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What Is a Foreign Branch?

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In my last installment for this publication, Multinational Service Partnerships and the New Foreign Branch Income Basket, [1] I wondered aloud whether a multinational partnership, particularly a services partnership, could be properly understood to be a branch of each of its U.S. partners. Now that I've had the chance to think about the new foreign branch rules enacted by the Tax Cuts and Jobs Act (TCJA), [2] it seems to me that there is a much more fundamental question that needs to be addressed: What is meant by the term "foreign branch"?

[1] 48 Tax Mgmt. Int'l J. 94 (Feb. 8, 2019).

[2] Pub. L. No. 115-97 (Dec. 22, 2017).

The concept of a branch has always been with the tax law, but the TCJA greatly increased the stakes. There are two provisions that specifically call out foreign branches: the new foreign branch basket at §904(d)(1)(B) and the new incentive for foreign-derived intangible income (FDII), which explicitly is not available to income earned by a U.S. person through a foreign branch. [3] A U.S. partner of a partnership doing business outside the United States now has to consider the possibility that his foreign taxes will be put in a separate basket. And a U.S. multinational now has to consider whether exporting through a partnership will cause the loss of an otherwise-available FDII benefit on the grounds that the partnership's non-U.S. activities constitute a foreign branch.

[3] §250(b)(3)(A)(i)(VI).

All section references are to the Internal Revenue Code, as amended (Code), or the Treasury regulations thereunder, unless otherwise specified.

Prior to 2017, the term "branch" was generally used in the Code without being defined. The check-the-box regulations state simply that the activities of a disregarded entity "are treated in the same manner as a sole proprietorship, branch, or division of the owner." [4] The principal inbound rule implicating the definition of a U.S. branch is §884. Probably because §884 involves a deemed branch rather than an actual one, the branch tax regulations don't even bother to define a branch; all that appears to be required to have a branch in this context is that the activities conducted by a foreign corporation give rise to effectively connected income. Notably, those regulations treat the branch tax as a dividend paid by a deemed U.S. subsidiary for treaty purposes, and not as income of a foreign person, even if the foreign owner's U.S. activities rise to the level of a U.S. permanent establishment. Those regulations, like other regulations in the foreign context, also treat partnerships as entities, that is, as very different from branches. [5]

[4] Reg. §301.7701-2(a).

[5] See, e.g., Reg. §1.884-1(d)(3).

The principal rules affecting outbound investment through foreign branches are the foreign currency rules for branch transactions under §987, the branch loss recapture rule of former §367(a)(3)(C) and the subpart F branch rule applicable in the context of determining foreign base company sales income. [6] In addition, a dual resident corporation's foreign business activities are treated for U.S. tax purposes as if conducted through a foreign branch. [7] At the risk of oversimplification, what these existing rules tell us about how to define a branch is almost nothing.

[6] §954(d)(2).

[7] Reg. §1.1503(d)-1et seq.

Although labeled "Branch Transactions," §987 says nothing about branches, and is designed solely to provide a framework for doing foreign currency translation when a taxpayer operates in a foreign country in a currency other than the U.S. dollar. The subpart F branch rules had no reason to try to define the term "branch," because they were concerned with any branch "or similar establishment" the operation through which "has substantially the same tax effect as if the branch or similar establishment were a wholly owned subsidiary." [8]

[8] Reg. §1.954-3(b)(1)(i)(a).

Regulations issued under the branch loss recapture rules, which are cross-referenced in the dual consolidated loss regulations, set out probably the most comprehensive definition of a foreign branch:

> For purposes of this section, the term "foreign branch" means an integral business operation carried on by a U.S. person outside the United States. Whether the activities of a U.S. person outside the United States constitute a foreign branch operation must be determined under all the facts and circumstances. Evidence of the existence of a foreign branch includes, but is not limited to, the existence of a separate set of books and records, and the existence of an office or other fixed place of business used by employees or officers of the U.S. person in carrying out business activities outside the United States. Activities outside the United States shall be deemed to constitute a foreign branch for purposes of this section if the activities constitute a permanent establishment under the terms of a treaty between the United States and the country in which the activities are carried out. [9]

[9] Reg. §1.367(a)-6T(g).

Even in the TCJA, Congress did not define the term "foreign branch." Instead, it defined the term "foreign branch income." It did so by reference to a "qualified business unit" (QBU), a concept borrowed from the §987 foreign currency regulations mentioned above. [10] Proposed regulations issued on December 7, 2018 ("FTC Regulations") took the further step of attempting to define a foreign branch. Those regulations defined a foreign branch as a QBU that conducts business outside the United States.

[10] §904(d)(2)(J).

Nothing on the face of the statute required the IRS to define a foreign branch as a QBU. And in fact, the FTC Regulations deviate from the definition of a QBU contained in the §987 regulations. The §987 regulations treat a partnership as a QBU, whereas the FTC Regulations state clearly that a partnership is not a QBU (and thus, by extension, not a foreign branch). Perhaps to fill the gap created by not treating a partnership as a QBU/branch, the regulations define foreign branch income as the sum of (1) income attributable to foreign branches of the U.S. person held directly or indirectly through disregarded entities, and (2) its distributive share of partnership income that is attributable to foreign branches held by the partnership.

