The Branch Profits Tax: Application and Exceptions

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In this article, the author discusses the branch structuring option for foreign corporations seeking entry into the U.S. market.

Foreign corporations seeking entry into the U.S. market have multiple structuring options for their activities. An often-used approach entails conducting U.S. activities through a branch (as opposed to, for example, setting up activities through a U.S. subsidiary). To eliminate significant tax benefits that would otherwise be available under the branch approach, the branch profits tax was enacted to impose a second level of tax on non-reinvested earnings of branch operations. The tax is designed to mirror the tax consequences of dividends from a subsidiary to its foreign parent. Given the desire to match tax consequences between branch operations and subsidiary operations, an exception to the branch profits tax is available on termination of U.S. operations (and is intended to mirror the results of the tax-free liquidation of a subsidiary).

Overview of Tax for Foreign Corporations

As a threshold concern, to be subject to the branch profits tax, a foreign corporation with a branch operation usually must be engaged in a trade or business in the United States and have income effectively connected with U.S. activities. One must first ascertain whether an entity is foreign (which normally is fairly straightforward) and then whether it is a corporation (which can be more complex). For the second question, a foreign entity is generally permitted to elect its classification for U.S. tax purposes unless it is classified as a per se corporation under the Treasury regulations requiring corporation classification in the United States.

If elections are not made, default rules for classification are applicable. Under those, a foreign entity is an association taxable as a corporation if its owner has limited liability.

Once the existence of a foreign corporation is established, tax ramifications can be evaluated. Generally, a foreign corporation engaged in a U.S. trade or business during the tax year is taxable on income effectively connected with that trade or business (and subject to U.S. corporate tax).[1]

Neither the code nor the regulations define U.S. trade or business for those purposes, and the IRS generally does not rule on whether a taxpayer is engaged in a trade or business.[2] However, the standard for a trade or business is typically low, with profit-oriented activities that are regular, substantial, and continuous meeting the test.[3]

As one example, an agent's activity is generally imputed to the principal for purposes of determining whether the principal has a U.S. trade or business.[4] Generally, all U.S.-source income, gain, or loss derived by a foreign corporation engaged in a U.S. trade or business is treated as effectively connected with the conduct

[1] 26 U.S.C. section 882(a); and 26 U.S.C. section 864(a)(1).

[2] *See* Rev. Proc. 2014-7, 2014-1 IRB 238.

[3] *See United States v. Balanovski*, 236 F.2d 298 (2d Cir. 1956); and *United States v. Northumberland Insurance Co.*, 521 F.Supp. 70 (D.N.J. 1981)

[4] Rev. Rul. 80-225.

of a U.S. trade or business (other than capital gains and fixed or determinable income).

Branch Profits Tax

In addition to the section 882 corporate tax, the branch profits tax levies a second tax on foreign corporations engaged in a U.S. trade or business equal to 30 percent (subject to treaty modification, as discussed below) of the foreign corporation's dividend equivalent amount for the tax year. That amount is its effectively connected earnings and profits for the tax year, adjusted based on U.S. net equity. The term "effectively connected earnings and profits" means E&P attributable to effectively connected income, without reduction for distributions made by the foreign corporation during any tax year or by the amount of branch profits tax or tax on excess interest paid by the foreign corporation. E&P attributable to specified items (such as gain on the disposition of a U.S. real property interest) are excluded.

Expanding on the rationale behind the branch profits tax is of benefit in understanding its operation. For foreign corporations conducting business through a U.S. subsidiary, two levels of tax are incurred — one at the corporate level when income is earned, and the second when that earned income is distributed to its parent (which is then taxed as a dividend). The branch profits tax, passed into law in 1986, attempts to place the foreign corporation with branch operations in a similar position by first taxing at the corporate level (when income is earned) and then imposing a second tax on transmittal of funds (at the same rate as a dividend). In that context, transmittal is largely presumed (as illustrated below), because no formal transfer between separate entities is necessitated by the branch structure.

Under the branch profits rules, U.S. assets are assets (aside from interests in partnerships, trusts, or estates) held by the foreign corporation as of the determination date (typically the close of the foreign corporation's tax year) if all income produced by the asset (as of the determination date) is ECI (or would be if the asset produced income) and all gain from the asset's disposition would be ECI.

U.S. liabilities are the amount of U.S.-connected liabilities of the foreign corporation, which normally equals the total value of U.S. assets for the tax year multiplied by the total amount of worldwide liabilities divided by the total value of worldwide assets for the year (unless the corporation elects an alternate method).

If, at the close of a tax year, U.S. net equity exceeds the U.S. net equity from the prior year, effectively connected E&P is reduced by the excess. Conversely, if the U.S. net equity as of the close of the prior year exceeds the U.S. net equity at the close of the current year, the effectively connected E&P amount is increased by the excess. Any increase in effectively connected E&P resulting from a decrease in U.S. net equity cannot exceed the accumulated effectively connected E&P (defined as the excess of the aggregate effectively connected E&P for preceding tax years over the aggregate dividend equivalent amounts determined for those preceding years) at the close of the preceding year.

As can be gleaned from the above, rules in the branch profits context are both dense and complex. Given the complexity, examples can help illustrate the implementation of the tax. Assume a foreign corporation with $5,000 of U.S. net equity at the end of Year 1 and $500 of effectively connected E&P for Year 2; the company acquires $100 of additional U.S. assets during Year 2, and its U.S. net equity at the close of the year is thus $5,100. The company's effectively connected E&P is reduced by the $100 increase in net equity, creating a $400 dividend equivalent amount for Year 2. If, instead, net equity decreases in Year 2 by $100 (leaving U.S. net equity at $4,900 at year-end), the company's effectively connected E&P is increased by $100, creating a $600 dividend equivalent amount. For these purposes, the dividend equivalent amount cannot be less than zero.

