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Whirlpool's Subpart F Position Was *Inconsistent* With Congressional Intent

To the Editor:

A recent article[1] authored by Lowell D. Yoder, David G. Noren, Jonathan D. Lockhart, and Elizabeth C. Lu, all of whom are with McDermott Will & Emery LLP, maintains that the Tax Court erred in its 2020 *Whirlpool* decision[2] that applied the manufacturing branch rule to a Luxembourg/Mexico maquiladora structure. In connection with the sale of products manufactured in Mexico to related group members, this pre-Tax Cuts and Jobs Act structure achieved a reduction of the Mexican tax rate on manufacturing profits, and eliminated any Mexican or Luxembourg taxation on the remainder of the profits. The structure was also meant to achieve deferral of those profits from any U.S. tax.[3] Crucial to this deferral objective was avoiding treatment of the sales income as foreign base company sales income (FBCSI) under the subpart F regime.

Yoder et al.'s conclusion that Whirlpool's position is consistent with congressional intent is incorrect. They claim:

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

I am concerned about several matters in the article's discussion supporting their conclusion. These matters are either insufficiently discussed or do not cover issues that I believe should be disclosed to interested readers, who otherwise may be unaware of them.

First, I applaud how well Yoder et al. summarized congressional intent concerning FBCSI when a controlled foreign corporation also manufactures. They wrote concisely:

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

In a prior exchange of letters to the editor,[4] Yoder et al. and I have had some differences with respect to the Whirlpool case and the application of the reg. section 1.954-3(b) branch rule. One area where I believe that we agree, despite what I think is a semantic difference, is their earlier stated contention that "the amount allocated to a manufacturing branch is the amount that would be derived by the branch if it were a separate

[1] Lowell D. Yoder, David G. Noren, Jonathan D. Lockhart, and Elizabeth C. Lu, "Whirlpool's Subpart F Position Was Consistent With Congressional Intent," *Tax Notes Int'l*, Apr. 3, 2023, p. 61.

[2] *Whirlpool Financial Corp. v. Commissioner*, 154 T.C. 142 (2020), *aff'd*, 19 F.4th 944 (6th Cir. 2021). I note that, in addition to the Sixth Circuit's affirming of the Tax Court decision, the Supreme Court denied on November 21, 2022, Whirlpool's June 30, 2022, petition for a writ of certiorari.

[3] Because the year at issue was prior to the TCJA's implementation of a territorial tax system, the desired result for U.S. tax purposes was that the zero- and low-taxed profits recorded within a group member CFC would be deferred from any U.S. taxation until repatriation of those profits to the U.S. shareholder.

[4] Yoder et al., "Another Spin on *Whirlpool*: Allocating Income to a Manufacturing Branch Under the Regs," *Tax Notes Int'l*, Oct. 24, 2022, p. 439; Jeffery M. Kadet, "Further Lessons From *Whirlpool*," *Tax Notes Int'l*, Dec. 12, 2022, p. 1373.

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corporation." Concerning this, I previously wrote something with which I expect Yoder et al. will agree:

> No matter which label [that is, referring to what I term our semantic difference] one uses when determining the allocation of a CFC's income between a branch and the remainder of the CFC, the process will be the same. And that process will include a full investigation for both the branch and the remainder of the activities and functions that each conducts (whether directly through officers and employees or through agents, including de facto agents, acting on the CFC's behalf), the assets that each utilizes, and the risks that each undertakes and controls.

We have also both expressed that it would have been beneficial if the Tax Court in its *Whirlpool* decision had engaged in a more detailed factual analysis, which could have provided useful and practical guidance to taxpayers and the government alike. For example, the court might have shown how the ownership by Whirlpool's Luxembourg CFC of certain manufacturing assets and inventory located in Mexico, and any production risks that the CFC was bearing under its sales contracts with related-party buyers, might be reflected in the allocation required between income derived by the branch and income derived by the "remainder of the CFC."

