The Branch Basket Takes Final Shape

By William Skinner

Introduction

Among the many international changes wrought by the TCJA was the addition of a separate Code Sec. 904(d) basket for income attributable to one or more branches of a U.S. person. The final foreign tax credit regulations issued in December 2019 (hereafter, the "*Final Regulations*")[1] provide new and definitive guidance on the branch basket. Attribution of income to a foreign branch is a new, but not unprecedented problem in U.S. international tax. Previously, many U.S. outbound taxpayers engaged in similar exercises for purposes of the dual consolidated loss ("DCL") rules of Code Sec. 1503(d), currency translation rules under Code Sec. 987, and Code Sec. 367 branch loss recapture, among other purposes. The attribution of income to the foreign branch category under Code Sec. 904 will follow a different and equally complex approach to Code Sec. 987. In this regard, the Final Regulations largely follow the 2018 proposed regulations[2] in their treatment of disregarded transactions between the branch and its sole owner, or between branches of the same U.S. taxpayer, with limited relief for certain transfers of IP. To limit cross-crediting, the Final Regulations also exclude not only passive income, but also intercompany financing and other low-taxed income from the branch basket.

Prior to the TCJA, branches with significant foreign tax expense were the exception not the rule for most U.S. multinational corporations. However, after the TCJA, more U.S. corporations have checked the box on their foreign subsidiaries for several reasons, including managing the base erosion anti-abuse tax ("BEAT") on outbound payments or facilitating the movement of IP back to the United States. Corporate taxpayers may also find themselves with foreign branches by having "checked the box" on a newly acquired foreign target company following a qualified stock purchase with a Code Sec. 338(g) election. In addition, foreign operations of partnerships, S corporations and other passthrough entities will often be organized as branches to enable U.S. individual owners to claim direct foreign tax credits under Code Sec. 901. These taxpayers will need to wrestle with computations of branch basket income.

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Identification of a Foreign Branch

Code Sec. 904(d)(2)(J) defines a "foreign branch" as any "qualified business unit" of a U.S. person as defined under the foreign currency rules—*i.e.*, Code Sec. 989. Accordingly, a controlled foreign corporation ("CFC") or other foreign entity cannot have income in the branch basket. As to the U.S. taxpayer, the branch basket generally is computed on an aggregate basis across all "branches,"[3] so that cross crediting of income and taxes of different branches is generally possible. While the branch basket is computed on an aggregate basis, a branch that provides goods or services to its U.S. owner may be allocated U.S. source income under the disregarded payment rules that are discussed below, and as a result, the U.S. owner may need to rely on an income tax treaty to claim foreign tax credits. As discussed in more detail below, the treaty basket is applied on a per country basis.[4]

Following the Proposed Regulations, the Final Regulations require that a "foreign branch" constitute a trade or business outside of the United States.[5] Thus, disregarded entities involved solely in financing or equity holding activities may not constitute a "foreign branch" for Code Sec. 904 purposes.[6] However, activities of a taxpayer that constitute a permanent establishment under an applicable income tax treaty are treated as a foreign branch.[7] The mere presence of a disregarded entity with separate books and records does not give rise to a foreign branch for purposes of Code Sec. 904. Also, a foreign trade or business of a corporation, partnership, estate or trust will be treated as a branch even if it does not maintain a separate set of books and records.[8]

In the case of a foreign branch held through a passthrough entity, the Final Regulations adopt a flat approach. In the case of a tiered set of disregarded entities, each disregarded entity's foreign branch is treated as if it were owned directly by the ultimate U.S. owner.[9] Branch category income also includes a distributive share of income from a partnership or other passthrough entity from its foreign branches.[10] Thus, U.S. individuals who indirectly own foreign entities through a passthrough structure will be subject to the separate Code Sec. 904(d) category for branch income.

Attribution of Income to a Branch

As under the Proposed Regulations, the starting point for computing the gross income attributable to a foreign branch is the gross income reflected on its books and records, as adjusted to conform to U.S. tax principles.[11] Under this basic rule, a taxpayer with a branch that operates as a standalone, fully integrated business can readily compute branch income. Life, however, is rarely so simple. The existence of intercompany transactions between branches or between the branch and its owner will give rise to major complexity, as discussed below.

