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Application of Branch Rule in Foreign Base Company Sales Income

Tiago Iorio
San Jose State University

Application of Branch Rule in Foreign Base Company Sales Income

By: Tiago Iorio, MST Student

Whirlpool Financial Corporation v. Commissioner, 19 F.4th 944 (6th Cir. 12/6/2021), affirmed the judgment of the Tax Court (154 T.C. 142 (2020)); rehearing en banc denied (6th Cir. 3/2/2022) The ruling was against the taxpayer and upheld that the sales revenue constituted foreign base company sales income (FBCSI) under the branch rule of Section 954(d)(2), and taxable as Subpart F income under Section 951(a). On June 30, 2022, Whirlpool asked the Supreme Court of the United States to review the Sixth Circuit's decision.

Introduction

This case focused on whether the branch rule of Section 954(d)(2) applied or not to override the manufacturing exception under Treas. Reg. 1.954-3(a)(4). This paper discusses in detail how the Tax Court and the Sixth Circuit reached the conclusion that the branch rule should be applied to Whirlpool, resulting in Subpart F income.

This paper is divided into three parts. The first part summarizes Whirlpool's structure before and after its 2009 reorganization. The second part assesses the main issues considered by the Tax Court and the Sixth Circuit. The third part concludes this paper.

Background

Whirlpool Financial Corp. is a Delaware corporation with its main place of business in Michigan. Through its foreign and domestic subsidiaries, Whirlpool manufactures and distributes household appliances, such as washing machines and refrigerators, in the United States and abroad.

Whirlpool Structure before 2007

Before 2007, Whirlpool US owned 100 percent of Whirlpool Mexico, a company created under Mexican law. Whirlpool Mexico owned 100 percent of Industrias Acros S.A. de C.V. (IAW) and Commercial Acros S.A. de C.V. (CAW), also created under Mexican law. These three companies, Whirlpool Mexico and its two subsidiaries, are considered controlled foreign corporations (CFC)[1] for Federal income tax purposes. [2]

CAW is the administrative arm of Whirlpool Mexico. Its employees provided marketing, selling, accounting, finance, and other services to IAW and its Mexican parent. [2]

IAW is the manufacturing arm of Whirlpool Mexico. It owned buildings, equipment, land and employed workers who manufactured washing machines, refrigerators, and other appliances (collectively referred as products). IAW manufactured these products in two different plants in Mexico, the Ramos plant and the Horizon plant. IAW sold these products to Whirlpool Mexico,

[1] According to the IRS, a foreign corporation is a CFC if more than 50 percent of its voting power or value is owned by U.S. Shareholders. A U.S. Shareholder of a foreign corporation is a U.S. person who owns 10 percent or more of the total voting power of that foreign corporation. https://www.irs.gov/pub/irs-utl/FEN9433_01_03R.pdf.

which subsequently sold them to Whirlpool US and other unrelated distributors in Mexico.[2] The figure below describes Whirlpool's structure before 2007:

