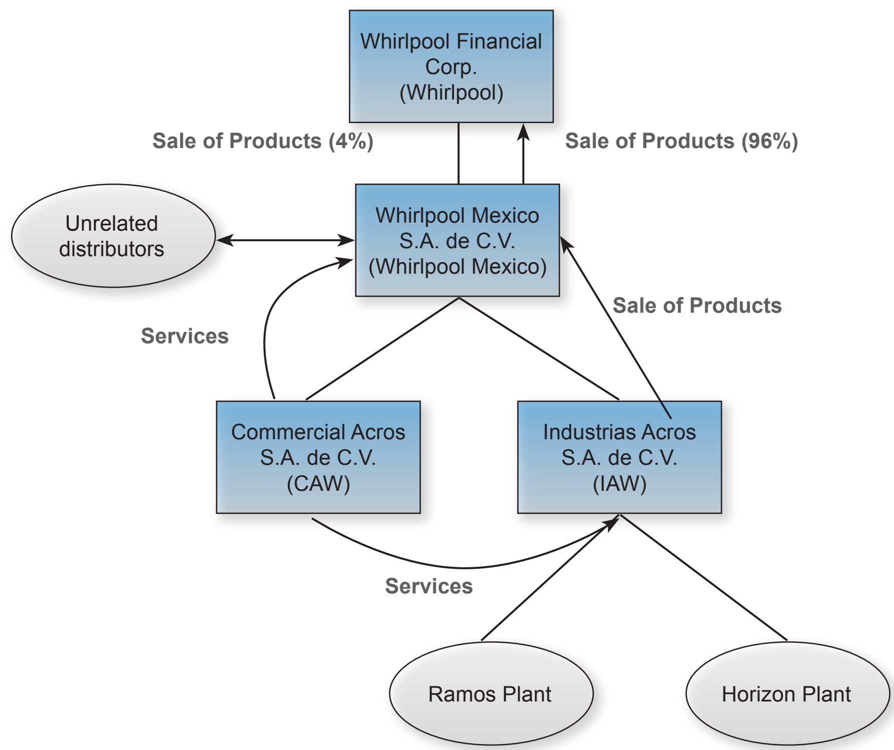
4 Also, over the summer of 2015, the I.R.S. released two International Practice Units ("I.P.U.'s") providing audit guidance regarding cases that Code §954(d)(2) targets, *i.e.*, the use of branches – that are disregarded for U.S. purposes - to avoid foreign base company sales income. For a detailed discussion of those I.P.U.'s see B. Erwin, K. Lobo, and S. Ruchelman, "I.R.S. Releases Subpart F Sales And Manufacturing Rules."

5 See J. Diaz de Leon Galarza, "Tax Reforms to the Maquiladora Regime," 21 *Intl. Transfer Pricing J.* 3 (2014), Journals IBFD (accessed 7 Sep. 2020); W. Hoke, "Maquiladoras Still Coming to Grips With Tough Mexico Tax Reforms," *Tax Analysts*, DOC 2014-23120.

6 Mexico – Luxembourg Income and Capital Tax Treaty (2001) (as amended through 2009).

Whirlpool Mexico, S.A. de C.V. ("Whirlpool Mexico"), a Mexican C.F.C. subsidiary. Whirlpool Mexico owned *Commercial Acros S.A. de C.V.* ("C.A.W.") and *Industrias Acros S.A. de C.V.* ("I.A.W."), both organized under the laws of Mexico. C.A.W. and I.A.W. performed different activities. C.A.W. was the administrative arm of Whirlpool Mexico and I.A.W. was the manufacturing arm. It owned land, buildings, and equipment and employed workers who manufactured refrigerators, washing machines, and other appliances ("Products") at two separate plants in Mexico: the Ramos Plant and the Horizon plant. I.A.W. sold these products to Whirlpool Mexico, which in turn sold the majority of the products (almost 96%) to Whirlpool and the remaining balance to unrelated distributors in Mexico. In the author's opinion, although the Tax Court did not expressly state that, Whirlpool's operations in Mexico before 2009 did not give rise to F.B.C.S.I. due to the "C.F.C. manufacturing exception" as the final products I.A.W. sold were substantially transformed from the raw materials it had purchased.

The following chart represents how Whirlpool's operations were conducted before 2009 Whirlpool Financial Corp.



Description

- CAW provided selling, marketing, finance, accounting, human resources, and other back office services to Whirlpool Mexico and IAW
- IAW owned land, buildings, and equipment and employed workers who manufactured refrigerators, washing machines, and other appliances ("Products") at two separate plants: Ramos plant (1,000,000.00 refrigerators) and Horizon plant (500,000.00 washing machines)
- IAW sold these products to Whirlpool Mexico, which in turn sold the majority of the products to Whirlpool and the remaining balance to unrelated distributors in Mexico.

Revised Structure Effective for TY 2009

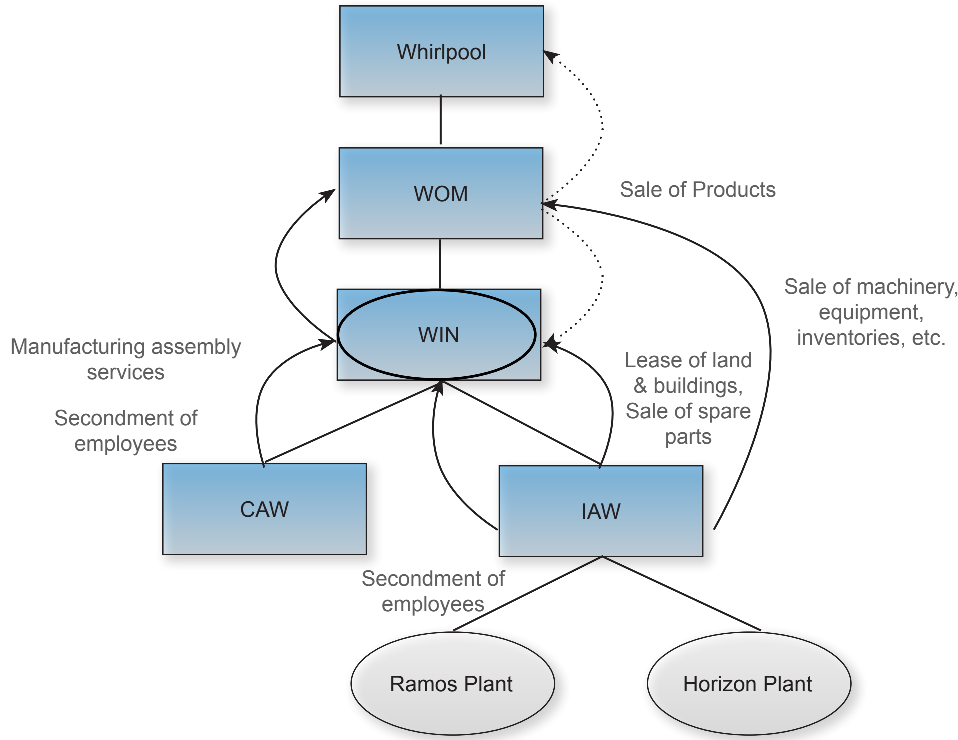
During 2007 and 2008, I.A.W. entered into a series of manufacturing arrangements involving a newly formed Luxembourg corporation Whirlpool Overseas Manufacturing, S.a.r.l. ("LuxCo") and a newly formed Mexican company *Whirlpool Internacional, S. de R.L. de C.V.* ("W.I.N."), in order to obtain significant tax savings. Under the restructured arrangements, I.A.W., the owner of the plants and prior manufacturer, leased to W.I.N. the land and buildings that housed the Ramos and the Horizon manufacturing plants; sold to W.I.N. the spare parts, hand tools and other items needed to support manufacturing activities at those plants; and sold to LuxCo all of the machinery, equipment, furniture, and other assets within the Ramos and Horizon plants, including all raw materials and work-in-progress and finished inventory. In addition, the restructured arrangements ensured that high-level and rank-and-file employees of I.A.W. and C.A.W., the administrative arm of Whirlpool Mexico, were seconded and subcontracted to W.I.N. to perform their respective duties.

Further, W.I.N. entered into an agreement with LuxCo whereby W.I.N. became the lessee of the Ramos and Horizon plants; LuxCo became the owner of the machinery, equipment, inventories, furniture and other assets situated within the Ramos and Horizon plants; LuxCo held title to all raw materials, work-in process and finished goods inventory; and W.I.N., through employees subcontracted from C.A.W. and I.A.W., provided manufacturing and assembly services to LuxCo to produce the goods. As a result, LuxCo became the owner of the manufactured products, which it then sold as finished products to Whirlpool and to W.I.N. for distribution in the U.S. and Mexico, respectively.

"Whirlpool killed two birds with one stone as it got the benefits of both domestic incentive tax regime (Mexican maquiladora program) and enjoyed the benefits of the Mexico-Luxembourg tax treaty to avoid the imposition of Luxembourg income tax."

By doing this, Whirlpool killed two birds with one stone as it got the benefits of both domestic incentive tax regime (Mexican *maquiladora* program) and enjoyed the benefits of the Mexico-Luxembourg tax treaty to avoid the imposition of Luxembourg income tax. For U.S. tax purposes, Whirlpool treated W.I.N. as a disregarded entity and thus treated LuxCo as the company that manufactured and sold the products, much like Whirlpool Mexico did under the old structure. The next part discusses the tax consequences of this revised structure under Mexican domestic tax law and the Mexico-Luxembourg tax treaty.

The following chart represents how Whirlpool's operations were conducted after its restructuring.



Description

- IAW leased to WIN land and buildings that house the Ramos and Horizon plants; sold to WIN spare parts, hand tools and other items needed to support manufacturing activities at those plants; and sold to WOM all of the machinery, equipment, inventories, furniture, and other assets
- Employees of IAW and CAW were seconded and subcontracted to WIN to perform their respective duties
- WIN agreed to supply WOM the services necessary to manufacture the products at the Ramos and Horizon plants using the workers subcontracted to it from CAW and IAW
- WOM in exchange supplied "free of charge" machinery, equipment, and raw materials necessary to manufacture the products
- WOM retained all right, interest to all raw materials, work in process, and finished goods inventory at all times during the manufacturing process
- WOM invoiced the products at the end of manufacturing process with title and risk of loss passing to Whirlpool and WIN at that point

FOREIGN TAX CONSIDERATION

Under the Mexican Income Tax Law (M.I.T.L.), companies resident in Mexico were subject to tax during 2009 at a 28% rate on their worldwide income. Non-resident companies operating through a permanent establishment ("P.E.") in Mexico were likewise subject to tax at a 28% rate on all income attributable to the P.E.

For many years Mexico has had in a place an incentive "*maquiladora* program" as set forth in the Decree for the Promotion of the Manufacturing Industry, *Maquiladora* and Exportation Services ("I.M.M.E.X. Decree"). This program was designed to promote Mexico's industrial development, generate new employment and increase the level of foreign direct investments.

In order to benefit from the *maquiladora* tax and trade incentives, the following three requirements must be satisfied: (i) the foreign principal (LuxCo) provides machinery, equipment, and raw materials to the resident *maquiladora* company (W.I.N.) so that the latter may import such assets and inventory temporarily into Mexico on a tax-free basis; (ii) the *maquiladora* (W.I.N.) must use the machinery, equipment and raw materials to provide manufacturing and assembly services pursuant to the intercompany agreements, in addition to some ancillary tasks dealing with the custody, warehousing and transportation of the imported and finished goods; (iii) the *maquiladora* (W.I.N.) must return (export) the finished goods and assets within certain deadlines.[7]

As LuxCo's activities conducted in Mexico through W.I.N. qualified for the *maquiladora* treatment, W.I.N.'s manufacturing income earned under its assembly agreements with LuxCo was taxed at the preferential 17% tax rate rather than the general corporate tax rate of 28%. In addition, by locating its manufacturing operations in Mexico, LuxCo would ordinarily be considered to have a P.E. in Mexico.[8] However, under Mexican law, provided that W.O.M. and W.I.N. satisfied specified transfer-pricing requirements, LuxCo was deemed to have no P.E. in Mexico and was thus exempt from Mexican income tax.

Surprisingly or not, the results under treaty and Luxembourg domestic law were quite different. Paragraph 1 of Article 7 (Business Profits) of the Mexico-Luxembourg Income Tax Treaty ("the Treaty") provides as follows, as translated into English:

> The profits of an enterprise [LuxCo] of a Contracting State (Luxembourg) shall be taxable only in that State [Luxembourg]unless the enterprise carries on business in the other Contracting State [Mexico] through a permanent establishment situated therein [W.I.N.]. If the enterprise [LuxCo] carries on business as aforesaid, the profits of the enterprise [LuxCo] may be taxed in the other State (Mexico) but only so much of them as is attributable to:
>
> a. that permanent establishment [W.I.N.];
>
> b. sales in that other State [Mexico] of goods or merchandise of the same or similar kind as the goods or merchandise through that permanent establishment [W.I.N.].
>
> However, the profits derived from the sales described in subparagraph (b) shall not be taxable in the other Contracting State [Mexico] if the enterprise (LuxCo) demonstrates that such sales have been carried out for reasons other than obtaining a benefit under this Convention.[9]

---

7 See J. Diaz de Leon Galarza, *supra* note 5.

8 LuxCo would ordinarily be considered to have a P.E. in Mexico because it owned the equipment, tooling, raw materials, component parts, supplies, and inventories used in its Mexican manufacturing operations, as well as because it used fixed places of business at the Ramos and Horizon manufacturing plants and sold in Mexico some of the refrigerators and washing machines it produced.

