Bloomberg Tax

Tax Management
International Journal™

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Subpart F Sales Income: The 'Whirlpool' Case

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In a case before the Tax Court, *Whirlpool Financial Corporation & Consolidated Subsidiaries v. Commissioner*,[1] the Internal Revenue Service (''IRS'') asserts that income derived by a controlled foreign corporation (''CFC'') from the sale of products is Subpart F income that should have been currently included in Whirlpool's gross income. It has been over 25 years since a Subpart F sales income case was litigated.[2]

The CFC carried on its business outside the United States, and, therefore, as a foreign corporation it was not subject to U.S. taxation on its sales income.[3] Furthermore, a fundamental principle of U.S. tax law is that a corporation is a separate taxpayer, and, therefore, under the general rules Whirlpool was not subject to taxation on income earned by the CFC. This treatment is not in dispute.

Subpart F, however, provides a limited exception to these fundamental rules for taxing corporations and their shareholders. Under Subpart F, a U.S. shareholder of a CFC[4] includes currently in its gross income the Subpart F income derived by the CFC.[5]

The *Whirlpool* case involves income derived by a CFC from the manufacture and sale of products to related corporations. The CFC was formed under the laws of Luxembourg. It owned all of the stock of a Mexican company that was disregarded for U.S. tax purposes (i.e., treated as a branch in Mexico).[6] The products sold were manufactured in Mexico at facilities leased by the disregarded entity.

As a general rule, income earned by a CFC from the sale of products is not Subpart F income. Such income is Subpart F income only if meets the definition of foreign base company sales income.[7]

The general definition of foreign base company sales income is income earned by a CFC through the purchase of personal property from any person and its sale to a related person[8] or through the purchase of personal property from a related person and its sale to

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[1] Dkt. No. 13986-17 and Dkt. No. 13987-17. The case involves Whirlpool's 2009 taxable year. Whirlpool filed motions for partial summary judgment and the IRS has filed a cross-motion for summary judgment.

[2] Since 1962 when Subpart F was enacted, the IRS has litigated five cases arguing that sales income derived by a CFC was Subpart F income—the IRS lost every case. *See* Yoder, *The IRS Has Never Won a Subpart F Sales or Services Case*, 46 Tax Mgmt. Int'l J. 636 (Oct. 13, 2017).

[3] §881, §882.

[4] A CFC is a foreign corporation in which U.S. shareholders own, by vote or value, more than 50% of the stock. §957(a). U.S. shareholders are U.S. persons who own, by vote or value, at least 10% of the stock of the foreign corporation. §951(b). Both tests take into account stock that is owned directly, indirectly, and constructively. §958.

[5] §951(a)(1)(A). For taxable years of CFCs beginning after December 31, 2017, a U.S. shareholder must also include in its gross income its global intangible low-taxed income based on CFC tested income and other attributes. §951A(a).

[6] Reg. §301.7701-2(a) (a ''[disregarded entity's] activities are treated in the same manner as a sole proprietorship, branch, or division of the owner'').

[7] §952(a)(2), §954(d).

[8] A person is generally considered related to a CFC if such person controls, or is controlled by, the CFC, or is controlled by the same person or persons who control the CFC. §954(d)(3). For this purpose, control means ownership, directly or indirectly, of stock representing more than 50% of the total voting power, or of the total stock value, of the corporation.

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any person.[9] The definition 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.[10]

Sales income derived from the above related-person transactions, however, is not foreign base company sales income if the products are manufactured in the CFC's country of organization or sold for use in such country.[11] In addition, income from selling products generally is not foreign base company sales income if the CFC is considered as manufacturing the products it sells.[12]

In the *Whirlpool* case, the taxpayer took the position that the income of the Luxembourg CFC from the sale of products to related corporations was not foreign base company sales income because the products sold were manufactured at its Mexican branch from raw materials and components purchased by the CFC. The Mexican disregarded entity conducted its operations in leased facilities comprising nearly 1.3 million square feet of manufacturing space using over $146 million of equipment and tooling owned by the Luxembourg CFC and located at the Mexican manufacturing facilities. The Mexican disregarded entity seconded and leased from a related Mexican regarded entity more than 3,300 individuals to manufacture refrigerators and washers. The individuals carrying out the manufacturing functions, including purchasing raw materials and components, were located in the Mexican facilities. The Mexican disregarded entity produced nearly one million refrigerators and a half-million washers during the year at issue.

