Bloomberg Tax

Tax Management
International Journal™

Reproduced with permission from Tax Management International Journal, 49 TMIJ 6, 06/12/2020. Copyright © 2020 by The Bureau of National Affairs, Inc. (800-372-1033) http://www.bna.com

Subpart F Sales Income and the Branch Rule: The IRS Prevails in Whirlpool

By Amanda Varma and Aaron Hsieh[*]
Steptoe & Johnson LLP
Washington, D.C.

Although the subpart F foreign base company sales income rules have generated a number of disputes between taxpayers and the Internal Revenue Service (IRS), taxpayers have generally prevailed in litigated cases.[1] The Tax Court's recent decision in *Whirlpool Financial Corporation v. Commissioner* is a notable change in this trend.[2] In *Whirlpool*, the Tax Court determined that certain sales income earned by Whirlpool's Luxembourg controlled foreign corporation (CFC) from the sales of products manufactured in Mexico should be treated as foreign base company sales income under the "branch rule" of §954(d)(2) and the regulations thereunder.[3]

Under the subpart F rules, U.S. shareholders of a CFC must include in their gross income on a current basis their pro rata share of the subpart F income earned by the CFC.[4] Subpart F income includes foreign base company sales income, which includes income earned by a CFC from sales of personal property where the property is purchased from, or sold to, related persons.[5]

Although the *Whirlpool* case concerned a tax year prior to the Tax Cuts and Jobs Act (TCJA)[6] and the effective date of the Global Intangible Low-Taxed Income (GILTI) regime that has significantly modified the U.S. taxation of CFC income, the *Whirlpool* court's analysis and conclusion remains relevant to the application of the §954(d)(2) branch rule and supply chain planning. Practitioners and taxpayers should note how the court's analysis of the statute and regulations is coupled with consideration of whether the taxpayer's position is consistent with the legislative history and the purposes of subpart F. The case is also notable for the court's application of the regulations' tax rate disparity test and the court's rejection of the taxpayer's arguments that the operative regulations are invalid, as discussed below.

SUMMARY OF FACTS

Whirlpool Financial Corporation ("Whirlpool") is a U.S. corporation engaged in the manufacture and distribution of major household appliances in the United States and abroad.

Prior to 2007, Whirlpool conducted Mexican operations through an indirectly wholly owned subsidiary, Whirlpool Mexico, S.A. ("Whirlpool Mexico"),

---

[*] Amanda Varma is a partner in the Washington, D.C. office of Steptoe & Johnson LLP. Her practice focuses on international tax planning, controversy, and policy issues. Aaron Hsieh is an associate in Washington, D.C.

[1] *See* Lowell D. Yoder, *The IRS Has Never Won a Subpart F Sales or Services Case*, 46 Tax Mgmt. Int'l J. 636 (Oct. 13, 2017).

[2] *Whirlpool Fin. Corp. & Consol. Subs. v. Commissioner*; *Whirlpool Int'l Holdings S.a.r.l., f.k.a. Maytag Corp. & Consol. Subs. v. Commissioner*, 154 T.C. No 9 (May 5, 2020).

[3] All section references are to the Internal Revenue Code, as amended, or the Treasury regulations thereunder, unless otherwise indicated.

[4] Under current law, a CFC is a foreign corporation in which U.S. shareholders own, directly or indirectly, or are considered to own constructively, more than 50% of the stock of the foreign corporation (by vote or value). §957(a), §958. U.S. shareholders are U.S. persons who own (directly, indirectly, or constructively) at least 10% of the stock of the foreign corporation (by vote or value). §951(b), §958.

[5] §952(a), §954(d).

[6] Pub. L. No. 115-97 (Dec. 22, 2017).

© 2020 The Bureau of National Affairs, Inc.
ISSN 0090-4600

which in turn conducted business through two wholly owned subsidiaries: Commercial Acros S.A. de C.V. (''CAW'') and Industrias Acros S.A. de C.V. (''IAW''). CAW conducted administrative activities and IAW conducted manufacturing activities. IAW owned land, buildings, and equipment. Its employees manufactured major household appliances at two separate plants, both located in Mexico: the Ramos plant, which produced refrigerators, and the Horizon plant, which produced washing machines. Once completed, these products were sold by IAW to Whirlpool Mexico, which resold them to Whirlpool U.S. and unrelated distributors in Mexico.