As with other taxes applicable to U.S. operations of a foreign corporation, income tax treaty provisions can modify the applicability of the branch profits tax. If a foreign corporation is a qualified resident of a country with which the United States has an income tax treaty, the tax rate is that specified by the treaty for branch profits or, if no rate is provided, the rate on dividends paid by a domestic wholly owned subsidiary to its foreign parent. The regulations list 28 countries for which the branch profits tax is eliminated for qualified residents (including Germany, Japan, and the U.K.). To be a qualified resident, the foreign corporation must be a resident of the relevant country and meet one of four tests provided by the regulations.

Conceptually (and as noted), the branch profits tax is intended to equalize tax ramifications between branch and subsidiary operations. In actuality, the branch profits tax can lead to tax advantages from the subsidiary structure. The branch profits tax applies regardless of any remittance of funds back to the foreign corporation (with repatriation essentially assumed if no corresponding reinvestment in the United States occurs). That can be juxtaposed against a subsidiary, which controls tax implementation by determining whether a dividend will be paid.

In application, branch profit tax rules provides incentives to reinvest in the United States (as long as reinvestment is not done to increase U.S. net equity artificially, as noted) as a method to at least delay tax imposition. Eliminating the branch profits tax may be achieved by terminating the U.S. branch activities.

Exception to Branch Profits Tax on Termination

Connected with the desire to mirror treatment between branch and subsidiary operations, an exception to the branch profits tax applies on a branch's complete termination of U.S. business. When requirements are met, a foreign corporation is not subject to the branch profits tax for the tax year in which it completely terminates all its U.S. trade or business. Further, previously untaxed accumulated effectively connected E&P (as of the close of the tax year of complete termination) are extinguished. Relatively strict standards must be met for the complete termination exception to apply, requiring care by the corporation and its shareholders both in the year of termination and prospectively.

Four requirements must be met for a complete termination of a foreign corporation's U.S. trade or business. First, the corporation is required either to have no remaining U.S. assets or to have its shareholders adopt an irrevocable resolution to completely liquidate and dissolve the corporation, with all U.S. assets distributed, used to pay off liabilities, or otherwise ceasing to be U.S. assets before the close of the succeeding tax year. U.S. assets are generally defined for termination purposes as they are for branch profits tax purposes — that is, as delineated above. Obvious care is required in evaluating what is classified as a U.S. asset to ensure that none remains after the branch's final year.

Second, the regulations impose a reinvestment prohibition rule. Under that rule, neither the foreign corporation nor a related corporation may directly or indirectly use any of the U.S. assets of the terminated U.S. trade or business or property attributable thereto or to effectively connected E&P earned by the foreign corporation in the year of complete termination in the conduct of a U.S. trade or business for three years from the close of the year of complete termination.

Under the reinvestment prohibition rule, U.S. assets include all money and other property that qualified as U.S. assets at the close of the tax year immediately preceding the year of termination. Property attributable to U.S. assets or to effectively connected E&P includes money or other property into which any part of those items is converted at any time before the expiration of the three-year period.

Corporations are related for those purposes if either corporation is a 10 percent shareholder of the other corporation or, if one of the corporations liquidates, either corporation would have been a 10 percent shareholder of the other had both corporations remained in existence. Direct or indirect use of property includes loans to a related corporation or use as security for indebtedness of a related corporation.

Based on its overarching scope, that reinvestment prohibition and the related definitions leave numerous avenues through which violations of the requirement can occur. Incorporated in the prohibition is not only a restriction on future use of the U.S. assets but also a restriction on assets attributable thereto. That can require careful tracking of assets (and their origins) if any U.S. operations are conducted in the future, even if those operations are conducted by a separate but related entity.

Third, the foreign corporation can have no income that is or is treated as effectively connected with the conduct of a U.S. trade or business for three years from the close of the year of complete termination. That requirement is at least comparatively straightforward: The corporation must ensure future activities do not create ECI.

Lastly, the foreign corporation must attach a waiver of the period of limitations to its income tax return for each year of complete termination (which can include multiple years, as in the case of a corporation that adopts a resolution to liquidate). The required waiver is made on Form 8848 and extends the period for assessment for six years.

Consequences of failure to meet the complete termination standards are severe. If a foreign corporation fails to completely terminate by not meeting one of the above requirements, its branch profits tax liability for the tax year (and all subsequent years) is determined under the general branch profits tax rules, taking into account any U.S. net equity reduction resulting from the corporation's change in U.S. assets.

Ramifications of a failed termination can thus be drastic: If U.S. net equity is significantly reduced, branch profits tax amounts rise accordingly (as illustrated). Interest and penalty amounts can also be owed as a result of a failed complete termination. Those ramifications exist on a failure to completely meet the above standards — even a seemingly innocuous error can cause punitive branch profits tax consequences (further emphasizing the care necessary for termination).

Special rules apply for liquidations and reorganizations. If a foreign corporation transfers its U.S. assets to another corporation in a complete liquidation or reorganization, and the transferor was previously engaged in the conduct of a U.S. trade or business, the complete termination rules do not exempt the transferor from branch profits tax. Instead, the dividend equivalent amount is determined under the general branch profits rules, with some modifications.

Conclusion

As stated, entry into the U.S. market by a foreign corporation can take numerous forms, with the optimal approach typically being fact-specific. While the branch profits tax rules are designed to mirror the results of subsidiary operations, the rules can function to create disparate results. Although tax drawbacks can exist in the branch realm, nontax considerations can provide incentives to take that approach (for example, branch operations can be more functionally straightforward than operating through a subsidiary). Evaluating options at the outset of U.S. operations is vital to ensure adoption of the approach offering the best long-term results (factoring in both tax and nontax factors). ■