The Branch Rule: An Unhurried Read of the Statute

by H. David Rosenbloom

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In this article, Rosenbloom considers the language of the branch rule of subpart F and whether it should apply to both sales and manufacturing branches.

No one is likely to nominate the IRS for a writing award, but some of the Internal Revenue Code's provisions are especially perplexing. One such provision is the branch rule of subpart F, found in section 954(d)(2):

> CERTAIN BRANCH INCOME: — For purposes of determining foreign base company sales income in situations in which the carrying on of activities by a controlled foreign corporation through a branch or similar establishment outside the country of incorporation of the controlled foreign corporation has substantially the same effect as if such branch or similar establishment were a wholly owned subsidiary corporation deriving such income, under regulations prescribed by the Secretary the income attributable to the carrying on of such activities of such branch or similar establishment shall be treated as income derived by a wholly owned subsidiary of the controlled foreign corporation and shall constitute foreign base company sales income of the controlled foreign corporation.

The provision's intent is clear. Foreign base company sales income requires the existence of at least two persons: a CFC and a related person.[1] Congress understood that a branch of a corporation is not separate from the corporation and that countries might tax the foreign branch of a foreign corporation differently (even exempting that branch from tax) than the country of incorporation would.[2]

That has an economic consequence similar to treating the branch as a separate person, but not a similar legal consequence. The branch rule supplies a cognizable second person for section 954 purposes so the definition of foreign base company sales income can operate in accordance with its terms.

The branch rule has been with us virtually unchanged since the origins of subpart F in 1962 and has been interpreted in extensive regulations first published in 1964.

In drafting the branch rule Congress was obviously thinking of a situation in which manufacturing was carried on in the country of incorporation while sales of the manufactured product were made by a foreign branch. It is easy to find coverage of a sales branch in section 954(d)(2). Almost from the first days of the statute, however, it has been recognized that there is an alternative situation in which the branch is

[1] *See* section 954(d)(1).

[2] The statute assumes that the country of incorporation is the country of corporate residence. That, of course, is fallacious, as tax planners noted many years ago. But that is a different story.

engaged in manufacturing and the portion of the entity in the country of incorporation handles sales. That is the fact pattern that confronted the U.S. Tax Court in *Whirlpool*, which the U.S. Court of Appeals for the Sixth Circuit affirmed in June 2021.[3]

This article will not discuss those important, first-impression decisions on the meaning of section 954(d)(2). The focus here is the language of the statute. The article proceeds on the belief that as a matter of tax policy, there is absolutely no difference between a sales branch and a manufacturing branch. Translating each situation into foreign base company sales income may require different technical rules for distinguishing that income from a CFC's other income — that is a main purpose of regulations — but there is no policy justification for distinguishing between the two situations. Moreover, both a structure involving a sales branch and one involving a manufacturing branch would escape foreign base company sales income without the branch rule for precisely the same reason: A branch is not a separate person.

As the Tax Court observed, the statute has two parts — the first is purposive and descriptive of the circumstances in which the positive rule of the second part applies; the second part, introduced by the authorization of regulations, deems the branch to be a second person — a wholly owned subsidiary corporation — and declares unequivocally that "the income attributable to the carrying on of such activities of such branch . . . shall constitute foreign base company sales income of the controlled foreign corporation."

The purposive first part of the statute refers to situations in which the carrying on of activities through a branch or similar establishment outside the CFC's country of incorporation has "substantially the same effect as if such branch or similar establishment were a wholly owned subsidiary corporation." That effect is achieved when there is a substantial difference between the foreign tax rate applied to the branch in the foreign country and the rate applied in the country of incorporation. Following the words "subsidiary corporation," the statute contains the words "deriving such income," which raise a question: What income is derived?[4]

The only prior statutory reference to income appears in the statute's introductory words: "for purposes of determining foreign base company sales income." That must be the referent for the phrase "deriving such income." Only a sales branch can derive foreign base company sales income, so Congress clearly had in mind a situation in which the branch is engaged in sales.

Does that mean the statute is limited in application to sales branches? Not necessarily. The statute refers to situations in which a branch's carrying on of activities outside the country of incorporation has substantially the same effect as if the branch were a wholly owned subsidiary corporation deriving that income. These words are broad enough to encompass a manufacturing branch. The difference between a branch and a separate corporate entity is precisely the same with a manufacturing branch as with a sales branch. Both types of branch produce substantially the same effect. Thus, insofar as the first part of the statute is concerned, the focus on a sales branch does not preclude coverage of a manufacturing branch. The description of a sales branch can be seen as an example of the situations the statute is meant to address.

The statute grants Treasury the authority to write regulations to provide that "the income attributable to the carrying on of such activities of such branch or similar establishment . . . shall constitute foreign base company sales income of the controlled foreign corporation." Income directly attributable to the activities of a manufacturing branch cannot constitute foreign base company sales income. Manufacturing is not sales, and income from manufacturing is not sales income. So, here again, the statute is referring to a sales branch.

In other words, the second part of the statute carries forward the sales branch example. As noted, the first part of the statute is broad enough to encompass a manufacturing branch, which presents exactly the same technical "problem" as

[3] *Whirlpool Financial Corp. v. Commissioner*, No. 20-1899 (6th Cir. 2021), *aff'g* 154 T.C. No. 9 (2020).

[4] Several analysts of the statutory language, including my frequent coauthor professor Fadi Shaheen, find the words "deriving such income" to be crucial and perhaps to point in the direction of limiting the branch rule to sales branches.

a sales branch: A branch is not a separate person. It would not make much sense to include manufacturing branches in the first part of the statute and exclude them from the second part. When the statute speaks of "income attributable to the carrying on of activities of such branch or similar establishment," it refers to income of a sales branch from activities outside the CFC's country of incorporation. The statute proceeds to declare flatly that the income in question "shall constitute foreign base company sales income of the controlled foreign corporation." Thus, the statute is not simply deeming the existence of a separate entity; it is also providing that the effect of that deeming is foreign base company sales income of the CFC (not the deemed separate entity), making the rate disparity test conclusive.

The fact remains that the statute fairly can apply to any situation in which a CFC's foreign branch has substantially the same effect as in the sales branch situation. That invites regulations to apply the analysis outlined in the statutory text to indistinguishable situations. Congress did not describe a manufacturing branch, but it intuited that the sales branch situation was not the only one for which a statutory remedy was needed. ■