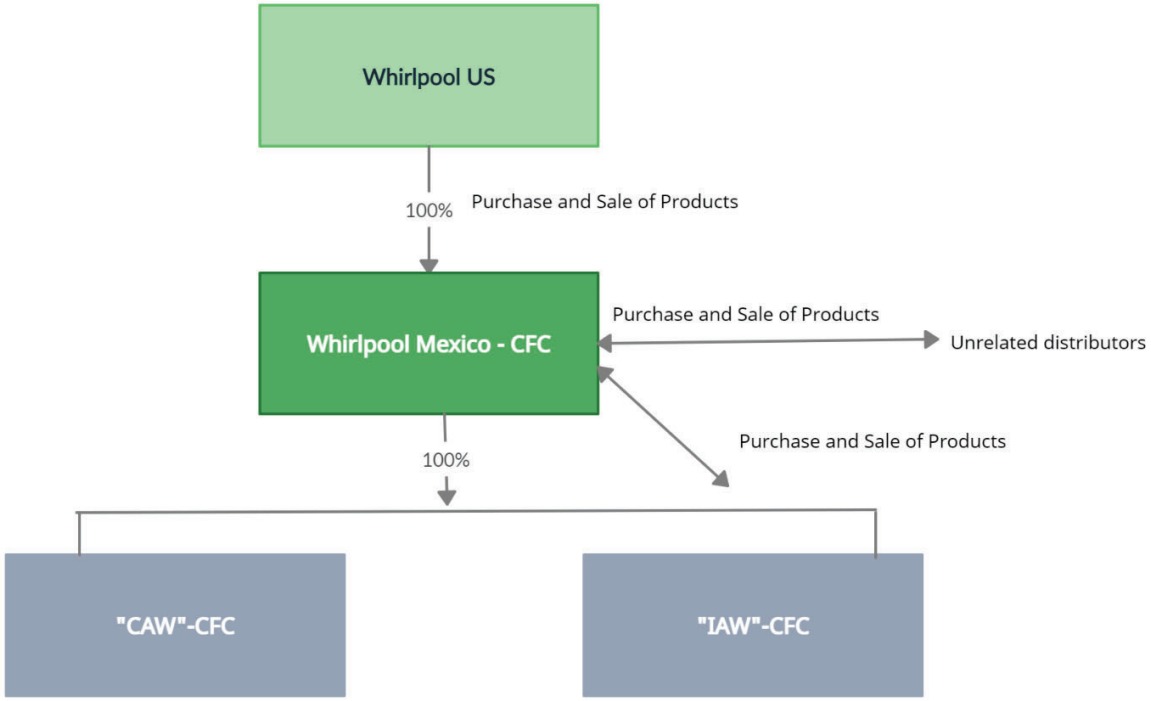

Figure 1: "Whirlpool Structure before 2007". Source: Tiago Iorio based on *Whirlpool Financial Corporation v. Commissioner*, Tax Court (154 T.C. 142 (2020)

Whirlpool after its 2007-2008 Reorganization

Beginning in 2007, Whirlpool undertook a reorganization that established a new structure for its Mexican activities as of 2009. On May 2007, Whirlpool US created Whirlpool Overseas Manufacturing, S.a.r.l. (WOM), a company organized under the laws of Luxembourg and considered a CFC. On August 2007, Whirlpool US transferred ownership of WOM to Whirlpool Luxembourg, also a CFC for Federal income tax purposes.

Whirlpool Luxembourg acted like a holding company[3] with no employees. WOM had one part-time employee, who performed administrative tasks, such as payment of utilities, rent, and other expenses related to the Luxembourg office. For the sake of simplicity, this paper refers to WOM and Whirlpool Luxembourg collectively as Whirlpool Luxembourg.

[2] *Whirlpool Financial Corporation v. Commissioner*, 154 T.C. 142 (2020).

[3] "A holding company is a parent business entity, usually a corporation or LLC, that doesn't manufacture anything or conduct any other business operations. Its purpose, as the name implies, is to hold the controlling stock or membership interests in other companies. Some of the subsidiary companies it owns actually do manufacture, sell, or otherwise conduct business. These are called operating companies". https://www.wolterskluwer.com/en/expert-insights/using-a-holding-company-operating-company-structure-to-help-mitigate-risk#what.