9 Art. 7 of the Treaty.

In this regard, an English translation of Paragraph 1 of Article 5 (Permanent Establishment) of the Treaty defines permanent establishment as, "a fixed place of business through which the business of an enterprise is wholly or partly carried on." In Paragraph 2, the term "permanent establishment" includes especially: (i) a place of management; (ii) a branch; (iii) an office; (iv) a factory; (v) a workshop; and (vi) a mine, an oil or gas well, a quarry or any other place of extraction of natural resources.[10] As can be seen, the Treaty is relatively standard.

LuxCo took the position that it had a P.E. in Mexico because it: (i) owned equipment, raw materials, component parts, supplies, and inventory used in its Mexican manufacturing operations; (ii) used fixed places of business in Mexico whereby it regularly conducted commercial activities; and (iii) sold products in Mexico. This position was also "certified" by a ruling that LuxCo obtained from the Luxembourg tax authorities stating that it had a P.E. in Mexico and that all income earned under its supply agreements with Whirlpool and W.I.N. was attributable to that P.E. The end result was that LuxCo paid no tax to Luxembourg on the income earned from the sale of finished products.[11] But also, most importantly, none of the income derived by LuxCo under its supply agreements was subject to tax in the U.S. under subpart F. LuxCo took the position that its sales income was not F.B.C.S.I. under Code §954(4)(1) because the final products it sold were substantially transformed by W.I.N. from the raw materials it had purchased.

THE I.R.S. CHALLENGE

After examining Whirlpool's tax return, the I.R.S. issued a notice of deficiency that determined that LuxCo's sale of products to Whirlpool and W.I.N. gave rise to F.B.C.S.I. of approximately $50 million. The I.R.S. included that sum in Whirlpool's income under Code §§954(d) and 951(a). After petitioning the Tax Court, Whirlpool filed motions for partial summary judgment contending that LuxCo's sales income was not F.B.C.S.I. under Code §954(d)(1) because the final products it sold were substantially transformed by W.I.N. from the raw materials it had purchased. The I.R.S. opposed that motion, contending that genuine disputes of material fact exist as to whether LuxCo actually manufactured the products. The parties filed cross-motions for partial summary judgment. The main question was whether the sales income was F.B.C.S.I. under Code §954(d)(2), the so-called "branch rule."

---

10 Art. 5 of the Treaty.

11 Luxembourg was prohibited under the Treaty from taxing the income, even though Mexico elected not to tax it as long as LuxCo and W.I.N. remained complaint with the *maquiladora* program. See art. 23(1)(a) of the Mexico – Luxembourg Income and Capital Tax Treaty (2001) (as amended through 2009):

> Subject to the provisions of the law of Luxembourg regarding the elimination of double taxation which shall not affect the general principle hereof, double taxation shall be eliminated as follows: [w]here a resident of Luxembourg [LuxCo] derives income or owns capital which, in accordance with the provisions of this Convention, may be taxed in Mexico, Luxembourg shall, subject to the provisions of subparagraphs (b) and (c), exempt such income or capital from tax, but may, in order to calculate the amount of tax on the remaining income or capital of the resident, apply the same rates of tax as if the income or capital had not been exempted.

U.S. TAX GOVERNING STATUTORY STRUCTURE

Before 1962 the income of a foreign corporation, even one wholly owned by U.S. shareholders, generally was not subject to current U.S. income tax but only when repatriated in the form of a dividend. This system incentivized U.S. corporations to shift passive and highly mobile income abroad, particularly to subsidiaries in low-tax jurisdictions. Congress enacted Subpart F to inhibit the accumulation of earnings by base companies in tax haven countries by adding Code §§951-964.[12]

"To better understand the governing statutory structure behind the Whirlpool's case, especially Code §954(a)(2) on F.B.C.S.I., it is necessary to discuss the case law which led Congress to enact Subpart F."

To better understand the governing statutory structure behind the Whirlpool's case, especially Code §954(a)(2) on F.B.C.S.I., it is necessary to discuss the case law which led Congress to enact Subpart F. The case is *E.I. Du Pont de Nemours & Co. v. U.S.* ("*Du Pont*,") which was decided by the U.S. Court of Claims on October 17, 1979.[13] Although the issue at stake there concerned the I.R.S.' reallocation of profits between the parent corporation and its wholly owned subsidiary on the sale of chemical products, the facts of *Du Pont* are very helpful in understanding the concept of F.B.C.S.I. and the reasons why Congress enacted Subpart F. Du Pont, the American chemical concern, had various subsidiaries in various high-tax jurisdictions, such as France, Germany, Italy, United Kingdom etc. Du Pont wanted to engage in transfer pricing tax planning, little would have been accomplished other than to shift profits and tax from the United States to all of these other countries that imposed tax at effective rates similar to those in the United States.

A decreasing volume of domestic sales, increasing profits on exports, and the recent formation of the Common Market in Europe convinced Du Pont's president of the need to form an international sales subsidiary. As such, Du Pont created early in 1959 a wholly-owned Swiss marketing and sales subsidiary for foreign sales – Du Pont International S.A. ("D.I.S.A."). Thus, Du Pont's tax strategy was simple and unsophisticated in terms of today's standards: it first sold most of its chemical products marketed abroad to D.I.S.A., at prices *below* fair market value which then arranged for resale, at prices *above* fair market value, to the ultimate consumer through independent distributors. D.I.S.A. did not provide any technical services to nor did it perform any work on these products. The products D.I.S.A. purchased and resold were substantially the same. Not surprisingly, the result was that D.I.S.A. was able to accumulate large, tax-free profits in Switzerland which were used to finance capital improvements and further foreign investments in Western Europe.

Ultimately, the I.R.S. was able to win the case after 20 years of litigation[14] but, in the meantime, it went to the Department of the Treasury ("Treasury") and asked for some rules against these situations because it was too hard to litigate them on

---

12 See Revenue Act of 1962, Pub. L. No. 87-834, sec. 12, 76 Stat. at 1006.

13 608 F.2d 445 (Fed. Cir. 1979).

14 The I.R.S. found several Du Pont's internal memoranda with references to tax advantages, particularly in planning prices on goods to be sold to D.I.S.A.

> It would seem to be desirable to bill the tax haven subsidiary at less than an 'arm's length' price because: (1) the pricing might not be challenged, by the revenue agent; (2) if the pricing is challenged, we might sustain such transfer (3) if we cannot sustain the prices used, a transfer price will be negotiated which should not be more than an 'arm's length' price and might well be less; thus we would no worse off than we would have been had we billed at the higher price.

a transfer pricing base. As a result, in 1962, Congress enacted Subpart F and the F.B.C.S.I. rules which can be seen as a backstop against transfer pricing abuse.

According to Code §954(d)(1), F.B.C.S.I. means income (whether in the form of profits, commissions, fees, or otherwise) that meets two tests.

The first test is that the income is derived in connection with any of the following activities:

- The purchase of personal property from a related person and its sale to any person.
- The sale of personal property to any person on behalf of a related person.
- The purchase of personal property from any person and its sale to a related person.
- The purchase of personal property from any person on behalf of a related person.

The second test is that the property which is purchased (or in the case of property sold on behalf of a related person, the property which is sold) is

- manufactured, produced, grown, or extracted outside the country under the laws of which the controlled foreign corporation is created or organized; and
- sold for use, consumption, or disposition outside such foreign country, or in the case of property purchased on behalf of a related person, is purchased for use, consumption, or disposition outside such foreign country.[15]

Also, the F.B.C.S.I. rules contain a foreign branch rule that can cause a portion of sales income to be Subpart F income. According to Code §954(d)(2), for purposes of determining F.B.C.S.I. in situations in which the carrying on of activities by a controlled foreign corporation (LuxCo) through a branch or similar establishment (W.I.N.) located outside the country of incorporation of the controlled foreign corporation (Luxembourg) has substantially the same effect as if the branch or similar establishment (W.I.N.) were a wholly owned subsidiary corporation deriving such income. Under the branch rule, the I.R.S. is authorized to prescribe regulations defining when the carrying on of activities of such branch or similar establishment (W.I.N.) is to be treated as income derived by a wholly owned subsidiary of the controlled foreign corporation (LuxCo) so that F.B.C.S.I. is deemed to be generated by the controlled foreign corporation (LuxCo).[16]

While enacting Subpart F and the F.B.C.S.I. rules, Congress was concerned that, by artificially separating sales income from manufacturing income both U.S. and foreign tax would have been avoided. In today's parlance, Congress was concerned with the creation of "stateless" income This is described in legislative history as follows:

> Your committee also has ended deferral for American shareholders in certain situations where the multiplicity of foreign tax systems has been taken advantage of by American-controlled businesses to

[15] See Code §954(d)(1).

[16] See Code § 954(d)(2).

> siphon off sales profits from goods manufactured by related parties either in United States or abroad. In such cases the separation of the sales function is designed to avoid either U.S. tax or tax imposed by the foreign country.[17]

The 2009 revised corporate structure was particularly advantageous for LuxCo being incorporated in Luxembourg that employs a territorial system of taxation as it would pay no tax to Luxembourg on income sourced through W.I.N. in Mexico, thus creating the possibility that Whirlpool could achieve indefinite deferral of both U.S. and foreign taxes. The legislative history goes on and describes F.B.C.S.I. in the following terms:

> [It is] income from the purchase and sale of property without any appreciable value being added to the product by the selling corporation. This does not, for example, include cases where any significant amount of manufacturing, installation, or construction activity is carried on with respect to the product by the selling corporation. On the other hand, activity such as minor assembling, packaging, repackaging, or labeling would not be sufficient to exclude the profits from this definition.[18]

Congress considered F.B.C.S.I. as particularly subject to being moved abroad to a shell corporation in a low-tax jurisdiction without any significant impact on the company's actual business operations. In this regard legislative history stated:

> The sales income with which your committee is primarily concerned is income of a selling subsidiary (whether acting as a principal or agent) which has been separated from manufacturing activities of a related corporation merely to obtain a lower rate of tax for the sales income. As a result, this provision is restricted to sales of property to a related person or purchases of property from a related person. Moreover, since the lower tax rate for such a company is likely to be obtained through purchases and sales outside of the country in which it is incorporated, the provision is made inapplicable to the extent the property is manufactured, produced, grown, or extracted in the country where the corporation is organized or where it is sold for use, consumption, or disposition in that country. Mere passage of title, however, is not intended to be determinative of the location of the purchase or sale for this purpose.[19]

The legislative history then concluded with the following statement as to the scope of F.B.C.S.I.:

> Also included in foreign base company sales income are operations handled through a branch (rather than a corporate subsidiary) operating outside of the country in which the controlled foreign corporation is incorporated, if the combined effect of the tax treatment accorded the branch, by the country of incorporation of the controlled foreign corporation and the country of operation of the branch, is

---

[17] BNA Legislative History, Sec. 951, The Revenue Act of 1962 (P.L. 87-834) at p. 58.

[18] See *supra* note at p. 62.

[19] See *supra* note at p. 62.

> to treat the branch substantially the same as if it were a subsidiary corporation organized in the country in which it carries on its trade or business.[20]

ISSUES CONSIDERED BY THE TAX COURT

Manufacturing Exception

The first issue that the Tax Court considered was whether LuxCo could itself be considered to have purchased personal property from unrelated suppliers and sold it to a related person, *i.e.* Whirlpool and W.I.N. In this regard, Treas. Reg. §1.954-3(a)(4)(i) provides for a so-called "manufacturing exception,"[21] under which income of a C.F.C. from the manufacture and sale of property is not F.B.C.S.I. subject to the Code §954(d)(2) branch rule if the C.F.C. performed any of the following tasks:

"The first issue that the Tax Court considered was whether LuxCo could itself be considered to have purchased personal property from unrelated suppliers and sold it to a related person ..."

---

[20] BNA Legislative History, Sec. 954, The Revenue Act of 1962 (P.L. 87-834) at p. 84. When section 954(d)(2) was first proposed, it met the resistance of almost all of the witnesses who participated in the hearings before the Finance Committee. Comments included:

> We are opposed to this provision. We see no reason for permitting the Treasury in effect to disregard the form of business organization adopted by the controlled foreign corporation in such circumstances * * *
>
> In a nutshell, this provision will interfere with normal business decisions, will cause some existing branches to be abandoned with a resulting decrease in foreign sales, and will deter U.S. businesses from setting up manufacturing subsidiaries in any underdeveloped country which does not itself provide a sufficient potential market for the product * * *
>
> The entire provision is vague and uncertain in the extreme. Its application and operation are so uncertain that comment upon the provision is most difficult. Many foreign countries do not tax corporations organized under their laws with respect to income attributable to branches located in other countries. * * *
>
> In such cases it would appear that section 954(d)(2) might well lead those countries not taxing branch income to impose a "soak-up" tax on U.S. controlled corporations organized under their laws, but not on their foreign competitors.

[21] Treas. Reg. 1.954-3(a)(4)(i): "Foreign base company sales income does not include income of a controlled foreign corporation derived in connection with the sale of personal property, manufactured, produced, or constructed by such corporation in whole or in part from personal property which it has purchased. *A foreign corporation will be considered,* for purposes of this subparagraph, *to have manufactured, produced, or constructed personal property which it sells if the property sold is in effect not the property which it purchased.* In the case of the manufacture, production, or construction of personal property, the property sold will be considered, for purposes of this subparagraph, as not being the property which is purchased if the provisions of subdivision (ii) or (iii) of this subparagraph are satisfied." (Emphasis added.)

