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TEI

The Sixth Circuit's *Whirlpool* Opinion—What's the Impact?

Ruling disregards regulatory manufacturing exception but preserves right to rely on regulations in applying branch rule

By Lowell Yoder, David Noren, and Britt Haxton

The US Court of Appeals for the Sixth Circuit issued a majority opinion in *Whirlpool Financial Corporation & Consolidated Subsidiaries v. Commissioner*[1] that disregards the regulatory manufacturing exception to foreign base company sales income (FBCSI). That said, taxpayers still have the right to rely on the regulations in applying the branch rule.

The *Whirlpool* case involves a Luxembourg controlled foreign corporation (CFC) that sold products to related parties. The products were manufactured by a wholly owned Mexican disregarded entity that was treated as a corporate branch for US federal income tax purposes.

Income earned by a CFC from the sale of personal property is subpart F income only if it falls within the definition of FBCSI. A CFC's income generally is FBCSI if it meets the requirements in either Section 954(d)(1) (the "general rule") or Section 954(d)(2) (the "branch rule").

Under Section 954(d)(1), a CFC's income generally is FBCSI if the income is earned by a CFC through the purchase of personal property from any person and its sale to a related person or through the purchase of personal property from a related person and its sale to any person.[2]

Several exceptions are provided. A CFC's sales income is not FBCSI if the property is sold for use in, or manufactured in, the CFC's country of organization (the "same country of use exception" and the "same country of manufacturing exception," respectively).[3] In addition, a CFC's sales income is not FBCSI if the CFC manufactured the products resulting in the income (the "regulatory manufacturing exception").[4]

Section 954(d)(2), the branch rule, provides additional rules for determining a CFC's FBCSI when the CFC carries on purchasing, selling, or manufacturing activities in a foreign branch and the CFC's income is not considered FBCSI under Section 954(d)(1). If the requirements for applying the branch rule are met, then under Section 954(d)(2) and the associated regulations, the FBCSI rules may be reapplied to determine if a portion of the CFC's income is FBCSI by treating the CFC's head office (remainder) and its branch as separate CFCs.[5]

The branch rule applies, however, only to certain described structures and if a tax rate disparity test is met. There are different operating rules depending on whether the foreign branch carries on purchasing or selling activities (the selling branch rule) or manufacturing activities (the manufacturing branch rule).

Treasury regulations issued under Section 954(d)(2) provide that a branch's (or remainder's) income is not FBCSI if it would not be FBCSI if derived by a separate CFC.[6] Therefore, income earned by a foreign branch cannot be FBCSI under the branch rule if, for example, the regulatory manufacturing exception would apply to income derived by the foreign branch with respect to products that it manufactured.[7]

The IRS is not permitted to argue against its own guidance and moreover has specifically conceded that the *Whirlpool* opinion should not be interpreted as preventing taxpayers from relying upon regulations.

Majority Opinion

In its majority opinion in *Whirlpool*, the Sixth Circuit interpreted the "branch rule" of Section 954(d)(2) without regard to the longstanding regulatory manufacturing exception. Rather, the Sixth Circuit majority's opinion misconstrued the branch rule as applying to any structure where a CFC carries on activities in a branch and the CFC's income is tax-deferred. This expansive interpretation of the branch rule treats the regulatory manufacturing branch rules as meaningless and ignores the detailed rules that limit the scope of the branch rules. Under this flawed reading, if a CFC carries on activities in a foreign branch, and its income otherwise is not subject to current-basis, full-rate US tax, *all* of its sales income is FBCSI.

Here is a simple example of how the Sixth Circuit majority's interpretation of Section 954(d)(2) would apply:

- A CFC organized in Country X manufactures and sells products through a branch in Country Y. Ten percent of the products are sold to Country Y customers and ninety percent are sold for export. The CFC's sales income is not subject to tax in Country X. Country Y has a fifty percent tax rate, but taxes only income from selling products to Country Y customers. To illustrate, if the CFC has $100 of sales income, it would pay $5 of tax ($100 x 10 percent x 50 percent), and $90 would be untaxed.
- Under the Sixth Circuit majority's opinion, which disregards the regulatory manufacturing exception, the entire $100 would be FBCSI, even though all $100 would qualify for the manufacturing exception, because Branch Y manufactures the products. This is squarely inconsistent with the Treasury regulations that taxpayers have relied upon for over fifty years.