Why does any of this matter? The relationship between a branch and a partnership is particularly murky under these new regimes. A priori, there are three ways that a foreign branch rule might be applied to partnerships:

- First, one could choose simply to treat branches and partnerships differently, taking the view that a taxpayer engaged in business activities outside the United States must be treated as doing so either through a branch or through a partnership. If the taxpayer does so directly or through a transparent entity of which the taxpayer is the only owner, it is a branch. If the taxpayer does so through an entity that has more than one owner, it is a partnership.

- Second, one could treat a partnership as a separate entity or "person" that can have its own branch. This approach is consistent with the approach taken by the FDII regulations. [11]

- Third and finally, one could treat the partnership as an aggregate of its partners, with the result that each U.S. partner is treated as having a foreign branch to the degree that the partnership has a foreign branch.

[11] The FDII regulation, as described below, conflate two distinct issues and are probably incorrect as to both. One issue is whether partnerships should be treated as entities such that a domestic partnership is a U.S. person for purposes of these rules, while a foreign partnership is not. I have written about this issue before; it is or should be entirely unrelated to how we should think of partnerships and branches.

As is well known, when choosing between an entity and aggregate approach to partnerships, taxpayers are instructed to take

into account the purpose and policy of the underlying tax rule being applied. Unfortunately, Congress provided no indication of what the policy of these new branch rules might be, and none has been suggested in the literature. My view is that the first approach above, which implicates neither the entity nor the aggregate theory of partnerships, is the correct one and the one most consistent with what Congress seems to have had in mind, which is mainly a distaste for operating in foreign branch (but not partnership) form.

Consider the second approach above. Some language in the branch loss recapture regulations, cited above, seems to adopt this approach: "Any U.S. person may be treated as having a foreign branch for purposes of this section, whether that person is a corporation, partnership, trust, estate, or individual." [12] An obvious problem with this approach, which the branch loss recapture regulations do not deal with, is that because only a U.S. person can have a foreign branch under these rules, treating a partnership as a person may mean that the rules apply differently to domestic and foreign partnerships. Because partnerships are not themselves taxpayers, this approach leads to arbitrary outcomes.

[12] See Reg. §1.367(a)-6T(g)..

Despite its flaws, the second approach is explicitly and unambiguously adopted in the recently issued FDII proposed regulations. Prop. Reg. §1.250(b)-3(g) states:

> For purposes of determining whether a sale of property to or by a partnership or a provision of a service to or by a partnership is a FDDEI transaction, a partnership is treated as a person. Accordingly, for example, a partnership may be a seller, renderer, recipient, or related party, including a foreign related party (as defined in *§1.250(b)-6(b)(1)*).

This statement is illustrated by two examples in the proposed regulations. [13] In each example, a U.S. corporation, DC, is an unrelated partner of a partnership. In each example, there are two sales that potentially qualify as FDDEI sales: one made by DC to the partnership and the second made by the partnership. In the first example, the partnership is a foreign partnership that makes its sale through what is stated to be a foreign branch. [14] In the second example, the partnership is a domestic partnership and has no foreign branch. [15]

[13] See Prop. Reg. §1.250(b)-3(g)(2).

[14] Prop. Reg. §1.250(b)-3(g)(2)(i).

[15] Prop. Reg. §1.250(b)-3(g)(2)(ii).

The results in the first example are that the sale by DC to the partnership qualifies, because the partnership is foreign, and the sale by the foreign partnership does not qualify, because it is made through a foreign branch. The results in the second example are the reverse: The sale made by DC does not qualify because the partnership is a U.S. person, and the sale by the partnership qualifies because the partnership is a U.S. person selling directly and not through a foreign branch. Note that the first example does not tell us what the result would be if the foreign partnership had made the sale directly and not through a foreign branch. Perhaps the drafter assumed that it was obvious that a foreign partnership can never claim a FDII benefit, but if so there was no need to stipulate that the sale was made through a foreign branch. In any event, the results are completely arbitrary and divorced from any conceivable policy.

The third approach, above, seems to be hinted at in the FTC Regulations but I have found no precedent for it anywhere else in the Code or regulations. It would probably make sense to treat a partnership as an aggregate for the purpose of analyzing any transaction it has with a truly separate foreign branch. However, if all foreign operations of any multinational partnership, conducted at the partnership level, are recharacterized as separate branches as to all partners, the resulting confusion would appear not worth the effort.

The first approach is consistent with the plain meaning of the statute. It is also consistent with the manner in which the §987 re gulations treat partnerships. Those regulations treat both partnerships and branches as QBUs in order to get the foreign currency translation right at the level where the translation needs to take place. It would make no sense to ask each partner of a partnership to separately compute its foreign currency gain or loss. Those regulations can be interpreted as adopting the first approach above, because they treat partnerships as branches as separate parallel constructs. If the FTC Regulations and the FDII proposed regulations had simply adopted the §987 approach unchanged, the foreign branch rules might have been limited in their application to simple foreign branches of U.S taxpayers (individual and corporations), without creating the confusion alluded to in this brief note.