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Out on a Limb: The New Significance of the Foreign Branch

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In this article, the author explains why partnerships operating outside the United States shouldn't be treated as having a foreign branch.

The drafters of the Tax Cuts and Jobs Act seem to have believed that foreign branches of U.S. persons are evil and that their use should be discouraged by any means possible. The TCJA added a new foreign tax credit limitation basket for foreign taxes attributable to foreign branch income, at section 904(d)(1)(B). It also explicitly excluded foreign branch income from the new incentive for foreign-derived intangible income.[1] And the TCJA added a new and unusually punitive branch loss recapture rule in section 91.

At least as important is what the TCJA did not do regarding foreign branches. The so-called territoriality of the TCJA does not extend to foreign income earned by a U.S. person through a branch — only to foreign income earned through a foreign corporation.[2] Taxable income earned by a U.S. person through a foreign branch is thus not only incapable of being deferred, it is also subject to tax at the highest applicable U.S. tax rate because it is ineligible for any deduction in section 250.

These new foreign branch income rules make the existence of a foreign branch — or at least the existence of foreign branch income — far more significant than it had been before the TCJA. If a U.S. branch owner seeks to avoid the punitive new rules for foreign branch income by transferring the assets of its foreign branch to a controlled foreign corporation, including by making an election to treat a disregarded entity as a regarded one, any gain realized on the transfer will generally be subject to full U.S. tax, and section 367(d) will apply to construct a deemed royalty for any intangible property transferred. If the branch had losses, the branch loss recapture rules will come into play. If instead the U.S. branch owner seeks to transfer the foreign branch assets to the United States, in many cases foreign taxes will apply, the creditability of which may be severely limited.

One might suppose that if foreign branches are really so evil, Congress would at least have attempted to define what a foreign branch is (and is not) so that taxpayers could avoid having a foreign branch, which they are obviously being encouraged to do. But Congress did not define the term.[3] The new provisions define only the term "foreign branch income," and they do so without using the phrase "foreign branch." The term "branch" has never been defined in the code, and it has been defined in regulations only for relatively narrow purposes; the various definitions are not necessarily consistent. It may be that how one defines the term "branch" depends on the purpose for which one is defining it; I have so far unearthed seven different definitions of the term. In providing guidance on the statutory term "foreign branch income," the IRS did try to define the term "foreign branch,"

[1] Section 250(b)(3)(A)(i)(VI).

[2] Section 245A.

[3] The new branch loss recapture rule added in section 91 does contain a definition of the term "foreign branch," but it appears that this definition is intended to be different from the one used in the new FTC and FDII rules. Section 91 is discussed further in Section I.C.

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but as will be discussed, that attempt was unsuccessful.

The foreign branch income rules of the TCJA lack any policy basis and do not seem to have been directed at any particular type of structure or planning. They appear to have been intended to target foreign branches of U.S. multinational corporations conducting an active business offshore. However, the intended target will rarely, if ever, have cause to struggle with these new rules. With some exceptions — notably, banks that are required to operate in branch form by local law and custom — U.S. corporations do not generally operate abroad directly through branches. They use branches of CFCs, which do not implicate the foreign branch rules. Or they may hold CFCs through branches that are not operating companies; any income earned by these directly held branches would ordinarily be passive income, which is excluded from the foreign branch income rules.

If the foreign branch rules missed their intended target, the flak seems to have caused collateral damage to a different target: multinational partnerships. Although no mention was made of partnerships in the statute or the legislative history, the IRS's proposed regulations treat the income of a partnership operating outside the United States as foreign branch income. This report explains why a partnership operating outside the United States should not be treated as having a foreign branch.

Section I explores the definitional quandaries posed by the new term "foreign branch income," whose apparent simplicity masks significant ambiguity. Section II looks at some difficulties associated with measuring foreign branch income and how those difficulties might inform how one thinks about it generally. Finally, Section III examines the application of the foreign branch income rules to partnerships.

I. Definitional Quandaries

A. The Statute and Legislative History

The plain meaning of the term "foreign branch income" suggests that one might be looking for the net taxable income attributable to the operations of a foreign branch. In some simple cases, this may be relatively easy to identify; but in many (if not most) cases, this will not be true. The definition of foreign branch income in new section 904(d)(2)(J) consists of no fewer than six components:

1. the business profits
2. of a U.S. person
3. attributable to
4. one or more qualified business units (QBUs)
5. in one or more foreign countries
6. excluding passive income.

Given the difficulties associated with interpreting the statutory terms and measuring foreign branch income, one would ordinarily turn to the legislative history for some clues about what Congress intended by the term. Unfortunately, there is very little legislative history to go on.

Insofar as the new foreign tax credit basket is concerned, it is relatively clear that Congress was worried about cross-crediting. However, that worry may have been based on a misunderstanding of the way in which the FTC rules operate. The explanation of the new foreign branch income basket was set out in the Senate Budget Committee report as follows:

> Reasons for Change
>
> Under present law, multinational enterprises have the ability to cross-credit foreign taxes attributable to low-tax subpart F income with those attributable to high-tax branch income and minimize overall tax liability. Changing the U.S. international tax system from a worldwide system of taxation to a participation exemption system of taxation exacerbates the incentive under present law to shift profits abroad. The Committee believes that this provision [the separate foreign branch limitation basket] would operate to prevent excess foreign taxes credits generated in high-tax branch countries to be used to reduce U.S. tax owed on income generated in a low-tax country.[4]

[4]Committee Print, "Reconciliation Recommendations Pursuant to H. Con. Res. 71, S. Prt. 115-20," at 393 (Dec. 2017) (Senate Budget Committee report).

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It is unclear why Congress believed that subpart F income is low-taxed or that branch income is high-taxed by a foreign country. It seems likely that Congress thought of subpart F income as passive income that can easily avoid high-tax regimes, although in practice that is not always the case, particularly after the enactment of the new global intangible low-taxed income tax imposed by section 951A. And although the quoted passage doesn't mention it, Congress did seem to believe that GILTI, at least, was targeting low-taxed income.

Congress may have believed that branch income is highly taxed because it assumed that most branch income would be attributable to active foreign operations in a country, which would generally take place in a "real" foreign country with a "real" tax system. But there is no reason to suppose that branch income is operating income; in fact, as already mentioned, branch income of U.S. nonfinancial multinational corporations is usually passive income, and for that reason is excluded from the new foreign branch income rules.[5] It has also been suggested to me that Congress was focused on the branch operations of oil and gas businesses, which were generally subject to the subpart F foreign oil and gas income rules at section 954(g), repealed by the TCJA. Interestingly, many oil and gas enterprises are operated in partnership form, which may also explain why the proposed regulations make the foreign branch income rules applicable to partnerships as well as single-owner corporate branches. Note that any presumed focus upon the extractive industries would be completely inconsistent with the notion that the policy of the foreign branch income rules related to locational advantage and that the rules were aimed at easily movable businesses.

Congress was clearly correct that the move to a participation exemption system increases the incentive to shift profits offshore. But this observation cannot possibly be relevant to foreign branch income. By definition, income earned through a foreign branch isn't being shifted offshore — it is earned by, and taxed directly to, the U.S. branch owner without deferral, as if it were U.S.-source income. And if foreign branch income is high-taxed, one would have supposed that such activities are the last thing a U.S. multinational would wish to shift offshore, particularly if the rate of local tax exceeds the new low U.S. rate of 21 percent.

