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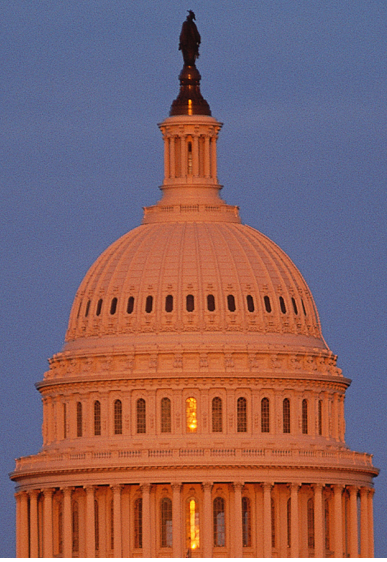

No. 2022-062
March 3, 2022

Sixth Circuit: Rehearing en banc denied in subpart F income case

The U.S. Court of Appeals for the Sixth Circuit denied the taxpayer's **petition** [PDF 545 KB] for a rehearing en banc of the Sixth Circuit's **decision** [PDF 272 KB] affirming the U.S. Tax Court's decision upholding an IRS deficiency determination that sales income from manufacturing operations in Mexico involving a Luxembourg controlled foreign corporation (CFC) was foreign base company sales income (FBCSI) under section 954(d).

The taxpayer has 90 days from the date a rehearing request is denied to petition for *certiorari* with the U.S. Supreme Court.

The case is: *Whirlpool Financial Corp. v. Commissioner*, Nos. 1899/1900 (6th Cir. March 2, 2022).

Background

The taxpayer (a U.S. corporation) was engaged in the manufacture and distribution of household appliances (refrigerators and washing machines) through domestic and foreign subsidiaries, including CFCs as defined by section 957(a).

During 2007-2009, the taxpayer restructured its Mexican manufacturing operations in a manner the Tax Court described as "driven largely by tax considerations." Following the restructuring, the taxpayer's Luxembourg CFC acted as the nominal manufacturer of appliances in Mexico, using a maquiladora structure through its disregarded Mexican subsidiary (Mexican DRE) that qualified for Mexican tax and trade incentives.

The Luxembourg CFC, which had a single employee, then sold these appliances to the taxpayer and to the taxpayer's Mexican distribution CFC, which distributed the appliances for sale to consumers. The Luxembourg CFC earned substantial income that was exempt from both Mexican and Luxembourg tax.

The IRS concluded that the income the Luxembourg CFC earned from sales of appliances to the taxpayer and to the taxpayer's Mexican CFC constituted foreign base company sales income (FBCSI) under section 954(d). Thus, the IRS determined that the FBSCI was taxable as subpart F income under

section 951(a). The IRS increased the taxpayer's taxable income for 2009 by approximately $50 million, which in turn decreased a consolidated net operating loss (NOL) carryback deduction.

Tax Court case

The taxpayer filed a petition with the Tax Court and then filed a motion for partial summary judgment contending that the sales income was not FBCSI under section 954(d)(1) because the appliances sold by the Luxembourg CFC were "manufactured" by its Mexican branch by "substantial transformation" of the component parts and raw materials it had purchased.

The government opposed the taxpayer's section 954(d)(1) summary judgment motion, contending that genuine disputes of material fact existed as to whether the Luxembourg CFC actually manufactured the products.

Further, the parties filed cross-motions for partial summary judgment as to whether the sales income was FBCSI under section 954(d)(2)—the so-called "branch rule."

The Tax Court in May 2020 granted summary judgment for the government with regard to the application of the branch rule.

The Tax Court—while agreeing with the government that genuine disputes of material fact may exist with respect to the application of subsection (d)(1)— agreed with the government on subsection (d)(2) of section 954. After analyzing both the statutory language of section 954(d)(2) and the extensive regulations that have been issued implementing those rules, the Tax Court concluded that whether or not the Luxembourg CFC was regarded as having manufactured the products under section 954(d)(1), its Mexican branch under section 954(d)(2) was to be treated as a subsidiary of the Luxembourg CFC, and that the sales income the Luxembourg CFC earned constituted FBCSI taxable to the taxpayer as subpart F income. Read ***TaxNewsFlash***

Sixth Circuit decision

The Sixth Circuit affirmed.

Focusing only on the statute, the Sixth Circuit explained that section 954(d)(2) consists of a single sentence that specifies two conditions and then two consequences that follow if those conditions are met.

- First, that the CFC was "carrying on" activities "through a branch or similar establishment" outside its country of incorporation.
- Second, that the branch arrangement had "substantially the same effect as if such branch were a wholly owned subsidiary corporation [of the CFC] deriving such income[.]"

Upon finding that these two conditions are met, according to the appeals court, two consequences follow as to "the income attributable to" the branch's activities—(1) that income "shall be treated as income derived by a wholly owned subsidiary of the controlled foreign corporation" and (2) the income attributable to the branch's activities "shall constitute foreign base company sales income of the controlled foreign corporation." Accordingly, for the Sixth Circuit, the primary question was whether the operation of the Mexican branch of the taxpayer's Luxembourg CFC had "substantially the same effect as if" the branch was a CFC. The appeals court concluded that it had "substantially the same effect" because it led to the deferral of tax on sales income. The Sixth Circuit, therefore, agreed with the Tax Court that under the text of the statute alone, the sales income was FBCSI that must be included in the taxpayer's income under subpart F.

The dissenting opinion concluded, based largely on the regulations, that there was no taxable foreign base company sales income generated in this case because the Luxembourg CFC "manufactured" the property it bought and sold under both subsections (1) and (2) of section 954(d). "[A]t the very least,"

the dissent noted that summary judgment should have been precluded if the "manufacturing" question remained a material disputed fact. Read ***TaxNewsFlash***

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