I. Intent of Whirlpool 2009 Reorganization

The article explains that Whirlpool's 2009 reorganization was executed "to qualify for the revamped Mexican maquiladora tax incentive provided to foreign companies manufacturing products in Mexico." The article goes out of its way to say that "the restructuring did not reduce U.S. taxes *relative to the prior structure*." (Emphasis added.) The prior structure reported *all* relevant income within Mexico, where it was subject to Mexican corporate tax at 28 percent (which was less than the then-applicable 35 percent U.S. tax rate). According to the Tax Court decision, profits under the new structure were shifted out of Mexico and into a Luxembourg CFC. As a result, the article truthfully claims that U.S. taxes were not reduced *relative to the prior structure*. The ease with which these profits were moved out of Mexico, however, suggests that profits prior to the 2009 reorganization were perhaps overstated in Mexico and understated within the United States.[5]

In its reorganization, Whirlpool chose to establish a Luxembourg CFC as a principal (Lux) that would own certain production assets and sell the products physically processed by a new Mexican subsidiary. This choice of a Luxembourg principal was *presumably* done solely to achieve no current U.S. taxation and was not because of any operational need or any Mexican maquiladora requirement. I say "presumably" because the article is silent about the apparent, and obviously important, objective of no current U.S. taxation.

Instead of establishing Lux as the principal, Whirlpool could have used a U.S. group member. Because about 96 percent of the 2009 Mexican production was sold to Whirlpool U.S., presumably for sale to U.S. customers, there was no apparent reason — aside from a strong desire to avoid current U.S. taxation — to have chosen Lux over a U.S. group member to be the principal.

I, of course, recognize that taxpayers are free to decide on which group entities to use and how to document their activities through intercompany agreements. Whirlpool had no obligation to use a U.S. group member as the principal in this effort to qualify for the maquiladora program. However, when any group creates a structure like that involved in the Whirlpool case with such a divergence between the few real functions performed by a CFC and the high level of profit recorded on the books of that CFC, then group management must know that their structuring is open to multiple potential challenges. In these cases, once the IRS

[5] As is indicated later in this discussion, about 96 percent of the 2009 product sales were made to Whirlpool U.S. This is why it is likely that U.S. profits were understated to the extent that Mexican profits were overstated. *See* the Tax Court decision, at 148. It, of course, must be added that it is unknown whether Mexican tax authorities reviewed this restructuring from the standpoint of the profits that were effectively moved from existing Mexican companies to, as Yoder et al. describe it, a nontaxable Mexican permanent establishment of Lux (defined *infra*). The Tax Court decision refers to the transfer pricing study prepared to determine WIN's (defined *infra*) income (solely manufacturing profits of Lux's Mexican subsidiary), but there is no mention of any other transfer pricing analyses. Regarding U.S. transfer pricing, the Tax Court did not analyze the propriety of the transfer pricing before the restructuring between the Mexican CFCs and Whirlpool U.S. or after the restructuring between Lux and Whirlpool U.S. Whether the IRS has ever reviewed these transfer pricing issues is unknown.

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understands the relevant facts, it must decide which of its tools best fits the facts and risks of litigation. These tools may include (i) substance vs. form or other judicial concepts, (ii) transfer pricing adjustments (including periodic adjustments where there's been a transfer of intangibles), (iii) subpart F, or (iv) the application of the effectively connected income rules. In *Whirlpool*, the IRS chose the subpart F manufacturing branch rule as the most appropriate tool.[6]

II. Sales Income Within Lux PE in Mexico

Yoder et al. claim that Lux earned all its income either through its newly established Mexican subsidiary (referred to as WIN and treated as a disregarded entity subsidiary for U.S. tax purposes) or *within* its Mexican permanent establishment. This was critically important to their claim that the Tax Court erred, because only if *both* manufacturing activities and sales activities occurred in Mexico would the FBCSI manufacturing exception apply to prevent FBCSI treatment of this income. The court's decision indicates that in the 2009 tax year after the reorganization, Lux (not WIN) recorded about $800 million of gross receipts from product sales that netted as much as $50 million in profits. These gross receipts and profits would have been recorded by Whirlpool's existing Mexican CFCs if the reorganization had not occurred. It is these sales and profits that would presumably be within the Lux PE that Yoder et al. describe.