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On June 2007, Whirlpool US created Whirlpool International, S.de.R.L. de C.V. (WIN), an entity organized under Mexican law and also known as the IMMEX Maquiladora[4]. WIN elected to be treated as a disregarded entity[5] for US federal income tax purposes by making the "check the box" election. On August 2007, Whirlpool US transferred its ownership of WIN to Whirlpool Luxembourg. [2]

WIN had no employees, but instead high-level employees of CAW and IAW were "seconded" to WIN. In July 2007, WIN and Whirlpool Luxembourg entered a "manufacturing assembly services agreement"[6] with the Ramos plant, and in March 2008 they also entered into a similar agreement with the Horizon plant. Under this agreement, WIN would be responsible to provide services necessary to manufacture products using workers subcontracted from CAW and IAW. [2]

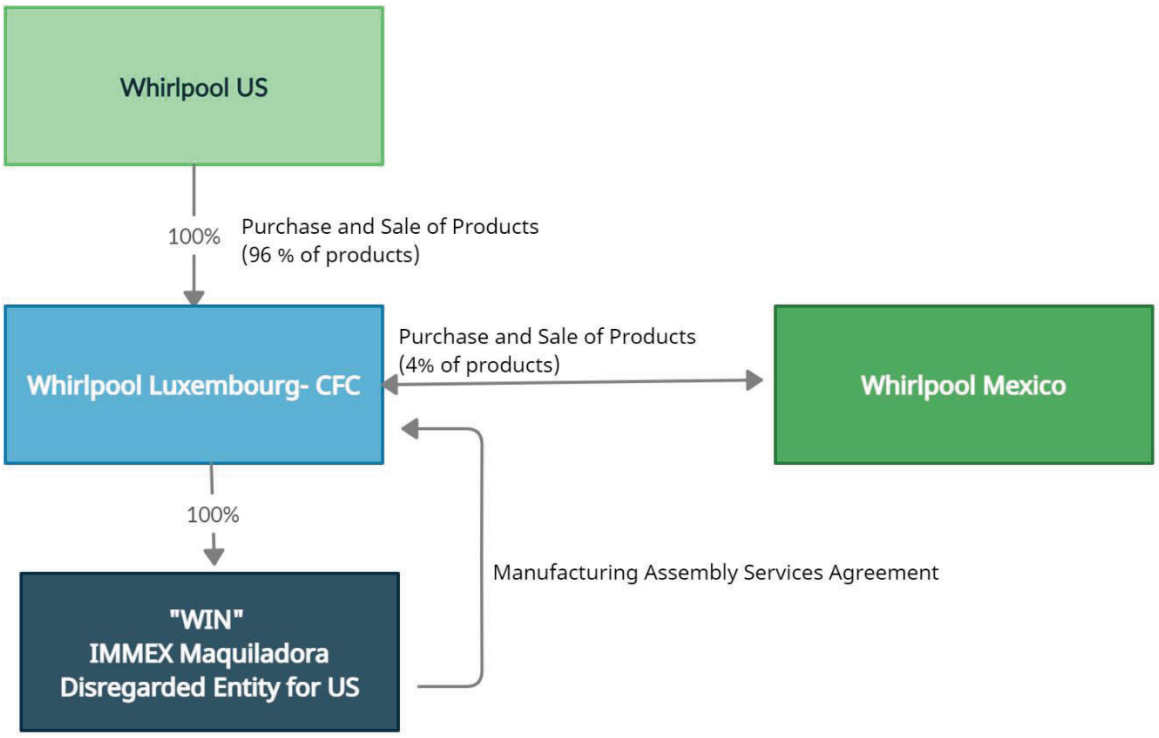

Figure 2: "Whirlpool Structure after 2007-2008 Reorganization".
Source: Tiago Iorio based on *Whirlpool Financial Corporation v. Commissioner*, Tax Court (154 T.C. 142 (2020)

[4] IMMEX Maquiladora, which is the legal entity that applied for and received an IMMEX Maquiladora approval (basically a permit) to carry out manufacturing activities (in compliance with agreed-upon requirements).
[5] "A foreign disregarded entity or "DRE" exists when a Taxpayer makes an election to treat a foreign entity with a single owner as disregarded from its owner (i.e., a branch) for U.S. tax purposes. The election is commonly referred to as a "check-the-box election" and is made on Form 8832." Thus, WIN was distinct from Whirlpool Luxembourg.
[6] Contract Manufacturing constitutes the legal agreement between the principal "WIN" and the IMMEX Maquiladora that sets the economic and operating terms for the latter to provide its manufacturing services to the principal. https://vdocuments.mx/pwc-immex-maquiladora-guide-doing-business-in-maquiladora-guide-doing-business.html.