The Treasury regulations, in fact, contain this exact example and conclude that none of the income derived by the Country Y branch would be FBCSI, because the Country Y branch, treated as a separate corporation, would qualify for the manufacturing exception, and therefore the manufacturing branch rules should not apply and thus should not cause its income to be FBCSI.[8] The Treasury regulations contain numerous other examples that apply the manufacturing exception for purposes of Section 954(d)(2) to all or a portion of the income of a CFC that manufactures and sells products.[9]

What Will This Mean?

Taxpayers understandably may wonder whether the majority's decision to disregard the regulatory manufacturing exception in applying Section 954(d)(2) could extend to other regulatory rules that limit a CFC's FBCSI. Below we address this question and explain why the Internal Revenue Service is bound by its own regulations, and thus taxpayers can continue to rely on those regulations. As demonstrated in the IRS' response to Whirlpool's petition for rehearing and rehearing en banc, the government acknowledges that the regulations continue to apply. We conclude with examples illustrating that a CFC's sales income is not FBCSI merely because the CFC carries on activities through a branch

and the CFC's income is not otherwise subject to current-basis, full-rate US tax.

IRS IS BOUND BY ITS REGULATIONS, SO TAXPAYERS CAN STILL RELY ON TREASURY REGULATIONS IN APPLYING BRANCH RULE

As a government agency, the IRS must abide by its own regulations.[10] A taxpayer has the right to rely on the Treasury regulations articulating and delimiting the branch rule, and the IRS cannot simply abandon them.[11]

It is well established that regulations (and other published guidance) are binding on the IRS and must be followed. As the Tax Court explained in *Rauenhorst v. Commissioner*[12] and other cases, the IRS may not take a position contrary to such guidance even if there is a court decision to the contrary.[13] The Tax Court's rationale is that positions taken in published guidance, even if contrary to how the Court might view the issue, should be treated as concessions by the IRS as to the proper conclusion on a matter.

In *Rauenhorst*, the taxpayers assigned stock warrants to charitable institutions and, relying on a 1978 revenue ruling, took the position that the assignments did not represent anticipatory assignments of income that were taxable to the taxpayer. The IRS argued that the on-point revenue ruling was not binding on either the IRS or the courts. The Tax Court disagreed with the IRS and refused to allow the IRS to disavow its revenue ruling, providing in relevant part:

> Although we do not question the validity of the opinions of this Court and the Courts of Appeals upon which respondent relies, we are not prepared to allow respondent's counsel to argue the legal principles of those opinions against the principles and public guidance articulated in the Commissioner's currently outstanding revenue rulings.
>
> While this Court may not be bound by the Commissioner's revenue rulings, and in the appropriate case we could disregard a ruling or rulings as inconsistent with our interpretation of the law, . . . in this case it is respondent who argues against the principles stated in his ruling and in favor of our previous pronouncements on this issue. The Commissioner's revenue ruling has been in existence for nearly 25 years, and it has not been revoked or modified. No doubt taxpayers have referred to that ruling in planning their charitable contributions, and indeed, petitioners submit that they relied upon that ruling in planning the charitable contributions at issue. Under the circumstances of this case, we treat the Commissioner's position in Rev. Rul. 78-197… as a concession.[14]

The IRS Office of Chief Counsel has agreed that its attorneys cannot make arguments contrary to final Treasury regulations in litigation.[15] Immediately after the Tax Court's decision in *Rauenhorst*, the IRS Office of Chief Counsel directed its attorneys not to take positions in litigation contrary to IRS published guidance:

> It has been a longstanding policy of the Office of Chief Counsel that we are bound by our published positions, whether in regulations, revenue rulings, or revenue procedures, and that we will not argue to the contrary. Accordingly, we do *not* take positions in litigation, TAMs, PLRs, CCAs, advisory opinions, etc., inconsistent with a position that the Service has taken in published guidance or in proposed regulations.[16]

In addition, Chief Counsel attorneys are not allowed to rely on a case that is contrary to IRS published guidance. Specifically, Chief Counsel attorneys may not rely on case law to take a position that is less favorable to the taxpayer in a particular case than the position set forth in published guidance. This means that in circumstances where Chief Counsel attorneys must follow published guidance under the aforementioned rule, it is irrelevant that the result under the case law would be more advantageous to the IRS than under the IRS published guidance.

As an example, if a revenue ruling provides that a particular expense may be currently deducted, Chief Counsel attorneys are not allowed to challenge the deduction even though, under the applicable case law, the expense might be capitalized. Applying this same principle to the *Whirlpool* Sixth Circuit majority's opinion and the longstanding Treasury regulations under Section 954(d)(2), if the relevant Treasury regulations would treat certain CFC income as excepted from the branch rule, Chief Counsel attorneys should not claim that such income is FBCSI under Section 954(d)(2), even if under the Sixth Circuit majority's opinion, the tax-deferred income would be treated as FBCSI.