- It substantially transformed the product.[22]
- It conducted substantial activities in incorporating component parts.[23]
- It made a substantial contribution to the manufacturing.[24]

In *Whirlpool*, the I.R.S. contended that LuxCo and W.I.N. did not actually perform or contribute meaningfully to any manufacturing operations. Treas. Reg. 1.954-3(a)(4)(i) proposed in 2008 and finalized in 2011 provide that the manufacturing exception can be satisfied only by looking to the activities of the C.F.C.'s own employees.[25]

---

22 Treas. Reg. 1.954-3(a)(4)(ii): "If purchased personal property is substantially transformed prior to sale, the property sold will be treated as having been manufactured, produced, or constructed by the selling corporation."

23 Treas. Reg. 1.954-3(a)(4)(iii): "If purchased property is used as a component part of personal property which is sold, the sale of the property will be treated as the sale of a manufactured product, rather than the sale of component parts, if the operations conducted by the selling corporation in connection with the property purchased and sold are substantial in nature and are generally considered to constitute the manufacture, production, or construction of property. Without limiting this substantive test, which is dependent on the facts and circumstances of each case, the operations of the selling corporation in connection with the use of the purchased property as a component part of the personal property which is sold will be considered to constitute the manufacture of a product if in connection with such property conversion costs (direct labor and factory burden) of such corporation account for 20 percent or more of the total cost of goods sold. In no event, however, will packaging, repackaging, labeling, or minor assembly operations constitute the manufacture, production, or construction of property for purposes of section 954(d)(1)."

24 Treas. Reg. 1.954-3(a)(4)(iv)(a) added by T.D. 9438, is effective after 6/30/09: "If an item of personal property would be considered manufactured, produced, or constructed (under the principles of paragraph (a)(4)(ii) or (a)(4)(iii) of this section) prior to sale by the controlled foreign corporation had all of the manufacturing, producing, and constructing activities undertaken with respect to that property prior to sale been undertaken by the controlled foreign corporation through the activities of its employees, then this paragraph (a)(4)(iv) applies. If this paragraph (a)(4)(iv) applies and if the facts and circumstances evince that the controlled foreign corporation makes a substantial contribution through the activities of its employees to the manufacture, production, or construction of the personal property sold, then the personal property sold by the controlled foreign corporation is manufactured, produced, or constructed by such controlled foreign corporation."

25 Treas. Reg. 1.954-3(a)(4)(i) after amendment by T.D. 9438, is effective after 6/30/09: "Foreign base company sales income does not include income of a controlled foreign corporation derived in connection with the sale of personal property manufactured, produced, or constructed by such corporation. *A controlled foreign corporation will have manufactured, produced, or constructed personal property which the corporation sells only if such corporation satisfies the provisions of paragraph (a)(4)(ii), (a)(4)(iii), or (a)(4)(iv) of this section through the activities of its employees (as defined in § 31.3121(d)-1(c) of this chapter) with respect to such property. A controlled foreign corporation will not be treated as having manufactured, produced, or constructed personal property which the corporation sells merely because the property is sold in a different form than the form in which it was purchased* …" (Emphasis added.)

The preamble to the regulations states that: "[t]his definition of the term 'employee' may encompass certain seconded workers, part-time workers, workers on the payroll of a related employment company whose activities are directed and controlled by C.F.C. employees, and contractors, so long as those individuals are deemed to be employees of the C.F.C. under § 31.3121(d)-1(c)."

Neither LuxCo nor W.I.N. themselves had employees who performed manufacturing activities, as such activities were performed by employees of C.A.W. and I.A.W. The Tax Court stated that the 2011 version of the regulation did not apply to the years at issue, but it did not decide whether the 2002 version of the regulations required the manufacturing activities to be carried out by the C.F.C., itself.

In Rev. Rul. 75-7, revoked by Rev. Rul. 97-48, the I.R.S. held that, for purposes of applying the C.F.C. manufacturing exception, the manufacture, production, or construction activities need not be performed by the C.F.C.'s own employees. Rather, the C.F.C. could, under certain circumstances, subcontract those manufacturing activities to another person (including persons not related under 954(d)(3) and have those third-party activities attributed to itself for purposes of meeting the C.F.C. manufacturing exception. The I.R.S. issued a number of private rulings that followed Rev. Rul. 75-7 prior to its revocation, attributing the activities of a contract manufacturer to a hiring C.F.C. for purposes of qualifying the C.F.C. for the manufacturing exception to F.B.C.S.I.

"The Tax Court ... decided the case under the branch rule of Code §954(d)(2)."

In addition, the Tax Court in *Electronic Arts v. Commr.,* 118 T.C. 226 (2002), stated the following at p. 265.

> Our examination of (1) section 936(h)(5)(B)(ii) and the legislative history of that provision's enactment in 1982, and (2) section 954(d)(1)(A) and the legislative history of that provision's enactment in 1962, convinces us that there is not an absolute requirement that only the activities actually performed by a corporation's employees or officers are to be taken into account in determining whether the corporation manufactured or produced a product in a possession, within the meaning of sections 936(h)(5)(B)(ii) and 954(d)(1)(A).

Other cases have generally concluded that, in the absence of a specific definition of manufacturing, a person is the manufacturer of products even though its employees do not physically manufacture the products if the person

- controls the manufacturing process;,
- provides the intangible property necessary to the manufacturing process, and
- is the economic entrepreneur who enjoys the benefits and assumes the risks associated with the products.

See, *e.g.*, *Charles Peckat Mfg. Co. v. Jarecki*, 196 F.2d 849 (7th Cir. 1952) and *Polaroid Corp v. U.S.*, 235 F. 2d 276, 277 (1st Cir. 1956).[26]

<u>Application of the Branch Rule</u>

The Tax Court took a different approach to the issue. It decided the case under the branch rule of Code §954(d)(2). As mentioned above, under the manufacturing branch rule of Code §954(d)(2), when: (i) LuxCo conducts manufacturing outside its country of incorporation (Luxembourg) by or through a branch or similar establishment (W.I.N.) and (ii) the use of the branch (W.I.N.) has substantially the same tax effect as if the branch were a wholly owned subsidiary deriving the income, the

26 For a more detailed analysis of these I.R.S. rulings and Court cases, see Yoder, Lyon, and Noren, 6240 T.M., "C.F.C.s – Foreign Base Company Income (Other than FPHCI)," at pp. A67 thru A-72.

manufacturing branch (W.I.N.) and the remainder of the C.F.C. (LuxCo) are treated as separate corporations for purposes of the F.B.C.S.I. rules. Consequently, the sales made by or through the remainder of the C.F.C. (LuxCo) are treated as made on behalf of the manufacturing "separate corporation" (W.I.N.), which generally results in F.B.C.S.I.

The Tax Court found that the two conditions to the application of the branch rule applied in Whirlpool's facts. In particular, the Tax Court noted that LuxCo manufactured the products in Mexico using assets that it owned in Mexico (machinery, equipment, raw materials, and inventory) and services provided by W.I.N., which elected to be disregarded as a separate entity, making it a branch of LuxCo. In the view of the court, this mode of operation had substantially the same effect as if W.I.N. were a wholly owned subsidiary of LuxCo.

> By carrying on its activities through W.I.N. in Mexico, LuxCo avoided any current taxation of its sales income. It thus achieved "substantially the same effect" – deferral of tax on its sales income – that it would have achieved under U.S. tax rules if W.I.N. were a wholly owned subsidiary deriving such income. That is precisely the situation that the statute covers … Even without the refinements supplied by the regulations implementing Section 954(d)(2), the bare text of the statute, literally read, indicates that LuxCo's sales income is F.B.C.S.I. that must be included in Whirlpool's income under Subpart F.

Evaluation of Branch Rule Under Treas. Reg. Sec. 1.954-3(b)

The Tax Court then continued to evaluate the application of the branch rule under Treas. Reg. §1.954-3(b). As noted by the Tax Court, the text of the regulation "is […] quite dense, and […] not one that Ernst Hemingway would have written," and dictates a two-phase inquiry. First, there is an allocation of income between the branch (W.I.N.) and the remainder of the C.F.C. (LuxCo). Then, a comparison is made between actual and hypothetical "effective rates of tax" ("E.T.R.s") applicable to the sales income allocated to the remainder (LuxCo).

With regard to the first phase, the Tax Court noted that activities and income of LuxCo and W.I.N. can be separated quite easily given that the two are separate corporations. W.I.N. earned all of the manufacturing income, and all of the sales income was allocable to the remainder of LuxCo. The Tax Court then applied the tax rate disparity test under Treas. Reg. §1.954-3(b)(1)(ii)(b) by looking at the actual Luxembourg E.T.R. and the hypothetical Mexican E.T.R. The Tax Court noted that LuxCo, as a foreign principal under the *maquiladora* program, was deemed to have no P.E. in Mexico and thus was not subject to tax in Mexico. At the same time, for Luxembourg tax purposes, LuxCo was deemed to have a P.E. in Mexico and thus was not subject to tax in Luxembourg. Accordingly, LuxCo paid no tax to either jurisdiction in 2009. The actual Luxembourg E.T.R. was thus 0%.

The next step in the analysis was to determine the E.T.R. that would apply to the sales income under Mexican law if LuxCo were a Mexican corporation doing business in Mexico through a P.E. in Mexico and deriving all of its income from Mexican sources allocable to that P.E. In making the analysis, the Tax Court did not look to the 17% reduced rate applicable to *maquiladora* companies. Rather, it looked at the 28% rate applicable to Mexican corporations generally. As a 0% rate is less than 90% of and is more than 5 percentage points below the 28% rate, LuxCo's use of

W.I.N. in Mexico was considered to have had substantially the same tax effect as if the branch were a wholly owned subsidiary corporation. Whirlpool would have passed the tax rate disparity test if the effective Luxembourg tax rate and hypothetical Mexican tax rate were 24.2% and 28% or 0 and 0.56%, respectively.[27]

The approach undertaken by the I.R.S. in determining whether the tax rate disparity test is met resembles Prof. Avi-Yonah's single tax principle ("S.T.P."), which states that cross-border income should be taxed only once at the source-country rate for active income and at the residence-country rate for passive income. But if the preferred country (*i.e.*, source for active, and residence for passive) does not tax, it is incumbent upon the other country to do so because otherwise double non-taxation would result.[28] In other words, having determined that LuxCo has a P.E. in Mexico and that all but a small portion of its profits are attributable to W.I.N. under the Treaty, in the event that Mexico elects not to tax the income due to its domestic tax incentives, Luxembourg should tax the income even though is prohibited from doing so under the Treaty.

As explained by Lowell Yoder in his article soon before the decision was rendered,[29] the I.R.S. in *Whirlpool* argued that the actual tax rate on income of the home office must be calculated by attributing to the Luxembourg home office any income that is not subject to tax in Mexico or Luxembourg. For example, let us assume that $100 of income arises from the sale by LuxCo to a related person of products manufactured in Mexico. Under Luxembourg tax laws, and pursuant to a tax ruling, $95 of income is attributed to a Mexican P.E. (W.I.N.) and therefore only $5 of income is considered as derived by the home office in Luxembourg (LuxCo). That office had one administrative employee, who likely was housed in a "substance office" in Luxembourg. The $5 allocated to that office would have been subject to a 25% tax rate in Luxembourg. Under Mexican tax laws, only $5 of income from selling products manufactured in Mexico by LuxCo (which owned the tooling, raw materials, work in process and finished products located in Mexico) was taxable in Mexico. The tax rate was 28%. On the surface, the tax rates appear to be comparable. However, in *Whirlpool*, the I.R.S. argued and the Tax Court held that for purposes of determining the actual effective rate of tax on purchasing or selling income in the home office (LuxCo), the $90 of income not subject to tax in any country should be deemed to be derived by LuxCo. This is certainly one of the most controversial aspects that the 6th Circuit will have to look into when examining the Tax Court's decision in *Whirlpool* and determining whether there is authority supporting I.R.S.'s novel approach to applying the tax rate disparity test or reaffirming the principle that the statutory

---

27 PLR 200945036 (Nov. 6, 2009); PLR 200942034 (Oct. 16, 2009). See Yoder, "Local Law Governs Manufacturing Branch Determinations," 36 *Int'l Tax J.* 3 (July-Aug. 2010). AM 2015-002 (Feb. 13, 2015), see Yoder, "I.R.S. Provides Guidance for Calculating The Subpart F Branch Rule's Tax Disparity Test," *Tax Management Weekly Report (BNA)* (Feb. 8, 2016).

28 Reuven. S. Avi-Yonah, "Who Invented the Single Tax Principle?: An Essay on the History of US Treaty Policy" N.Y.L. Sch. L. Rev. 59, no. 2 (2015): 305-15.

29 Lowell D. Yoder, "Subpart F Sales Income: The 'Whirlpool' Case," *International Journal (BNA)* (Jan. 10, 2020).

branch rule does not treat as F.B.C.S.I. any income attributed to a C.F.C.'s home office, but only the income derived in a foreign branch.[30]

Are Manufacturing Branch Regulations Valid?

Finally, the Tax Court rejected Whirlpool's argument that the manufacturing branch regulations are invalid because they exceed Treasury's authority. Whirlpool's argument was that, based on the plain language of Code §954(d)(2), the branch rule applies only in situations where a C.F.C. conducts manufacturing activities and has a sales branch, not in the situation at issue where LuxCo conducts sales activities and has a manufacturing branch in Mexico, W.I.N.. The Tax Court thus turned to Chevron two-step test for assessing the validity of the regulations. The Tax Court stated that legislative history of subpart F leaves no doubt about Congress' intent as it indicated a concern about a tax motivated separation of a sales function from a manufacturing function. This is the second most controversial aspect of the Tax Court's decision in *Whirlpool*.