During 2009, the Horizon plant produced more than 500,000 washing machines and the Ramos plant produced close to one million refrigerators. About 96 percent of the products manufactured were sold to Whirlpool US, and the other 4 percent sold to Whirlpool Mexico. From these sales, Whirlpool Luxembourg had gross receipts of more than $800 million.[2]

Tax Considerations

A. Mexico

IMMEX Maquiladoras are subject to a reduced tax rate of 17 percent, instead of the normal 30 percent income tax rate, and they would still be in compliance with transfer pricing rules provided that they follow certain requirements.[7] WIN qualified as a Maquiladora, and therefore, paid Mexico a 17 percent tax rate (instead of 28 percent) on the income WIN earned from providing manufacturing services under the Manufacturing Assembly Services Agreement. Whirlpool Luxembourg did not have to pay taxes to Mexico for the sale of products to Whirlpool US and Whirlpool Mexico. [8]

B. Luxembourg

The taxes in Luxembourg were even more advantageous. Even though the Luxembourg corporate tax rate was 28 percent, under certain provisions of the Mexico-Luxembourg tax treaty, all the income earned by a Luxembourg company that was attributable to a permanent establishment in Mexico was exempt from Luxembourg income tax. The Luxembourg taxing authorities provided Whirlpool Luxembourg tax rulings confirming that Whirlpool Luxembourg did have a permanent establishment in Mexico. As a result, all income earned by Whirlpool from sales of products to Whirlpool US and Whirlpool Mexico was attributable to Whirlpool Luxembourg's permanent establishment in Mexico. Thus, Whirlpool Luxembourg did not pay income tax to Luxembourg on the income from the sale of finished products to Whirlpool Mexico and Whirlpool US. [8]

Discussion

On Form 1120 for the tax year 2009, Whirlpool US stated that none of its income derived from Whirlpool Luxembourg (from the sale of products to Whirlpool Mexico and Whirlpool US) constituted Subpart F income[9]. However, on audit, the IRS had a different interpretation and considered Whirlpool Luxembourg's sale of products to Whirlpool Mexico and Whirlpool US as approximately $50 million of Foreign Base Company Sales Income ("FBCSI") under sections 951(a)[10] and 954(d)(2). Whirlpool petitioned the Tax Court, and shortly thereafter, filed motions

[7] Ibid.

[8] James C. Koenig, "International Fiscal Association USA Cleveland Reginal Webinar," May 2022, available at https://vimeo.com/708669743/6b7c447844.

[9] According to the IRS, there are three requirements under 951(a) for the applicability of the Subpart F rules to a U.S. person: the U.S. person must be a U.S. shareholder, the foreign corporation must be a CFC, and the CFC must have Subpart F income. The main categories of Subpart F income are foreign base company sales income (FBCSI), foreign base company service income, and foreign personal holding company income (FPHCI).

[10] Under section 951(a) "Amounts included in gross income of United States shareholders": "If a foreign corporation is a controlled foreign corporation at any time during any taxable year, every person who is a United States shareholder (as defined in subsection (b)) of such corporation and who owns (within the meaning of section 958(a)) stock in such corporation on the last day, in such year, on which such corporation is a controlled foreign corporation

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for partial summary judgment arguing that Whirlpool Luxembourg's sales should not be considered FBCSI under section 954(d)(1) because the products it sold were "substantially transformed by its Mexican branch from the raw materials it had purchased". [11] Respondent did not agree with that motion, contending if Whirlpool Luxembourg actually manufactured the products. [2]