Congress's intent regarding the FTC basket for foreign branch income is unclear, but its intent regarding the FDII carveout for foreign branch income is a matter of pure conjecture. Congress articulated no reason at all for that carveout. At least superficially, the carveout appears to contradict the overall design of the TCJA's international rules. The GILTI and FDII rules were designed such that a U.S. corporation would be subject to roughly the same rate of U.S. tax on foreign income whether earned directly or through a CFC.[6] The exclusion of foreign branch income from FDII seems inconsistent with that design because income earned through a foreign branch is subject to a rate of tax higher than the rate that applies to GILTI or FDII. To the extent that Congress believed that the existence of a foreign branch is correlated with the offshoring of jobs or income from the United States, there is no obvious reason to treat a foreign branch less favorably than a CFC.

It has been argued that the design of the TCJA's international tax provisions, of which GILTI and FDII are important parts, was predicated on the notion that any business, income, or assets that could be brought onshore should be. Congress may have believed that there was no good reason to allow a U.S. person to operate through a foreign branch.[7] Put another way, the FDII carveout for foreign branches may have been intended to discourage keeping mobile business, income, and assets offshore. So it is not enough to check the box on a former CFC to get into FDII — one must actually move assets, functions, and employees.

[5] It would be helpful to understand how the Joint Committee on Taxation scored the new foreign branch income FTC basket in its revenue estimates for the TCJA. Unfortunately, the revenue estimate for the new basket is bundled together with the revenue estimate for GILTI.

[6] *See* Senate Budget Committee report, *supra* note 4, at 375.

[7] *See* Patrick Driessen, "FDII Jilted by Design Flaws, Byrd Rule, and Regs," *Tax Notes Federal*, Sept. 30, 2019, p. 2269. It also seems possible that Congress became confused by its own "territorial" rhetoric, perhaps believing that foreign branch income was exempt from U.S. tax, which would explain almost everything in this report were it true.

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Congress might have been thinking about so-called locational advantage, trying to provide incentives for multinational corporations to move offshore activities to the United States. Perhaps the reasoning was that any business capable of being moved onshore is not truly a foreign business and should be moved onshore, such that a "real" foreign business would always take the form of a CFC. This explanation does not hold up under scrutiny, however. Because the definition of foreign branch income excludes passive income, the foreign branch rules appear to target active business income. In most cases, property used in an active trade or business cannot easily be moved. One is left wondering whether Congress's real goal was to penalize offshore ownership of intangible property, which can generate non-passive income and be moved. Even if that were the intention, for tax and other reasons, most intangible property producing active income is not held directly in branch form.

If Congress was indeed motivated by the desire that U.S. corporations repatriate their intangible assets located offshore, it might have designed the FDII carveout to apply more narrowly to that type of income. This was the model for the Obama administration's fiscal 2016 budget proposal. That proposal would have treated a foreign branch in the same manner that a CFC is treated, with a minimum tax of 19 percent on the foreign branch's income. It would then have cut back on the benefit of the 19 percent rate for income earned through a foreign branch from the exploitation of intangible property, by imputing a deemed royalty back to the U.S. home office.[8] In this way, the Obama budget proposal would have granted the same territorial benefits to branches as it did to CFCs, subject to an exception for income from intangible property. That is at least a rational policy choice. To deny any territorial benefits to foreign branches and tax all foreign branch income at the highest corporate rate does not appear to be a policy choice at all — it appears to be a mistake.

B. Definitions in the Regulations

Given the lack of any clear legislative intent and the absence of any real precedent about how to define foreign branch income, it is not surprising that the IRS has struggled to provide guidance under the foreign branch income rules. As discussed in Section II, regulations issued under the new TCJA rules provide a different definition of foreign branch income for FTC purposes than they do for FDII purposes. This is so even though the statutory definition in the FDII context expressly cross-references the section 904 definition.[9]

The preamble to the final FTC regulations (T.D. 9882)[10] notes that taxpayers had suggested that the preamble include a discussion of the "tax policy considerations" relevant to the regulations.[11] The ensuing two pages of the preamble are a masterpiece of not answering that unanswerable question (unanswerable because there is no tax policy underlying these rules). Instead, the preamble talks about balancing regulatory objectives such as administrability. When it comes to the actual tax policy of the rules themselves, the preamble simply refers to the "policies of sections 250(b)(3)(A)(i)(VI) and 904(d)(1)(B)," pointedly failing to indicate what those policies might be.[12] This becomes troubling when the design of specific FTC regulations is justified by reference to the policies of those rules. For example, the preamble to the final FTC regulations justifies the rule that disregarded payments of interest are disregarded in calculating foreign branch income, because it would "allow taxpayers to 'strip' the foreign branch category, potentially resulting in manipulation of the limitations in sections 250(b)(3)(A)(i)(VI) and 904(d)(1)(B)."[13] But because no one appears to know what the policies of either of those code provisions are, it is hard to

[8] *See* Treasury, "General Explanations of the Administration's Fiscal Year 2016 Revenue Proposals" (Feb. 2, 2015).

[9] Section 250(b)(3)(A)(i)(VI) refers to "any foreign branch income (as defined in section 904(d)(2)(J))."

[10] The final regulations adopt substantially all of the provisions of proposed regulations (REG-105600-18) that are relevant to this report.

[11] T.D. 9882, Part III.B.1, at 37.

[12] I am dubious that any code provision that can be referred to by shorthand only by using five sets of parentheses could ever be said to have a policy.

[13] T.D. 9882, Part III.B.2.iv, at 45.

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get exercised over a taxpayer being able to manipulate their limitations.

The regulations attempt to define the term "foreign branch." It is unclear why the IRS felt it necessary to define foreign branch at all. The new foreign branch rules in the TCJA use only the term "foreign branch *income*," not the term "foreign branch." The statutory definition of foreign branch income does not speak in terms of business profits attributable to a foreign branch, but only those attributable to a QBU. A QBU is not the same thing as a foreign branch; in fact, it is not even close.

It is unclear why Congress chose to define foreign branch income by reference to the income attributable to a QBU rather than income attributable to a foreign branch. The QBU concept was developed and is used to deal with foreign currency translation, which has nothing to do with whether a given set of activities is treated as a branch, and does not attempt to measure net income. Although a QBU can include a branch, it is not limited to branches; there may be cases in which two formally separate branches of the same U.S. taxpayer are treated as a single QBU, at least if they use the same foreign currency and keep common books and records. Linking the attribution prong of the foreign branch income definition to business profits attributable to a QBU was an odd choice on Congress's part, and the FTC regulations clearly demonstrate the IRS's struggle to deal with it.

The FTC regulations define a foreign branch as a QBU — as that term is in turn defined in the regulations issued under the foreign currency provisions of the code (the FX regulations) — that conducts a trade or business outside the United States.[14] The FX regulations define a QBU in terms of the activities of a unit of a trade or business that keeps separate books and records, which makes sense in the context of currency translation. They provide that the activities of a corporation, partnership, trust, estate, or individual qualify as a QBU if they constitute a trade or business and if a separate set of books and records is maintained for the activities.

[14] Reg. section 1.904-4(f)(3)(vii), referencing reg. section 1.989(a)-1(b)(2)(ii) and (b)(3).

