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Subpart F Branch Rule Considerations Post-Whirlpool

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The U.S. Court of Appeals for the Sixth Circuit recently issued its opinion in *Whirlpool Financial Corporation & Consolidated Subsidiaries v. Commissioner*,[1] affirming the decision of the Tax Court in favor of the government. The Tax Court held that income derived by a controlled foreign corporation (CFC) was foreign base company sales income (FBCSI) under the manufacturing branch rule.[2] A two-judge majority of the three-judge Sixth Circuit panel hearing the case upheld the Tax Court's ruling, but surprisingly did so relying entirely on the statutory language of §954(d)(2) as opposed to the implementing regulations of Reg. §1.954-3(b). The Sixth Circuit's majority opinion, if adopted broadly and followed to its logical conclusions, would significantly expand the scope of the Subpart F branch rule by effectively denying taxpayers the ability to rely on the branch rule regulations. Assuming the opinion stands, it should be given weight only as affirming the Tax Court's legal conclusion under the particular facts of the case, and not as having broader implications for a wide range of structures that have been planned and implemented in reliance on various aspects of the branch rule regulations.

The taxpayer in *Whirlpool* owned a Luxembourg CFC (Lux CFC) that had a single administrative employee located in Luxembourg. Lux CFC owned a Mexican disregarded entity (Mex DE) that manufactured products for the Lux CFC under a toll manufacturing services arrangement, using seconded employees of a related Mexican CFC. Lux CFC sold the products to related persons. Lux CFC owned the raw materials, work-in-process, and finished goods, as well as the machinery and equipment used to manufacture the products, all of which were located in Mexico.

Mexico taxed the manufacturing service fee received by Mex DE from Lux CFC. Under the Mexican maquiladora incentive regime, Lux CFC was deemed to not have a taxable permanent establishment (PE) in Mexico, and thus its income was not subject to taxation in Mexico. At the same time, Luxembourg viewed Lux CFC as deriving its sales income through a Mexican PE, and under the income tax treaty between Luxembourg and Mexico, taxed only a small amount of income earned in Luxembourg for administrative activities.

The Tax Court addressed the application of the manufacturing branch rule to the income derived by Lux CFC. For this purpose, the Tax Court treated Lux CFC's income from selling products to related persons as not constituting FBCSI under the general rule of

- • §954(d)(1)

based on the sound assumption that the manufacturing exception applied (since all manufacturing activity was disregarded into Lux CFC for purposes of the general rule). The Tax Court, however, granted summary judgment to the IRS, holding that income of Lux CFC not derived by Mex DE was FBCSI under the manufacturing branch rule.

The taxpayer argued that the manufacturing branch rule was invalid because it was not specifically provided for in §954(d)(2). The language of 954(d)(2) describes only income derived by a foreign branch from purchasing or selling products and does not ref-

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[1] Nos. 20-1899/1900 (6th Cir., *decided and filed* Dec. 6, 2021), *aff'g* 154 T.C. 142 (2020).

[2] Reg. §1.954-3(b).

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erence income derived by the CFC in its home country. Nevertheless, the Tax Court concluded that the manufacturing branch rule in the Treasury regulations, which treats income derived by a CFC's home office as FBCSI, was a valid exercise of the Treasury's authority in carrying out the purposes of §954(d)(2) by providing a backstop to the purchasing or selling branch rule (as otherwise the purchasing or selling branch rule could easily be avoided by having a low-tax CFC purchasing/selling remainder and a high-tax manufacturing branch, rather than a high-tax manufacturing remainder and a low-tax purchasing/selling branch).