Yoder et al. explain:

> Under the tax laws of Mexico, all the income derived by the new maquiladora structure from the manufacture and sale of the products was considered to be derived by a Mexican company or attributable to the Luxembourg CFC's PE in Mexico. Therefore, absent qualifying for the manufacturing tax incentive [that is, the maquiladora program], the income would continue to be subject to full taxation in Mexico at the 28 percent tax rate. Under the maquiladora regime, however, only the income earned by the Mexican legal entity that carried out the Mexican manufacturing operations was subject to taxation at 17 percent. *Mexico exempted the remaining [sales] income from taxation by "deeming" Whirlpool Luxembourg's PE in Mexico to not be a PE for Mexican tax purposes.* [Emphasis added and footnote omitted.]

From this explanation, one might think that the Lux PE in Mexico (which Mexico is ignoring for tax purposes) will have earned its large profits through actual sales and other activities performed in Mexico and nowhere else. But factually, this is not the case.

My two prior items[7] explained in relative detail that whatever sales and other activities Lux conducted, or that were conducted by Lux officers and actual or de facto agents on Lux's behalf, did *not* take place in Mexico.

Further, even *if* there had been any sales activities conducted in Mexico, they could not have been conducted by the Lux Mexican PE. Yoder et al. actually make this clear within their article. They make what they believe is a positive point for their overall argument when they explain that the 2009 reorganization was just on paper with no operational changes. They concisely say: "All activities, assets, and personnel generating the income remained in Mexico following the restructuring."

Accordingly, if there were any sales activities conducted in Mexico following the 2009 reorganization, they continued to be conducted by the same Mexican personnel who had conducted them before the reorganization.

Neither the Lux Mexican PE nor WIN had any employees of their own in Mexico. Despite having no employees, WIN (the Mexican legal entity

[6] The amicus brief filed August 3, 2022, by the National Association of Manufacturers expressed serious concern about the potential additional taxation that would be payable should the IRS's win in *Whirlpool* be sustained through any rejection by the Supreme Court. In particular, the brief stated: "For example, if conservatively one assumes 25 percent of the income from manufacturing and selling products was earned by CFCs that operated in a branch structure, roughly $3.675 billion of additional U.S. taxes would be due in 2018 under the Sixth Circuit's decision (the income would be subject to the full 21 percent tax rate rather than the 10.5 percent effective tax rate imposed on GILTI)." Taxpayer group managements should more carefully consider and understand their risks in these situations, especially considering the increased enforcement resources that the IRS will have in coming years.

[7] Kadet, *supra* note 4; Kadet, "The Lessons of *Whirlpool*," *Tax Notes Int'l*, Oct. 3, 2022, p. 53.

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referred to in the above quoted lines from Yoder et al.'s article) was able to carry out its manufacturing operations through contractually accessing manufacturing personnel through secondment and subcontract agreements with the Whirlpool Mexican CFCs that had conducted this manufacturing before the reorganization.

WIN itself conducted no sales activities. First, it is understood that under the maquiladora program, WIN was limited to the conduct of manufacturing. To have also conducted sales activities would have presumably violated the terms of the program. Second, the Tax Court decision states, at 171:

> A transfer pricing study commissioned by WIN represented to the Mexican Government that "no sales effort is made" by WIN and that "all responsibility for the distribution, marketing, and sale of [the] products" fell to Whirlpool Luxembourg [Lux].