Not only did the statute not require the IRS to define the term "foreign branch," nothing in the statutory definition of foreign branch income required the IRS to equate the term "qualified business unit" with the term "foreign branch." Nothing in the definition of foreign branch income suggests that Congress believed that a branch was the same thing as a QBU. Having taken the step of equating a foreign branch with a QBU, the FTC regulations then take several giant steps back in an attempt to undo the same. First, the FTC regulations provide that activities carried out in the United States, which a QBU described in the FX regulations can have, do not give rise to foreign branch income.[15] Second, because the definition of foreign branch income is limited to income from business activities and excludes passive income, the FTC regulations added the requirement that the branch/QBU be engaged in a business — a requirement not found in the FX regulations' definition of a QBU.[16]

Third, whereas the FX regulations treat a partnership as a QBU, the FTC regulations state clearly that a partnership cannot be a QBU and cannot have foreign branch income at the partnership level. Rather, as is explored in some detail in Section III, the FTC regulations provide that a partnership can have a QBU and a foreign branch, but cannot have foreign branch income. Only the U.S. partners of a partnership can have foreign branch income.[17] The regulations contain a long and repetitive example illustrating the point that a partnership can be a foreign branch owner but cannot have foreign branch income, and that only its U.S. partners can have foreign branch income.[18] To fill the gap they created by not treating a partnership as a QBU/branch of its partners, the FTC regulations define foreign branch income as the *sum* of (1) income

[15] Reg. section 1.904-4(f)(2)(ii).

[16] Reg. section 1.904-4(f)(3)(vii)(A).

[17] In fact, the regulations state that a partnership can have a QBU even without its having separate books and records. Reg. section 1.904-4(f)(3)(vii)(C).

[18] Reg. section 1.904-4(f)(4)(i), Example 1. The example states that the partnership in question conducts activities solely in Country A, and those activities constitute a trade or business outside the United States. This is strange, because the example later states that the partnership conducts activities not only in Country A, but also in Country B and Country C through disregarded entities. The final regulations eliminated the proposed regs' references to the partnerships.

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attributable to foreign branches of the U.S. person held directly or indirectly through disregarded entities and (2) its distributive share of partnership income attributable to foreign branches held by the partnership.[19]

A few months after the issuance of the proposed FTC regulations, the IRS promulgated proposed regulations under section 250 (REG-104464-18), including the FDII rules (the FDII regulations). The FDII regulations do not contain any separate definition of the term "foreign branch." They generally follow the definition of foreign branch income as set forth in the FTC regulations, with some differences that will be briefly discussed in Section II.

C. Prior Definitions of Foreign Branch

The concept of a branch has always been with the tax law, but before the TCJA there had been little focus on the tax significance of a branch. Unlike other countries, the United States has traditionally taxed — and still does tax — the worldwide income of its residents, regardless of where earned. The United States does not treat a branch as a separate entity, and traditionally it has ignored transactions between a branch and its owner.

In countries having a territorial system applicable to the active foreign income of resident taxpayers, the definition of a foreign branch takes on far greater significance. These countries tend to treat a foreign branch in the same manner that a foreign subsidiary is treated. They typically give tax effect to transactions between the branch and the home office and deem specific transactions to occur in order to reflect the separate income of the branch.

U.S. persons would not typically use a "natural" branch to conduct operations outside the United States unless forced to do so by regulatory concerns or if losses were expected. Operating in branch form generally exposes the branch owner to nontax liabilities as well as direct income taxes. From a purely tax perspective, operating through a CFC is generally preferred because it allows deferral of U.S. tax until repatriation.[20] Another reason to avoid the branch model would be to avoid state taxation of foreign income.

Foreign branches, in the U.S. tax sense, became common only after the adoption of the check-the-box regulations in the late 1990s. These branches are typically hybrid branches respected as foreign corporations in the countries where they operate, limiting the state law liability exposure of the U.S. parent. In most cases, these branches are not directly held operating branches; instead, they are either branches of CFCs or are directly held holding companies that own only CFCs. A CFC cannot have foreign branch income, nor can a branch owning CFC stock. Thus, neither type of foreign branch is likely to have significant amounts of foreign branch income.

The term "branch" has generally been used in the code and regulations 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,"[21] apparently seeing no need to define any of those terms. The section 884 branch tax rules similarly do not define the term "branch"; all that appears to be required to have a branch for this purpose is that the activities conducted by a foreign corporation give rise to effectively connected income.

The laws of many countries contemplate the existence of a branch whose activities do not rise to the level of a business. The term "branch" in those countries generally refers to any presence of the taxpayer's personnel or property not in separately incorporated form, similar to the concept of a QBU.[22] In contrast, under U.S. tax law, it appears that a taxpayer can be said to have a branch if and only if it is engaged in activities in another jurisdiction that rise to the level of a

[19] Reg. section 1.904-4(f)(1)(i).

[20] Following the introduction of GILTI, this may be less true, but it remains partly true.

[21] Reg. section 301.7701-2(a).

[22] For some interesting recent background on this issue, see Oliver R. Hoor, "Luxembourg's Amended Definition of a Permanent Establishment: Is It Really Something New?" *Tax Notes Int'l*, May 20, 2019, p. 709.

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taxable business presence.[23] A QBU, however, need not have any business activities at all. Thus, even if the statutory definition of foreign branch income had not limited the term to non-passive business income, the IRS would probably have added the business requirement onto its definition of branch, given that it used a QBU as its starting point.

Although the title of section 987 is "Branch Transactions," nothing in the body of that section or its regulations defines or even uses the term "branch," other than a couple of examples that refer to a foreign branch as a type of QBU. Those regulations do use the term "interbranch transaction" to disregard those transactions. This disregarding of interbranch transactions is another feature of the precedent FX regulations that was reversed by the FTC regulations.[24] The point of the new foreign branch income definition is to figure out what income is attributable to the branch, a task that the foreign currency translation rules are not designed to accomplish.

The subpart F branch rules of section 954(d)(2) refer to 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."[25] Again, the phrase "branch or similar establishment" is not defined. Perhaps for that reason, there is a rich history of controversy over what constitutes a branch for this purpose. In Rev. Rul. 75-7, 1975-1 C.B. 244, the IRS ruled that the activities of an unrelated contract manufacturer were considered to be performed by a CFC outside the country of its incorporation through a branch. In effect, the IRS attributed the activities of the unrelated person to the CFC. In Rev. Rul. 97-48, 1997-2 C.B. 89, the agency relented to the opposing view taken by the courts, which was that the activities of an unrelated person cannot be treated as a branch.[26]

Although these subpart F branch debates have been largely rendered moot by subsequent developments, they do shed light on what constitutes a branch. We know that for there to be a branch, there must be a single branch owner. Although tax treaties and other countries treat a dependent agent as a type of branch/permanent establishment, U.S. tax rules would not find a branch unless the dependent agent is owned by, or is a direct employee of, the home office. The mere fact that a taxpayer hires an unrelated person to do work on its behalf does not give that taxpayer a branch.

Regulations issued under the former branch loss recapture rules, which are cross-referenced in the dual consolidated loss regulations,[27] set out what appears to be the only definition of a foreign branch in the code or the regulations thereunder. The regulations under the former branch loss recapture rules define a foreign branch as follows:

> 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

[23] In the McDonald's state aid investigation, Luxembourg ceded taxing jurisdiction to the United States over what Luxembourg believed to be a U.S. branch of a Luxembourg taxable corporation on the ground that the tax treaty between the two countries required it to do so in the presence of what Luxembourg believed was a U.S. permanent establishment. The United States did not tax the "U.S. branch" because it did not engage in the type of business activities that rose to the level of engaging in a U.S. trade or business.

[24] Reg. section 1.904-4(f)(2)(vi)(A) (regarding disregarded transactions between foreign branches).