After the restructuring, which was effective for the 2009 tax year, new wholly owned subsidiaries became involved in the Mexican business, including a Luxembourg subsidiary (''Whirlpool Lux'') and Whirlpool Internacional S. de R.L. de C.V. (''WIN''), a Mexican entity, which made an election to be treated as a disregarded entity of Whirlpool Lux for U.S. federal income tax purposes.[7] Whirlpool Lux employed one part-time employee who performed minimal administrative functions, such as the payment of rent, utilities, and other operating expenses. WIN did not have its own employees. WIN leased from IAW the Ramos and Horizon plants and purchased from IAW the spare parts, hand tools, and other items needed to support manufacturing activities at both plants. Whirlpool Lux purchased from IAW the machinery, equipment, inventories, furniture, and other assets located in both plants.

WIN and Whirlpool Lux entered into manufacturing assembly services agreements under which WIN agreed to supply the services necessary to manufacture products at the Ramos and Horizon plants and Whirlpool Lux agreed to supply the machinery, equipment, and raw materials necessary to manufacture the products. To carry out the manufacturing, WIN used the services of seconded or subcontracted IAW and CAW employees. All raw materials, work-in-process, and finished goods inventory were owned at all times by Whirlpool Lux in the manufacturing process. Whirlpool Lux subsequently sold the manufactured products to Whirlpool U.S. and Whirlpool Mexico.

FOREIGN TAX TREATMENT

After the restructure, Whirlpool Lux did not pay tax in either Mexico or Luxembourg on its sales income. WIN paid Mexican tax on its manufacturing income.

Under Mexico's *maquiladora* program in effect in 2009, a foreign principal would be deemed not to have a permanent establishment in Mexico if both the foreign principal and the maquiladora company satisfied certain transfer pricing requirements. WIN qualified as a maquiladora company and paid a 17% tax to Mexico with respect to its income from supplying manufacturing services to Whirlpool Lux. Whirlpool Lux was treated as a foreign principal with no permanent establishment in Mexico and was exempt from Mexican tax on its income from sales to Whirlpool and Whirlpool Mexico.

With respect to Luxembourg, the Mexico-Luxembourg tax treaty provided that income earned by a Luxembourg company that was attributable to a permanent establishment in Mexico was exempt from Luxembourg tax. Whirlpool Lux took the position that it had a permanent establishment in Mexico as a result of its ownership of materials used in manufacturing, its use of the plants, and its sales in Mexico. Whirlpool requested and received a tax ruling from Luxembourg confirming that Whirlpool Lux's sales income was attributable to a Mexican permanent establishment.

IRS POSITION

The IRS determined that Whirlpool Lux's sales income, which was not taxed in either Mexico or Luxembourg, constituted foreign base company sales income and was therefore taxable to Whirlpool as subpart F income.

TAX COURT DECISION

Section 954(d) defines foreign base company sales income as income arising from one of four types of transactions where property is manufactured by a CFC outside its country of organization and is sold or purchased for use outside such foreign country. The four types of covered transactions are where a CFC (1) purchases personal property from a related person and sells it to a related person; (2) sells personal property to any person on behalf of a related person; (3) purchases personal property from any person and sells it to a related person; or (4) purchases personal property from any person on behalf of a related person. For this purpose, a related person is defined as any person controlling (or controlled by) a CFC, where control is defined as directly, indirectly, or constructively owning more than 50% of the vote or value of stock or other interests in the entity.

The first issue before the *Whirlpool* court was whether Whirlpool Lux could itself be considered to have purchased personal property and sold it to a related person (Whirlpool U.S. and Whirlpool Mexico).

---

[7] Whirlpool Luxembourg S.a.r.l., a Luxembourg entity, owned Whirlpool Overseas Manufacturing S.a.r.l., a Luxembourg company. The court refers to them collectively as Whirlpool Luxembourg and it appears that Whirlpool Overseas Manufacturing S.a.r.l. owned WIN.