What about the Lux Mexican PE? Did it similarly second or subcontract personnel who had been conducting sales activities prior to the reorganization from the Mexican group member or members that employed these personnel? No, it did not. As a result, even if there had been any actual sales activities conducted within Mexico, they were performed by existing Mexican group members in 2009, not by the Lux Mexican PE. When applying reg. section 1.954-3, activities conducted by one CFC are not attributed to any other CFC (unless the former CFC is factually acting as an agent of the latter CFC).[8] Therefore, even if a Mexican group member CFC had conducted all relevant sales activities and had charged Lux a service fee for those services, under the section 954(d)(2) branch rule and the manufacturing exception Lux would not be treated as conducting both manufacturing and sales activities within Mexico.[9]

Despite this explanation that the Lux Mexican PE conducted zero sales activities, Yoder et al. sidestep the reality of Whirlpool's facts by not providing them to the reader in this article. Rather, when they criticize the Tax Court's decision, they simply repeat the above quoted item, saying: "All the activities and assets that gave rise to the income in Mexico before the restructuring continued to be in Mexico after the restructuring." It may be added that Yoder et al. also chose not to refer to, question, or refute any of my discussion on the nature of Lux's sales activities and where they were conducted (see *supra* note 7 and accompanying text).

III. Allocation of Income

At the heart of any application of the manufacturing branch rule is the need to factually determine the allocation of a CFC's income between the portion allocable to the manufacturing branch and the portion allocable to the remainder of the CFC.[10] Where a branch conducts all manufacturing activities and all sales activities, then all income will be allocable to the branch.[11] Once all income is allocable to the branch, the manufacturing exception will apply so that there will be no FBCSI. On the other hand, any sales income that is allocable to the remainder of the CFC will be FBCSI.[12]

Yoder et al. maintain in their article that Lux's Mexican branch (which includes for U.S. tax purposes both the Lux PE and WIN due to its disregarded entity status) in 2009 conducted all the activities, owned or leased all relevant assets

[8] It is understood that the Mexican group member CFCs are separate CFCs from Lux. Only WIN, which is a disregarded entity subsidiary of Lux, is treated as a branch of Lux so that its activities are attributed to Lux for U.S. tax purposes.

[9] There is no suggestion within the Tax Court's recitation of facts that any actual sales activities that the Mexican CFCs might have conducted were provided as a service to Lux after the 2009 reorganization. Interestingly, regarding the personnel who were seconded or subcontracted by their Whirlpool CFC employers to WIN, the Tax Court commented, at 157: "There is no evidence that these workers were aware of any change in their employment status after 2008."

[10] *See* reg. section 1.954-3(b)(1)(ii)(*b*).

[11] This is what the regulation example cited by Yoder et al. in their article demonstrates. Reg. section 1.954-3(b)(4), Example 3 (scenario three). This example is factually inapplicable to Whirlpool because Lux did not conduct any selling activities within Mexico.

[12] Of course, if the remainder of the CFC itself conducts manufacturing regarding the allocated income, then the manufacturing exception may apply to prevent that allocated income from being FBCSI. This is not relevant to Whirlpool's factual situation.

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used to manufacture the products, and seconded or subcontracted from related CFCs all personnel involved in generating the relevant income prior to the restructuring. As for anything happening outside Mexico, they noted only the one part-time administrative employee located in Luxembourg. They explained that this left all income subject to the Mexican taxing jurisdiction. While not stated within the article, an implication of this factual situation is that all income would be allocable under the FBCSI branch rule to the branch with no income allocable to the remainder of the CFC.

I will not repeat here what may be found in their recent letter to the editor[13] or in my letter to the editor[14] that explains why both this factual situation and its implication are incorrect. Suffice it to say that, in this present article, they chose to just label the Tax Court's finding of fact "a fundamental flaw." They chose not to reference interested readers to my letter that went into considerable detail about why only manufacturing income was derived in the Mexican branch. They also chose not to question or refute the extensive detail and discussion included in that letter that identified Lux officers located outside Mexico who were acting on behalf of Lux.