The taxpayer also argued that the Lux CFC's income was not subject to the manufacturing branch rule under its terms, because Lux CFC did not carry on any purchasing or selling activities in Luxembourg, as required by the regulations.[3] Without explicitly addressing the ''purchasing or selling activities'' requirement in the regulations, the Tax Court concluded that, because Lux CFC derived income from selling products, the manufacturing branch regulations applied. This conclusion was questionable as an interpretation of the plain language of the regulations, and at odds with the long-held view of the IRS and tax professionals that having purchasing or selling activities of employees in the home country (or in a purchasing or selling branch) is a requirement for the manufacturing branch rule to apply.[4]

The manufacturing branch rule also applies only to income derived outside the branch's country. While the Tax Court opinion acknowledges this rule, a critical factual question not addressed by the Tax Court in granting summary judgment was the amount of Lux CFC's income that was derived by the home office in Luxembourg, and thus was capable of being treated as FBCSI under the manufacturing branch rule. The IRS has indicated that this determination is made under general U.S. tax principles, presumably the arm's length standard.[5] All of Lux CFC's value-driving functions were performed, and assets located, in Mexico, not Luxembourg, and thus arguably only a small portion of Lux CFC's income should be FBCSI under the regulatory manufacturing branch rule (which would be consistent with the conclusion of the Luxembourg tax authority).[6]

The Sixth Circuit affirmed the Tax Court's opinion, with a two-judge majority and one dissenting opinion which would have held for the taxpayer. The Sixth Circuit majority opinion based its conclusion solely on its interpretation of §954(d)(2) and the associated legislative history, and not on the regulations. As a result, the opinion does not address the validity of the manufacturing branch regulations, nor the various requirements in the regulations that must be met in order for a CFC to have FBCSI by operation of the branch rule.

Section 954(d)(2) provides that if a CFC carries on activities through a foreign branch, the branch rule applies if the arrangement has ''substantially the same effect as if such branch or similar establishment were a wholly owned subsidiary'' deriving the income attributable to the branch's activities. The Sixth Circuit majority opinion interprets that language as applying whenever the CFC's income is subject to deferral (which would have been the case for the year at issue with the income of any CFC branch structure that is not reported as FBCSI). The opinion then states that the amount of a CFC's FBCSI is not determined by reapplying the general definition of §954(d)(1) as though the branch were a separate CFC, but instead by simply treating 100% of the CFC's income as FBCSI under §954(d)(2), including the income of the manufacturing branch.

The Sixth Circuit majority opinion's interpretation of §954(d)(2) is inconsistent with the longstanding interpretation of that provision by the Treasury Department and IRS, the Tax Court, and tax professionals for over 50 years (as discussed in the dissenting opinion), and is not supported by the legislative history accompanying the enactment of the branch rule. Importantly, the majority's interpretation is fundamentally contrary to the manufacturing branch regulations, which themselves should be considered fairly authoritative as a reflection of the common understanding of the intent of §954(d)(2) around the time of its enactment (the statute was enacted in 1962 with the active involvement of the Kennedy administration and Treasury Department, and the Treasury Department and IRS issued the regulations in 1964).

Under the manufacturing branch regulations, if a CFC manufactures products in a foreign branch, the arrangement is treated as having ''substantially the same tax effect as if such branch or similar establishment were a wholly owned subsidiary'' only if the income derived by the home office from purchasing or selling activities meets an effective tax rate disparity test (i.e., the purchasing/selling income is subject to a

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[3] Reg. §1.954-3(b)(1)(ii)(b) and (c), (2)(i)(c) and (ii)(c) (1964); Reg.§1.954-3(b)(1)(i) and (ii) and (2) (2009).

[4] *See, e.g.*, TAM 8509004.

[5] AM 2015-002 (Feb. 13, 2015), n. 19.

[6] The dissenting opinion to the Sixth Circuit majority opinion may have arrived at a similar view and therefore would have held that Lux CFC's income qualified for the manufacturing exception provided in the branch regulations. *See also* Reg. §1.954-3(b)(4), *Ex.* 3 (where all manufacturing and selling activities occurred in the country where the CFC operated through a foreign branch, none of the branch's income was FBCSI because it qualified for the manufacturing exception, even though 90% of the income was not subject to tax).