© 2020 The Bureau of National Affairs, Inc.
ISSN 0090-4600

The court looked to the manufacturing exception in the regulations, which provide that if a CFC manufactures the property sold, the income is not foreign base company sales income (subject to the §954(d)(2) branch rule discussed below). In order to qualify as ''manufacturing,'' the CFC must have either substantially transformed the product, conducted substantial activities in incorporating component parts, or made a substantial contribution to the manufacturing. Reg. §1.954-3(a)(4)(ii)-(iv).

The IRS did not dispute that the materials were substantially transformed but contended that the CFC must itself have undertaken such activities. The IRS pointed to regulations, proposed in 2008 and finalized in 2011, which provide that the manufacturing exception can be satisfied only by looking to the activities of the CFC's own employees. The 2011 regulations followed the IRS's earlier change in position with respect to whether the activities of a contract manufacturer could be imputed for purposes of the manufacturing exception.[8] Neither Whirlpool Lux nor WIN themselves had employees who performed manufacturing activities, as such activities were performed by employees of affiliates.

The court stated that the 2011 regulations did not apply to the years at issue. The court did not decide whether the applicable 2002 regulations themselves required the manufacturing activities to be carried out by the CFC itself. Instead, it decided the case under §954(d)(2), commonly referred to as the branch rule, as discussed below.

Under §954(d)(2), for purposes of determining foreign base company sales income, where a CFC carries on activities through ''a branch or similar establishment'' outside the country of incorporation of the CFC and the carrying on of activities through the branch ''has substantially the same effect as if such branch or similar establishment were a wholly owned subsidiary corporation deriving such income,'' the income attributable to the carrying on of the activities of such branch will be treated as income derived by a wholly owned subsidiary of the CFC.

In assessing the application of the branch rule, the court first looked to the language of the statute and concluded that Whirlpool Lux was carrying on activities ''through a branch or similar establishment'' outside its country of incorporation. The court also determined that WIN's manufacturing activities had ''substantially the same effect'' as if it were a wholly owned subsidiary of Whirlpool Lux. According to the court:

> By carrying on its activities ''through a branch or similar establishment'' in Mexico, Whirlpool Luxembourg 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 its Mexican branch were a wholly owned subsidiary deriving such income. That is precisely the situation that the statute covers.

The court stated that ''bare text of the statute, literally read,'' indicated that Whirlpool Lux's sales income was foreign base company sales income. The court reached this conclusion even though the statute refers to the income ''attributable to the branch'' as being treated as foreign base company sales income.

The court then continued to evaluate the application of the regulations, which contain parallel sets of rules for ''sales or purchase branches'' and ''manufacturing branches'' (even though the statute appears to contemplate only sales branches). To determine whether the carrying out of activities through the branch has ''substantially the same effect,'' the regulations require an allocation of income between the branch and ''the remainder'' of the CFC, followed by a comparison of the actual and hypothetical ''effective rates of tax'' applicable to the income allocated to the remainder. For a CFC with a manufacturing branch, the ''substantially the same tax effect'' condition is satisfied where sales income is taxed at an effective rate (i) less than 90% of, and (ii) at least 5 percentage points less than, the effective rate that would have applied to the income under the laws of the country in which the manufacturing branch is located. Reg. §1.954-3(b)(1)(ii)(b).

With respect to allocation, the court concluded that the activities and income of Whirlpool Lux and WIN could be separated ''quite easily'' given that the two were separate corporations. The court allocated all the manufacturing income to the Mexican branch and all the sales income to the remainder.

The court then looked to the actual and hypothetical effective rates of tax. The court determined that the actual rate that Whirlpool Lux paid on the sales income, 0%, was less than 90% of, and at least 5 percentage points less than, the effective rate, 28%, that Mexico would have imposed on the sales income.

The court's analysis of the actual and hypothetical effective rates of tax is brief, despite interpretational questions arising under the tests, as reflected in the

---

[8] *See* Rev. Rul. 97-48, 1997-2 C.B. 89 (revoking Rev. Rul. 75-7, 1975-1 C.B. 244). Rev. Rul. 97-48 followed the IRS's losses in *Ashland Oil Co. v. Commissioner*, 95 T.C. 348 (1999), and *Vetco, Inc. v. Commissioner*, 95 T.C. 579 (1990), in which the Tax Court held that a third-party contract manufacturer and a wholly owned subsidiary of a CFC, respectively, cannot be treated as a branch for purposes of the §954(d)(2) branch rule.