IRS ACKNOWLEDGED THAT TREASURY REGULATIONS UNDER BRANCH RULE CONTINUE TO APPLY

In its response to Whirlpool's motion for rehearing and rehearing en banc, the IRS acknowledges that taxpayers can continue to rely on Treasury regulations in determining whether a CFC has FBCSI.

The relevant part of the IRS response states that "nothing in the panel's opinion precludes taxpayers who did *not* engage [in Whirlpool's exact structure] from relying on the regulations to demonstrate why they do not have FBCSI on their specific facts."[17] The IRS response argues that "Whirlpool's case-specific concessions made consideration of the

regulations unnecessary" and that "the transaction fails under both the statute and the regulations."[18]

Particularly with respect to the regulatory rules that limit the application of the branch rule to foreign branches that have "substantially the same tax effect" as a separate corporation (the tax rate disparity test),[19] the IRS response includes a footnote indicating its position that "[n]othing in the panel's analysis . . . precludes a different taxpayer from relying on the regulations to demonstrate that its use of a branch did not have substantially the same tax effect as the use of a separate corporation."[20]

The IRS response also addresses the regulatory rule that the branch rule does not apply to income that is FBCSI apart from the branch rule (the "priority rule").[21] The IRS response provides that "[n]othing in the panel's decision precludes a different taxpayer from relying on [the priority rule]."[22]

The IRS' response to the motion for rehearing and rehearing en banc indicates that the IRS does not intend to apply the Sixth Circuit opinion to support an argument that is contrary to the FBCSI regulations, and thus acknowledges that taxpayers continue to have the right to rely on the regulations, particularly the regulatory rules that limit a CFC's FBCSI under Section 954(d)(2).

Examples

We conclude by providing examples of CFC structures that should not give rise to FBCSI under the Treasury regulations, despite the Sixth Circuit majority's conclusion that any CFC that operates through a branch, with income otherwise not subject to current-basis, full-rate US tax, has FBCSI.

By the government's own admission, "nothing in the panel's opinion precludes taxpayers . . . from relying on the regulations to demonstrate why they do not have FBCSI." Therefore, these CFC structures should qualify for regulatory exceptions and limitations to FBCSI.

EXAMPLE 1: TAX RATE DISPARITY TEST

Under the tax rate disparity test, the branch rule will apply only if the effective tax rate in the country where the sales are made is less than ninety percent of, and at least five percentage points less than, the effective tax rate in the country where the manufacturing occurs.

Consider the following example. An Irish CFC manufactures products in Ireland that are sold to customers throughout Europe through a branch operation in the United Kingdom (the UK branch). The Irish CFC has $100 of income (seventy percent attributed to sales operations and thirty percent attributed to manufacturing operations). The effective tax rate in Ireland is 12.5 percent, and the effective tax rate in the United Kingdom is eighteen percent. This structure does not satisfy the tax rate disparity test, because the UK branch's $70 sales income is subject to a higher tax rate than the home office that manufactures the products. Because the tax rate disparity test is not met, the branch rule does not apply.[23]

Taxpayers with a similar structure should continue to have the right to rely on the tax rate disparity test. The Chief Counsel attorneys are not allowed to rely on the Sixth Circuit majority opinion to treat all of the Irish CFC's income as FBCSI, without regard to the tax rate disparity test, and the IRS clearly acknowledged in its response to Whirlpool's motion for rehearing that it did not intend to "preclude[] a different taxpayer from relying on the regulations," including the tax rate disparity test, "to demonstrate that its use of a branch did not have substantially the same tax effect as the use of a separation corporation."[24]

EXAMPLE 2: MANUFACTURING EXCEPTION

The Treasury regulations provide that the income of a CFC—whether derived through a branch or home office—is not FBCSI to the extent the sales income is derived in connection with personal property "manufactured, produced, or constructed by such corporation."[25] To illustrate the application of the manufacturing exception, consider the following examples. To simplify these and all remaining examples, we assume that the tax rate disparity test is satisfied.

