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Women In Law

Foreign Companies Doing Business in the U.S. –

Understanding the Branch Profits and Branch Interest Tax Regime in Federal Taxation

by William A. Harwood

"Doing business in the United States" is a term of art in the tax law. It represents a threshold concept, the point at which a foreign company's activities rise to the level that the Internal Revenue Service will exercise income taxing jurisdiction. What constitutes doing business in the United States, as a threshold question, remains beyond the scope of this article, yet the reader should take note that the demarcation between what does and what does not varies significantly based upon four criteria: 1) the home country and its tax treaty (if any) with the United States, 2) the industry, 3) the form of doing business, and 4) the specific functions carried out in the United States in furtherance of the overall business of the foreign company.

Reaching this threshold and consequently becoming subject to United States income tax, the foreign company will be taxed under the Internal Revenue Code as one of four identities.

1. through a U.S. corporate entity
2. direct operations of the foreign company, or a true branch
3. as a partner in a partnership (or LLC) that is itself "doing business in the U.S."
4. as a de facto branch by virtue of being the sole owner of a U.S. LLC.

In the first scenario—when a foreign company operates under the veil of a U.S. corporation—federal tax compliance begins with the filing of Form 1120 – US Corporation Income Tax Return. However, in all other instances, a foreign company will file Form 1120F – US Income Tax Return of a Foreign Corporation. For the balance of this article, we will refer to the 1120F filing entity types as *branch operations*.

U.S. taxation of a foreign corporation generally follows all the rules of taxation applicable to a U.S. corporate entity filing Form 1120. But some important differences must be noted.

First, the foreign corporation need only report the portion of its income that is "effectively connected" with its U.S. trade or business. Conversely, a U.S. corporation is taxable on all of its income regardless of geographic source. Second, any U.S.-sourced fixed, determinable, annual, or period income (FDAPI) separate from the branch operation's U.S. trade or business is subject to a separate taxing regime. Finally, U.S. taxing jurisdiction does not extend to dividends paid by a foreign corporation because those distributions occur in the home country, rather than in the United States.

Because the U.S. taxes dividends paid by domestic corporations, there would be clear advantages to filing under a branch operation regime. However, the United States takes measures to level the playing field between branch operations and those of companies filing as U.S. corporate entities. The United States assesses a tax on repatriations of income from a branch operation back to the home country. This tax approximates the way the United States taxes dividends paid by a U.S. subsidiary to its foreign parent company. Known as the Branch Profits Tax, it is assessed with the income tax and is calculated on Form 1120F. Branch operations are also subject to the branch interest tax.

BRANCH PROFITS TAX – THE THEME

The Branch Profits Tax, a creature of the Tax Reform Act of 1986, assesses a 30% tax on a "dividend equivalent amount". The tax applies to all earnings repatriated in a return year and bases the amount of earnings for the return year plus any positive, cumulative retained earnings from prior years, which together have been repatriated to the foreign home country during the return year.

Expressed as a formula, the branch profits tax equals the rate (30%) times the return year earnings that are effectively connected to the U.S. trade or business (ECI) reduced or increased by the excess or deficiency as the case may be of end of the year equity (E2) over the beginning of the year equity (E1).

Branch Profits tax = 30% X (ECI – E2 + E1)

BRANCH INTEREST TAX – THE THEME

Somewhat less conceptually obvious than the branch profits tax is the branch interest tax. The branch interest tax gets assessed against so much of the "total reported interest costs" (my terminology) of the branch as exceeds the interest expense with respect to what one might call qualified liabilities. To get to the root of this tax on interest, we must come to understand three broad concepts; 1) what is the total reported interest cost, 2) what of the total interest cost is deductible, and 3) what are qualified liabilities.

<u>Total Reported Interest Cost</u>

Much more complex than simply taking total interest paid by the branch, total reported interest cost starts with the determination of where borrowing occurred to finance the acquisition of U.S. assets. Detailed rules for determination of the deductable interest expense of a foreign corporation are provided in Treasury regulations. These rules essentially provide that total reported interest costs include those arising from 1) non-recourse, acquisition indebtedness that directly encumbers the acquired U.S. assets, plus 2) an allocated portion of the total, worldwide interest expense of the foreign corporation based on the ratio of U.S. assets to total worldwide assets.

The devil is in the details of worldwide apportionment of interest expense. But a few complications to consider:

- A foreign corporation operating through a U.S. actual or DRE branch cannot lend money to the branch as the IRS treats this as a non-event. A foreign company, typically closely held, with no outside interest bearing debt would be barred by Reg. §1.882-5 from capitalizing the U.S. operation in part with loans giving rise to tax deductible interest. Tax treaties can alter this result, but not nearly as broadly as one might expect.

- For purposes of determining the ratio of U.S. assets to worldwide assets, U.S. assets must be reduced to the extent of the balance of non-recourse, acquisition indebtedness.

- Assets are generally valued at net tax basis, but an election to use fair market value is available. Once made, this FMV election cannot be revoked without permission of the IRS.

- A special interest calculation election is available for foreign corporations with liabilities expressed in multiple currencies.

- Special ratio based elections are available to foreign banks with U.S. branch operations.

<u>Deductible Interest Cost</u>

Not all of the total interest cost may be deductible. The normal rules for capitalizing interest costs and allocating interest costs to non-taxable income may reduce the amount of the total interest cost that makes it to the deduction at 1120F, Schedule II, line 18 to reduce taxable income.

Also having the potential to take a bite out of the interest deduction is I.R.C. Section 163(j). This provision, aimed pretty squarely on foreign controlled corporations, is a principle anti base erosion tool in the IRS arsenal. Section 163(j) operates as a thin capitalization limitation of the deductibility of interest costs.

<u>Qualified Liabilities</u>

And that's not all! The complex and exclusive procedure for determining total interest cost makes the determination of "qualified liabilities" critically important. Interest cost from qualified liabilities is a baseline. IRS treats the excess of the deductible portion of total reported interest costs over the amount of interest cost that arises from qualified liabilities as having been paid by the U.S. branch to a foreign person. Of course, most interest paid to a foreign person by a U.S. person, other than a U.S. financial institution, is taxable as FDAPI. So like the branch profits tax, branch interest tax is assessed at a 30% rate.

Qualified liabilities come in three flavors. *Regular* – these are the liabilities that appear on the separate books and records of the branch, which were entered on such books "relatively" contemporaneously with the time at which it was incurred, and which relates to the U.S. business; *Special* – these are liabilities not recorded on the books of the branch but which are secured predominantly by U.S. assets, and; *Extra Special* – or those liabilities which do not appear on the books and records but which are identified as connected to the U.S. business. These "extra special" liabilities are subject to the significant restrictions of not being materially secured by non U.S. assets, not incurred in the ordinary course of business, and a 15% haircut.

WRAPPING UP

This article looks only at the U.S. operations of a foreign entity that is treated as a corporation for U.S. tax purposes. Thus the rules for foreign entities that are treated for U.S. tax purposes as pass-through companies with natural persons as beneficial/taxable owner are not subject to the branch tax rules. Additionally, foreign investment in U.S. real property is beyond the scope of this article.

Finally, U.S. comprehensive income tax treaties, which currently number about sixty, alter the tax rates of both the branch profits tax and the branch interest tax. Branch profits taxes are generally subject to the reduced treaty rates applicable to dividends, and the branch interest tax is assessed at applicable rates for interest payments made to qualified resident corporations of treaty partners.

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