Branch Profits Tax
Branch-Level Interest Tax: General Concepts

The complexity of the rules of computing these taxes will make you second think whether to form a branch or a subsidiary

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Branch Profits Tax: Overview

- Branch profits tax was put in law in 1986 to reduce the disparity in US income tax treatment of foreign corporations that conduct businesses in the US through branches and foreign corporations that conduct such business through subsidiaries.
- It is a 30% tax on a foreign corporation’s profits derived from the operation of businesses in the US and not reinvested in those businesses.
- Similar in concept to a 30% withholding tax on dividend distribution made by a US subsidiary.

Branch Profits Tax - Determination

- Branch profits tax is imposed at a rate of 30% on the “dividend equivalent amount” (“DEA”).
  - A US income tax treaty may reduce the rate of tax; however, the foreign corporation must be a “qualified resident” of the treaty country
- DEA is determined by reference to effectively connected earnings and profits (“ECEP”) not reinvested in the United States.
  - ECEP is defined as earnings and profits (with certain modifications) attributable to a U.S. trade or business.

Branch Profits Tax - Determination

- Whether ECEP is reinvested in the United States is measured by changes in U.S. net equity (“USNE”) which equals the excess of US assets over US liabilities
- DEA = ECEP – Increase in USNE
- DEA = ECEP + Decrease in USNE
    - Decrease in USNE should not exceed the accumulated ECEP as of the close of the preceding tax year

US Assets

- The term “US assets” means money and aggregate adjusted bases of property of the foreign corporation treated as connected with the conduct of the US trade or business
- Special rules apply for specific types of property, such as depreciable property, inventory, and installment obligations.
- Special rules also exist to determine the amount of a partnership interest that is treated as a US asset.

US Liabilities

- The regulations define the term “US liabilities” by multiplying a foreign corporation’s total US assets as of the determination date (close of tax year) by either:
  – Actual ratio: worldwide liabilities/worldwide assets
  – Fixed ratio: 93% for banks and 50% for non-banks
- The amount of US liabilities determined above is increased by insurance liabilities for an insurance company
- At the election of the foreign corporation, the US liabilities is reduced by an amount that does not exceed the excess, if any, of the amount determined above over the amount of “US booked liabilities”
  – The election to reduce US liabilities will have effects on interest deduction and branch-level interest tax.

Artificial Increase of US Net Equity

- US assets do not include assets acquired or used by a foreign corporation if one of the principal purposes of such acquisition or use is to increase artificially the US assets of a foreign corporation on the determination date.
- It's a facts-and-circumstances determination.

Example 1

Accumulated ECEP at 12/31/2000			30
ECEP for 2001			30
US Net Equity at 12/31/2000		150	
US assets at 12/31/2001	2,500		
US liabilities (fixed ratio 93%)	(2,325)		
US net equity at 12/31/2001		175	
Increase in US net equity			(25)
DEA			5
Branch profits tax rate			30%
Branch Profits Tax			1.5

Example 2

Accumulated ECEP at 12/31/2000			20
ECEP for 2001			30
US Net Equity at 12/31/2000		150	
US assets at 12/31/2001	1,800		
US liabilities (fixed ratio 93%)	(1,674)		
US net equity at 12/31/2001		126	
Decrease in US net equity (limited by Acc. ECEP)			20
DEA			50
Branch profits tax rate			30%
Branch Profits Tax			15

Branch-Level Interest Tax: Overview

- Same as branch profits tax, the law was introduced in1986 to reduce disparity for foreign corporation conducting business through a US branch and a foreign corporation conducing such business through a domestic subsidiary
- Interest paid by a US branch may constitute US-source income subject to 30% withholding tax
- The law also imposes a corporate-level tax at 30% on the excess of the amount of interest deductible by a foreign corporation over the amount of interest paid by the US trade or business.

Interest Deductible by US Branch

- Step 1: Determine total value of US assets for the taxable year
  - Similar to branch profits tax but determined on average basis
- Step 2: Determine total amount of US-connected liabilities for the taxable year
  - Similar to branch profits tax but determined on average basis
- Step 3: Determine the amount of interest expense allocable to ECI under the adjusted US booked liabilities method

Branch-Level Interest Tax

- Excess of interest allocable to ECI over interest paid by the branch is subject to 30% branch-level interest tax
- For a bank, a portion of excess interest is treated as interest on deposit and is exempt
  - – Multiply the excess interest by the greater of:
    - 85% or
    - Worldwide interest-bearing deposits/ Worldwide interest-bearing liabilities

Example 1

US-connected liabilities (fixed ratio 93%)	1,860
Average US booked liabilities	1,500
Excess	360
Interest paid or accrued on US booked liab	120
Interest expense asscociated with the excess	22
Interest expense allocable to ECI	142
Excess of allocable interest over interest paid	22
Interest treated as interest on deposit (85%)	(18)
Taxable excess interest	4
Branch-level interest tax (30%)	1.20

Example 2

Average US assets	1,600
US-connected liabilities (fixed ratio 93%)	1,488
Average US booked liabilities	1,500
Excess	(12)
Interest paid or accrued on US booked liab	120
Scaling ratio	99.2%
Interest expense allocable to ECI	119
Branch-level interest	-

Artificial Increase of US Assets or US Booked Liabilities

- They are not permitted.
- It's a facts-and-circumstances determination.

Ultimate Way to Avoid Branch Profits Tax

- A foreign corporation is not subject to the branch profits tax for the tax year in which it completely terminates all of its US trade or business.
- Four requirements have to be met.

Requirements of Complete Termination

- As of the close of the tax year, the foreign corporation either has no US assets or its shareholders have adopted an irrevocable resolution to completely liquidate and dissolve the corporation and, before the close of the immediately preceding year, all of its US assets are either distributed, used to pay off liabilities, or ceases to be US assets;
- Neither the foreign corporation nor a related corporation uses any of the US assets in the conduct of US trade or business at any time during a period of 3 years from the close of the year of termination
- The foreign corporation has no income that is, or is treated as, effectively connected with a US trade or business during the period of 3 years from the close of the year of complete termination; and
- The foreign corporation waves the period of limitations.

Conclusion

- The computation of branch-level taxes is a complex process.
- Sometimes difficult to manage.
- Consider converting the branch into a U.S. subsidiary.
  - There is branch profits tax consideration in the process

Final Words

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