[25] Reg. section 1.954-3(b)(1)(i)(a).

[26] In relenting, the IRS cautioned that it never viewed Rev. Rul. 75-7 as allowing a contract manufacturer's activities performed outside the CFC's country of incorporation to be attributed to the CFC without treating those activities as performed through a branch of the CFC. What was at stake here was that taxpayers were arguing that their CFCs were actively producing property under contract with unrelated manufacturers, and thus did not earn subpart F income, while at the same time arguing that the CFCs did not do so through a branch.

[27] Reg. section 1.1503(d)-1(b)(4).

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> under the terms of a treaty between the United States and the country in which the activities are carried out. 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.[28] [Emphasis added.]

Note that this definition expressly contemplates that a branch can have only one owner, which must be a U.S. person. Thus, although this definition makes clear that a partnership can have a branch, the definition by its terms applies only to a domestic partnership treated as a U.S. person. This is consistent with the long-standing position of the IRS that a partnership is an entity for purposes of determining who a U.S. person is. Although that position has recently been altered because of the anomalies it creates under GILTI, it has so far persisted in other areas of international tax rules.

Like the definition in the FTC regulations, the section 367 definition of a foreign branch focuses on "business operations" offshore. Like the QBU definition that was incorporated by reference into the FTC regulations' definition, the section 367 definition looks to the existence of a separate set of books and records, although only as a factor. The section 367 definition, unlike that of the FTC regulations, is based on all the facts and circumstances and focuses on the presence of employees or officers of the U.S branch owner.

Although the branch loss recapture rule of section 367(a)(3)(C) was repealed by the TCJA, the act added a new section 91 that operates in much the same way. Unlike the other foreign branch rules added by the TCJA, which do not use or define the term "foreign branch," section 91 uses the term and defines it by explicit reference to the now-repealed section 367(a)(3)(C) and the regulations thereunder. The legislative history of section 91 illustrates congressional antipathy to foreign branches generally:

> Reasons for Change
>
> A participation exemption system could provide double tax benefits in certain circumstances. In particular, a distribution from a foreign subsidiary that is eligible for a DRD [dividends received deduction] would reduce the value of the foreign subsidiary, reducing any built-in gain or increasing any built-in loss in the shareholder's stock of the subsidiary. Reducing gain in this manner is consistent with the application of section 1248(a) (or section 964(e)) to recharacterize gain as a dividend for which a DRD may be allowed. Increasing loss in this manner, however, creates a double U.S. tax benefit for receiving a tax-free distribution from a foreign subsidiary.
>
> In addition, taxpayers may arbitrage the application of the participation exemption system to foreign subsidiaries but not foreign branches. Specifically, a taxpayer may deduct losses from a foreign branch operation against U.S. taxable income and then incorporate that branch once it becomes profitable. Present law provides an array of loss recapture rules to address such a fact pattern, but those rules generally rely on the worldwide system of taxation to recapture losses in excess of built-in gains by taxing future earnings when repatriated. Instead of only recapturing such losses upon a later repatriation of earnings, the Committee wishes to recapture the U.S. tax benefits of these losses immediately upon the incorporation of a foreign branch that has generated losses. This is to avoid the negative tax consequences of the repatriation of foreign earnings, which is one of the reasons for moving to a participation exemption system of taxation.[29]

The foregoing passage represents a creditable explanation why a better recapture rule was needed for branch losses and why new section 961(d) was enacted, providing a basis reduction for a section 245A dividends received deduction. But it seems unlikely that a U.S. shareholder would have a built-in loss on stock of a subsidiary

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[28] Reg. section 1.367(a)-6T(g)(1).

[29] Senate Budget Committee report, *supra* note 4, at 360.

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that is paying excludible dividends, which can only come out of earnings and profits. And the sweeping statement predicated on the assumption that the United States no longer has a worldwide system of taxation is just wrong.

The legislative history cited earlier explains that Congress no longer wished to rely on branch loss recapture rules that operated only over a period of years; it instead wanted immediate recapture as U.S.-source income. It has been suggested that this definition is different from that adopted by the FTC regulations in that it is not focused on defining foreign branch income and thus does not exclude U.S. activities or add back disregarded transactions.[30]

Proposed regulations issued under both the new base erosion and antiabuse tax in section 59A and the new disallowance of deductions for hybrid interest and royalties under section 267A address payments to and by branches. These proposed regulations make a sharp distinction between "regular" branches and branches that are treated as permanent establishments by reason of a tax treaty. They have been criticized for doing so, especially because the new proposals would often result in worse tax treatment of treaty branches than of non-treaty branches. This is a function of the fact that tax treaties, like the laws of most countries, essentially treat a PE as a fully taxable separate entity, whereas U.S. tax law traditionally has treated a branch as nothing more than a bag of its owner's assets. Whereas many other countries respect payments between a PE and its home office, U.S. tax law has traditionally ignored those payments.[31] The distinction drawn by these regulations between a mere branch and a PE is consistent with the notion, referred to previously, that for U.S. tax purposes a branch is not the same thing as what a treaty partner may regard as a PE.

Reflecting this distinction, the proposed regulations under the anti-hybrid rules of section 267A define a new term — "taxable branch" — that appears to mean something similar to a PE. A taxable branch is defined as "a branch that has a taxable presence under its tax law."[32] (Presumably, "its" tax law refers to the tax law of the country in which the branch operates.) The section 267A regulations state:

> The term U.S. taxable branch means a trade or business carried on in the United States by a tax resident of another country, except that if an income tax treaty applies, the term means a permanent establishment of a tax treaty resident eligible for benefits under an income tax treaty between the United States and the treaty country. Thus, for example, a U.S. taxable branch includes a U.S. trade or business of a foreign corporation taxable under section 882(a) or a U.S. permanent establishment of a tax treaty resident.[33]

D. Summary

There is no one definition of foreign branch. It is not clear why the FTC regulations even attempted to define the term "foreign branch," which is not used in the relevant portion of the statute. The traditional concept of a QBU is entirely unsuited to act as a proxy for the term "foreign branch." The IRS should abandon the project of trying to define a foreign branch and focus instead on the definition of foreign branch income, addressed in the next section.

II. Determining Foreign Branch Income

Although this report does not focus on the definition of foreign branch income in detail, some of the choices made in the FTC regulations are relevant to the more fundamental question of how one defines a foreign branch. Just as it is unclear why we have new foreign branch rules at all, it is also unclear what Congress may have had in mind when it referred to foreign branch income or to income "attributable to" a QBU. In particular, it is unclear whether Congress understood that transactions between a branch and a home office (as well as transactions between disregarded branches) are disregarded for U.S. tax purposes, such that measuring income or loss

[30] Ron Dabrowski, "Perspectives on the Treatment of Losses in the Reformed U.S. International Tax System," 130 *J. Tax'n* (Apr. 2019).

[31] The regulations under section 1503(d) make a similar distinction between a branch that calculates its income using U.S. tax principles and one that calculates its income using treaty principles. *See* reg. section 1.1502(d)-5(c)(2).

[32] Prop. reg. section 1.267A-5(a)(22).

[33] Prop. reg. section 1.267A-5(a)(25).

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attributable to a branch can be a non-trivial exercise.

To measure foreign branch income, the FTC regulations start with the income shown on the branch's books and records. However, a pure books and records approach, standing alone, could never function as an accurate measurement of foreign branch income. For one thing, it is too easy to manipulate. Moreover, even scrupulous books and records will not necessarily reflect income as measured for U.S. tax purposes. And most important, books and records would ordinarily not reflect disregarded intercompany transactions.