"[T]he Tax Court rejected Whirlpool's argument ... based on the plain language of Code §954(d)(2), the branch rule applies only in situations where a C.F.C. conducts manufacturing activities and has a sales branch ..."

In 1965, Stanley R. Fimberg was one of the first to study the language of Code §954(d)(2). He provided three different readings of Code §954(d)(2). Section 954(d)(2) reads as follows:

> For purposes of determining foreign base company sales income in situations in which the carrying on of activities by a controlled foreign corporation through a branch or similar establishment outside the country of incorporation of the controlled foreign corporation has substantially the same effect as if such branch or similar establishment were a wholly owned subsidiary corporation deriving *such income*, under regulations prescribed by the Secretary the income attributable to the carrying on of such activities of such branch or similar establishment shall be treated as income derived by a wholly owned subsidiary of the controlled foreign corporation *and shall constitute foreign base company sales income of the controlled foreign corporation*. (Emphasis added.)

For Stanley Fimberg, absent this emphasized language, there would be no problem in interpreting Code §954(d)(2) in such manner as to make it applicable to

---

[30] Andrew Velarde, "Whirlpool to Appeal Tax Court Manufacturing Branch Rule Decision," *Tax Notes Federal*, (Jul. 27, 2020); see also Whirlpool 10-Q, Quarterly Report, (Jul. 23, 2020) at p. 29:

> During its examination of Whirlpool's 2009 U.S. federal income tax return, the I.R.S. asserted that income earned by a Luxembourg subsidiary via its Mexican branch should be recognized as income on its 2009 U.S. federal income tax return. The Company believed the proposed assessment was without merit and contested the matter in United States Tax Court (US Tax Court). Both Whirlpool and the I.R.S. moved for partial summary judgment on this issue. On May 5, 2020, the US Tax Court granted the I.R.S.'s motion for partial summary judgment and denied Whirlpool's. The Company intends to appeal the US Tax Court decision to the United States Sixth Circuit Court of Appeals. The Company believes that it will be successful upon appeal and has not recorded any impact of the US Tax Court's decision in its consolidated financial statements.

manufacturing branches.[31] His question was whether such emphasized language could have prevented a court from applying the branch rule to manufacturing branches.

According to his first interpretation,[32] which is the strictest and most literal reading, Code §954(d)(2) was intended to cover only sales activities conducted through a branch. Section 954(d)(2) did not intend to cover manufacturing activities conducted through a branch. Thus, the emphasized language "such income" refers back to the sales income generated by the branch and indicates that such income shall constitute F.B.C.S.I. of the C.F.C.. According to Mr. Fimberg, this is not the only plausible construction of the statute.

A second possible construction of the statutory language would be to construe Code §954(d)(2) as applying to the branch, no matter what activities the branch is engaged in, *i.e.* manufacturing or selling activities. According to Fimberg, the income derived by a branch which has the requisite tax savings effect will be considered F.B.C.S.I., even though such branch is engaged in manufacturing and the selling is done by the remainder of the C.F.C. This construction results in the conversion of what would have been manufacturing income, if the activities had been conducted through a separate wholly owned subsidiary, to F.B.C.S.I. But, according to Mr. Fimberg, the conversion of manufacturing income into F.B.C.S.I. makes so little sense from the standpoint of proper interpretation of the overall statute that this construction was not advanced by the regulations.[33]

---

31 As mentioned above, see *supra* note n. 22, section 954(d)(2) was highly criticized by almost everyone who participated in the hearings before the Finance Committee. On October 3, 1962, Senator Carson added the following,

> My attention has been called to a serious ambiguity in connection with the language in proposed section 954(d)(2), found in section 12 of the bill. This concerns itself with treating a separate foreign wholly owned subsidiary, when the branch is located outside the country of incorporation of that controlled foreign corporation. The Secretary of the Treasury, under this section, is given the power to prescribe regulations for the purposes of treating as foreign base company sales income, certain income attributable to the carrying on of activities of this type of branch. This section has been criticized because the language might subject to tax the income of a branch which would not be treated as foreign base company sales income if it had been derived by a separate controlled foreign subsidiary. This was never intended. I want to set the record straight. The purpose of section 954(d)(2) is to treat as foreign base company sales income only such items of income of the branch which would have constituted foreign base company sales income to a controlled foreign corporation incorporated where the branch is located and performing the same or similar activities and functions. It was never intended that this section could be used to broaden the types of income, subject to tax under section 12, beyond those encompassed by these provisions when earned by controlled foreign corporations.

32 Stanley R. Fimberg, "The Foreign Base Company Engaged in Selling Activities: A Reappraisal of the Conduct of Foreign Business," 17 *MAJOR TAX PLAN*. 237 (1965), at pp. 267-268.

33 See *supra* note at p. 268.

Mr. Fimberg's opinion is that such emphasized language was

> intended only to prevent a constructive dividend, which constructive dividend was possible only in the sales branch case. Unless "such income" of a sales branch constitutes "foreign base company sales income of the controlled foreign corporation," there would be a substantial possibility that after the creation of the branch and the allocation of income thereto, in order to explain how the income actually got back to the remainder of the corporation, the branch would be treated as distributing a dividend to the remainder of the corporation. Thus, in the case of a sales branch, this emphasized language is very important. On the other hand, where manufacturing occurs in a branch, there is no need to provide special language in order to avoid a constructive distribution, since the sales income is already considered to be income of the remainder of the corporation and Subpart F does not, by its terms, deal with the manufacturing income. Therefore, in the manufacturing branch case, this phrase could be treated as surplusage and ignored.[34]

"[A] C.F.C.'s use of a manufacturing branch presented similar tax savings effect as the C.F.C.'s use of a purchasing or sales branch ..."

According to Stanley Fimberg[35] and Lowell Yoder,[36] when the Treasury Department and the I.R.S. promulgated the manufacturing branch rule, they believed that a C.F.C.'s use of a manufacturing branch presented similar tax savings effect as the C.F.C.'s use of a purchasing or sales branch, and that the manufacturing branch rule in the regulations therefore, is within the scope of Congress' intended purpose of Code §954(d)(2). Otherwise, an apparent loophole would have existed if manufacturing branches were not covered as taxpayers could easily avoid taxation simply by switching the functions around, placing the sales activities in the C.F.C. rather than in the branch. There is no doubt that Stanley Surrey would have regarded this as an absurd result.

In conclusion, as of consequence of Code §954(d)(2), W.I.N. is deemed to be a wholly owned subsidiary of LuxCo and LuxCo is deemed to have sold products to Whirlpool and W.I.N. on behalf of its deemed Mexican subsidiary. LuxCo thus derived income in connection with the sale of personal property to any person on behalf of a related person. Products were manufactured outside Luxembourg and were sold for use or consumption outside Luxembourg. LuxCo's sale income thus constituted F.B.C.S.I. under Code §954(d) and was taxable to Whirlpool as

---

34 See *supra* note at pp. 268-269.

35 See *supra* note at pp. 265-266: "Obviously, the same potential for separating the income derived from selling activities from the income derived from manufacturing activities and thereby obtaining a lower rate of tax for such selling activities than would obtain if all of the income had been subject to tax in the country in which manufacturing is undertaken exists with respect to a manufacturing branch as with respect to a sales branch."

36 Yoder, Lyon, and Noren, 6240 T.M., "C.F.C.s – Foreign Base Company Income (Other than FPHCI)."

Subpart F income under Code §951(a). In particular, the Tax Court pointed to example 2 under Treas. Reg. 1.954-3(b)(4) which

> reache[d] a similar conclusion after positing facts substantially identical to those here … [and] conclud[ed] that income derived by a manufacturing branch was not F.B.C.S.I. but that sales income derived by the remainder of the C.F.C. was F.B.C.S.I. under the branch rule because it was derived from 'the sale of personal property on behalf of the branch.[37]

The Tax Court thus concluded that

> Whirlpool's manufacturing activity in Mexico was conducted after 2008 exactly as it had been conducted before 2009, using the same plants, workers, and equipment. But the sales income was carved off into a Luxembourg affiliate that enjoyed a 0% rate of tax. The Luxembourg sales affiliate epitomizes the abuse at which Congress aimed … If LuxCo had conducted its manufacturing operations in Mexico through a separate entity, its sales income would plainly have been F.B.C.S.I. under sec. 954(d)(1). Sec. 954(d)(2) prevents Whirlpool from avoiding this result by arranging to conduct those operations through a branch.

---

[37] *Whirlpool*, n.11. Treas. Reg. Sec. 1.954-3(b)(4) Example 2, "Controlled foreign corporation C is incorporated under the laws of foreign country X. Corporation C maintains branch B in foreign country Y. Branch B manufactures articles in country Y which are sold through the sales offices of C Corporation located in country X. These activities constitute the only activities of C Corporation. Country Y levies an income tax at an effective rate of 30 percent on the manufacturing profit of C Corporation derived by branch B but does not tax the sales income of C Corporation derived by the sales offices in country X. Country X does not impose an income, war profits, excess profits, or similar tax, and no tax is paid to any foreign country with respect to income of C Corporation which is not derived by branch B. If C Corporation were incorporated under the laws of country Y, the sales income of the sales offices in country X would be taxed by country Y at an effective rate of 30 percent. In determining foreign base company sales income of C Corporation, branch B is treated as a separate wholly owned subsidiary corporation of C Corporation, the zero rate of tax on the income derived by the remainder of C Corporation being less than 90 percent of, and at least 5 percentage points less than, the 30 percent rate. *Branch B, treated as a separate corporation, derives no foreign base company sales income since it produces the product which is sold. Income derived by the remainder of C Corporation, treated as a separate corporation, from the sale by or through it for use, consumption, or disposition outside country X of the personal property produced in country Y is treated as income from the sale of personal property on behalf of branch B, a related person, and constitutes foreign base company sales income*." (Emphasis added.)

CONCLUSION

After *Ashland Oil*[38] and *Vetco*,[39] it seems that the Tax Court finally accepted the I.R.S.'s argument that Congress intended the C.F.C. branch rule to be a broad "loop-hole closing" provision, which should apply any time an arrangement separates the manufacturing and sales functions so as to avoid or limit tax on the sales income. There are some interesting takeaways for practitioners from the *Whirlpool* case: the court's application of the regulations' tax disparity test and the court's rejection of Whirlpool's arguments that the manufacturing branch regulations are invalid. But the most important one is whether and to what extent the result in *Whirlpool* will impact other cases, such as the one involving Apple,[40] and whether Code §954(d)(2) can be used to capture some stateless income.

---

[38] *Ashland Oil, Inc. v. Commr.*, 95 T.C. 348, 358 (1990).

[39] *Vetco, Inc. v. Commr.,* 95 T.C. 579, 590 (1990).

[40] See Lee A. Sheppard, "What About Cupertino?" *Tax Notes Federal* (Jul. 27, 2020) at p. 565 where the author argued that Apple would have had F.B.C.S.I. under the branch rule. Similar arguments had been made by Jeffery Kadet. See, Jeffery M. Kadet, "Attacking Profit Shifting: The Approach Everyone Forgets," *Tax Notes*, (Jul. 13, 2015), at p. 193.

FINAL REGS IMPLEMENT CHANGES TO SOURCE-OF-INCOME RULES FOR INVENTORY SALES

Author
Léa Verdy

Tags
863(b)
865(e)
Inventory
Sale
U.S. Office
50/50 Method
IFP

Léa Verdy is an attorney admitted to practice in New York and Paris. She holds an LL.M. in Taxation from New York University School of Law, a J.D. from Cornell Law School, and a Master 2 in International Commercial Law from University of Paris I – Panthéon-Sorbonne.

INTRODUCTION

In late 2019, the I.R.S. proposed regulations modifying rules for determining the source of income from sales of inventory property produced by a taxpayer without and sold within the United States, or produced by the taxpayer within and sold without the United States.[1] A public hearing on the proposed regulations was held on June 2020, and final regulations were published in October.[2]

The regulations implement changes made by the Tax Cuts and Jobs Act[3] (the "T.C.J.A."), to Code §863(b). These regulations also provide guidance under Code §865(e)(2) regarding sales of inventory through a U.S. office or fixed place of business. The regulations resolve interpretative issues arising from the T.C.J.A. and have important international tax planning implications for cross-border sales of inventory by U.S. corporations in outbound transactions and non-U.S. corporations in inbound transactions.

This article proceeds in three parts. The first presents the sourcing rules for sales of inventory before the T.C.J.A. The second describes the changes implemented by the T.C.J.A. and the guidance offered by the I.R.S. in the published regulations. Finally, the third part details some of the consequences of these regulations for taxpayers.

SOURCING RULES BEFORE THE T.C.J.A.

Code §865(a) generally sources income derived from the sale of goods to the residence of the taxpayer. However, Code §865(b) provides special sourcing rules for certain categories of sales, including sales of inventory property.

The Code distinguishes three types of inventory property sales and prescribes specific sourcing rules for each of them:

- Sales of purchased property, subject to sourcing rules under Code §§861(a)(6) and 862(a)(6);
- Sales of produced property, subject to sourcing rules under Code §863;
- Sales by nonresidents through a U.S. office, subject to sourcing rules under Code §865(e)(2) and (3).

---

1 REG-100956-19, issued December 30, 2019.

2 T.D. 9921 announced on October 19, 2020.

3 Pub. L. 115-97 (2017).

Of the three categories, the T.C.J.A. created uncertainty regarding the sale of produced inventory property sourced under Code §863 and the sale of inventory property through a U.S. office sourced under Code §865(e)(2).