There is no dispute that the products sold by the Luxembourg CFC were manufactured in Mexico at the manufacturing facilities leased by the Mexican disregarded entity. The IRS, however, asserts that the Subpart F manufacturing exception can apply to the sales income only if the individuals performing the manufacturing functions were the employees of the Mexican disregarded entity. The IRS argues that whether the employees of the related Mexican regarded entity should be treated as employees of the disregarded entity raises issues of material fact, and, therefore, the court should not grant the taxpayer's motion for partial summary judgment.

The taxpayer points out that neither the Code nor the applicable regulations required a CFC to be treated as the employer of the individuals performing the manufacturing functions for sales income to fall outside the definition of foreign base company sales income.[13] The taxpayer's brief discusses a number of rulings in which the IRS reached the same conclusion,[14] and the Tax Court has stated that activities of individuals other than employees of a CFC may be taken into account for purposes of the manufacturing exception.[15] The taxpayer also argued that, while not necessary to sustain its position, the facts show that the seconded and leased employees that engaged in the manufacture of the products at the CFC's Mexican facilities were the common law employees of the Mexican disregarded entity under U.S. principles.[16]

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[9] §954(d)(1); Reg. §1.954-3(a)(1) (1964). The current foreign base company sales income regulations were substantially revised and made effective for taxable years of a CFC beginning after June 30, 2009. T.D. 9438, 73 Fed. Reg. 79,334 (Dec. 29, 2008), as corrected at 74 Fed. Reg. 11,843 (Mar. 20, 2009). The prior regulations, which were issued in 1964, were effective for the year at issue in the *Whirlpool* case.

[10] §954(d)(1); Reg. §1.954-3(a)(1) (1964).

[11] §954(d)(1); Reg. §1.954-3(a)(2), §1.954-3(a)(3) (1964).

[12] *See* Reg. §1.954-3(a)(4) (1964).

[13] The language of the Code, and the language of the regulations in effect for the year at issue, provided that income from the sale of personal property was not foreign base company sales income if the property sold (i.e., washers and refrigerators) was not the same property purchased (i.e., raw materials and components) by the CFC (i.e., the CFC functioned as more than a mere distributor). *See* §954(d)(1) (the definition of foreign base company sales income requires "the purchase of property. . .and *its* sale") (emphasis added); Reg. §1.954-3(a)(4)(i) (1964) ("A foreign corporation will be considered...to have manufactured, produced or constructed personal property which it sells if the property sold is in effect not the property which it purchased.").

[14] *See* Yoder, Lyon, and Noren, 6240 T.M., *CFCs—Foreign Base Company Income (Other than FPHCI)*, at pp. A67 thru A-72 (discussing a number of IRS rulings that treated a CFC as manufacturing the products it sold when the CFC hired a contract manufacturer to physically manufacture the products on its behalf). Without any change in the language of the statute or regulations, the IRS subsequently reversed the ruling position it had taken for over 30 years. *See* Rev. Rul. 97-48, 1997-2 C.B. 89, *revoking* Rev. Rul. 75-5, 1975-1 C.B. 244.

[15] *See Electronic Arts, Inc. v. Commissioner*, 118 T.C. 226, 265 (2002) (The Tax Court stated that "Our examination of ... section 954(d)(1)(A) and the legislative history of that provision's enactment in 1962, convinces us that there is not an absolute requirement that only the activities actually performed by a corporation's employees or officers are to be taken into account in determining whether the corporation manufactured or produced a product...within the meaning of section 954(d)(1)(A)."). A number of cases in other contexts have concluded that, in the absence of a specific definition of manufacturing, a person was the manufacturer of products even though its employees did not physically manufacture the products. *See, e.g., Carbon Steel Co. v. Lewellyn,* 251 U.S. 501, 503 (1920); *Warner-Patterson Co. v. United States,* 68 Ct. Cl. 237, 241-42 (1929). *Charles Peckat Mfg. Co. v. Jarecki*, 196 F.2d 849 (7th Cir. 1952). *Polaroid Corp. v. United States*, 235 F.2d 276, 277 (1st Cir. 1956). These cases generally conclude that a person is a manufacturer if the person: (i) controls the manufacturing process; (ii) provides the intangible property necessary to the manufacturing process; and (iii) is the economic entrepreneur who enjoys the benefits and assumes the risks associated with the products.

