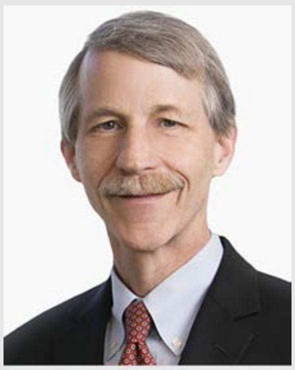
Whirlpool's Subpart F Position Was Consistent With Congressional Intent

by Lowell D. Yoder, David G. Noren, Jonathan D. Lockhart, and Elizabeth C. Lu



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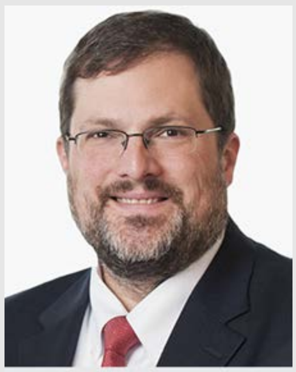

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In this article, the authors contend that *Whirlpool* was incorrectly decided by the Tax Court and argue that the income derived by Whirlpool's maquiladora structure is the type of income that Congress intended not to be subject to current taxation as foreign base company sales income.

The authors prepared an amicus brief on behalf of the National Association of Manufacturers that was submitted to the U.S. Supreme Court in August 2022 supporting Whirlpool's cert. petition.

The Tax Court in *Whirlpool*[1] held that sales income derived by a controlled foreign corporation for products that it manufactured in Mexico through a maquiladora incentive structure was subject to U.S. taxation as foreign base company sales income (FBCSI). The case has been the subject of a great deal of commentary in *Tax Notes* and elsewhere.[2] Rather than revisit the tax technical and administrative law issues considered in prior commentary, this article addresses a contention made by the Tax Court and some commentators that the legislative history supports the government's position in the case.

[1] *Whirlpool Financial Corp. v. Commissioner*, 154 T.C. 142 (2020), *aff'd*, 19 F.4th 944 (6th Cir. 2021), *cert. denied*, No. 22-9 (Nov. 21, 2022).

[2] *See, e.g.*, Mindy Herzfeld, "The Sixth Circuit Knows Subpart F Income When It Sees It — Or Does It?" *Tax Notes Int'l*, Jan. 17, 2022, p. 268; Robert Goulder, "*Whirlpool*: Have We Reinvented the Branch Rule?" *Tax Notes Int'l*, Apr. 4, 2022, p. 155; Jeffery M. Kadet, "The Lessons of *Whirlpool*," *Tax Notes Int'l*, Oct. 3, 2022, p. 53; Jeffrey L. Shore, "*Whirlpool* and the Subpart F Manufacturing Branch Rule," *Tax Notes Federal*, Feb. 17, 2020, p. 1119; David G. Noren, "Subpart F Branch Rule Considerations Post-Whirlpool," 51(1) *Tax Mgmt. Int'l J.* (Jan. 7, 2021); Jasper L. Cummings, Jr., "Enough Said About *Whirlpool*?" *Tax Notes Int'l*, Mar. 13, 2023, p. 1483; Lowell D. Yoder, Noren, and Britt Haxton, "The Sixth Circuit's *Whirlpool* Opinion — What's the Impact?" *Tax Executive*, July 15, 2022; Gary B. Wilcox, "The Sixth Circuit's *Ultra Vires* Opinion in *Whirlpool* — What Now?" *Int'l Tax J.* 47 (Mar.-Apr. 2022).

In support of its decision, the Tax Court opinion quotes the legislative history:

> This 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." H.R. Rept. No. 87-1447, *supra* at 62, 1962-3 C.B. at 466. That is precisely the objective that Whirlpool aimed to achieve here.

Some commentators have similarly expressed that *Whirlpool* was properly decided because Congress intended that the income derived by the maquiladora structure should be subject to current taxation as FBCSI. In a recent article, Philip Cohen concludes:

> Whirlpool undertook a restructuring of its Mexican appliance manufacturing operation with virtually nothing changing on the ground, but by a series of paper shuffles, related party sales income was shifted to a Luxembourg CFC, in this case, the remainder of the entity . . . it properly lost because it undertook a practice of separating related party sales income from the manufacturing entity or, to be precise in this case, from the manufacturing branch. This was the type of activity that Congress meant to be denied income deferral.[3]

In contrast, we believe that the income derived by Whirlpool's maquiladora structure is "precisely" the type of income that Congress intended *not* to be subject to current U.S. taxation under subpart F. The income simply benefited from a typical local manufacturing incentive and was not shifted from the location of manufacturing to any other jurisdiction.