Acknowledging all these problems and more, the FTC regulations first require that book income be adjusted to conform to U.S. tax principles.[34] They then set out a long list of exceptions to the adjusted books and records rule. These exceptions cover:

- income from U.S. activities;
- income and gain from stock;
- gain on the disposition of an interest in a passthrough entity;
- income attributed to the branch under an antiabuse rule; and
- adjustments for disregarded transactions between the branch and the branch owners, and between branches having the same branch owner.[35]

Given all these adjustments and exceptions, it is worth asking why the IRS chose the books and records method as the starting point, rather than the seemingly more obvious alternatives available to it (mentioned later). If the books and records method was chosen because the IRS believed itself beholden to the statute's reference to a QBU, that decision should be revisited. The statute does not equate a branch with a QBU; only the regulations do that. The statute simply asks what income is attributable to a QBU. Congress probably believed that because foreign currency gain or loss is determined at the level of a QBU, and because a QBU keeps separate books and records, it would be easy to determine foreign branch income at that level. Unfortunately, the foreign currency rules are not designed to measure income. The IRS was therefore compelled to write income attribution rules from scratch. It should have done so directly, without starting from an irrelevant starting point and backing out of it.

In other areas of the tax law in which it is necessary to determine the income of a branch or PE, two basic approaches have been used. These approaches are described in the regulations under section 1503(d) as well as in the proposed regulations under sections 59A and 267A, noted earlier. The first approach is based on the effective connection rules in section 864. It is usually described as follows: "The principles of section 864(c)(2), (c)(4), and (c)(5), as set forth in section 1.864-4(c), and section 1.864-5 through 1.864-7, shall apply."[36] In determining the amount of interest expense apportionable to a branch or separate unit, this approach looks to the principles of reg. section 1.882-5, which is based largely on the notion that money is fungible.

The second approach is used mainly for tax treaty purposes in determining the income of a PE. It is usually referred to as the "authorized OECD approach" or the AOA.[37] This approach is a transfer pricing approach, designed to treat a branch as a separate corporation insofar as possible. The income attributable to the PE is that which it "might be expected to make, in particular in its dealings with other parts of the enterprise, if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the enterprise through the permanent establishment and through the other parts of the enterprise."[38] A primary difference between the first and the second approach is how they deal with interest expense.

Ironically, the preamble to the final FTC regulations mentions the AOA and section 864(c) approaches in the context of allocating deductions, such as interest.[39] To attribute income based on a books and records starting point while

[34] Reg. section 1.904-4(f)(2)(i).

[35] Reg. section 1.904-4(f)(2)(ii)-(vi).

[36] Reg. section 1.1503(d)-5(c)(2)(i).

[37] *See* reg. section 1.1503(d)-5(c)(2)(iii).

[38] Article VII(2) of the 2016 U.S. model treaty.

[39] T.D. 9882, Part III.B.4.iii, at 56.

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allocating deductions using a wholly different method seems odd if not simply incorrect.

The FTC regulations eschew both of these traditional approaches in favor of a mechanical approach based on books and records. The preamble to the final FTC regulations even goes so far as to suggest that the choice of the books and records approach was motivated by a belief that it would best comport with the measure of income being taxed by the foreign country in which the branch operates. This looks like an unforced error. A given foreign country is unlikely to use the branch's books and records as a basis for determining its local tax liability, much less books and records maintained using U.S. tax principles. The resulting likelihood of a mismatch between foreign and U.S. income is particularly troubling after the TCJA, given that FTCs are now calculated annually and will often be stranded.[40]

In the post-tax-reform environment, in which FTCs are calculated annually, any mismatch created by the FTC regulations will lead to double taxation. If the taxpayer is lucky enough to have an applicable tax treaty to rely on, any income that the regulations treat as having a U.S. source, but that the treaty partner is allowed by the terms of the treaty to tax, will generally be re-sourced as foreign-source income for basketing purposes. This may free up the FTC, but at the cost of yet another basket for income re-sourced by treaty (a rule designed for a very different tax system). The preamble to the proposed FTC regulations anticipated the re-sourcing issue:

> U.S. source gross income that is reallocated from the general category to the foreign branch category and that is properly subject to foreign tax may be eligible to be treated as foreign source income under the terms of an income tax treaty, in which case the resourced income would be subject to a separate foreign tax credit limitation for income resourced under a tax treaty. See section 904(d)(6).[41]

The preamble did not mention that the treaty re-sourcing basket was enacted as an antiabuse rule and not as a rule to ameliorate the harsh effects of the then-unknown foreign branch basket.

Although the FDII regulations define foreign branch income first by cross-reference to the FTC regulations, they do incorporate some differences:

> The term foreign branch income means gross income attributable to a foreign branch of a domestic corporation or a partnership under section 1.904-4(f)(2), except that the term also includes any income or gain that would not be treated as gross income attributable to a foreign branch under section 1.904-4(f) but that arises from the direct or indirect sale (as defined in section 1.250(b)-3(b)(7)) of any asset (other than stock) that produces gross income attributable to a foreign branch, including by reason of the sale of a disregarded entity or interest in a partnership. See also section 1.904-4(f)(2)(v) (providing that if a principal purpose of recording or failing to record an item of gross income on the books and records of a foreign branch is the avoidance of the purposes of section 250 (in connection with section 250(b)(3)(A)(i)(VI)), the item must be attributed to one or more foreign branches of the foreign branch owner in a manner that reflects the substance of the transaction).[42]

The quoted regulation deviates from the FTC regulations in that it includes in foreign branch income for FDII purposes gain that arises from the direct or indirect sale of any asset (other than stock) that produces foreign branch income, including gain on the sale of an interest in a disregarded entity or an interest in a partnership. This type of income or gain was likely excluded from the FTC limitation basket because it is unlikely that the foreign country in which the branch is subject to tax would levy tax on that income. However, when foreign tax is imposed on such a disposition, the rule will generally result in the stranding of FTCs. This is yet another example

[40] For a discussion, see, e.g., Dabrowski, *supra* note 30.

[41] REG-105600-18, 83 F.R. 63200, at Part II.B.2.i (Dec. 7, 2018).

[42] Prop. reg. section 1.250(b)-1(c)(11).

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of how the FTC regulations' approach to measurement of foreign branch income seems maladapted to the purpose of the rule.

Another example of how the FTC regulations' definition of foreign branch income departs from what appears to have been the intended statutory scheme is in the special rule adopted for section 367(d) transfers. For purposes of the adjustment for disregarded payments, the FTC regulations provide that foreign branch income must be adjusted for transfers of section 367(d)(4) intangible property between a foreign branch and its owner: "For example, if a foreign branch owner transfers property described in section 367(d)(4) to a foreign branch, the principles of section 367(d) are applied by treating the foreign branch as a separate foreign corporation to which the property is transferred in exchange for stock of the corporation in a transaction described in section 351."[43] This rule is unusual in that it applies in both directions — outbound and inbound — regardless of whether the transfer is accompanied by actual payment. The amount of the adjustment is made under the principles of sections 367(d) and 482, which generally require an annual adjustment commensurate with the income generated by the property.