[16] The regulations (but not the Code) were amended to expressly impose a requirement that the regulatory manufacturing

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On two prior occasions, the Tax Court rejected the IRS's arguments for a narrow application of the manufacturing exception. In those cases, the CFCs engaged in the assembly of products (e.g., sunglasses) in jurisdictions with low tax rates (e.g., Hong Kong and Ireland). The IRS asserted that the assembly operations were simple and did not require skill or take much time (e.g., the assembly of sunglasses took only a few minutes), and therefore should not constitute the manufacture of a product. The Tax Court rejected the IRS's arguments in both cases, concluding in favor of the taxpayer that the assembly activities did constitute manufacturing and therefore the income from selling the assembled products to related persons was not foreign base company sales income.[17]

Because the Luxembourg CFC operated through a branch in a foreign country (i.e., Mexico), a special foreign base company sales income branch rule also must be considered. If the requirements for application of the branch rule are met, then a portion of the Luxembourg CFC's sales income—that is not Subpart F income under the general definition of foreign base company sales income—may be treated as foreign base company sales income.

The Code contains two basic requirements for the branch rule to apply. First, the CFC must ''carry on activities'' through a ''branch or similar establishment'' outside the country of organization of the CFC. Second, that carrying on of such activities must have ''substantially the same effect'' as if the branch were a wholly owned subsidiary corporation deriving the income.[18] If these requirements are satisfied, the branch is treated as a wholly owned subsidiary of the CFC and ''income from carrying on such activities of such branch...shall constitute foreign base company sales income of the controlled foreign corporation.''[19]

The IRS asserts that, even if the Luxembourg CFC were considered as manufacturing the products that it sold, the foreign base company sales income branch rule applied to treat a portion of the CFC's income as foreign base company sales income. The IRS does not assert that the income of the Mexican branch is foreign base company sales income under the branch rule.[20] Rather, the IRS argues that the income not subject to tax in Mexico is foreign base company sales income.

As the taxpayer points out, however, §954(d)(2) treats only income of a foreign branch as foreign base company sales income. The language of the Code is unambiguous in this regard. Therefore, there is no basis in the language of the Code to treat income not derived in the Mexican branch as foreign base company sales income.[21]

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exception can apply only by taking into account the activities of a CFC's own employees (although the regulations do not require the CFC's employees to physically manufacture property for the CFC to be treated as manufacturing the property). Reg. §1.954-3(a)(4)(i) (2009). The general definition of ''employee'' for U.S. federal income tax purposes applies for this purpose, and the preamble to the regulations states that employees may include seconded workers and employees of related entities. T.D. 9438, 73 Fed. Reg. 79,334, 79,338 (Dec. 29, 2008); Reg. §31.3121(d)-1(c); Rev. Rul. 87-41, 1987-1 C.B. 296; Rev. Rul. 69-316, 1969-1 C.B. 263; Rev. Rul. 66-162, 1966-1 C.B. 234. As mentioned above, the amended regulations are effective only for years after the year at issue in the *Whirlpool* case.

[17] *Dave Fischbein Mfg. Co. v. Commissioner*, 59 T.C. 338 (1972); *Bausch & Lomb, Inc. v. Commissioner,* 71 (CCH) T.C.M. 2031 (1996).

[18] The regulations apply a tax rate disparity test (discussed below) to determine if this requirement is met. Reg. §1.954-3(b)(1)(i)(b), §1.954-3(b)(1)(ii)(b) (1964).

[19] §954(d)(2). The branch rule applies only upon determination that a CFC's income is not foreign base company sales income under §954(d)(1). The regulations contain separate operative rules for determining whether a portion of the sales income, if any, of the CFC that is not foreign base company sales income under the general rule is nevertheless deemed to be foreign base company sales income under the branch rule. Reg. §1.954-3(b)(1)(ii)(b), §1.954-3(b)(2) (1964). The regulations do not merely treat the branch as a separate CFC and reapply the rules of §954(d)(1), e.g., the branch operative rules ignore actual transactions and provide the necessary related-person transaction by deeming the branch to be a separate corporation, and purchasing and selling activities to be performed on behalf of a related separate corporation. *See* Reg. §1.954-3(b)(2)(ii) (1964). *See* AM 2015-002 (Feb. 9, 2015), n.15 (''Treas. Reg. §1.954-3(b)(2)(i) treats the branch as selling on behalf of the CFC, notwithstanding the fact that the branch may be a hybrid entity that, in its country of incorporation, is treated as a separate corporation that purchases property from the CFC and sells the property to customers or purchases property from suppliers, contracts with the CFC to manufacture the property, and then sells the property to customers.'').