Sale of Produced Inventory Property Under Code §863

"Prior to the effective date of the T.C.J.A., Code § 863(b) and Treas. Reg. §1.863-3 provided a three-step analysis to determine the source of income resulting from Code §863 sales."

Prior to the effective date of the T.C.J.A., Code §863 focused on income from the sale of inventory produced in one location and sold in a different location. To illustrate, the property could have been produced wholly or partly within the U.S. and sold outside the U.S., or it could have been produced wholly or partly outside the U.S. and sold within the U.S. ("Code §863 Sales"). The source of gross income from Code §863 Sales was considered to be derived from sources partly within the U.S. and partly from sources outside the U.S.

Code § 863(b) and Treas. Reg. §1.863-3 provided a three-step analysis to determine the source of income resulting from Code §863 sales. The first step was to apportion gross income between the production function and the sales function, using one of the following three methods:

- **The 50/50 method.** Under this method, 50% of the gross income from Code §863 Sales could be allocated to production activity and 50% could be allocated to sales activity.[4] This method applied to all Code §863 Sales unless the taxpayer properly elected the independent factory price ("I.F.P.") method or the books and records method for those sales.[5]
- **The I.F.P. method.** Under this method, a taxpayer could allocate its gross income based on the price at which the taxpayer regularly sold its inventory to wholly independent distributors or other selling concerns, provided that the taxpayer's sales activities with respect to such sales were not significant.[6]
- **The books and records method.**[7] Under this method, a taxpayer could allocate its gross income from Code §863 Sales between production and sales activities based upon the taxpayer's books of account.[8] The books and records method required prior approval from the District Director having audit responsibility over the taxpayer's tax return. Anecdotally, this method is believed not to have been widely used. It required a taxpayer to "fully explain . . . the methodology used, the circumstances justifying use of that methodology, the extent that sales are aggregated, and the amount of income so allocated."[9]

The second step was to determine the source of production income and sales income.[10] The source of the former category of income looked to the place of production,[11] whereas the source of the latter looked to the place of sale.[12] Production

[4] Treas. Reg. § 1.863-3(b)(1), as in effect at the time.

[5] Treas. Reg. § 1.863-3(e)(1), as in effect at the time.

[6] Treas. Reg. § 1.863-3(b)(2)(i), as in effect at the time.

[7] Treas. Reg. § 1.863-3(b), as in effect at the time.

[8] Treas. Reg. § 1.863-3(b)(3), as in effect at the time.

[9] Treas. Reg. §1.863-3(f)(2), as in effect at the time.

[10] Treas. Reg. §1.863-3(c), as in effect at the time.

[11] Treas. Reg. §1.863-3(c)(1), as in effect at the time.

[12] Treas. Reg. §1.863-3(c)(2), as in effect at the time.

activity meant "an activity that creates, fabricates, manufactures, extracts, processes, cures, or ages inventory."[13] The only production activities taken into account were those conducted directly by the taxpayer. Activities by contract manufacturers were not taken into account. If production activity was carried on both within and outside the U.S., the source of income was apportioned under a formula that looked to the average adjusted basis of all production assets within and outside the U.S.[14]

$$\text{Income attributable to production activity} \times \frac{\text{Average adjusted basis of production assets located outside the U.S.}}{\text{Average adjusted basis of production assets located within and outside the U.S.}}$$

The source of the taxpayer's income that was attributable to sale activities was determined under the title passage rule, according to which a sale of inventory property occurred when and where title passed.[15]

The third and final step was to determine the taxable income by allocating and apportioning expenses, losses, and other deductions to the various classes of gross income from Code §863 Sales.[16] Expense was first allocated and apportioned between Code §863 Sales and other sales under Code §863(b), and the portion allocated or apportioned to Code §863 Sales was then apportioned between gross income from sources within and without the United States.

Sale of Inventory Through a U.S. Office Under Code §865(e)(2)

Code §865(e)(2) addresses sales of inventory by a nonresident through a U.S. office. It provides the following:

Notwithstanding any other provisions of [Code §§861 to 865], if a nonresident maintains an office or other fixed place of business in the United States, income from any sale of personal property (including inventory property) attributable to such office or other fixed place of business shall be sourced in the United States.

Under Code §865(e)(3), the principles of Code §864(c)(5) related to the computation of effectively connected income apply to determine whether a nonresident maintains a U.S. office and whether a sale is attributable to that office. In determining whether a nonresident alien individual or a foreign corporation has a U.S. office, Code §864(c)(5)(A) disregards an agent's office or other fixed place of business except when the following two facts exist with regard to the agent:

- The agent:
  - Has, and regularly exercises, the authority to negotiate and conclude contracts in the name of the individual or foreign corporation or
  - Has merchandise from which the agent regularly fills orders on behalf of the nonresident individual or foreign corporation, and
- The agent is not a general commission agent, broker, or other agent of independent status acting in the ordinary course of its business.

---

13 Treas. Reg. §1.863-3(c)(1)(i)(A), as in effect at the time.

14 Treas. Reg. §1.863-3(c)(1)(ii)(A), as in effect at the time.

15 Treas. Reg. §§1.863-3(c)(2) & 1.861-7(c), as in effect at the time.

16 Treas. Reg. § 1.863-3(d)., as in effect at the time.

Additionally, Code §864(c)(5)(B) does not attribute income, gain, or loss to a U.S. office unless the U.S. office is a material factor in the production of that income, gain, or loss, and the U.S. office regularly carries on activities that generate such income. In practice, for inventory produced outside the U.S. and sold through a U.S. office, the I.R.S. historically approved a 50-50 split between U.S. source and foreign source income in applying Code §865(e)(2) to such produced inventory.

Code §864(c)(5)(C) further provides that, with respect to certain sales of inventory involving a sale or exchange outside the U.S. and described in Code §864(c)(4)(B)(iii), the amount attributable to the office or fixed place of business cannot exceed the income that would otherwise have been U.S. source had the sale been made in the United States. Among other things, this rule ensures that taxable effectively connected income from the sale of inventory is computed in the same manner whether the sale generates foreign source effectively connected income or U.S. source effectively connected income.

"... the place of production solely determines the source for sales of produced inventory."

CHANGES IMPLEMENTED BY THE T.C.J.A. AND THE FINAL REGULATIONS REGARDING SOURCE RULES FOR INCOME FROM THE PRODUCTION OF INVENTORY

The T.C.J.A. added the following sentence to the flush language of Code §863(b):

> Gains, profits, and income from the sale or exchange of inventory property described in paragraph (2) shall be allocated and apportioned between sources within and without the United States solely on the basis of the production activities with respect to the property.

Hence, the place of production solely determines the source for sales of produced inventory. This change gave rise to three distinct issues, addressed by the proposed regulations:

- The move to a single factor rule to determine source of income;
- The overlap of Code §863(b) and Code §865(e)(2) for a nonresident's foreign-source income attributable to a U.S. office;
- The applicability of Code §864(c)(5)(C)(iii) for purposes of Code §865(e)(2).

The Move to a Single Factor Rule to Determine Source of Income

To reflect the changes made by the T.C.J.A., the final regulations remove the three apportionment methods of Treas. Reg. § 1.863-3(b). In their place, the final regulations reiterate the flush language of Code §863 by providing that income from Code §863 Sales is sourced "solely on the basis of the production activities with respect to the inventory."[17]

Where production activity takes place within the U.S. and outside the U.S., the final regulations adopt several rules to avoid inappropriate computations that increase foreign source production activity:

[17] Treas. Reg. §1.863-3(b).

- The first is an anti-abuse rule to ensure that *de minimis* activity outside the U.S. does not affect the source of the income. This is achieved by reference to production activity as defined in the Foreign Base Company Sales rules that appear in Treas. Reg. §954-3(a)(4), which specifically eliminates packaging, repackaging, labeling, or minor assembly operations.[18]

- The second eliminates the consideration of any activity that constitutes a "substantial contribution to the manufacturing of personal property" under Treas. Reg. §1.954-3(a)(4)(iv).[19]

- Third, when there is production activity both within and without the United States, the ability of a taxpayer in the U.S. to write down the cost of qualifying property under Code §168(k) is expressly eliminated. Instead, the final regulations mandate use of the alternative depreciation system ("A.D.S.") of Code §168(g)(2) when computing the adjusted cost basis of production assets in the U.S. and outside the U.S.[20] The basis of both U.S. and non-U.S. production assets should thus be measured consistently on a straight-line method over the same recovery period.

- Lastly, the final regulations adopt a general anti-abuse rule ("G.A.A.R.") to prevent a corporate group from artificially skewing the computation of the amount of production activity apportioned to the U.S.[21] The G.A.A.R. rule has broad application. It can be used to neutralize any plan, such as a plan in which domestic production assets are acquired by a related partnership rather than the taxpayer if a principal purpose of the plan is a reduction in income subject to tax under Code §863.

The Overlap of Code §§863(b) and 865(e)(2)

The amendment to Code §863(b) under the T.C.J.A. raised several questions as to the scope and application of Code §865(e)(2) to determine the amount of gross income from sales of inventory through a U.S. office. Code §865(e)(2) applies notwithstanding any other provisions in Code §§861 through 865. Consequently, the statute may be read as overriding Code §863(b), where Code §863 Sales of a nonresident are attributable to an office or another fixed place of business in the United States. In this case, all inventory income from Code §863 Sales—*i.e.*, both production and sales income—attributable to a U.S. office would automatically be treated as U.S. source income. On the other hand, Code §865(e)(3) limits the scope of Code §865(e)(2) by providing that the principles of Code §864(c)(5) apply in determining whether a taxpayer has a U.S. office and whether a sale is attributable to that office. More specifically, Code §864(c)(5)(C) limits the amount of "income, gain, or loss" from sales that meet the "material factor" threshold of Code §864(c)(5) to the amount of income "properly allocable" to the office in the United States.

Before the T.C.J.A., the I.R.S. interpreted the amount properly allocable to the U.S. office as the amount reflecting sales activity rather than production activity. It is therefore a lesser amount of income than would be allocated under a literal reading of Code §865(e)(2) (*i.e.*, the entire amount of income). This seemed in turn to indicate that Code §865(e)(2) did not sweepingly override Code §863(b).

---

18 Treas. Reg. §1.954- 3(a)(4)(iii).

19 Treas. Reg. §§1.863-3(c)(1)(i) and 1.865- 3(d)(2).

20 Treas. Reg. §1.863-3(c)(2)(ii)

21 Treas. Reg. §1.563-3(c)(3).

This approach is retained in the final regulations. Treas. Reg. §1.865-3 applies only if a nonresident maintains an office or other fixed place of business in the United States to which a sale of personal property is attributable.[22] Otherwise, the source of the income, gain, or loss from the sale will be determined under other applicable provisions of section 865, such as section 865(b) through (d).

When an office exists in the U.S., the final regulations retain rules for determining the portion of gross income from sales and production activities that are attributable to the office.[23] The 50/50 method remains the default method in the final regulations. because it is viewed to be an appropriate and administrable way to apply Code §865(e)(2).[24] As in the proposed regulations, the final regulations allow nonresidents to elect a books and records method that would more precisely reflect gross income from both sales and production activities in the U.S., provided the nonresidents meet certain requirements for maintaining their books of account. However, once a taxpayer demonstrates the ability to use books of account to determine U.S. source gross income under the books and records method, it must continue to apply the books and records method until revoked. Moreover, the election to use the books and records method may not be revoked without the consent of the I.R.S. for any taxable year beginning within 48 months of the end of the taxable year in which the election is first made.

The Applicability of Code §864(c)(5)(C)(iii) for Purposes of Code §865(e)(2)

Code §864(c)(5)(C)(iii) imposes a limitation on income from sales outside of the United States made through an office or other fixed place of business in the United States: this income "shall not exceed the income that would be derived from sources within the United States if the sale or exchange were made in the United States." This special limitation appears to cap the amount of income from sales of inventory outside the United States that can be attributable to the U.S. office by the amount that would be U.S. source under the rules of Code §863(b). This is based on the assumption that the sale is made in the United States. Without application of Code §865(e)(2)(A), which treats the income from such foreign sales domestic income, the U.S. would not have the primary right to impose tax on the resulting income. Consequently, U.S. tax on such income could be offset by a foreign tax credit. Under the approach of the regulations, that is no longer the case.

But if income from the sale of inventory produced by a taxpayer is now sourced solely based on production activity under Code §863(b), is the rule in Code §865(e)(2)(A) overridden? If the answer is yes, none of the income would be allocable to a U.S. office under Code §865(e)(2).

The regulations disagree with this interpretation. As explained above, the I.R.S. believes that it is appropriate to maintain apportionment between production and sales activity when a foreign taxpayer maintains a U.S. office that materially participates in sales of inventory produced outside of the United States, even though such apportionment is no longer necessary under the general sourcing rule of Code §863(b). Under this view, Code §865(e)(2) applies notwithstanding any other provisions of Code §s 861 through 865, because the T.C.J.A. did not amend Code §865(e)(2) when it amended Code §863.

---

22 Treas. Reg. §1.863-3(b).

23 Treas. Reg. §1.865-3(d).

24 Treas. Reg. §1.865-3(d)(2)(i).

IMPLICATIONS OF THE FINAL REGULATIONS

Effective Dates of Final Regulations

Wiggle room exists as to the effective date of the proposed and final regulations. The proposed regulations were proposed to apply to taxable years ending on or after December 23, 2019, although taxpayers and their related parties could generally apply the rules in their entirety for taxable years beginning after December 31, 2017, and ending before December 23, 2019.