The preamble to the proposed FTC regulations explained that this rule was needed to prevent artificial reductions in foreign branch income. If the concern is base erosion, there would seem to be no basis for distinguishing between transfers of section 367(d) property and transfers of any other property that can give rise to income. Nor did the preamble elaborate on why any such reduction might be viewed as artificial, or why this rationale would apply to transfers in both directions. As noted earlier, the TCJA is designed such that a U.S. corporation should be treated in the same way whether it earns foreign income through a CFC or directly. One might ask whether retaining intangible property in a CFC rather than transferring it to a foreign branch of the U.S. shareholder is "artificial." Suppose that a U.S. corporation owns a foreign branch that would be expected to earn foreign branch income. If the U.S. branch owner checks the box to convert the branch into a CFC, resulting in an outbound section 367(d) transfer, does the income remain foreign branch income under the FTC regulations' antiabuse rule?

Predictably, this rule generated a small firestorm of negative comment letters. Application of the section 367(d) rule in this inbound scenario would generally result in the annual realization of income in the foreign branch basket where it would never be matched by creditable foreign taxes. The country from which the property was repatriated would recognize the transfer, and thus would no longer tax the income from the intangible property.

Several commentators pointed out that some U.S. multinationals had repatriated intangible property formerly held in CFCs after the adoption of the OECD's base erosion and profit-shifting reforms and the enactment of the TCJA, which in fact encouraged them to do so. Although a transfer of intangible property directly from a CFC to its U.S. shareholder would not implicate the foreign branch rules, in some cases the repatriation was carried out by first making a check-the-box election to treat a CFC as a branch for U.S. tax purposes. If that election were followed by a transfer, the first question was whether the transitory ownership of the intangible property by a foreign branch was enough to trigger the application of this rule.

The final FTC regulations solved this particular problem with a rule for transitory branches.[44] But if the term "foreign branch" were properly defined, this fix would not have been required. A foreign branch should, at a minimum, require the dedication of significant activities conducted in branch form, reported as a branch, with books and records being kept for the branch. Oddly, none of the commentators thought to raise that fundamental question. The assumption seems to have been that if there is an "oval inside a rectangle" at any point in time on the corporate chart, the foreign branch rules are implicated.

One commentator pointed out that from a FDII perspective, the section 367(d) rule rewards taxpayers that transfer intangible property

[43] Reg. section 1.904-4(f)(2)(vi)(D).

[44] Reg. section 1.904-4(f)(2)(vi)(D)(3). The final FTC regulations also made this rule prospective, in response to comments. Reg. section 1.904-4(f)(2)(vi)(D)(2).

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offshore, which was precisely the target of original section 367(d).[45] On an outbound transfer, the branch owner's general category income is increased while the branch's income is decreased, by the amounts of the imputed payments. The larger amount of general category income increases the deduction-eligible base for FDII purposes. It was also pointed out that the FDII results contravened the statement in the FTC regulations to the effect that the reallocation rules were intended to affect only FTC basket calculations. It might have also been pointed out that if the purpose of the FDII carveout for foreign branch income was to encourage U.S. persons to locate their intellectual property in the United States, this rule runs directly counter to that purpose.

The foreign branch income rules added to the code by the TCJA are already devoid of any policy justification and result in untoward consequences. In defining the term "foreign branch income," the IRS should refrain from inventing rules that exacerbate an already-flawed statute. The goal should be to limit the definition as far as good policy permits.

III. Partnerships and Branches

Probably the most difficult question presented by the lack of meaningful legislative history for the new foreign branch rules is whether the rules apply to partnerships, and if so, how. It seems fairly clear that in writing the new foreign branch rules, Congress had in mind a single-owner foreign branch of a multinational corporation. No mention of anything other than that classic paradigm is made in the legislative history. The exclusion of foreign branch income from FDII is by its terms limited to foreign branches of U.S. corporations, because only U.S. corporations can benefit from FDII, although, as discussed later, the regulations do permit a domestic corporate partner of a partnership to claim FDII benefits under some circumstances. None of the many comment letters sent to the IRS regarding the foreign branch rules mention partnerships, except a passing reference in the comments of the American Petroleum Institute, which referred to the portion of the FTC regulations addressing a corporate partner's distributive share of partnership income attributable to the sale of a foreign branch.[46] Despite the absence of any mention of partnerships, commentators and the IRS appear to have assumed that when a partnership has business activities outside the United States, those activities constitute a foreign branch of the partnership, such that any U.S. partner has foreign branch income.

As explained below, it appears that the FTC regulations' approach to partnerships is based on the assumption that a partnership would conduct a trade or business solely outside the United States. That is, the FTC regulations do not seem to have considered the fact pattern in which a true multinational partnership, the partners of which might include both U.S. and non-U.S. persons, would conduct a trade or business both within and outside the United States. The issue in the base case, in which a partnership conducts only non-U.S. business activity, comes down to whether operating through a partnership should be viewed as the equivalent of operating through a wholly owned branch.

Because a partnership is not a taxpayer, any foreign branch that a partnership might be treated as owning would necessarily have a tax impact only on the partnership's U.S. partners. But if each partner — or at least each U.S. partner — of a partnership is treated as having a branch, by definition the branch would not be a branch at all, but instead would be a partnership. That is, we normally think of a tax-transparent entity as being either a branch or a partnership, but not both simultaneously. If two or more persons come together to conduct a business, that's a partnership. If only one person conducts business in an unincorporated form, that's a branch. If a partnership is treated as an aggregate of its partners, a branch of the partnership would be treated as a branch of each of its partners. But a branch by definition can have only one owner, leading back to the conclusion that it is meaningless and redundant to speak of a branch of a partnership.

[45] *See* letter from Synopsis to Treasury (Feb. 4, 2019).

[46] American Petroleum Institute letter to the IRS, at 7 (Feb. 5, 2019).

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Despite this, the FTC regulations appear purposefully drafted in a manner that permits the IRS to treat the offshore operations of a partnership as a branch. The regulations achieve this by adopting inconsistent approaches to a partnership. The FTC regulations first treat a partnership as an *entity* for purposes of finding a partnership-held, single-owner branch — that is, they treat the partnership as the branch owner. The regulations then treat a partnership as an *aggregate* to determine the level at which foreign branch income is earned. They provide that only the U.S. partners of a partnership, and not the partnership itself, can earn foreign branch income.

Adopting this approach required the IRS to add a prong to the definition of foreign branch income that is not found in the statute: The FTC regulations add to the statutory definition of foreign branch income a second prong that picks up a partner's distributive share of partnership income that is attributable to foreign branches held by the partnership. The preamble to the proposed FTC regulations justified this approach as follows:

> Section 904(d)(2)(J) limits foreign branch income to income of a United States person. Therefore, foreign persons (including CFCs) cannot have foreign branch category income. While a domestic partnership (or other pass-through entity) that is a United States person may earn income that is attributable to a foreign branch of such partnership, a distributive share of income earned by a domestic partnership cannot be foreign branch category income to foreign partners of the partnership. To avoid any conflict, the proposed regulations define foreign branch category income as the gross income of a United States person (other than a pass-through entity).
>
> Specifically, proposed section 1.904-4(f)(1)(i) provides that foreign branch category income means the gross income of a United States person (other than a pass-through entity) that is attributable to foreign branches held directly or indirectly through disregarded entities by the United States person. Foreign branch category income also includes a United States person's (other than a pass-through entity) distributive share of partnership income that is attributable to a foreign branch held by the partnership directly or indirectly through another partnership or other pass-through entity. Similar principles apply for income of any other type of pass-through entity that is attributable to a foreign branch. All the income described is aggregated in a single foreign branch category; there are not separate categories for each foreign branch. Conforming changes are made to the rules for allocating and apportioning partnership deductions and creditable foreign tax expenditures. See proposed sections 1.861-9(e)(9) and 1.904-6(b)(4)(ii).[47]

This passage seems to be saying that foreign branch income cannot be calculated at the partnership level because the income would then be allocated and attributed to foreign partners. Why such a scenario would present a problem is unclear; there are many types of income that a partnership can earn, the character of which is irrelevant to one or more classes of partners. This is like saying that a partnership cannot have unrelated debt-financed income described in section 514 because that category of income has relevance only to U.S. tax-exempt partners.