[20] The regulations are clear—and the IRS does not dispute—that income earned by a branch in the country where products are manufactured is not foreign base company sales income under the branch rule. Reg. §1.954-3(b)(2)(ii)(c) (1964) (operative rules resulting in foreign base company sales income do not apply to manufacturing branch); Reg. §1.954-3(b)(4) *Ex.* (2) (1964) (''Branch B, treated as a separate corporation, derives no foreign base company sales income since it produces the product that is sold.''). The revised regulations provide the same result. *See* Reg. §1.954-3(b)(4) (2009) *Ex.* (2) (same as *Ex.* (2) of 1964 regulations) and *Ex.* (3)(ii) (last sentence states the same conclusion).

[21] The legislative history likewise explains that §954(d)(2) applies to treat income of a foreign branch as foreign base company sales income, and does not indicate that income of a CFC's home office can be foreign base company sales income under §954(d)(2). *See* S. Rep. No. 87-1881, at p. 246 (1962); H.R. Rep. No. 87-2508, at p. 31 (1962). *See also* Reg. §1.954-3(b)(1)(i), §1.954-3(b)(2)(i)(b)(2), and §1.954-3(b)(2)(ii)(b)(2) (1964) (under the ''purchasing or selling branch'' rule in the regulations, consistent with the language of §954(b)(2), only purchasing and selling income derived in a branch is subject to that regulatory branch rule; any purchasing or selling income derived by the CFC's home office is not subject to that regulatory branch rule, even if such income is taxed at a much lower rate than if the home office income were earned in the purchasing or selling branch).

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The IRS appears to acknowledge that the language of the branch rule in §954(d)(2) does not apply to income that is attributed to a CFC's home office, but points out that regulations contain a so-called manufacturing branch rule. That regulatory manufacturing branch rule can apply when a CFC manufactures products in a foreign branch and sells the products through its home office.[22] If the requirements for application of the manufacturing branch rule are met, then under the regulations the purchasing and selling income of the CFC's home office may be foreign base company sales income.[23]

Under the regulations, however, the manufacturing branch rule applies only if the home office engages in "activities" of purchasing or selling, and it is only the income that is attributable to such purchasing or selling "activities" that can be foreign base company sales income.[24] The Luxembourg CFC's home office had only one part-time employee who performed certain limited general accounting and administrative functions. The Luxembourg-based employee did not perform any purchasing functions, which were performed in Mexico, and the related affiliates who purchased the finished products carried out the functions of selling the products to customers. Thus, there is no basis under the language of the regulations to apply the manufacturing branch rule.[25]

Even assuming the regulatory manufacturing branch rule is relevant to the income earned by the Luxembourg CFC's home office, the alleged "purchasing or selling income" would be subject to the regulatory branch rule only if a tax rate disparity test were satisfied. The regulations provide that the tax rate disparity test is met if the Luxembourg CFC's income derived from purchasing or selling activities carried on in the home office (i.e., Luxembourg) is taxed at an effective rate that is both less than 90% of, and at least five percentage points less than, the effective tax rate that would apply to such income in the country where the products are manufactured (i.e., Mexico).[26] The regulations provide that for purposes of calculating the tax rate disparity test, the "[t]ax determinations shall be made by taking into account only the income, war profits, excess profits, or similar tax laws (or absence of such laws) of the countries involved."[27]

The regulations in effect for the year at issue appear to apply the test based on the nominal tax rates in the two countries.[28] Under this approach, the tax rate disparity test would not be met, because for the year in issue the Luxembourg tax rate was 25% and the Mexican tax rate was 28% (there was not a five-percentage-point difference in the two rates).[29]

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[22] Reg. §1.954-3(b)(1)(ii) (1964).

[23] The validity of this regulatory manufacturing branch rule is doubtful since it is inconsistent with the language of the statute. *See Chevron USA Inc. v. Natural Resources Defense Council Inc.*, 467 U.S. 837, 843 n.9 (1984) ("The judiciary is the final authority on issues of statutory construction and must reject administrative constructions which are contrary to clear congressional intent.").