© 2020 The Bureau of National Affairs, Inc.
ISSN 0090-4600

IRS's own ruling practices.[9] Under certain prior IRS rulings, the actual rate of tax should arguably be computed by looking to Luxembourg law for both the amount of income subject to testing (the denominator of the fraction) and the amount of tax imposed on the income (the numerator of the fraction).[10] Because, under Luxembourg law, Whirlpool Lux's sales income was attributable to a Mexican permanent establishment, it would not be included in the denominator under this approach, so that the actual effective rate of tax would be 24.2%, the Luxembourg statutory tax rate and the Luxembourg tax rate actually imposed on a small amount of income (from administrative activities) considered taxable in Luxembourg. The court acknowledged this argument but said that the regulations require the sales income to be allocated to the ''remainder'' and consider the rate at which this allocated sales income would be taxed.

Under the manufacturing branch rules, income is treated as foreign base company sales income where ''purchasing or selling activities [are] performed by or through the remainder of the [CFC] with respect to the personal property manufactured'' by the branch. Reg. §1.954-3(b)(2)(i)(c). The court did not accept Whirlpool's argument that the manufacturing branch rule did not apply because Whirlpool Lux's one part-time employee, who performed only administrative functions, could not be considered to be engaged in purchasing or selling activities. The court described this argument as ''facetious'' and inconsistent with other arguments made by Whirlpool.

The court also rejected the argument that the manufacturing branch regulations were invalid because they exceeded Treasury's authority. Whirlpool's basic argument was that the plain language of the §954(d)(2) branch rule applies only in situations where a CFC conducts manufacturing activities and has a sales branch, not in the situation at issue where a CFC conducts sales activities and has a manufacturing branch. The court turned to the *Chevron* two-step test for assessing the validity of a regulations. The court treated the statute as ambiguous or silent on the issue under step one, then concluded that the regulations are a reasonable interpretation of the statute under step two. The court stated that the 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. According to the court,

> an artificial separation of sales income from manufacturing income can be engineered regardless of whether the CFC or its branch makes the sales. If section 954(d)(2) applied only where taxpayers used a ''sales branch,'' the branch rule that Congress enacted as a backstop to subsection (d)(1) would be a dead letter. Taxpayers could easily evade taxation simply by switching the functions around, placing the sales activities in the CFC rather than in the branch. We have no doubt that Congress would have regarded this as an absurd result.

The court concluded that, under §954(d)(2) and the regulations thereunder, the Mexican branch is deemed to be a wholly owned subsidiary of Whirlpool Lux, and Whirlpool Lux is deemed to have sold products to Whirlpool U.S. and Whirlpool Mexico on behalf of its deemed Mexican subsidiary so that Whirlpool Lux has derived income in connection with ''the sale of personal property to any person on behalf of a related person.'' Because the products were manufactured outside Luxembourg and were sold for use outside Luxembourg, the court concluded that Whirlpool Luxembourg's sales income constituted foreign base company sales income under §954(d). The Tax Court stated that

> [t]his conclusion comports with the overall statutory structure and with Congress' purpose in enacting subpart F. The sales income with which Congress was concerned was ''income of a selling subsidiary * * * which has been separated from manufacturing activities of a related corporation merely to obtain a lower rate of tax for the sales income.'' That is precisely the objective that Whirlpool aimed to achieve here. (citations omitted).

CONCLUSION

As noted above, the IRS's record in subpart F foreign base company sales income cases has been poor. The *Whirlpool* case stands as a rare exception (though, as of the date of this writing, an appeal is still possible), with the overall tax result (no taxation of sales income in Luxembourg or Mexico and deferred U.S. taxation) perhaps influencing the court's statutory and regulatory analysis.

[9] See PLR 200942034 (Oct. 16, 2009); PLR 200945036 (Nov. 6, 2009); AM 2015-002 (Feb. 13, 2015).

[10] *See* Lowell D. Yoder, *Local Law Governs Manufacturing Branch Determinations*, 36 Int'l Tax J. 3 (July-Aug. 2010).

© 2020 The Bureau of National Affairs, Inc.
ISSN 0090-4600