

Choosing A Branch Or Subsidiary For Overseas Expansion

By **Samuel Pollack and Naoko Watanabe** (April 1, 2021)

When expanding your business operations into a new jurisdiction, whether organically or through an acquisition, one of the first decisions you will need to make is whether to operate through a branch or a subsidiary entity. It is often a threshold decision, taking into account several factors including legal characteristics and tax consequences of each alternative.

Each jurisdiction has its own distinct rules and options, making it crucial for U.S. based multinational companies to have a good handle on the relevant local laws, and their interaction with U.S. tax law, prior to making a foray into a foreign market.

Prior to the enactment of the Tax Cuts and Jobs Act at the end of 2017,^[1] U.S. multinationals were not eager to operate through foreign branches, which, unlike corporate subsidiaries, did not offer a deferral benefit.

The TCJA effectively ended the U.S. deferral regime and the option to operate through a foreign branch began to grow in appeal. However, the TCJA included ambiguous rules that specifically applied to foreign branches and to their owners' ability to access tax benefits, such as foreign tax credits and the foreign derived intangible income, or FDII, deduction.

Regulations clarifying the terms of those rules were released in December of 2020, opening the door for U.S. companies to choose to operate through a foreign branch, without much of the uncertainty that had persisted since the enactment of the TCJA.

In this article, we discuss key corporate and U.S. federal income tax law considerations in selecting the most efficient option for offshore business operations.

Legal Personality

A branch is an unincorporated, direct extension of a parent company that operates business activities on behalf of the parent to the extent the business purposes of the parent permit.

In contrast, a subsidiary is a separate entity that is incorporated or formed by the parent company, may have its own business purposes separate from its parent's and has its own management structure — although, in the case of a single-member, member-managed limited liability company, the sole member, i.e., the parent, will manage the business of that entity.

In many jurisdictions, from a corporate law perspective, a branch is considered the same entity as its parent, and thus, does not have a separate legal personality.

For example, in the United Arab Emirates, a branch may not enter into an agreement on its own. Its parent will be the contracting party in its capacity as the owner of the branch.

However, in Brazil, that is not the case. Brazilian corporate law recognizes a separate legal personality of branches, allowing branches to enter into contracts with third parties without having to involve their parent entities.

From a U.S. tax perspective, a foreign branch is generally viewed as part of its owner and



Samuel Pollack



Naoko Watanabe

not as a separate entity. As a result, transactions between a branch and its owner are disregarded.

The rules for foreign currency gain or loss, foreign tax credits, and FDII are notable exceptions, when, in some respects, a branch and its owner are viewed as separate under complex rules specifically tailored to the treatment of foreign branches.

Additionally, for U.S. federal income tax purposes, a company can achieve branch status for a foreign — or domestic — operation even when, for corporate purposes, the operation is held through a legal entity. Any entity that is not specifically identified as a per se corporation under Treasury regulations can elect to be treated as "disregarded" from its sole owner.

A disregarded entity that maintains separate books and records, and operates a business generally, is treated in the same manner as a branch. However, unlike a true branch, a disregarded entity may be treated as regarded for a number of nonincome tax purposes, e.g., employment and certain excise taxes.

Control

Because of the very nature of branches, it may seem that this type of foreign enterprise will guarantee its parent more control over its business activities. However, it is worth noting that subsidiaries may, and many do, appoint their parent entities' directors and officers as their own directors and officers — subject to residency requirements — so that they can stay aligned on the overall business strategies.

Additionally, single-member, member-managed limited liability companies will provide to their sole members directors control over their business affairs.

In some jurisdictions, like Canada, it is also possible to put in place a shareholder declaration that restricts the powers of the directors of the subsidiary entity, vesting the directors' authority in the parent entity.

Transferability From Parent to Another Entity

Because branches are not considered to have a separate legal personality in many jurisdictions, unlike subsidiaries, it is not possible to transfer a branch to another entity, for example, as part of a transaction at the parent level. The branch must be deregistered and then registered by the new parent entity.

Note, however, that in Brazil, because it gives a separate legal personality to branches, it is possible to transfer branches to another entity. Further, uniquely, the United Arab Emirates also allow branches to be transferred, both in the mainland and in the free zones.

The transfer of a branch — or of an entity treated as a branch — is different for U.S. tax purposes than the transfer of a separate entity. When an acquirer purchases a branch, the acquirer generally receives a stepped-up tax basis in the assets of the branch, which is particularly beneficial with respect to assets subject to depreciation or amortization and with respect to subsequent asset dispositions.

When an acquirer purchases the stock of a corporation, the acquirer generally receives a stepped-up tax basis only in the shares of the acquired corporation.

Options such as the elections under Section 338 of the Internal Revenue Code^[2] can provide a stepped-up basis, but may raise other issues — e.g., imposition of additional tax

on a seller.

Exposure to Liabilities

Because in many jurisdictions, a branch is a mere extension of its parent, the parent will be directly exposed to all liabilities and risks associated with conducting business overseas. They may include tort liabilities, product liabilities, employment-related litigations, etc., which could have a severe business impact depending on the local laws and policies.

With subsidiaries, however, unless the parent chooses to incorporate an unlimited company, where local laws allow for this option, such as in the United Kingdom and certain provinces in Canada, all liabilities of the subsidiary are contained within the subsidiary. In other words, subsidiaries add a layer of protection for their parents.