FBCSI Legislative History

In 1961 the Kennedy administration proposed to subject all sales income of foreign subsidiaries to current U.S. taxation. Congress rejected that proposal. Instead, Congress narrowed its proposal and limited the types of sales income subject to current taxation. Congress was concerned that "imposing U.S. tax currently on U.S. shareholders of American-owned businesses operating abroad would place such firms at a disadvantage with other firms located in the same areas not subject to U.S. tax."[4]

Congress described the sales income intended to be subject to current U.S. taxation as follows:

> 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.[5] [Emphasis added.]
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> [Section 954(d)] has ended tax deferral for American shareholders in certain situations where the *multiplicity of foreign tax systems* has been taken advantage of by American-controlled businesses *to siphon off sales profits from goods manufactured by related parties*. . . . In such cases the separation of the sales function is designed to avoid either U.S. tax or tax imposed by the foreign country.[6] [Emphasis added.]

On the other hand, Congress intended not to tax income derived by a CFC selling products manufactured in the country in which the CFC is organized.[7] The legislative history states: "The [FBCSI] provision is made inapplicable to the extent the property is manufactured, produced, grown, or extracted in the country where the

[3] Philip G. Cohen, "*Whirlpool Financial Corp. v. Commissioner* Was Properly Decided," 76(2) *Tax Law*. 247, 291-292 (2023).

[4] H.R. 1447, at 461-462 (1962).

[5] S. Rep. No. 1881, at 84 (1962).

[6] H.R. 1447, at 462.

[7] Section 954(d)(1)(A).

corporation is organized."[8] To prevent placing U.S. companies at a competitive disadvantage, Congress did not want sales income within the taxing jurisdiction of the manufacturing country to be FBCSI. These structures do not separate selling income from manufacturing activities, nor do they take advantage of any foreign tax systems to siphon off sales profits from goods manufactured to avoid tax imposed by the foreign country where the goods were made.

Under certain circumstances, section 954(d)(2) and the corresponding regulations treat a CFC's operations in a foreign branch as a separate CFC to apply the FBCSI rules. Where a CFC manufactures products in a branch, the regulations provide that the CFC's income from selling the products outside the branch country's tax jurisdiction is FBCSI. On the other hand, the CFC's sales income that is within the branch country's tax jurisdiction where the products are manufactured is not FBCSI.[9]

The regulations — which aimed to comport with congressional intent — contain an example clarifying that a CFC's income from selling products manufactured in a foreign branch, where the income is within the tax jurisdiction of the country of manufacture, is not FBCSI even when the manufacturing country exempts a portion of the income. In the example, a CFC manufactured and sold products, and all operations and assets were in the foreign country where the products were manufactured. The income was subject to tax in the foreign branch's country, but the country of manufacture exempted 90 percent of the income from selling the products so that sales income was not taxed in any country. The example concludes that none of the CFC's income was FBCSI because it was all within the tax jurisdiction of the foreign branch country where the products were manufactured and the manufacturing exception applied.[10]

Thus, Congress intended to tax as FBCSI income derived from a structure in which the income from selling products is not within the tax jurisdiction of the country of manufacture. On the other hand, Congress intended *not* to tax as FBCSI income from selling products when the income is within the tax jurisdiction of the country where they are manufactured. This is the intended result even when the country of manufacture provides an exemption for a portion of the income — for example, under a typical manufacturing incentive.

Application to Whirlpool's Structure

Whirlpool established operations in Mexico to manufacture refrigerators, washers, and other appliances for sale by Whirlpool. Initially, these operations were carried on through three separate Mexican CFCs: One CFC manufactured the products, a second CFC sold the products to related parties, and a third CFC provided various services, including sales, marketing, finance, accounting, human resources, and other back-office services.

Under Whirlpool's initial operating structure, the income was subject to a 28 percent tax rate in Mexico. The sales income indisputably was not FBCSI. Separating sales income from manufacturing activities into two CFCs did not cause the sales income to be FBCSI because the selling CFC was organized in Mexico, all of its sales income was within the tax jurisdiction of Mexico, and the products were manufactured in Mexico.

Then in 2009 Whirlpool reorganized its operating structure to qualify for the revamped Mexican maquiladora tax incentive provided to foreign companies manufacturing products in Mexico. A new Mexican CFC was responsible for manufacturing the products, a Mexican permanent establishment of a new Luxembourg CFC provided the machinery, equipment, and raw materials in Mexico to manufacture the products, and legal title to the products transferred from the Luxembourg CFC to the related parties (only one part-time administrative employee was located in Luxembourg). All activities, assets, and personnel generating the income remained in Mexico following the restructuring.

Under the tax laws of Mexico, all the income derived by the new maquiladora structure from the manufacture and sale of the products was considered to be derived by a Mexican company

[8] S. Rep. No. 1881, at 84.

[9] Reg. section 1.954-3(b)(2) and (4), examples.