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materially lower effective tax rate than if the income were subject to tax in the manufacturing branch's country).[7] In addition, the regulations provide that income derived by the CFC in the manufacturing branch's country is not FBCSI under the regulations because, if such income had been derived by a separate CFC, it would qualify for the manufacturing exception or same-country-of-manufacture exclusion.[8] Furthermore, while purchasing or selling income derived by the home office of a CFC generally would be FBCSI, it is not FBCSI if the home office also satisfies the manufacturing exception or the products are sold for use in the CFC's country of organization.[9] While the majority opinion acknowledges these limiting rules in the regulations—and that §954(d)(2) itself states that the consequences of §954(d)(2) are to be prescribed by regulations—the opinion indicates that, to the extent the regulations conflict with the majority's novel interpretation of §954(d)(2) they are invalid.

The Sixth Circuit panel's majority was particularly concerned by the fact that no current tax was paid anywhere on the core Lux CFC income, due to the non-taxation of that income by both Mexico and Luxembourg, and the taxpayer's position that the income was not FBCSI. These policy concerns presumably affected the majority's interpretation of the legislative history of §954(d)(2). Unfortunately, the majority opinion, if taken to its logical conclusion, would effectively eliminate taxpayers' ability to rely on the limiting language of the branch rule regulations in a wide range of different structures, even though those regulations themselves clearly represent an informed and contemporaneous understanding of the intent behind §954(d)(2). For example, the effective tax rate disparity test that has been at the heart of the operation of the branch rules since 1964 apparently would be discarded. This is a remarkable proposition in light of the history of the promulgation and application of these regulations, not to mention the fact that the statutory language in question (''substantially the same tax effect'') is not so clear as to require no interpretation at all, and indeed the Congress placed a direct delegation of regulatory authority at the heart of §954(d)(2). Clearly the idea was that the Congress knew it had left a good deal of interpretative and implementation work here to the Treasury Department and IRS, and wanted to give them the scope to do it (as the addition of the purely regulatory manufacturing branch rule as a backstop to the purchasing or selling branch rule itself illustrates).

The dissenting opinion would have held for the taxpayer. The dissenting opinion would apply the rules in the regulations and hold that, once it is concluded that the branch rule applies, the amount of FBCSI would be determined by reapplying §954(d)(1) as though the branch were a separate CFC. The dissent concluded that the income of Lux CFC was derived from the manufacture of the products (or at least there was a question of material fact precluding summary judgment in the government's favor), and therefore no portion of Lux CFC's income would be FBCSI under the manufacturing exception.

The Sixth Circuit majority opinion may not be the last word on the *Whirlpool* case. The taxpayer can file a petition for rehearing *en banc*, which would seem to stand a good chance of being granted in light of the split panel, not to mention the surprising and sweeping basis for upholding the Tax Court's ruling. Failing that, the taxpayer could petition the Supreme Court to hear the case, although that is always a long shot for a tax case, especially in the absence of a circuit split. If the Sixth Circuit majority decision ultimately stands, it should be limited to its facts, and not followed in such a way as to deny taxpayers the ability to rely on Treasury regulations. In addition, although the decision upheld a Tax Court decision, it is hoped that the Tax Court itself would not extend the Sixth Circuit's specific legal reasoning in branch rule cases not appealable to the Sixth Circuit.[10]

Notwithstanding *Whirlpool*, taxpayers operating through branches of CFCs clearly should be entitled to rely on the limits set forth in the branch rule regulations, including the effective tax rate disparity requirement, the manufacturing exception, the same-country exceptions, and the rule that only the amount of purchasing or selling income derived outside a manufacturing branch's country can be treated as FBCSI.

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[7] Reg. §1.954-3(b)(1)(ii)(b).

[8] Reg. §1.954-3(b)(2)(ii).

[9] Reg. §1.954-3(b)(2)(ii)(e).

[10] *See Golsen v. Commissioner*, 54 T.C. 742 (1970), *aff'd,* 445 F.2d 985 (10th Cir. 1971).

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