[24] Reg. §1.954-3(b)(1)(ii)(b), §1.954-3(b)(1)(ii)(c), §1.954-3(b)(2)(i)(c), §1.954-3(b)(2)(ii)(c) (1964) (only income arising from "purchasing or selling activities" in a CFC's home office or a branch is taken into account for purposes of the regulatory manufacturing branch rule). *See also* Reg. §1.954-3(b)(1)(i)(a) (1964) (only income from "purchasing or selling activities" in a branch is taken into account for purposes of applying the regulatory purchasing or selling branch rule). The regulatory prerequisite for application of the branch rule—that a CFC engage in activities at the purchasing or selling location—is required by the language of §954(d)(2) which limits the application of the branch rule to "carrying on of activities," and only income from "carrying on of such activities" can result in foreign base company sales income (which is not an express requirement for purposes of applying the general definition of foreign base company sales income in §954(d)(1)). *See also* TAM 8509004 (the only IRS guidance addressing this requirement held that the branch rule did not apply because the home office "performs no selling or sales activities with respect to product Z...manufactured by the branch...."). The revised regulations effective in 2009 contain the same "purchasing or selling activities" requirement for the branch rule to apply. *See* Reg. §1.954-3(b)(1)(i), §1.954-3(b)(1)(ii), and §1.954-3(b)(2) (2009).

[25] This regulatory purchasing-or-selling activities requirement may be a reason the IRS decided not to litigate the manufacturing branch issue in *The Cooper Companies Inc. v. Commissioner*. That case involved a CFC that was organized in the U.K. as a reverse hybrid entity and was not subject to tax in the United Kingdom. It manufactured products in its wholly owned U.K. disregarded entity. The CFC had a Barbados branch with three employees who performed clerical, administrative, high-level oversight and compliance tasks for the U.K. CFC, and other entities carried on the purchasing of raw materials and the selling of the products to customers. The IRS argued that $53 million of sales income derived by the CFC—which was not subject to tax in any country—should be foreign base company sales income as a result of applying the regulatory manufacturing branch rule to the Barbados branch. The taxpayer argued that the manufacturing branch rule did not apply because the Barbados branch did not engage in "purchasing or selling activities" as required by the regulations. The IRS settled the case prior to trial with the taxpayer agreeing to a tax deficiency of only $50,000. T.C. No. 14816-11 (settlement order entered Feb. 2, 2012).

[26] Reg. §1.954-3(b)(1)(ii)(b) (1964).

[27] Reg. §1.954-3(b)(2)(i)(e) (1964).

[28] In determining the actual tax rate at the purchasing or selling location for purposes of the tax rate disparity test, the examples in the regulations refer to the tax rate that is levied by the country on the income subject to tax in such country arising from purchasing or selling activities. *See* Reg. §1.954-3(b)(4) (1964) *Illustrations*.

[29] These rates may not be the actual tax rates for the years at issue, but, in any event, the IRS does not dispute that the tax rate disparity test would not be met if it were determined based on a

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In two private letter rulings issued in 2009, the IRS stated that, under the regulations, the tax rate disparity test should be applied to determine the actual tax rate on income earned in the purchasing or selling country based on the taxes imposed by that country on any purchasing or selling income subject to tax in such country.[30] The IRS in the rulings points out that the regulations require the application of the local tax law in the purchasing or selling location to determine the income and deductions, including any advance pricing agreements for determining the amount of income subject to tax in the country.[31] Under this approach, in the *Whirlpool* case the actual tax rate also would be 25%, because the Luxembourg tax laws do not provide any special tax rates for the business income treated as derived by the Luxembourg CFC in Luxembourg. Again, the tax rate disparity test would not be met, and thus the manufacturing branch rule would not apply.

The IRS apparently does not dispute the above tax rates or calculations. Rather, it has come up with a novel approach for determining whether the tax rate disparity test is met. The IRS asserts that the actual tax rate on income of the home office must be calculated by attributing to the Luxembourg home office any income that is not subject to tax in Mexico or Luxembourg.

For illustration, assume $100 of income arises from the sale by a Luxembourg CFC to a related person of products that are manufactured in Mexico. Under the tax laws of Luxembourg and pursuant to a tax ruling, $95 of the income is attributed to a Mexican permanent establishment where the products are manufactured in large manufacturing facilities by thousands of employees and using tooling owned by the CFC, and, therefore, only $5 of income is considered as derived by the home office in Luxembourg that has one administrative employee, which income is subject to a 25% tax rate. Mexico has special tax incentives to attract manufacturing and under the laws of Mexico only $5 of the income from selling products manufactured in Mexico by the Luxembourg CFC (which owned the tooling, raw materials, work in process and finished products located in Mexico) is taxable in Mexico and subject to a 28% tax rate. The IRS apparently would argue that for purposes of determining the actual effective rate of tax on purchasing or selling income in the home office, the $90 of income not subject to tax in any country should be deemed to be derived by the Luxembourg home office (contrary to Luxembourg tax law), in which case the tax rate disparity test would be met [$1.25/($5 + $90) = 1.32%].

