UNITED STATES
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The *Whirlpool* case and Subpart F

Mark Martin and Thomas Bettge of KPMG in the US describe the Whirlpool case and its implications for Subpart F planning and controversy.

The US Internal Revenue Code (IRC) is supported by thousands of pages of Treasury regulations. Usually this is a good thing. How else, for example, could taxpayers and the US Internal Revenue Service (IRS), make sense of Section 482? However, it becomes problematic when a court takes the view that the statute and the associated regulations do not quite align.

In the eyes of most practitioners and taxpayers, there is no conflict between Section 954(d)(2) of the IRC and the underlying regulations. Indeed, as discussed below, the statute clearly predicates its application on the regulations. Yet in the case *Whirlpool Financial Corp. v. Commissioner*, two of the three judges on the Sixth Circuit panel decided that there was such a conflict – and then they decided that the way to resolve it was to ignore the regulations entirely.

Background to the case

Whirlpool was decided by the US Tax Court in 2020 and affirmed by the Court of Appeals for the Sixth Circuit in December 2021. The Sixth Circuit subsequently declined to rehear the case. *Whirlpool* involves Subpart F of the IRC, which taxes US shareholders of controlled foreign corporations (CFCs) on certain categories of income earned by the CFCs, including foreign base company sales income (FBCSI). The FBSCI rules are complex.

What is central to *Whirlpool* is that FBCSI includes sales income earned by a CFC on certain sales to, from, or on behalf of a related party, and that a special 'branch rule' in Section 954(d)(2) provides that a foreign branch of the CFC may, under certain conditions, be treated as a related party for purposes of determining FBCSI. The statutory branch rule consists of a single – although admittedly rather long – sentence. The regulatory branch rule under Treasury Regulation § 1.954-3(b) spans pages and is replete with paragraphs, subparagraphs, and examples.

Whirlpool structured its operations through a Luxembourg CFC with a Mexican manufacturing branch in a manner that it believed complied with the section 954 regulations and would not generate FBCSI. The products were manufactured by the branch, which qualified as a maquiladora under Mexico's manufacturing incentive regime, and were sold by the Luxembourg CFC to related parties in the US and Mexico.

Many taxpayers and practitioners interpreted the regulations in the same way as Whirlpool, but the IRS, taking a different view of the matter, increased Whirlpool's Subpart F income for 2009 by almost $50 million.

Dispute between Whirlpool and the IRS

Whirlpool and the IRS disputed whether the Luxembourg CFC's income constituted FBCSI under the regulatory branch rule. The Tax Court held that the taxpayer had FBCSI under the regulations; Judge Nalbandian, who dissented from the Sixth Circuit opinion, believed that it did not. Concerningly, the Sixth Circuit majority felt it unnecessary to even consider the question.

Section 954(d)(2) clearly envisions that it will be applied in accordance with the regulations. Specifically, the statute states that if its prerequisites are met, "under regulations prescribed by the Secretary the income attributable to [the branch's activities] . . . shall constitute foreign base company sales income."

Judge Nalbandian's dissent respected this nuance, but the Sixth Circuit majority inexplicably swept it aside. The majority opinion offered no explanation for Congress' inclusion of the words "under regulations prescribed by the Secretary" in the statute, asserting instead that the "agency's regulations can only implement the statute's commands, not vary from them." Yet the statutory command that the majority purports to respect is expressly subjected to the application of Treasury's regulations, and it is not at all clear that the regulations do vary from the statute. At the very least, the regulations merited the Sixth Circuit's consideration.

Even if the Sixth Circuit were correct, the notion that a taxpayer could have FBCSI under the statute, even if the taxpayer would not have FBCSI under the regulations, would create serious reliance issues. A large number of taxpayers, faced with voluminous and complex regulations implementing the branch rule, made the effort to apply those regulations to their facts, on the understanding that the regulations did, in fact, describe how Treasury understood and intended the branch rule to apply.

Because the Tax Court and Sixth Circuit decisions in *Whirlpool* upend a settled understanding of how Subpart F applies, and because the IRS is generally keen to follow up on strategic litigation victories with broader enforcement, it is likely that similar disputes will arise elsewhere. Perhaps a circuit split will arise in this area in the future..

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