Tax Court

The Tax Court started its review of the rule for FBCSI, which is defined in Section 954(d)(1)[12], and applied that in the context of Whirlpool's structure after its 2007-2008 reorganization. Whirlpool Luxembourg was created under the laws of Luxembourg, and all of its products sold were manufactured in Mexico and sold for use in the United States or Mexico. Since the products were manufactured and sold for use outside Luxembourg, the conditions stated under Section 954(d)(1) subparagraphs (A) and (B) were met. Thus, Section 954(d)(1) applies if the income derived by a CFC are in connection with any of the four categories of property transactions listed under this section. The Tax Court determined that the third fact pattern "the purchase of personal property from any person and its sale to a related person" applied because Whirlpool Luxembourg purchased raw materials from suppliers and made sales to "related person[s]", namely Whirlpool US and Whirlpool Mexico. [2]

However, Whirlpool contended that the products it sold were not the same as the raw materials it had purchased. Rather, the raw materials were converted into washing machines and refrigerators during the manufacturing process. In other words, Whirlpool argued that it qualified for the "CFC manufacturing exception" per Treas. Reg. 1.954-3(a)(4)[13] and thus the income should not be considered FBCSI. [2]

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shall include in his gross income, for his taxable year in which or with which such taxable year of the corporation ends his pro rata share (determined under paragraph (2)) of the corporation's subpart F income for such year". Additionally, "the term "United States shareholder" means, with respect to any foreign corporation, a United States person (as defined in section 957(c)) who owns (within the meaning of section 958(a)), or is considered as owning by applying the rules of ownership of section 958(b), 10 percent or more of the total combined voting power of all classes of stock entitled to vote of such foreign corporation, or 10 percent or more of the total value of shares of all classes of stock of such foreign corporation". https://www.law.cornell.edu/uscode/text/26/951.

[11] *Whirlpool Financial Corporation v. Commissioner*, 154 T.C. 142 (2020).

[12] Section 954(d)(1) applies to income derived by a CFC in connection with four categories of property transactions: (i) "the purchase of personal property from a related person and its sale to any person," (ii) "the sale of personal property to any person on behalf of a related person," (iii) "the purchase of personal property from any person and its sale to a related person," and (iv) "the purchase of personal property from any person on behalf of a related person." Commissions, fees, or other profits derived by a CFC from such transactions constitute FBCSI if: (A) 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 *** [CFC] is created or organized, and (B) the property is 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". https://www.law.cornell.edu/cfr/text/26/1.954-3.

[13] According to the IRS LB&I International Concept Unit, "when Congress enacted the FBCSI rules, it was focused on "income from the purchase and sale of property, without any appreciable value being added to the product by the selling corporation" (S. Rep. No. 1881, 87th Cong., 2d Sess., reprinted at 1962-3 CB 703, 790). As such, Treas. Reg. 1.954-3(a)(4) provides that FBCSI does not include income in connection with the purchase or sale of property manufactured, produced, or constructed by the CFC itself ("CFC manufacturing exception"). A CFC is generally

The Tax court questioned whether Whirlpool Luxembourg carried its activities in Mexico "through a branch or similar establishment". Even though Whirlpool Luxembourg did not have employees in Mexico, it owned assets and had a manufacturing assembly services agreement in Mexico. Whirlpool Luxembourg even received from the Luxembourg tax authorities a ruling stating that it had a "permanent establishment" in Mexico. The Tax Court concluded that Whirlpool Luxembourg carried on transactions in Mexico "through a branch or similar establishment"[2], thus subject to Section 954(d)(2)[14], also known as the "branch rule". This rule would override the manufacturing exception, causing Whirlpool US to have FBCSI included as Subpart F income[15].