The final regulations generally apply to taxable years ending on or after December 23, 2019. Taxpayers may choose to apply the final regulations for any taxable year beginning after December 31, 2017, and ending before December 23, 2019, provided that the taxpayer and all persons that are related to the taxpayer within the meaning of section 267 or 70 apply the final regulations in their entirety and, once applied, the taxpayer and all such related persons continue to apply the final regulations in their entirety for all subsequent taxable years.[25]

Alternatively, taxpayers may rely on the proposed regulations for any taxable year beginning after December 31, 2017, and ending on or before December 31, 2020 provided that the taxpayer and all persons that are related to the taxpayer rely on the proposed regulations in their entirety and provided that the taxpayer and all such persons have not applied the final regulations to any preceding year.

Manufacturers of Inventory Property

Given that the T.C.J.A. amendment to Code §863(b) applies to tax years beginning after December 31, 2017, the removal of the apportionment methods available under the current Code §863(b) regulations was expected.

"Wiggle room exists as to the effective date of the proposed and final regulations."

In comparison, the computation of adjusted basis of U.S.-located production assets using the A.D.S. method may be a surprise to nonresident taxpayers who believed that the T.C.J.A. should be read as a unified whole, including Code §§863(b) and §168(k).[26]

The burden of maintaining multiple asset books cannot be overstated. According to Fox Rothschild LLP, taxpayers may have to maintain as many as four sets of depreciation schedules covering various provisions of the Code and financial accounting reporting.[27]

Nonresidents Selling Inventory Property Through a U.S. Office

The proposed regulations require sourcing of Code §863 Sales based solely on the location of production activities, consistent with the amended Code §863(b). However, this does not mean that sales are necessarily foreign source if the production activities are entirely outside the United States. Under Code §865(e)(2), a portion of this income can be characterized as U.S. source income if the nonresident maintains

---

[25] See section 7805(b)(7).

[26] US: Source-of-Income Rules Modified by Proposed Regulations Implementing T.C.J.A. Changes, EY (Jan. 9, 2020).

[27] Fox Rothschild LLP, comment. on Notice of Proposed Rulemaking: Proposed Amendments to Regulation Code §1.863-3 on Source of Income from Certain Sales of Personal Property, at 7 (Feb. 28, 2020).

a U.S. office, and if such U.S. office is a material factor in generating the income. As a result, in order to avoid U.S source income under the proposed regulations, a nonresident must establish that it does not have a U.S. office or place or business or, if it does, that such U.S. office is not a material factor in generating the income. Of course, if personnel in the U.S. receive compensation that is directly tied to sales, the ability to avoid U.S. source income is likely remote.

Individuals Operating a Business as a Sole Proprietorship/Pass-Through

The proposed regulations also raise questions in the context of Code §199A. Code §199A provides a deduction to owners of sole proprietorships, partnerships, S corporations, and some trusts and estates in connection the operation of a qualified trade or business. Subject to certain limitations, the Code §199A deduction generally equals 20% of the individual's qualified business income ("Q.B.I.").[28] Q.B.I. arises from qualified items of income, gain, loss and deduction in a qualified trade or business. Code §199A(c)(3)(A) further provides that whether the income arises in a qualified business is determined under concepts developed under Code §864(c) related to nonresident persons and income that is effectively connected to the conduct of a trade or business in the U.S. Thus, whether an individual is a U.S. resident or a nonresident, noncitizen, the tax return preparer must be familiar with the concepts of Code §864.

CONCLUSION

The final regulations issued under Code §s 863(b) and 865(e)(2) provide necessary guidance on the changes implemented by the T.C.J.A. The application of the new rules may change the amount of U.S. and foreign source income for certain taxpayers, who must be particularly attentive to the implications of the proposed regulations.

28 Code § 199A(a)(1).

WITH GREAT POWER (CONTROL) COMES GREAT RESPONSIBILITY – FORM 5471 CATEGORY 4 FILER

Authors
Neha Rastogi
Galia Antebi

Tags
Attribution
Bare Ownership
Category 4 Filer
Code §6038
Control
Form 5471
Nonresident Family Member
Usufruct

No, we are not talking about our favorite Marvel comic superhero, friendly neighborhood Spider-Man! But we are borrowing the Peter Parker principle to place emphasis on the fact that if you have the power to control a foreign corporation, then it comes with a greater responsibility when filing Form 5471, Information Return of U.S. Persons With Respect To Certain Foreign Corporations ("Form 5471"). This article will focus on the application of the attribution rules for purposes of determining who is a Category 4 Filer (a term of art) who is deemed to be in control for purposes of Form 5471.

LET'S BACK UP BEFORE MOVING FORWARD

A Controlled Foreign Corporation ("C.F.C.") is a foreign entity treated as a corporation for U.S. tax purposes that is owned by one or more "U.S. Shareholders" that collectively own (directly, indirectly, or constructively) more than 50% of the total combined voting power of all classes of stock or more than 50% of the total value of the stock of the foreign corporation. A U.S. Shareholder is a U.S. person who (directly, indirectly, or constructively) owns shares representing at least 10% of (i) the total combined voting power of all classes of stock entitled to vote or (ii) the total value of all issued and outstanding stock of a foreign corporation.

If a foreign corporation meets the definition of a C.F.C., each U.S. Shareholder of the corporation is subject to U.S. Federal income tax on his *pro-rata* share in the income of the corporation attributed to shares owned directly or indirectly (but not constructively). This means that while constructively owned stock is considered as actually owned for purposes of determining whether a U.S. person is a U.S. Shareholder and whether a foreign corporation is a C.F.C., the constructively owned stock is ignored for the purposes of income inclusion. Constructive ownership for these purposes is provided for in Code §958(b), with reference to the attribution rules of Code §318, subject to certain modifications.

If certain conditions are met, a U.S. person who directly, indirectly, or constructively own shares in a foreign corporation is required to file Form 5471 to provide the I.R.S. with information relating to the foreign corporation and its financial results. Form 5471 is attached to the filer's U.S. Federal income tax return and is due by the due date (including extensions) for the income tax return. The obligation to file Form 5471 may exist even if the foreign corporation is not a C.F.C.

There are total of five Form 5471 filing categories, however the focus of this article is the Category 4 Filer only. As will be discussed below, due to the application of the attribution rules for these purposes, which differs from its application for purposes of determining the U.S. person's status as a U.S. Shareholder, a U.S. person may not be a U.S. Shareholder for purposes of determining whether a foreign corporation is a C.F.C. but may still meet the definition of a Category 4 Filer and be subject to the full responsibilities that come with that status.

FORM 5471 CATEGORY 4 FILER

The reporting requirement of a Category 4 Filer is found in Code §6038 and Treas. Reg. §1.6038-2 (“Category 4 Filer Regulations”). A Category 4 Filer includes a U.S. person who has control of a foreign corporation during the annual accounting period of the foreign corporation.[1] A person is in control of a corporation if such person owns stock possessing more than 50% of the total combined voting power of all classes of stock entitled to vote, or more than 50% of the total value of shares of all classes of stock, of a corporation.[2] Additionally, a person in control of a corporation which, in turn, owns more than 50% of the combined voting power, or of the value, of all classes of stock of another corporation is also treated as being in control of such other corporation.[3]

For purposes of determining a person’s control of a corporation, the Category 4 Filer Regulations make reference to Code §318(a) which provide for the application of the attribution rules, subject to certain modifications.[4] Those modifications are not identical to the modifications in Code §958(b) which provides for constructive ownership for purposes of determining the status of a U.S. person as a U.S. Shareholder.

Family Attribution Rules under Code §318(a) for a Form 5471 Category 4 Filer

The direct or indirect ownership interest of a family member of a U.S. person is attributed to the U.S. person for purposes of determining whether he or she controls a foreign corporation.[5] The family members of an individual include the following:

1. The spouse of the individual.
2. The children, grandchildren, and parents of the individual.[6]

No rule prevents attribution of shares of stock from a nonresident, non-citizen individual. Hence, for purposes of determining whether a U.S. person has control, ownership is attributed for shares held by a nonresident-noncitizen family member.[7] However, there is no attribution among siblings and no attribution from grandparents, *i.e.*, stock owned by a grandparent will not be deemed owned by a grandchild. But stock owned by a grandchild will be deemed owned by a grandparent. Additionally, stock attributed to a family member will not be treated as actually owned for purposes of reattribution to another.[8]

---

1 Code §6038(a)(1)(D)(ii).

2 Code §6038(e)(2).

3 Treas. Reg. §1.6038-2(b).

4 Treas. Reg. §1.6038-2(c).

5 Code §6038(e)(2); Treas. Reg. §1.6038-2(c).

6 Code §318(a)(1).

7 In contrast, as modified under Code §958(b)(1), for purposes of determining the status of a U.S. person as a U.S. Shareholder, the family attribution rule of Code §318 is only applied for stock owned by a family member who is a U.S. person.

8 Code §318(a)(5)(B).

Example 1

A family comprises of a foreign husband (H) and a U.S. citizen wife (W). The couple has a son, S, and daughter, D, both of whom are also U.S. citizens. The family owns foreign corporation, FC, in which H owns 75%, W owns 15% and each of S and D own 5%. The voting rights and value of each shareholder is in proportion to their ownership interest in FC. Can W, S, and D be treated as having control over FC such that each of them must file Form 5471 on an annual basis?

Analysis

1. For W:

    a. W directly owns shares representing 15% of the ownership in FC.

    b. Due to family attribution between a mother and her children, W will be deemed to own the direct interest of her children, resulting in W being treated as owning 25% of FC.

    c. Additionally, due to family attribution between a husband and wife, W will also be deemed to own the direct interest owned by H, notwithstanding his nonresident status. This is because unlike the modification in Code §958(b)(1) with respect to U.S. Shareholder, the family attribution rules under the Category 4 Regulations do not prohibit attribution from a nonresident family member.

    d. Therefore, W is treated as owning 100% interest in FC and therefore is said to control FC. As a result, she is a Category 4 Filer and must file Form 5471 with respect to FC on an annual basis.

2. For S and D:

    a. S and D will also be treated as having control over FC since each will be treated as owning 95% interest in FC. This is because more than one family member can be attributed the same stock. Therefore, each of S and D will be attributed the ownership interest of their parents (75% from their father; 15% from their mother; and their own 5%).

    b. Attribution is not allowed among siblings, therefore, neither will be deemed as owning the 5% owned by the other.

    c. Therefore, both S and D are treated as Category 4 Filers and must file Form 5471 with respect to FC on an annual basis.[9]

Wondering, if FC is a C.F.C.? For purposes of determining C.F.C. status, family attribution does not apply in the case of a nonresident shareholder. Nevertheless, more than 50% of FC will be deemed U.S. owned as follows: W is deemed to own 25% (15% directly plus 5% from each of her children, S and D; but not her nonresident husband's 75%), S and D will be deemed to own 20% each (5% directly plus 15% from their mother). As a result, all three U.S. family members are deemed U.S. Shareholders and collectively, they are deemed to own 65% of FC. As a result, W, S and D may have income inclusion with respect to FC's earnings, in proportion to their actual ownership in FC.

---

[9] Notwithstanding the obligation to file, the Multiple Filer Exception discussed below may alleviate this obligation.

Observe, however, that if W owned 9% and H owned 81%, while all U.S. family members would still be treated as having control for purposes of Category 4 Filer, FC would not be a C.F.C. and no one would face income inclusion. This is because W would be treated as owning 19% (9% directly plus 5% from each child) and each of S and D would be treated as owning 14% (5% directly plus 9% from their mother). As a result, all would have been treated as U.S. Shareholders whose ownership count towards C.F.C. status, but together, their ownership would have been 47%, lower than the required threshold. Additionally, while the filing obligation would theoretically apply, an exception discussed below would have eliminated such obligation.

EXCEPTIONS TO FILING FORM 5471 AS CATEGORY 4 FILER

A U.S. person who is a Category 4 Filer for Form 5471 reporting purposes may be exempt from the reporting obligation under the following alternate circumstances:

1. **First Exception:** If two or more persons are required to file a Form 5471 with respect to the same foreign corporation for the same period, they may jointly file one Form 5471 and attach it to the tax return of any one of the persons required to file.[10] This is known as the Multiple Filer Exception.

2. **Second Exception:** A person who does not directly own stock of the corporation, but is required to file a Form 5471 solely by reason of attribution of stock from a U.S. person, is excused from filing if the direct owner of the stock from whom the stock was attributed furnishes the required information.[11]

3. **Third Exception:** A U.S. person who does not own a direct or indirect interest in the foreign corporation; and is required to furnish information solely by reason of attribution of stock ownership from a nonresident alien(s) as a result of the attribution rules of Code §318(a) is exempt from filing a Form 5471.[12]

Under the Multiple Filer Exception, the person who does not attach Form 5471 to his or her income tax return must submit with the return a statement indicating that the reporting obligation is being satisfied by another and identify the person who fulfils the reporting obligation and the place where his return is filed.[13] The person who files Form 5471 must identify the persons who are included on his or her return. Under the second and third exceptions, no statement is required to be included with the tax return of the person claiming the exception.

Example 2

The facts are the same as in the Example 1. Since W, S, and D are all required to file Form 5471 for FC for the same period, any one of them may file Form 5471 on behalf of the other two and absolve them of their reporting obligation. The person filing

[10] Treas. Reg. § 1.6038-2(j)(1).

[11] Treas. Reg. § 1.6038-2(j)(2).

[12] Treas. Reg. § 1.6038-2(l).

[13] Treas. Reg. § 1.6038-2(j)(3).