Example 2A

A Swiss CFC sells products to non-Swiss customers. The products are manufactured through the Swiss CFC's German branch. The Swiss CFC has $100 income (seventy percent attributed to sales operations and thirty percent attributed to manufacturing operations). The effective tax rate in Switzerland is ten percent, and the effective tax rate in Germany is thirty percent. The $30 of income derived by the German branch would not be FBCSI, since it manufactures the products that are sold. The $70 of income derived by the Swiss CFC through its sales operations would constitute FBCSI to the extent the products are sold outside Switzerland.[26]

Example 2B

The manufacturing exception would also apply to a CFC manufacturing branch structure, even if the income derived by the manufacturing branch is subject to a tax incentive regime in the manufacturing company. For example, assume a Netherlands CFC operates entirely through a Mexican branch, which manufactures products in Mexico and sells products to related persons for resale to customers outside Mexico. The Netherlands CFC has $100 of income (all attributable to the Mexican branch where all business operations and assets

are located). Mexico has a statutory tax rate of thirty percent, but because the Netherlands CFC satisfies certain requirements, the Mexican branch income from manufacturing and sales operations is subject to a special effective tax rate in Mexico of ten percent. The $100 of income derived by the Netherlands CFC through the Mexican branch would not be FBCSI, since the Mexican branch manufactures the products that are sold.[27]

EXAMPLE 3: SAME COUNTRY OF USE EXCEPTION

The Treasury regulations also provide that income derived by a CFC in a sales branch's country is not FBCSI in a situation in which, had such income been derived by a separate CFC, it would qualify for the same country of use exception.[28] To illustrate the application of the same country of use exception to a CFC-branch structure, consider the following example.

A China CFC manufactures products and sells such products to its Irish branch for resale to Irish customers. The China CFC has $100 income (seventy percent attributed to sales to Irish customers and thirty percent attributed to manufacturing activities). The effective tax rate in China is twenty-five percent, and the effective tax rate in Ireland is 12.5 percent. The $30 of manufacturing income generated by China CFC is not FBCSI under Section 954(d)(1) or Section 954(d)(2), because the products are manufactured by the China CFC. The $70 of sales income derived by the Irish branch is also not FBCSI under Section 954(d)(2), which treats the Irish branch as a separate CFC incorporated in Ireland. The same country of use exception is applied under the selling branch rule to the extent the products are sold to customers for use in Ireland (100 percent of sales). Therefore, none of the China CFC's is FBCSI.

EXAMPLE 4: SAME COUNTRY OF MANUFACTURING EXCEPTION

As stated earlier, the Internal Revenue Code and Treasury regulations provide that income derived by a CFC is not FBCSI under Section 954(d)(1) if the products sold are manufactured in the CFC's country of organization (the same country of manufacturing exception).[29] The products will be considered as manufactured in a country in which the products are physically manufactured by a related or unrelated person.[30] The following example illustrates the application of the same country of manufacturing exception to a selling branch located in the country where the products are manufactured.

A CFC organized in the United Kingdom operates through a Singapore branch. Singapore taxes the income of the Singapore branch at a special rate of five percent. The Singapore branch purchases products from unrelated manufacturers who manufacture the products in Singapore. The Singapore branch sells the products to the UK home office, which sells the products to unrelated customers throughout Europe, with the sales income subject to eighteen percent UK tax. The Singapore branch's income is not FBCSI because the Singapore branch is treated as incorporated in Singapore where the products are manufactured, and the same country of manufacturing exception applies.[31]

Conclusion

The examples above illustrate the absurdity of the Sixth Circuit majority's opinion. In each example, the Sixth Circuit's reasoning, if applied to the facts, would cause all of the income derived with respect to the personal property to be FBCSI under the branch rule. However, the limitations and exceptions provided by Treasury regulations clearly cause the CFC's income to not be treated as FBCSI in these situations. The Sixth Circuit's opinion simply has no credibility, since it disregards regulations on which taxpayers are plainly entitled to rely. Taxpayers can continue to apply the limitations and exceptions to FBCSI to their CFC-branch structures. The IRS is not permitted to argue against its own guidance and moreover has specifically conceded that the *Whirlpool* opinion should not be interpreted as preventing taxpayers from relying upon regulations.

Lowell Yoder, **David Noren**, and **Britt Haxton** are partners at McDermott Will & Emery LLP.

Lowell Yoder

David Noren

Britt Haxton

Endnotes

1 19 F.4th 944 (6th Cir. 2021), affirming 154 T.C. 142 (2020).

2 Section 954(d)(1); Treasury Regulations Section 1.954-3(a). The definition of FBCSI also includes fees and commissions received for purchasing personal property on behalf of a related person or for selling personal property on behalf of a related person.

3 Section 954(d)(1)(A); Section 954(d)(1)(B); Treasury Regulations Section 1.954-3(a)(2); Treasury Regulations Section 1.954-3(a)(3).