Devotees of the IRS's "domestic partnership blocker" pronouncements[48] may perceive a deeper motivation at work here. Those pronouncements addressed a fact pattern in which a domestic partnership having solely or mainly CFC partners in turn held a lower-tier foreign corporation. Because the IRS treated a domestic partnership as an entity and a U.S. shareholder for purposes of subpart F, the lower-tier foreign corporation was treated as a CFC, and the partnership itself had subpart F income from that CFC. However, that subpart F income, characterized as such at the partnership level, did not pass up as such to its CFC partners, because a CFC cannot have subpart F inclusions. The IRS

[47] 83 F.R. 63200, at Part II.B.2.i (Dec. 7, 2018).

[48] Notice 2010-41, 2010-22 IRB 715; and Notice 2009-7, 2009-3 IRB 312.

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was concerned that if it tried to correct this problem by treating the partnership as an aggregate, the foreign corporation that the partnership owned might no longer be a CFC — for example, when no ultimate U.S. owner owned 10 percent or more of the lower-tier foreign corporation through the partnership. (Why this would not have been the theoretically correct answer has always been unclear to me, and with the promulgation of the GILTI final regulations it appears that the IRS may be coming around to the same view.[49])

Accordingly, Notice 2010-41, 2010-22 IRB 715, adopted an inconsistent approach to the partnership. It treated the domestic partnership as an *entity* to make the partnership *the* unitary U.S. shareholder of the CFC that it owned, and it treated the domestic partnership as an *aggregate* only to the extent that the foreign corporation it owned would continue to be treated as a CFC by its partners.

Here, in the foreign branch income context, the IRS may have been concerned that because the partnership needs to be treated as the (single) foreign branch owner, it would be the person deemed to earn foreign branch income, and that this income might not be foreign branch income in the hands of *any* of its partners, including its domestic partners, on the grounds that a partner can be a partner or a branch owner, but not both. To force a U.S. partner into having foreign branch income, the FTC regulations skip over the partnership, purporting to allocate the foreign branch income directly to the partnership's U.S. partners, but not to it non-U.S. partners. It is as if the partnership did not exist at all — except to make its activities offshore a branch.

If the goal of the FTC regulations was to treat U.S. persons operating offshore through a partnership in the same manner they would be treated as if they operated offshore through a foreign branch, the approach taken by the regulations seems needlessly convoluted. It would have been easier to adopt standard aggregate theory and treat the partnership's non-U.S. activities as being conducted by each of its partners through a separate foreign branch, with each partner treated as a separate branch owner.

[49]*See* reg. section 1.951A-1(e).

One wonders whether the IRS had concerns about its authority to treat a partnership as a branch of each of its partners. Given the lack of any policy for the branch rules, a good argument can be made that the foreign branch rules simply should not apply to operations through partnerships at all, at least when a significant number of partners are unrelated to one another.

It seems possible that the approach to partnerships taken by the FTC regulations was motivated by a concern that whatever the policy of the foreign branch rules might be, a U.S. corporation should not be able to avoid the foreign branch rules by using a partnership rather than a branch. Partnerships between affiliated parties often raise this type of concern. If that is a concern, a rule could be written that treats a partnership as having a branch unless there is at least one non-de-minimis unrelated partner.[50]

For a multinational partnership, the application of the foreign branch income rules leads to unwarranted and unfair results and should be reconsidered. Attributional principles of U.S. tax law treat a partner of a partnership as actually doing what the partnership does and doing it wherever the partnership does it. This principle forms the basis for the IRS's current position on multinational service partnerships.[51] Each partner is treated as engaging in the activities that the partnership engages in, and as earning the income the partnership earns.[52]

If a multinational partnership conducts activities outside the United States, a U.S. partner is taxable on the foreign-source income from those activities regardless of whether that partner performs those activities herself. It is as if she were performing the activities directly through the "agency" of her partners.

The only definition of foreign branch contained in the code or regulations — the one under section 367(a)(3)(C), mentioned earlier — focuses on the presence of employees or officers of the U.S. branch owner. Although partnerships can certainly *have* employees, they do not *need*

[50]This approach was recently featured in regulations under section 721(c). *See* reg. section 1.721(c)-1T et seq.

[51]*See* Kimberly S. Blanchard, "The Unresolved Tax Status of Multinational Service Partnerships and Their Partners," 56 *Tax Law*. 779 (2003).

[52]*See*, *e.g.*, section 875.

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employees to conduct activities in faraway places, unlike corporations or individuals; their activities can be performed by the local partners themselves. Partnerships, of course, do not have officers in the traditional sense of that word.

Application of this fundamental attributional principle leads to the conclusion that a multinational partnership, at least, should not be treated as having a foreign branch. Because each partner is engaged directly in the business of the partnership, there is no single branch owner. Any partnership income that might be said to be booked outside the United States is treated as earned directly by all the partners in all countries where the partnership conducts activities, not through a branch.[53] Treating the partnership's foreign income as foreign branch income is inconsistent with the notion that each partner is taxable in all countries where the partnership does business. It is also pointless.

Another problem with the notion that a partnership can have a branch is that a partnership does not have a home office. The FTC regulations make clear that to have a branch, there must be a home office. But a home office requires a residence, and a partnership, because it is not a taxpayer, does not have a taxable residence, at least in the sense used in ordinary parlance. A partnership may be formed under the laws of one country, have partners from multiple other countries, and do business in multiple countries; there is no rule prescribing what the residence of such a partnership is. Moreover, U.S. tax law recognizes the concept of a deemed partnership. Such a partnership may conduct business within and outside the United States; it may have both U.S. and non-U.S. partners, which may be corporations or individuals. Such a partnership cannot be labeled as "domestic" or "foreign," except arbitrarily. If a single deemed partnership takes the form of separate partnerships organized in different countries, calling any of the constituent entities a branch of another makes no sense given that U.S. tax law would view them all together as a single deemed partnership.

Given these and other reasons why it seems to make no sense to posit a foreign branch owned through a multinational partnership, it is worth asking why the IRS went to so much trouble to achieve that result. It seems likely that the IRS got stuck on the statutory use of the term "qualified business unit," which consists of any set of activities that maintains separate books and records.[54] Whatever it might mean for a partnership to have a set of books and records separate from those of the home office, the books and records concept does not fit well with the realities of multinational partnerships. If the books and records concept is applied functionally with a view to its purpose, a single partnership operating within and outside the United States cannot, by definition, have two separate sets of books and records for tax purposes; it can have only one. As has been noted, the definition of a QBU under the FX regulations, from whence the term was taken, includes a partnership. The FX regulations use the partnership's books and records to determine the required foreign currency translation adjustments. In contrast, the FTC regulations do not treat a partnership as a QBU. Rather, the FTC regulations treat only the activities of a partnership outside the United States as a QBU, and thus treat only the separate books and records of this deemed QBU as a foreign branch of the partnership as foreign branch owner.[55] The FTC regulations are thus wholly at odds with the FX regulations, both in terms of whose books and records matter and in terms of what is and is not a QBU.