Form 5471 (assume W, the mother) must complete Item F, *Person(s) on Whose Behalf This Information Return Is Filed*, on Page 1 of Form 5471 to report S and D's full name, address, and their U.S. Tax Identification Number (generally, their S.S.N.). At the same time, S and D must submit with their Form 1040, *U.S. Individual Income Tax Return*, a statement indicating that their Form 5471 reporting obligation is being satisfied by their mother, W, and including her S.S.N. and the I.R.S. service center where her tax return is filed.

Example 3

Ms. Texas is a single mother of Florida and Georgia. All of them are U.S. citizens. Ms. Texas and Florida own a European travel company, Going Places Inc. 60% / 40%, respectively. Does Georgia have a Form 5471 filing obligation?

Analysis

a. Georgia does not own any direct or indirect interest in Going Places Inc.

b. However, the 60% ownership interest of her mother, Ms. Texas will be attributed to her under the family attribution rules.

c. The attribution rules do not apply attribution between siblings and therefore, Florida's 40% interest will not be attributed to Georgia.

d. As a constructive owner of 60%, Georgia is treated as having control over Going Places.

e. Georgia may claim exemption from reporting under the Multiple Filer exception if Texas agrees to identify her on her Form 5471 and Georgia submits a statement indicating that her reporting obligation has been met by Texas.

f. Alternatively, since Georgia does not *directly* own any stock of Going Places, Inc., but is required to file a Form 5471 solely by reason of the attribution of stock ownership from her U.S. mother, Ms. Texas, she can claim exemption from filing Form 5471 under the second exception. The second exception is likely better than the Multiple Filer Exception since neither Georgia is required to attach any statement with her U.S. personal income tax return nor is Ms. Texas required to furnish any information about Georgia on her Form 5471.

Example 4

D is the daughter of a wealthy Australian couple. The parents equally own multiple conglomerates all around the world. D arrived in the U.S. on an F-1 visa on Jan 1, 2018, to pursue a master's degree. She is expected to complete the course by December 31, 2020, after which she intends to obtain an H-1b visa (work visa) and work for a U.S. employer on a full-time basis. D asks about her U.S. tax reporting obligations once she becomes a U.S. resident under the substantial presence test, in particular, with respect to non-U.S. entities owned by her parents.

Analysis

a. D does not own any direct or indirect interest in any of the family owned foreign corporations.

b. The 50% ownership of each of the parents will be attributed to D under the family attribution rules, as applicable for purposes of the Category 4 Filer Regulations, despite the fact her parents are nonresidents.

c. As a result, D will be treated as owning 100% of the voting rights and value of the foreign corporations and therefore will be treated as having control of each such corporation.

d. However, under the third exception mentioned above, D will be exempt from filing Forms 5471 with respect to such foreign corporations. This is because she does not own any direct or indirect interest in any foreign corporation and would be required to furnish Form 5471 solely by reason of attribution of stock ownership from nonresident aliens.

If D owned a 10% direct interest in one of the foreign corporations in which her parents also own equal direct interest of 45% each, no exception would apply and she would have to file Form 5471 with respect to such foreign corporation. This is because no other person is required to furnish the same information, the attribution is not from a U.S. person who fulfils the reporting requirement, and she owns a direct interest.

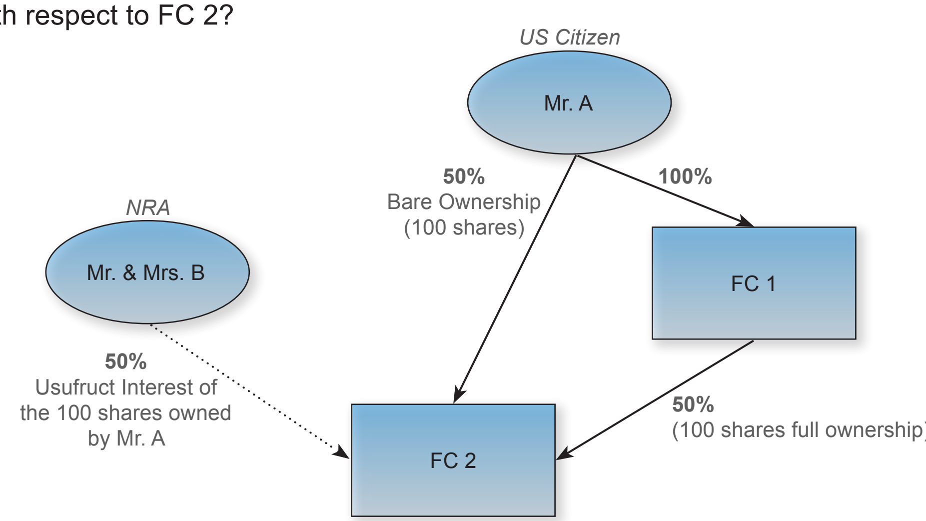
DETERMINING CONTROL WHEN OWNERSHIP IS SPLIT BETWEEN *USUFRUCT* AND BARE OWNERSHIP

Splitting ownership into *usufruct* and bare ownership is a common estate planning technique in several civil law countries. It typically involves an older generation making a gift of bare ownership in an income generating asset to members of a younger generation. The person making the gift retains the *usufruct* interest. A *usufruct* interest gives its holder the right to the enjoyment of the underlying asset and the right to the income generated by the underlying asset. With respect to the stock of a company, the *usufruct* holder, typically, also has the voting rights. A bare ownership, on the other hand, essentially indicates that the stock is held in the name of the holder of bare ownership that gives him the right to transfer the stock, but not to receive dividends.

When viewed from a U.S. tax point of view, this planning technique may give rise to reporting obligations as a Category 4 Filer for Form 5471 purposes for the bare legal owner and / or the *usufruct* interest holder, depending on the different facts.

Example 5

FC 2, a foreign corporation, has one class of stock and 200 outstanding shares. Mr. A, a U.S. citizen, owns the bare legal title of 100 shares of the stock. Mr. A's parents, Mr. and Mrs. B are nonresidents noncitizens. Mr. and Mrs. B hold the *usufruct* interest with respect to the 100 stock of FC 2 owned by their son, A. The *usufruct* interest gives them the right to receive dividends and right to vote. A is the sole shareholder of another foreign corporation, FC 1, which in turn owns the remaining 100 shares of FC 2 (both the bare ownership and *usufruct*). Is Mr. A required to file Form 5471 with respect to FC 2?



<u>*Analysis*</u>

a. Mr. A owns the bare legal title to 100 shares of stock of FC 2. It means that the stock certificates with respect to the 100 shares indicate Mr. A as the legal shareholder.

b. Mr. and Mrs. B have *usufruct* interest with respect to the 100 shares of stock owned by Mr. A. In other words, Mr. and Mrs. B, both, own 50% of the voting rights and value of FC 2.

c. The *usufruct* interest of Mr. and Mrs. B will be attributed to Mr. A under the family attribution rules of the Category 4 Filer regulations.

d. As a result, Mr. A will be treated as owning 50% of the voting rights and value of FC 2.

e. Additionally, Mr. A also fully owns 100% of FC 1, which in turn, owns the remaining 100 shares of stock of FC 2 (or 50% ownership interest).

f. As a result, by attribution from FC 1, Mr. A will be treated as owning a proportionate interest in the stock of FC 2. In other words, Mr. A will be treated as indirectly owning 50% ownership interest (100% x 50%) in FC 2.[14]

g. Consequently, Mr. A is treated as owning 100% of FC 2 for purposes of determining control of FC 2 as a Category 4 Filer.

Observe that for purposes of determining whether FC 2 is a C.F.C., the 50% voting rights and value owned by Mr. and Mrs. B as a result of their *usufruct* ownership will not be attributed to Mr. A because the family attribution rules are "turned off" for nonresidents under Code §958(b). Therefore, while FC 2 is not a C.F.C., Mr. A must file Form 5471 as a Category 4 Filer.

---

[14] Treas. Reg. §1.6038-2(c)(3) read with Code §318(a)(2)(C) provides that if a person owns 10% or more in the value of the stock of a corporation, that person shall be deemed to own the stock owned by that corporation in proportion to the person's interest in that corporation.

PENALTIES FOR FAILURE TO TIMELY FILE FORM 5471

A failure to timely file Form 5471 by a Category 4 Filer is subject to a $10,000 penalty for each annual accounting period of each foreign corporation.[15] An additional $10,000 penalty, limited to $50,000, (per foreign corporation) may be imposed if the form is not filed within 90 days after a notification of noncompliance by the I.R.S. for each 30-day period, or fraction thereof, after the 90-day period has expired.[16] Further, a failure to timely file Form 5471 results in a reduction of the foreign tax credits by 10% which are further reduced if noncompliance continues after a notification by the I.R.S.[17] More importantly, the statute of limitation on the assessment of a tax return does not begin to run if Form 5471 is not filed, as a result, the tax return remains open for audit indefinitely. A failure my also attract criminal penalties.[18]

CONCLUSION

Thousands of foreign nationals come to the U.S. every year. The reasons may be umpteen: higher education, better employment opportunities, business venture, etc. Depending on many factors, these individuals may become U.S. residents sooner or later. Due to the significant penalties applicable for noncompliance, when this epic event occurs, and ideally, before, it is imperative to carefully examine foreign structures and determine U.S. tax consequences that may result, including when the effect is "merely" that of compliance.

"More importantly, the statute of limitation on the assessment of a tax return does not begin to run if Form 5471 is not filed, as a result, the tax return remains open for audit indefinitely."

15 Treas. Reg. §1.6038-2(k)(1)(i).

16 Treas. Reg. §1.6038-2(k)(1)(ii).

17 Treas. Reg. §1.6038-2(k)(2).

18 Treas. Reg. §1.6038-2(k)(4).

WAIT NO LONGER, THE OTHER SHOE WON'T DROP IN DENMARK

Author
Michael Peggs

Tags
Arm's Length
Ecco
Inventory
Transfer Pricing

INTRODUCTION

Imagine you are in a Lower East Side tenement in the 19th century. It is 2:00 a.m. and the building is totally quiet. Then, a sound from above. It is a shoe dropping on the floor. You wait for the inevitable follow-up: the sound of a second shoe landing on the floor.

In October, the Danish Tax Agency received a decision[1] from the Western High Court concerning an appeal originating from a transfer pricing audit commenced in 2006. The audit outcome and the lower court decision was the sound of the first shoe. Where is the sound of the second shoe?[2]

Understanding that inevitable has a different meaning for companies and tax authorities, we summarize a recent decision concerning the price of finished shoes and shoe shafts[3] paid by Ecco Sko A/S to its foreign controlled producers. It seems in the world of transfer pricing litigation, a pattern of mutual expectations has emerged. Companies expect tax authorities to take revenue-maximizing positions and expect courts see the issue more clearly and vacate or substantially vary the assessment of the tax authority. At the same time, tax authorities expect that courts will uphold audit findings of material transfer pricing income adjustments using methods and data overlooked or ignored by companies.

Here Ecco Sko A/S prevailed on appeal from an adverse National Tax Court decision, showing that litigation continues to highlight how companies and tax authorities remain at odds over several fundamental matters.[4]

A STUDY IN TRANSACTION PRICING

In the case of Ecco Sko A/S ("Ecco"), the company is the Danish parent of a group that is the designer and producer of various styles of leather shoes sold around the world. The group produces shoes and shoe components (shafts and handles) in controlled and uncontrolled production companies, purchases all finished product that meets its quality standards, and then sells finished shoes to both controlled

---

1 Sagsnummer/Case number BS-714/2016, Vestre Landsret.

2 Wait for the other shoe to drop, a term believed to have an origin on the Lower East Side, is defined as "To defer action or decision until another matter is finished or resolved" in the *American Heritage dictionary of the English language (5th ed.)*. 2011. New York: Houghton Mifflin Harcourt,

3 The portion of a boot between the top of the heel and the top of the boot.

4 Ecco Sko A/S was represented by Plesner Advokatpartnerselskab. Plesner has written a case summary available here.

and uncontrolled sales companies. The Danish parent performs the functions of company headquarters, with the exception of purchasing that is a split responsibility with another group company.

We don't need to know many more facts to make an informed guess at which broad transfer pricing questions will be critical to the ultimate finding of whether products were priced at arm's length. The important questions are:

1. Were shoes purchased from controlled and uncontrolled producers on comparable terms and under comparable conditions?

2. Were shoes sold to controlled and uncontrolled sales companies on comparable terms and under comparable conditions?

Ecco answered these questions in its 2005 transfer pricing documentation and supplemented its response with other data and analysis submitted to the Danish tax authority during the course of the audit. Its answers were perhaps not as expected by the tax authority, as they had much to do with the operation of an industry standard used to set prices and the process by which these prices are set. It is apparent that Ecco's initial 2005 transfer pricing documentation was neither comprehensive nor comprehensible to the tax authority owing to several contradictions and shortcomings. This appears to have made the verification process difficult from the get-go.

"It is apparent that Ecco's initial 2005 transfer pricing documentation was neither comprehensive nor comprehensible to the tax authority."

Ecco explained that shoe producers and buyers negotiate prices for each season using producer information on expected production costs, volumes, production efficiency, and technology. Ecco, as the buyer, had to consider its product pricing at various market levels (wholesale, retail, own-stores), demand for various styles, and discounts to intermediaries (both controlled and uncontrolled). Between Ecco and its controlled and uncontrolled producers, annual price negotiations took place that appeared to treat all producers the same despite Ecco's information advantage when negotiating with a controlled producer.