4 Treasury Regulations Section 1.954-3(a)(4).

5 Treasury Regulations Section 1.954-3(b).

6 Treasury Regulations Section 1.954-3(b)(2)(ii)(e).

7 See Treasury Regulations Section 1.954-3(b)(4), example 2 ("Branch B, treated as a separate corporation, derives no foreign base company sales income since it produces the product that is sold"), as well as Treasury Regulations

Section 1.954-3(b)(4), example 3(ii), whose last sentence states the same conclusion.

8 See Treasury Regulations Sections 1.954-3(a)(4) and 1.954-3(b)(4), example 3.

9 See, for instance, the example in Treasury Regulations Section 1.954-3(b)(1)(ii)(c)(1), where all activities of a CFC are conducted through a sales branch and a manufacturing branch, the regulatory manufacturing exception can apply to the manufacturing branch; and 1.954-3(b)(1)(ii)(c)(3)(v), example 1, where multiple branches contribute to the manufacture of a single product, the activities of each branch are tested independently to determine whether they satisfy the requirements of the regulatory manufacturing exception.

10 *United States ex rel. Accardi v. Shaughnessy*, 347 U.S. 260 (1954).

11 See *Mutual Savings Life Insurance v. United States*, 488 F.2d 1142, 1145 (5th Cir. 1974), which states that "A taxpayer has the right to rely upon the Government's Regulations. . . . Treasury Regulations having the force and effect of law are binding on tax officials, as well as taxpayers. . . . [T]he Government cannot just abandon . . . the regulation[] and direct it into some type of obscurity oblivion as if it never existed" (internal citations omitted).

12 119 T.C. 157 (2002); see also *Dover Corp. & Subs. v. Commissioner*, 122 T.C. 324 (2004), which reaffirms the principles of *Rauenhorst*.

13 See, for example, *Estate of Mittleman v. Commissioner*, 522 F.2d 132, 141 n.61 (D.C. Cir. 1975).

14 *Rauenhorst*, 119 T.C. at 170-73 (references and citations omitted).

15 CC- 2003-014.

16 CC-2002-043, clarified and superseded by CC-2003-014.

17 Commissioner-Reply-Br. 17 (emphasis included in brief).

18 *Ibid.* at 18.

19 See Treasury Regulations Section 1.954-3(b)(1)(ii)(*b*).

20 Commissioner-Reply-Br. 17-18 n.12.

21 See Treasury Regulations Section 1.954-3(b)(2)(ii)(*f*).

22 Commissioner-Reply-Br. 19.

23 See the example in Treasury Regulations Section 1.954-3(b)(1)(ii)(*c*)(2), which concludes that the tax rate disparity test is not satisfied by comparing the effective tax rate in the country from which the CFC exported products to customers and the effective tax rate in the country where the branch manufactured the products; see also Treasury Regulations Section 1.954-3(b)(1)(ii)(*c*)(3)(v), example 2; and -3(b)(4), example 8.

24 Commissioner-Reply-Br. 17-18 n.12.

25 Treasury Regulations Section 1.954-3(b)(2)(ii)(e) and Treasury Regulations Section 1.954-3(a)(4).

26 See Treasury Regulations Section 1.954-3(b)(4), example 2 (similar facts and conclusion). If the facts were reversed such that a German CFC manufactured products that were sold through its Swiss branch, the sales income of the Swiss branch would be FBCSI, and the manufacturing income of the remainder of the German CFC would qualify for the manufacturing exception. See Treasury Regulations Section 1.954-3(b)(4), example 1.

27 See Treasury Regulations Section 1.954-3(b)(4), example 3, where all manufacturing and selling activities occurred in the country where the CFC operated through a foreign branch, and none of the branch's income was FBCSI because it qualified for the manufacturing exception, even though ninety percent of the income was not subject to tax.

28 See Treasury Regulations Section 1.954-3(b)(2)(ii)(e) and Treasury Regulations Section 1.954-3(a)(3).

29 Section 954(d)(1)(A); Treasury Regulations Section 1.954-3(a)(2).

30 *Ibid.*

31 See TAM 8509004 (a ruling that where a CFC organized under the laws of Country X established a branch in Country Y, and the branch purchased raw materials and provided them to a related corporation to manufacture products on its behalf in Country Y and then sold the finished goods to customers, the branch's income is not FBCSI because the same country of manufacturing exception applies). Note that in the above example the UK CFC's income would not be FBCSI under the branch rule, because the sales branch rule does not apply to income from sales and purchasing operations carried on in the remainder of the CFC. See Treasury Regulations Sections 1.954-3(b)(1)(i) and 1.954-3(b)(2)(ii)(b)(2).