Appeal to Sixth Circuit

The taxpayer, Whirlpool, appealed to the Sixth Circuit. The majority opinion considered exclusively the two preconditions for the application of the "branch rule" from Section 954(d)(2). The first condition is that the CFC must "carry on activities through a branch or similar establishment" outside its country of incorporation. The majority ruled that this condition was met because Whirlpool Luxembourg operated through Whirlpool International and Whirlpool International's operations were carried outside of Luxembourg. The second condition specifies that the branch establishment must have "substantially the same effect" as if such branch were a "wholly owned subsidiary" of the CFC deriving such income. The majority also ruled that this

eligible for the CFC manufacturing exception if it satisfies one of the following three tests: Substantial Transformation Test---Treas. Reg. 1.954-3(a)(4)(ii); Component Parts Test---Treas. Reg. 1.954-3(a)(4)(iii); or Substantial Contribution Test---Treas. Reg. 1.954-3(a)(4)(iv)".

[14] According to the IRS LB&I International Concept Unit, "the FBCSI rules are intended to prevent a US shareholder from using a CFC to shift sales income from the US or a high-tax foreign country to a low-tax foreign country. The branch rules prevent a US shareholder from using a branch, in lieu of a separate CFC, to shift sales income from a high-tax foreign country to a low-tax foreign country. Absent the branch rules, a CFC and its branch would be treated as a single entity for US tax purposes. However, when a CFC carries on selling, purchasing or manufacturing activities by or through a branch outside its country of incorporation and the use of the branch has substantially the same tax effect (SSTE) as if the branch were a separate CFC, the branch and the remainder of the CFC will be treated as separate corporations in determining whether the CFC has FBCSI from the sale of property. Purchases or sales will be treated as made on behalf of the remainder of the CFC (in the case of purchases or sales made by or through a branch), or on behalf of the branch (in the case of manufacturing activities performed by or through a branch), which generally results in FBCSI to the CFC. Three key factors are relevant with respect to the CFC in determining whether to apply the branch rules for FBCSI: whether the CFC has a branch or similar establishment outside its country of incorporation; whether the CFC derives sales income from products purchased, sold or manufactured by or through that branch or similar establishment; or whether there is TRD when the actual ERT (in the sales jurisdiction) is compared to the hypothetical ERT (in the manufacturing or CFC remainder jurisdiction)". https://www.irs.gov/pub/irs-utl/DPLCUC_2_1_2_07.pdf.

[15] According to the IRS LB&I International Concept Unit, "under Subpart F, certain types of income earned by a CFC are taxable to the CFC's U.S. shareholders in the year earned even if the CFC does not distribute the income to its shareholders in that year. Subpart F operates by treating the shareholders as if they had actually received the income from the CFC. There are many categories of Subpart F income. In general, it consists of movable income. For example, a major category of Subpart F income is Foreign Base Company Income (FBCI), as defined under I.R.C. § 954(a), which includes foreign personal holding company income, or FPHCI, which consists of investment income such as dividends, interest, rents and royalties. Other forms of FBCI includes income received by a CFC from the purchase or sale of personal property involving a related person (i.e., foreign base company sales income, or FBCSI) and from the performance of services by or on behalf of a related person (i.e., foreign base company services income, or FBC Services Income)". https://www.irs.gov/pub/int_practice_units/DPLCUV_2_01.PDF.

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condition was met because Whirlpool Luxembourg carried its activities through Whirlpool International, substantially deferring its tax until the repatriation of such income. Therefore, the Sixth Circuit held that because the two conditions of Section 954(d)(2) were satisfied, the income "shall constitute foreign base company sales income," and be included as Subpart F income.[16]

Conclusion

Whirlpool US relied on the "CFC manufacturing exception" per Treas. Reg. 1.954-3(a)(4) in structuring its Mexican activities to qualify for the IMMEX Maquiladora program without creating FBCSI. In this case, the court decided against Whirlpool solely based on Section 954(d)(2), without consulting the regulations. On June 30, 2022, Whirlpool asked the Supreme Court of the United States to review the Sixth Circuit's decision, arguing that the Sixth Circuit's decision on FBCSI solely relied on the statue, and not regulations.

[16] *Whirlpool Financial Corporation v. Commissioner,* 19 F.4th 944 (6th Cir. 12/6/2021).