In a purposeful way, Ecco set prices and output targets to provide an incentive for all producers (both controlled and uncontrolled) to increase productive efficiency, lower production costs, and retain any profit resulting from exceeding agreed targets. Ecco explained this was an industry norm demonstrated by its 3rd party producer negotiations and transactions. Producers and buyers divide the risk encountered at the various stages in the supply chain at arm's length, and no pricing adjustments are made throughout the year. Importantly, Ecco showed that negotiations with controlled producers approximated arm's length negotiations in part by virtue of the alignment of producer productivity and efficiency targets with managerial compensation and the general company philosophies of continuous improvement and openness. It is well known that hard bargaining is not evidence of arm's length terms, but Ecco appears to have offered a more structured explanation based on the known business practices of its industry.

Ecco's position was therefore based on the O.E.C.D. transactional net margin method, with operating profit measured in the most reliable way, at the transaction level. In addition to measuring the transactional profit of the producer, Ecco employed a secondary transfer pricing method to examine its resale margins on sales of shoes purchased from controlled and uncontrolled producers. As was the case with its primary transfer pricing method, detailed knowledge of the business and the economic conditions prevailing in the controlled and uncontrolled transactions was needed to reliably check the outcome of the company transfer pricing policy. Interpretation of resale margin variations caused by different product types and product market conditions (children's shoes earned relatively low margins while women's shoes and golf shoes earn higher margins), and different manufacturing techniques and cost structures (injection-molded soles versus glued or cemented soles) later became important in argumentation concerning the correct application of the resale price method.

TAX AUTHORITY POSITION

The tax authority position was based primarily on its finding that Ecco's transfer pricing documentation was deficient. The finding of deficiency allowed the tax authority to use its discretion to adjust the transfer prices in both the purchase and sale transactions carried on by Ecco during the 2005 tax year. The finding of deficiency depended on the date of the transfer pricing documentation, with the tax authority having determined that supplementary documentation and analysis submitted by Ecco during the audit could be disregarded. The appeal before the High Court concerned only the purchase transactions, as the tax authority agreed not to pursue an adjustment of the sale prices.

The income adjustment to two transaction series, purchases from Thai and Indonesian controlled producers, was estimated using the transactional net margin method and a rate of return on producer cost derived from a set of general manufacturers identified in a database search. The tax authority found that the cost markups reported by the Thai and Indonesian controlled producers was greater than its derived rate of profit, and reassessed tax on Ecco by lowering its cost of purchased inventory.

A further adjustment to another controlled producer was determined after the tax authority noted its relatively high level of profitability. In this instance, the tax authority attributed royalty income to Ecco from the controlled producer, arguing that Ecco had inappropriately allowed its intangible property to be used by the controlled producer at no charge. As this producer supplied an Ecco affiliate with finished shoes and shafts, the practical result of the transfer pricing adjustment was an increase in the producer's total cost of production. It is less clear which Ecco affiliate other than the producer should be given inventory cost relief.

HIGH COURT DECISION

The case before the High Court concerned only the legal questions of the exercise of discretion by the tax authority in setting aside Ecco's transfer pricing documentation and estimating an income adjustment, and the appropriateness of this income adjustment under Danish tax law. Ecco requested that its case be heard by a panel of judges made up of three High Court justices and two expert judges, but was denied this request. Aside from the number of judges hearing the matter, the appeal proceeded somewhat like transfer pricing litigation in the U.S. Tax Court, in that the panel of judges had wide discretion in interpreting the substance of the transfer pricing issues at hand.

Ecco was successful in convincing the Court of the reliable use of budgeted transfer prices without year-end adjustment using actual company results over the objection of the tax authority that relied on the O.E.C.D. guidance that advises against using budget figures to apply a transfer pricing method. It was instead the evidence of Ecco's budgeting and price-setting process as an arm's length process that convinced the Court that Ecco's transactional net margin method based on budgeted costs and revenues produced an arm's length outcome in the 2005 tax year.

The Court also disagreed with the tax authority positions concerning the Ecco secondary method in large part because of its finding that more detailed product-specific analysis submitted during the audit should not have been disregarded. This richer information source appears to have demonstrated the employment of a reasonable level of business logic by Ecco in ensuring that the purchase price it paid to controlled producers was arm's length from the perspective of both the purchaser and the seller in the transaction.

While the High Court decision does not evaluate the Ecco position on the purchase price of shoes explicitly, it does evaluate the qualitative factors that affect comparability analysis to reach a conclusion that there was no evidence the company did not price its transactions at arm's length during the 2005 tax year. In the instant case, the High Court did not have to determine whether the petitioner's expert or the tax authority's expert was relatively more reliable, as there were no expert reports. The High Court justices therefore interpreted and weighed the evidence themselves and rendered a decision referencing many of the factors that are ordinarily identified, explained, and quantified in expert reports.

"... the High Court did not have to determine whether the petitioner's expert or the tax authority's expert was relatively more reliable, as there were no expert reports."

BUILDING A BETTER HAMMER

From the U.S. perspective, it is somewhat puzzling how this dispute reached an appellate court on its technical merits. In U.S. transfer pricing disputes it is more typical to see the methodological shoes on opposite feet, with a company arguing for an application of the C.P.M. (the typically less transactional American cousin of the transactional net margin method), and the I.R.S. relying on transactional evidence previously unexamined or discounted by the company. Alternatively, a poorly-supported initial position like Ecco's would likely result in a settlement with the I.R.S. In the case of Ecco, the tax authority had abundant transactional data at hand to use in verifying and critiquing the taxpayer's approach but opted instead to rely on a relatively uninformative application of the transactional net margin method. The Danish tax authority's arguments were even somewhat American-accented, with emphasis placed on tested party selection, transaction aggregation, and a commensurate-with-income approach used in a licensing transaction.

Reading commentary from Ecco's counsel, it becomes clear that limitations to the mandate of lower tax tribunals left Ecco little choice in resolving the dispute. Denmark's growing body of transfer pricing jurisprudence is proving increasingly helpful to dispute resolution, but administrative questions, such as those litigated in *Altera*,[5] remain unresolved in the Danish and broader European context.

Assuming that the case progressed as it did largely as a result of poor quality in the initial taxpayer documentation, one would hope that the improved documentation standard resulting from B.E.P.S. Action 13 now summarized in the O.E.C.D. Transfer Pricing Guidelines will make better information available to tax authorities

---

5 *Altera Corp. v. Commr.,* 926 F.3d 1061 (9th Cir. 2019), *revg*. 145 T.C. 91 (2015), *cert. den*. 207 L. Ed. 2d 1078 (U.S. 2020).

so that disputes such as this one can be resolved at the audit level. Also notable is the change since 2005 in the capacity of non-O.E.C.D. tax administrations to contend with double tax matters, thereby reducing the incentive of all tax authorities to argue for their thinly supported transfer pricing adjustments with foreign competent authorities.

The Danish tax authority's approach recalls a previous *Insights* article[6] that examined Maslov's hammer as a cognitive bias, summarized in the old adage "if all you have is a hammer, everything looks like a nail." It appears it is time to build a better hammer, or to try some of the other unused tools in the audit toolkit. Time marches on however, as the arm's length principle is under revision at the O.E.C.D. Analog tools found in a box are being refashioned at warp speed for use in pricing transactions or splitting company profit in the digital economy as a policy alternative to a constellation of digital services taxes. Is a positive technology shock on the way for those that wield Maslov's hammer, or will the new methods amount to a codification of the law of the instrument?

6 Peggs, Michael. "Managing a Transfer Pricing Exam? Wash Your Hands with Soap and Water." *Insights* Volume 5, Number 5, June 2018

DON'T LET YOUR I.T.I.N. EXPIRE

Authors
Galia Antebi
Samantha Benenson

Tags
Form W-7
I.T.I.N.

Samantha Benenson is a student at Brooklyn Law School and a summer intern at Ruchelman P.L.L.C.

INTRODUCTION

Individual Taxpayer Identification Numbers (I.T.I.N.'s) are required by any individual who has a U.S tax filing obligation but is not eligible to be issued a Social Security Number (S.S.N.). U.S. tax filing obligation can arise even when no tax liability exists. For example, a foreign seller of U.S. real property would be subject to 15% withholding even when the selling price is lower than the purchase price (this is known as "F.I.R.P.T.A. withholding"). Avoiding F.I.R.P.T.A. withholding is possible by applying for a withholding certificate from the I.R.S. prior to the closing; And this can only be done if one has an I.T.I.N. An I.T.I.N. is also required any time a non-U.S. person has to file a U.S. tax return to request a refund of over-withholding of tax.

Obtaining an I.TI.N. is done by completing Form W-7, *Application for I.R.S. Individual Taxpayer Identification Number*. As many will attest, this is not an easy task, and requires obtaining a certified copy of one's passport from the governmental issuing agency. Additionally, the I.R.S. will not issue an I.T.I.N. unless one of the reasons mentioned on the application is met. The process takes about seven weeks and can take up to eleven weeks during peak processing periods or if filing from overseas. Occasionally, the I.R.S. will request more information, further prolonging the process. Thus, once obtained, it may be worth renewing. If allowed to expire, a new application would have to be made for any future need.

WHEN DO I.T.I.N.'S EXPIRE?

An I.T.I.N. expires and has to be revalidated every five years, or after three consecutive years of not being used.

There is a toll-free number to call the I.R.S to check the status of an I.T.I.N. Also the I.R.S will send out Letter 5821 letting the individual know that their I.T.I.N number must be renewed. Recently, the I.R.S. reminded those holding I.T.I.N.'s issued before 2013 and having middle digits of 88 (Example: (9XX-88-XXXX) that their I.T.I.N.'s will expire at the end of 2020. Additional middle-digits numbered I.T.I.N.'s assigned before 2013 are set to expire at the end of 2020, as previously announced by the I.R.S. in earlier months. The I.R.S. is urging anyone whose I.T.I.N. is expiring at the end of 2020 to file a complete renewal application as soon as possible.

SHOULD YOU RENEW YOUR I.T.I.N. IF YOU ARE ISSUED A S.S.N.?

If an individual becomes eligible for a S.S.N. after an I.T.I.N. had been obtained, they must apply for a S.S.N., because an I.T.I.N. will not be renewed under such circumstances. As mentioned above, one of the reasons listed on the form must be met to be granted an I.T.I.N. If an individual is eligible for a S.S.N., they are not eligible for an I.T.I.N.

Once a S.S.N. is issued, the individual must notify the I.R.S. of the number, and the I.R.S. will void the I.T.I.N., so it cannot be used by others. Additionally, the I.R.S. will merge the cases so that it can associate all prior tax information filed under the I.T.I.N. with the new S.S.N.

IMPLICATIONS OF AN EXPIRED I.T.I.N.

If an individual files a return with an expired I.T.I.N., the return will still be processed.

However, certain tax credits and exemptions may not be allowed, and refunds will not be processed unless and until the I.T.I.N. is renewed. The taxpayer will receive a notice from the I.R.S. showing the changes made to their return due to their I.T.I.N. being expired. Interest and penalties for any tax owed as a result of disallowed exemptions and credits may be applied. Once renewed, any exemptions and/or credits previously disallowed will be automatically reconsidered.

If at the time of filing the return an individual has a pending application for renewal, the treatment would be the same.

CAN AN I.T.I.N. BE RENEWED BEFORE IT IS SET TO EXPIRE?

The I.R.S. asks that those having I.T.I.N.'s valid through 2021 to wait until their I.T.I.N. is scheduled to expire to renew. To assist taxpayers in figuring out when to renew, the I.R.S. will be putting into place a rolling renewal schedule and will announce the middle digits every year. In the past they have notified in mid to late summer.

About Us

Ruchelman P.L.L.C. is a boutique law firm based in New York City. It was founded in 1989 by an alumnus of a legacy firm that is now Deloitte's.

Our firm provides a wide range of tax planning and commercial legal services to clients across the Americas, Asia, Europe, and the Middle East. Clients include global investors, multinational corporations expanding into the U.S., and U.S. businesses with international operations. Our core practice focuses on cross-border transactions.

About Insights

Insights, the tax journal of Ruchelman P.L.L.C., provides in-depth reporting on the evolving landscape of U.S. and international taxation. It offers complex analysis of current issues, legislative updates, and practical introductions to the tax law from leading tax professionals in their respective countries.

Special features include an annual examination of the use of holding companies in European tax planning and a look at the year in review.

Location

Architects and Designers Building | 150 East 58th Street, 22nd Floor | New York, New York 10155

Contacts

If you have any questions regarding this publication, please contact the authors or one of the following members.

Galia Antebi	antebi@ruchelaw.com	+1 212.755.3333 x 113
Andreas Apostolides	apostolides@ruchelaw.com	+1 212.755.3333 x 127
Nina Krauthamer	krauthamer@ruchelaw.com	+1 212.755.3333 x 118
Michael Peggs	peggs@ruchelaw.com	+1 212.755.3333 x 232
Simon H. Prisk	prisk@ruchelaw.com	+1 212.755.3333 x 114
Neha Rastogi	rastogi@ruchelaw.com	+1 212.755.3333 x 131
Stanley C. Ruchelman	ruchelman@ruchelaw.com	+1 212.755.3333 x 111
Samantha Benenson	benenson@ruchelaw.com	+1 212.755.3333 x 121

Editorial Staff

Stanley C. Ruchelman .... Editor in Chief
Claire Melchert .... Copyeditor
Hali Woods .... Copyeditor
Francesca York .... Graphic Designer

WITH PHOTOS BY:
Galia Antebi, Jennifer Lapper, Simon Prisk, Stanley C. Ruchelman, and Francesca York.