

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

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Tags

Foreign Base Company
Sales Income
Foreign Branch Rule
Subpart F Income

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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 regulations² 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 finished 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* program⁵ 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 J.* 24 (Jan. 1991); see also Kathleen Matthews, “U.S. Official Discusses Subpart F Rules on Contract Manufacturing,” 93 *TNI* 157-4 (Aug. 16, 1993).

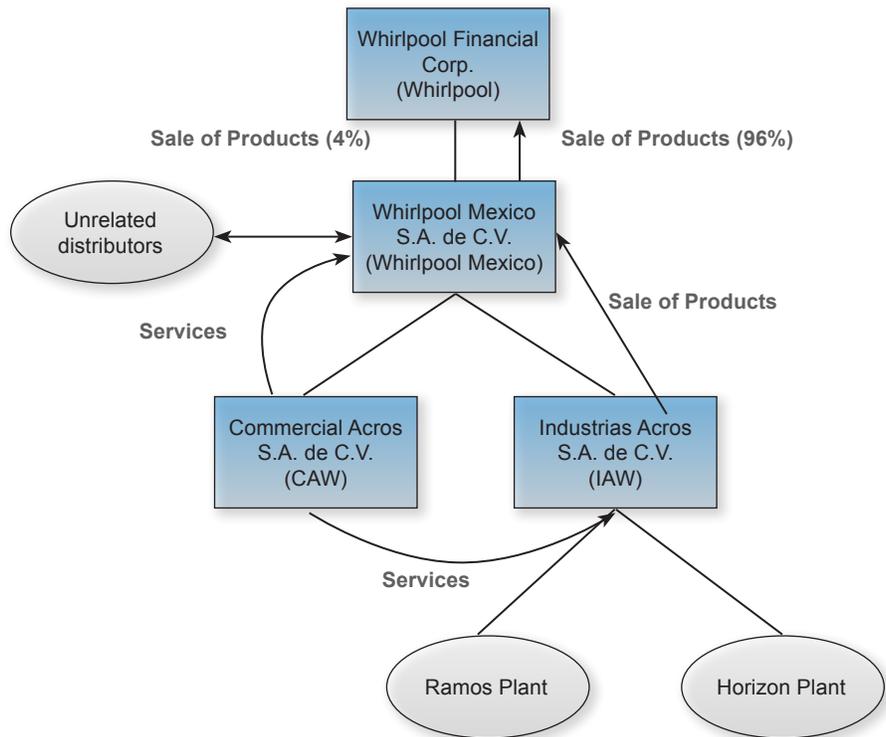
⁴ Also, over the summer of 2015, the I.R.S. released two International Practice Units (“I.P.U.’s”) providing audit guidance regarding cases that Code §954(d)(2) targets, *i.e.*, the use of branches – that are disregarded for U.S. purposes - to avoid foreign base company sales income. For a detailed discussion 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

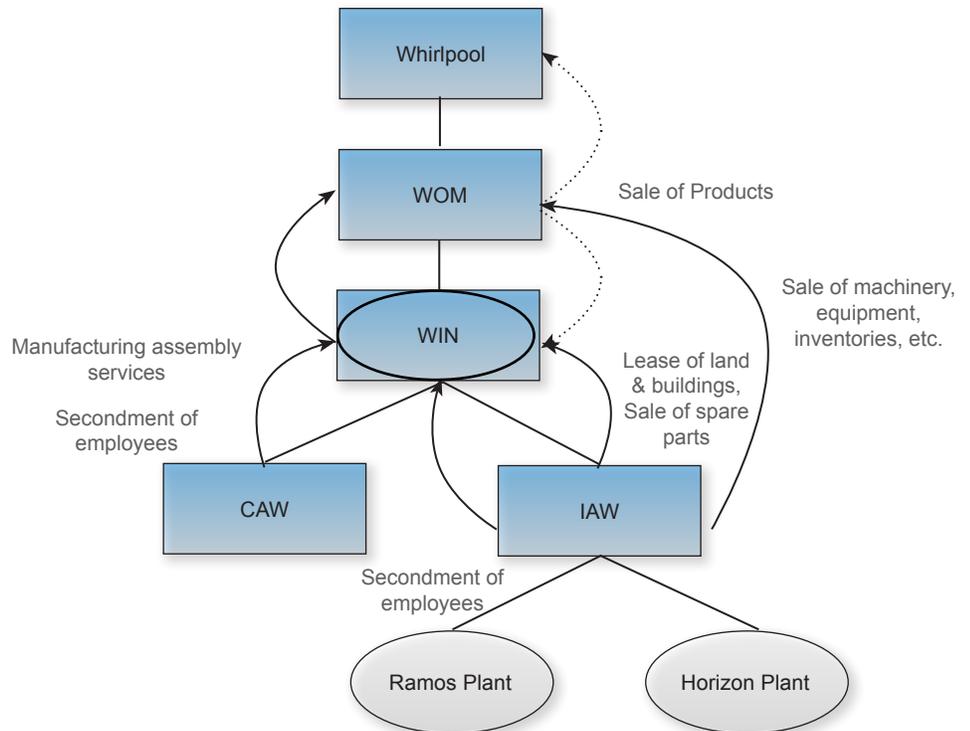
During 2007 and 2008, I.A.W. entered into a series of manufacturing arrangements involving a newly formed Luxembourg corporation Whirlpool Overseas Manufacturing, S.a.r.l. (“LuxCo”) and a newly formed Mexican company *Whirlpool Internacional, S. de R.L. de C.V.* (“W.I.N.”), in order to obtain significant 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.

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.

“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.”



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 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 compliant 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 litigation¹⁴ 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:

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.)

“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 ...”

- 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).”



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

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.

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

Application of the Branch Rule

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*.

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

“[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 ...”

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.

“[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 ...”

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

According to Stanley Fimberg³⁵ 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.