Obviously, there is nothing in the Code supporting the IRS's argument—indeed, as discussed above, the statutory branch rule does not treat as foreign base company sales income any income attributed to a CFC's home office, but only the income derived in a foreign branch. In addition, there is no rule in the applicable regulations supporting the IRS's approach, which indicate that the tax rate disparity test should be determined based on the taxes imposed on the amount of purchasing or selling income that is subject to tax in Luxembourg.[32] As discussed above, in two private letter rulings the IRS applied the regulations as looking to the tax laws of the purchasing or selling country to determine the amount of income, deductions, and taxes for purposes of calculating the actual tax rate on any purchasing or selling income.[33]

The IRS's previous novel arguments attempting to apply the branch rule and tax rate disparity test were rejected by the Tax Court in the only two cases that have addressed the foreign base company sales income branch rule. The IRS asserted that the branch rule should be applied broadly as a ''loophole closing'' provision to prevent the use of multiple foreign countries to separate manufacturing and sales functions in order to obtain a lower tax rate on sales income. It argued that the term ''branch'' should include a contract manufacturer (related or unrelated) located in a different country than where the CFC was organized and that was hired by the CFC to manufacture products on its behalf, because the CFC's sales income was subject to a significantly lower tax rate than the rate imposed on the income of the contract manufacturer. The Tax Court rejected the IRS's creative arguments for applying the branch rule, stating that the Congress did not authorize the IRS to provide a special definition of a branch, and specifically, that the IRS cannot apply the branch rule just because there was a tax rate disparity between the low tax rate on

comparison of the nominal rates of tax in Luxembourg and Mexico.

[30] PLR 200945036 (Nov. 6, 2009) and PLR 200942034 (Oct. 16, 2009). *See* Yoder, *Local Law Governs Manufacturing Branch Determinations*, 36 Int'l Tax J. 3 (July-Aug. 2010).

[31] *See* Reg. §1.954-3(b)(1)(ii)(b) and §1.954-3(b)(2)(i)(e) (1964).

[32] As mentioned above, the branch regulations were significantly modified effective for years beginning in 2009, and the revised regulations do not support the IRS's argument.

[33] After issuing the private letter rulings, the IRS issued AM 2015-002 (Feb. 13, 2015) addressing certain questions concerning the application of the regulatory tax rate disparity test. The IRS again confirmed that foreign law is the basis for applying the tax rate disparity test, which may differ from U.S. tax law. While that guidance contains some differences in applying the tax rate disparity test from the approach in the above private letter rulings, AM 2015-002 does not support the IRS's argument in the *Whirlpool* case, and the IRS does not cite to that guidance as supporting its position. Indeed, the IRS does not cite to any authority supporting its novel approach to applying the tax rate disparity test.

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ISSN 0090-4600

the sales income in one country as compared with the high tax rate on the manufacturing income in another country.[34]

The Treasury and IRS in the past attempted to expand the scope of the Subpart F branch rule to apply to income that did not fall within the foreign base company sales income branch rule. They issued temporary regulations that would treat as Subpart F income certain payments that were made to a hybrid branch and disregarded for U.S. tax purposes but reduced foreign taxes.[35] Members of Congress sent letters to the Treasury stating that the temporary regulations concerned important issues of tax policy that should be addressed only in the legislative process, and the Senate passed legislation placing a moratorium on implementation of the regulations, stating that the regulations should be withdrawn. The temporary regulations were subsequently withdrawn, and there has never been any legislative change expanding the branch rule.[36]

In summary, neither the Code nor the regulations provide a basis for the IRS's novel arguments in the *Whirlpool* case. The law firmly supports that the Luxembourg CFC's income from selling refrigerators and washers manufactured in its Mexican branch should not be considered as foreign base company sales income under the general definition, and the requirements for application of the special branch rule simply were not met. The IRS's arguments ask the court to add to the Code an application of the branch rule to income that is not derived in a branch;[37] render meaningless the ''purchasing-or-selling activities'' requirement of the branch regulations (and the Code); and accept a new argument for applying the tax rate disparity test that is contrary to the IRS's own interpretation of the regulations applied in two private letter rulings issued during the same year that is before the court.[38] As discussed above, in all prior Subpart F income cases the courts have uniformly rejected the IRS's policy arguments, stating that if the law creates benefits perceived as inappropriate for taxpayers, it is Congress that must change the law.[39]