[10] Reg. section 1.954-3(b)(4), Example 3 (scenario three).

or attributable to the Luxembourg CFC's PE in Mexico. Therefore, absent qualifying for the manufacturing tax incentive, the income would continue to be subject to full taxation in Mexico at the 28 percent tax rate.[11] Under the maquiladora regime, however, only the income earned by the Mexican legal entity that carried out the Mexican manufacturing operations was subject to taxation at 17 percent. Mexico exempted the remaining income from taxation by "deeming" Whirlpool Luxembourg's PE in Mexico to not be a PE for Mexican tax purposes. But, to avoid the 28 percent tax rate on all income, Mexico required the foreign company to be in a country with a tax treaty so that the income would be attributed to the Mexican PE, and the treaty country would cede primary taxing jurisdiction to Mexico, as was the case with Luxembourg.

Significantly, the restructuring did not reduce U.S. taxes relative to the prior structure. However, the IRS argued that the income from manufacturing the products in Mexico under the new maquiladora structure became FBCSI. The court agreed and held that the Luxembourg CFC's income was FBCSI under the manufacturing branch rules, treating the income as not derived by the manufacturing operations in Mexico, and therefore as not qualifying for the manufacturing exception.

As we have discussed in a recent letter to the editor,[12] a fundamental flaw in the court's opinion is that it did not follow the manufacturing branch rule regulations to determine how much income was derived in Mexico from the Mexican manufacturing operations under the maquiladora structure. The court observed that the group's manufacturing functions in Mexico did not change:

> 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 . . . Whirlpool Luxembourg . . . had a subsidiary in Mexico (WIN) and a distinct PE in Mexico by virtue of owning assets and conducting business activities in Mexico. . . . All of Whirlpool Luxembourg's activities in Mexico were thus conducted by a branch.[13]

Even though all the activities and assets that gave rise to the income in Mexico before the restructuring continued to be in Mexico after the restructuring, the court allocated only 10 percent of the income to the Mexican operations, stating, without any economic analysis, that treating 90 percent of the income as derived outside Mexico "seems intuitively clear."[14] Thus, contrary to the regulations, the court held that 90 percent of the Luxembourg CFC's income did not qualify for the manufacturing exception and was FBCSI.

The court compounded its error by misapplying the legislative history in an attempt to support its decision. The court viewed the maquiladora structure as causing an "artificial separation of sales income from manufacturing income," as "splitting sales income from manufacturing income," and as a "siphon[ing] off sales profits from goods manufactured by" a branch because the "sales income was carved off into a Luxembourg affiliate."[15]

However, such a view of the maquiladora structure is contrary to the facts. The restructuring did not remove any of the income from the taxing jurisdiction of Mexico, where the products were manufactured. All the operations and assets were in Mexico, and, absent the manufacturing tax incentive, the income remained fully subject to Mexican taxation in a Mexican company and a Mexican PE. No portion of the income left Mexico for Luxembourg — the sales income was not "siphoned" out of Mexico to Luxembourg, and it was not "carved off" into a Luxembourg affiliate. This is demonstrated by Mexico's insistence under

[11] Consistent with the general Mexican tax laws, if the same operations had been conducted in the United States, 100 percent of the income would be subject to U.S. taxation. *See* sections 861, 864, and 865. No amount of the income would be allocated away from the United States to the Luxembourg home office because, under Treasury regulations, *no* income from selling products is attributable to a foreign office where: (1) such office is used for purposes of having title to the property pass outside the United States, or (2) such office performs merely clerical functions incident to the sale. Reg. section 1.864-6(b)(3)(i).

[12] Yoder, Noren, Jonathan D. Lockhart, and Elizabeth C. Lu, "Another Spin on *Whirlpool*: Allocating Income to a Manufacturing Branch Under the Regs," *Tax Notes Int'l*, Oct. 24, 2022, p. 439.

[13] *Whirlpool*, 154 T.C. at 155-156, 170.

[14] *Id.* at 167.

[15] *Id.* at 153, 162, 170, 178.

the maquiladora regime that its treaty partner cede primary taxing jurisdiction to Mexico. Thus, the lower effective tax rate under the maquiladora structure was not the result of taking advantage of a "multiplicity of tax systems" but rather was because Mexico, the country of manufacture, provided an exemption for income that was otherwise subject to tax in Mexico.

Many countries around the world, including the United States and its states and localities, use tax incentives to encourage local manufacturing. Nothing in the statute or legislative history of the FBCSI rules indicates any congressional objection to the use of such incentives by U.S.-based groups. Indeed, Congress pared back the Kennedy administration's original 1961 proposal based on its concern about unduly burdening U.S.-based groups in this regard relative to foreign-based groups.

Conclusion

Congress did not intend for supply chains like the Whirlpool maquiladora structure to give rise to FBCSI because, just like the pre-2009 structure, all the income remained within the tax jurisdiction of Mexico, the country where the products were manufactured. While Mexico exempted a portion of the income derived in Mexico to encourage local manufacturing, Congress intended sales income within the taxing jurisdiction of manufacture *not* to be subject to U.S. taxation, even when the country of manufacture exempts a portion of the income. *Whirlpool* was wrongly decided not only on the tax technical merits, but also from the perspective of tax policy and congressional intent. ■