Yoder et al. questioned how the Tax Court allocated income between the branch and the remainder of the CFC. They wrote:

> The court allocated only 10 percent of the income to the Mexican operations, *stating, without any economic analysis*, that treating 90 percent of the income as derived outside Mexico "seems intuitively clear." Thus, contrary to the regulations, the court held that 90 percent of the Luxembourg CFC's income did not qualify for the manufacturing exception and was FBCSI. [Emphasis added and footnote omitted.]

Yes, it's true that the Tax Court did not make its own economic analysis. However, that's because this approximate 10/90 split was taken from the taxpayer's own books and records. The court, at 167, explained its decision as follows:

> Because Whirlpool Luxembourg and WIN were separate corporations (although not distinct tax entities for U.S. tax purposes), their activities and income can be separated quite easily. WIN leased the Ramos and Horizon plants from IAW, and it derived income (computed on a cost-plus basis) for supplying the manufacturing services needed to assemble the Products at those plants. The manufacturing income WIN earned was treated as having been earned at arm's length under Mexican transfer pricing rules. Although Whirlpool Luxembourg owned the machinery and equipment, it allowed WIN to use that machinery and equipment free of charge under the "bailment agreement." *See supra* p. 9. The proper allocation of income between the branch and "the remainder" thus seems intuitively clear: The Mexican branch earned all of the manufacturing income, and all of the sales income was allocable to "the remainder."

The Tax Court's determination was, without question, reasonable. Despite this, I made clear in my October 2022 article that the court could have provided important guidance to taxpayers and the IRS if it had conducted a more detailed analysis in determining the allocation. Yoder et al. and I are in complete accord on this.

IV. Need for Increased Regulatory Guidance

The income allocation issue described in Section III carries particular importance for the application of the branch rule. Despite this importance, there is little guidance within reg. section 1.954-3(b) on how to make this allocation between a branch and the remainder of the CFC. While such guidance is needed generally, it is especially necessary in the context of sales to related parties.

Interested readers will know that in centrally managed multinational structures, intercompany product sales from one group member to another do not require teams of sales personnel to knock on doors soliciting orders, negotiating terms, and concluding sales agreements. Despite the lack of those personnel, corporate taxpayers legally operate and pay taxes based on each group

[13] Yoder et al., *supra* note 4.

[14] Kadet, *supra* note 4.

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member being treated as a separate independent entity. When tax law and regulations are applied, they are applied on this separate-entity basis. As a result, although a group member might not have specific employees who negotiate sales terms and conclude sales contracts with another group member, those legal functions occur on a separate-entity basis through decisions made and contracts signed by officers and directors of each group member legally operating on that member's behalf, as well as through other group personnel who process the legally effective paperwork (for example, intercompany contracts, invoices, and so forth). In the context of *Whirlpool*, it is clear that these legal sales and related functions took place outside of Mexico. (See additional discussion of this in the context of *Whirlpool* in both the article and letter to the editor cited in note 7.)

I believe that Whirlpool took an untenable position on allocation in its 2009 tax filings. The Tax Court in its *Whirlpool* decision corrected this position using a reasonable approach that used the taxpayer's own accounting. Now, in their article, Yoder et al. have labeled the Tax Court's approach a "fundamental flaw" while championing Whirlpool's position. Considering this situation, it is critical that Treasury and the IRS add appropriate guidance to reg. section 1.954-3. This would clarify that in the case of sales to related or unrelated persons, with no locally based sales personnel and where group personnel in other locations determine the timing, pricing, and other terms of sale for products manufactured by the branch, the relevant sales income will be allocated to the remainder of the CFC — not to the branch. As Whirlpool's position has likely been taken, and will continue to be taken, by many other multinationals with similar branch structures, an amendment to reg. section 1.954-3 or other appropriate IRS guidance on this should be considered a priority. ■

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