One important thing to keep in mind related to limited or unlimited liability in foreign jurisdictions relates to the default U.S. federal income tax status of a foreign entity.

A foreign entity that is eligible to elect to be treated as a corporation or as a transparent entity — an "eligible entity" — defaults to treatment as a corporation if any of its owners have limited liability. This presents a stumbling block to some because a U.S. eligible entity always defaults to treatment as a transparent entity.

Allocation/Transfer of Assets and Liabilities

The legal personality of an entity also has an impact on how its assets and liabilities are treated. With subsidiaries, the assets and liabilities are considered to be held by the subsidiaries. Thus, when distributing assets to the parent entities, subsidiaries must satisfy certain financial thresholds as provided by local laws — such as having sufficient distributable reserves — to declare a dividend.

In many countries, because directors or managers of a subsidiary owe fiduciary duties to the subsidiary, the decision to declare a dividend must be evidenced by a written board approval. Further, in some jurisdictions, such as in Singapore, if noncash assets will be distributed, then additional steps are required, such as executing a distribution agreement, obtaining a shareholders consent and registering such consent with the Accounting and Corporate Regulatory Authority of Singapore.

However, with branches, the allocation of assets and liabilities are typically done via accounting entries. Often, only a simple letter of notice from the branch entity to the parent entity is needed to document the allocation from a legal perspective.

As noted above, for most purposes the transactions between a branch and its owner — or between branches owned by the same owner — are disregarded for U.S. federal income tax purposes. In this way it is easier for a company to access the cash and assets of its branch than it is to access the cash and assets of a corporate subsidiary.

However, as also noted above, in the context of a foreign branch, there are three major rules that deviate from this general rule, which are the rules pertaining to: (1) foreign currency gain or loss; (2) the foreign tax credit limitation; and (3) the FDII deduction.

Name Restrictions and Traceability

If your company has any sensitivities around disclosing markets that your firm operates in, then it should be taken into account that in many jurisdictions, branches are required to adopt the names of their parent entities.

For example, in China, a branch name must be in Chinese and contain (1) the nationality of the parent entity, (2) the Chinese name of the parent entity, (3) the city where the branch is located; and (4) the suffix "representative office." There are no such restrictions with respect to subsidiaries, allowing subsidiaries to select names that do not give away which global enterprise group it is a part of.

There are, however, exchange of information rules under which U.S. tax law requires some degree of reporting on relationships between business operations, whether an operation is through a foreign branch or a foreign corporation.

The two most significant rules related to international reporting are the country-by-country filings that large U.S. multinational corporations must file on Form 8975, Country by Country Report, and reporting under the Foreign Account Tax Compliance Act. Generally, reporting under these regimes is supposed to remain confidential between a taxpayer and relevant governmental agencies.

Ease of Setting Up a Branch Versus a Subsidiary

It is a common misconception that branches are easier to establish. It may be just as cumbersome as opening a subsidiary, and may require extensive disclosure of the parent entity information.

For example, in the United Kingdom, where opening a branch is relatively straightforward, the registration form must include the following:

- Incorporation details: name, legal form, identity of the relevant commercial registry in which the parent entity is registered, etc.;
- Details of the directors of the parent entity and the extent of the directors' power to represent the parent entity;
- The name, address, and details of the business carried on, and the contact details for the branch;
- A certified copy of the parent entity's constitutional documents, and a certified English translation if they are not in English; and
- In most cases, a copy of the latest set of audited accounts of the parent entity, and a certified English translation if they are not in English.

In the wake of the TCJA, nothing about foreign operations is easy, whether it be through a branch or through a corporate subsidiary. Through a foreign corporate subsidiary, you now have the global intangible low taxed income regime, the Section 245A dividends received deduction,[3] the previously taxed earnings and profits regime, as well as old favorites like

subpart F income regime.

On top of that, there is the TCJA's far more complex approach to indirect foreign tax credits. Foreign branches should be easier, but they too must contend with added complexity owing to their special treatment with respect to the foreign tax credit limitation and to their impact on FDII.

One dramatic element of simplification from operating through a foreign branch relates to the base erosion anti-abuse tax.

A U.S. company can run afoul of the base erosion anti-abuse tax by making payments to its foreign subsidiaries, even if no actual base erosion or abusive behavior is taking place. For this reason, some U.S. taxpayers have opted to transform foreign operations — to which they make payments — into branches to avoid the negative impact of this tax.

Other Considerations

This article does not address any regulatory or employment considerations that should be considered as well in determining the best structure. For example, some countries, such as the United Arab Emirates, require all foreign entities engaging in certain business activities to have at least a majority local shareholder, driving many multinational companies to open a branch instead.

Other U.S. Federal Income Tax Considerations

Generally, from a U.S. tax perspective, a U.S. corporation is better served operating its foreign business through a branch for the period that the foreign business generates net deductions and operating through a foreign corporation for the period that the foreign business generates net income.

However, with the sweeping changes to the U.S. international tax system under the TCJA, and the complicated international tax regime assembled by U.S. Department of the Treasury in its wake, much more consideration must now go into whether to operate through a foreign subsidiary or foreign branch.

Samuel Pollack and Naoko Watanabe are associates at Baker McKenzie.

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[1] 115 P.L. 97 .

[2] Internal Revenue Code Section 338 .

[3] Internal Revenue Code Section 245A .