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[34] *Ashland Oil v. Commissioner*, 95 T.C. 348, 357–58 (1990); *Vetco, Inc. v. Commissioner*, 95 T.C. 579 (1990). In *Vetco*, the sales income was earned by a Swiss CFC that hired a related U.K. CFC to engage in all of the supply chain activities, and the Swiss CFC itself had no employees. The Tax Court refused the IRS's urging to ''look past [the taxpayer's] 'contractual wizardry' and apply the branch rule as a loophole-closing device to circumvent [the taxpayer's] attempted tax avoidance,'' because the government's arguments lacked a basis in the language of the Code or regulations. *See also Brown Grp., Inc. v. Commissioner*, 77 F.3d 217 (8th Cir. 1996), *vac'g and rem'g* 104 T.C. 105 (1995) (sales income derived by a Cayman Islands CFC—that was not subject to tax in any country—was not Subpart F income because the income did not fall within the statutory or regulatory definition of foreign base company sales income).

[35] T.D. 8767, 63 Fed. Reg. 14,613 (Mar. 26, 1998).

[36] T.D. 8827, 64 Fed Reg. 37,677 (July 13, 1999). For a discussion of the history of these regulations, see Yoder, *Subpart F in Turmoil: Low-Taxed Active Income Under Siege*, 77 TAXES 142 (Mar. 1999). Indeed, Congress subsequently passed a Subpart F income exception permitting regarded deductible payments to enjoy the same foreign tax reduction benefits as disregarded payments that were deductible only for foreign tax purposes. §954(c)(6). Consistent with the withdrawal of the temporary regulations and the enactment of §954(c)(6), in the two private letter rulings discussed above the IRS did not apply the branch rule to disregarded payments of interest and royalties that were deductible for foreign purposes and were received by the home office and a branch of a CFC. This conclusion was reached even though such payments reduced selling income of a branch of the same CFC for purposes of applying the branch rule, and the CFC's Form 5471 would have included such amounts in the reported sales income of the CFC; i.e., the branch rule should not apply because the home office and branch receiving the disregarded interest and royalties did not engage in purchasing or selling activities.

[37] In *The Limited, Inc. v. Commissioner*, 286 F.3d 324 (6th Cir. 2002), *rev'g* 113 T.C. 169 (1999), the government argued that the exception to taxation of earnings invested in U.S. property under Subpart F for ''deposits with persons carrying on the banking business'' should not apply to a CFC's loans to a *related* domestic bank. Because the position required adding language to the Code, the Sixth Circuit rejected the argument and reversed the Tax Court's decision, stating: ''While obviously not the policy that the Tax Court would promote were it an uber-legislature, interpreting §956(b)(2)(A) without a related-party prohibition hardly rises to the level of unreasonableness that merits ignoring the plain language of the statute.'' *Id.* at 336.

[38] In *Lovett v. United States*, 621 F.2d 1130 (Ct. Cl. 1980), the taxpayer argued that a regulation issued under Subpart F was invalid because it lacked support from the language of the Code. The government argued that the Subpart F regulation was ''necessary to avoid the 'absurd' results which flow from a literal application of the language of §951(d).'' The court rejected the government's argument and held the regulation invalid, stating that: ''Neither we nor the Commissioner may rewrite the statute simply because we may feel that the scheme it creates could be improved upon.'' *Id.* at 1140 (quoting *United States v. Calamaro*, 354 U.S. 351, 357 (1957)).

[39] Indeed, rather than expanding the Subpart F income rules, Congress took a different approach to address perceived concerns by enacting in December of 2017 a new regime under Subpart F causing most of the income of CFCs to be currently included in the income of U.S. shareholders (subject to 50% of the corporate tax rate), and also subjecting to tax (at a lower rate) the historic untaxed earnings of CFCs (which generally would include the earnings for the year at issue in this case). §250, §951A, §965. Studies estimate that the amount of earnings of CFCs that had not been subject to tax under Subpart F or repatriated as of the end of 2017 was as much as $3 trillion.

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ISSN 0090-4600