It appears from the preamble to the final FTC regulations that the IRS may have assumed that a partnership having a foreign branch would never conduct operations in the United States. That is, the drafters appear to have assumed that a partnership operating outside the United States would be a partnership of two or more corporations or other taxpayers that did not

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[53] This likely explains why multinational partnerships do not report foreign currency gain or loss on cross-border funds flows, because all funds of the partnership are treated as belonging to all partners pro rata as those amounts are earned. Even though a partnership is a per se QBU of a partner under the FX regulations, most multinational partnerships do not apply the rules applicable to "remittances." This position appears to be based on the same theory propounded herein, which is that it is meaningless to speak of a remittance between a QBU and a home office when all partners are subject to tax currently on a worldwide basis.

[54] Reg. section 1.989(a)-1(b)(2)(i)(C).

[55] *See* reg. section 1.904-4(f)(3)(vii)(A) (referring only to selected portions of the section 989 regulations); and reg. section 1.904-4(f)(3)(vii)(C).

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engage in activity in the United States through the same partnership. Evidence for this is found in the preamble's explanation of why the FTC regulations dispense with the separate books and records rule in the context of partnerships. The preamble states:

> A foreign branch exists when a partnership records on a single set of books income from a trade or business conducted outside the United States *and also income earned from unrelated investment activity*. The proposed regulations deem the partnership to maintain a separate set of books and records with respect to the trade or business conducted outside the United States. [Emphasis added.]

Note that the second line of activity in this example is an unrelated investment activity, not the partnership's trade or business in the United States. This is likely because the drafter did not imagine that a partnership would conduct a trade or business in more than one country.

Note also that the FTC regulations treat any partnership, domestic or foreign, as an entity for purposes of finding a single owner of a branch. This approach deviates from the foreign branch definition in the section 367(a)(3)(C) regulations, which treats only a domestic partnership as having a branch. An obvious problem is that treating only a domestic partnership as a person would mean that the FTC regulations would apply differently to domestic and foreign partnerships. Because partnerships are not themselves taxpayers, this approach leads to arbitrary outcomes. This likely explains why the FTC regulations did not adopt that approach.

The FDII regulations create a distinction between a domestic and foreign partnership, but only in determining whether a third U.S. person has qualifying income. For other purposes, the FDII regulations treat a partnership in a manner similar to the FTC regulations, with domestic and foreign partnerships treated consistently. It is important to note that the FDII regulations deal simultaneously with two distinct issues: One is whether a partnership should be treated as a person, and therefore as an entity, in determining whether a sale to a partnership is a sale to a foreign person; and the second is whether a partnership can be said to sell property, or to provide services, through a foreign branch. It appears that the drafter of the regulation in question believed that the branch issue would be presented only if a partnership is treated as a person.

The relevant regulation, prop. reg. section 1.250(b)-3(g), provides in full as follows:

> 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 [foreign-derived deduction-eligible income] 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 section 1.250(b)-6(b)(1)). [Emphasis added.]

This statement is illustrated by two examples in the proposed regulations. In each example, a U.S. corporation (DC) is a partner of a partnership. In each example, there are two sales that potentially qualify for the FDII deduction: one made by DC to the partnership, and the second made by the partnership to a foreign third party. In the first example, the partnership is a foreign partnership that makes its sale through what is stated to be a foreign branch. In the second example, the partnership is a domestic partnership and has no foreign branch.

The results in the first example are that the sale by DC to the partnership qualifies as a sale to a foreign person because the partnership is foreign,[56] but the sale by the foreign partnership does not qualify because it is made through a foreign branch. The results in the second example are that the sale to the partnership does not qualify because the partnership is not a foreign person, but 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

[56] The FDII regulations treat a disregarded entity wholly owned by a U.S. person — that is, a foreign branch — as not being a foreign person for this purpose. It is hard to explain why a sale to a foreign branch of a U.S. person does not qualify for FDII benefits, whereas a sale to a foreign partnership (all whose partners may be U.S. persons) does qualify.

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through a foreign branch. Perhaps the drafter assumed that a foreign partnership could act only through a foreign branch, although there does not seem to be any reason to suppose that is true. Any rationale based on the assumption that a foreign partnership could never have FDII attributable to its domestic corporate partners is impossible to reconcile with other provisions in the FDII regulations treating all partnerships as an aggregate for this purpose.

Whatever the reason for the FTC regulations' insistence on finding foreign branches of partnerships, it will result in multinational partnerships bearing the brunt of the cost of Congress's decision to adopt foreign branch rules. Before the TCJA, most of the foreign-source income and taxes of a U.S. partner of an operating partnership were placed in the general limitation basket. Now, assuming the approach of the FTC regulations remains as proposed, most will be in the foreign branch basket. This will mean that if the partner has any foreign-source income in the general limitation basket, there will be no cross-crediting of the taxes in the two baskets. General basket foreign-source income might be earned when a U.S. partner spends time working in a foreign country in which the partnership has no branch, even if the work is done on partnership business. For a services partnership, one could interpret the FTC regulations such that if a U.S. partner works out of a branch office, the income allocable to that work falls into the general basket on the grounds that it is not earned by and booked to the "foreign branch."

This is an absurd result. A partner in this situation might take the position that its income is attributable to a directly owned branch of which it is the owner, having nothing to do with the partnership. Under that view, the income would be aggregated with the partner's share of the foreign branch income of the partnership. If it seems strange to say that a partner working out of a foreign office has a directly owned branch, it is no stranger than saying that a partnership's directly conducted foreign activities give rise to foreign branch income to a U.S. partner.

Unlike a domestic corporation, a domestic partner of a partnership cannot simply avoid foreign branch income by domesticating the activities of the foreign branch. That is because the foreign branch consists simply of the foreign activities of the partnership, which by definition cannot be done in the United States. Also, a partnership by definition has other partners, who may be unrelated, who may be foreign, and who may have no interest in bringing the partnership's foreign activities back to the United States. As a practical matter, neither the partner nor the partnership can check the box to treat the foreign branch as a CFC, because the "branch" does not take the form of an entity. And in any case, if the partnership has many partners from different countries, it is highly unlikely that any foreign corporation it owned would be a CFC. Multinational partnerships do not operate through corporations; they are partnerships operating as partnerships in multiple countries.

The IRS's decision to treat the international activities of partnerships as branches leads to the ironic result that the new foreign branch provisions apply primarily to partnerships, and in particular to multinational partnerships, rather than multinational corporations, as Congress surely envisioned. Corporations rarely operate outside the United States through operating branches. Partnerships, if they operate directly outside the United States, have no choice but to conduct their activities through what the IRS's approach would apparently treat as a branch.

There does not appear to be any defensible policy for treating foreign branches, or foreign branch income, as evil. But if they are indeed evil, the concepts should be carefully defined and kept narrow. In particular, there is no defensible policy for treating multinational partnerships as having foreign branches. The foreign branch rules should be limited by applying them only to single-owner branches of U.S. corporations, the intended targets of the rules. U.S. corporations do not typically operate in branch form, except to the extent that branches of CFCs are used, or a branch owns only stock of CFCs. Because foreign branch income does not include passive income, these common structures will be largely unaffected. Unless the rules are limited to branches of U.S. corporations, the main impact of the foreign branch rules will be on operating partnerships, which do not appear to have been considered by Congress at all and which have no choice but to operate in what the FTC regulations label "branch" form. ■

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