Foreign branches of the taxpayer are likely to be high-taxed entities. Many taxpayers may find themselves in an excess credit position in the branch basket and seek to increase their Code Sec. 904 limitation on branch income. Although the statute only excludes "passive basket income" from the branch basket,[12] the Final Regulations expand this exclusion to other income that might be a source of low-taxed income in a foreign branch. Adjustments are made to remove income from investment-type activities, such as income from the branch's ownership of stock.[13] Under an anti-abuse rule for income booked in (or outside) a branch with a principal purpose of reducing U.S. tax, interest income received from related persons is also excluded from branch income unless it falls within the financial services basket for Code Sec. 904. This would seem aggressive rulemaking to deem any location of financing transactions abusive. For example, if the taxpayer chooses to locate an intercompany loan from a CFC in a branch, why shouldn't this reasonable business and booking practice be respected? Due to look-through rules under Code Sec. 904(d) and Code Sec. 954(c)(6), taxpayers are generally able to cross credit low-taxed interest income against high-taxed income in the general or global intangible low-taxed income ("GILTI") baskets. There would not seem to be a principled reason to prohibit financing income from being attributed to the branch basket if it is earned in a foreign branch of the taxpayer. However, under the Final Regulations, locating an intercompany receivable in a foreign branch would be *per se* an improper booking practice.[14]

In addition, the Final Regulations like the Proposed Regulations do not "push down" gain from the sale of an interest in a foreign disregarded entity (FDE) (or partnership) to the branch basket, unless the sale of the interest is made by the branch in the ordinary course of business.[15] The sale is deemed to occur in the ordinary course of business only if the transferred branch and the branch making the sale are engaged in the same or a related trade or business.[16] Such gain would otherwise typically default to the general

basket. The source of that gain would depend on the residency of the seller and other applicable rules of Code Sec. 865.

One question that has yet to be addressed in final regulations is whether a U.S. taxpayer's gain on the sale of a FDE is eligible for foreign derived intangible income ("FDII") benefits, if the purchaser is a foreign person. FDII does not include any foreign branch income,[17] and if gain on a sale of a disregarded entity were pushed down to the branch category for Code Sec. 904 purposes, such gain would be barred from FDII benefits. (However, in such a case, low-taxed gain on the sale could absorb branch basket FTC carryovers.) The position set out in the Final Regulations described above would seem to require that gain on the sale of a disregarded entity be treated as U.S.-related income that is generated by the home office. Despite this now final conclusion for Code Sec. 904 purposes, the FDII proposed regulations took the position that, *for FDII purposes only*, the gain on the sale of a FDE is attributable to the branch and excluded from FDII.[18] However, under Code Sec. 250, the exclusion for branch income specifically cross-references branch income as defined in Code Sec. 904(d)(2)(J). It is untenable for the FDII rules' cross reference to Code Sec. 904(d)(2)(J) to be interpreted differently from Code Sec. 904(d)(2)(J) itself.

Branch Accounting Rules for Disregarded Payments

Transfers of IP Involving a Branch

One much criticized aspect of the Proposed Regulations was the application of Code Sec. 367(d) and Code Sec. 482 principles to transfers of intangible property between a branch and its owner, including contributions and distributions. Particularly in the case of domestication of IP to the United States, this rule was criticized for preventing taxpayers from obtaining the benefits of FDII intended by Congress. For example, assume a U.S. corporation checked the box to convert a CFC IP owner to a disregarded entity in an inbound Code Sec. 332 liquidation or F reorganization, and then had the disregarded entity distribute IP to the U.S. taxpayer in a now disregarded transaction. Under general principles, and but for the Proposed Regulations, the income from the exploitation of the IP would be in the general basket and potentially eligible for FDII. The liquidation or reorganization would be tax-free, giving the U.S. taxpayer a carryover basis in the IP assets and mitigating GILTI or BEAT issues.[19] Under the branch basket Proposed Regulations, the distribution of the IP by the branch to the U.S. taxpayer seemingly would have given rise to a deemed sale of IP for royalties contingent on use for foreign tax credit basket purposes. The allocation of such income to the branch basket also would reduce deduction eligible income for FDII purposes.[20]

The Final Regulations retain the rule for transfers of IP between the owner and its branch, but add two helpful exceptions. First, the Final Regulations provide that IP transfers either to or from a branch before December 7, 2018, are not subject to the IP transfer rule.[21] This exception is helpful and warranted to prevent a taxpayer that domesticated its IP from finding itself stuck in the lobster pot of the United States, while also being deprived of its FDII benefits. Second, for transactions after December 7, 2018, an exception is provided where ownership of the IP by the U.S. owner or the branch is merely "transitory" before it is transferred to the other party, and such transferor does not own, develop or exploit the IP other than in the ordinary course of business during that transitory period.[22] Neither the regulations nor the Preamble defines the term "transitory." However, the Preamble explains that the rule is intended to apply where the branch (or its owner) transfers IP that was not originally developed by it.

Disregarded Payments for Services

The Final Regulations retain and expand on the rules of the Proposed Regulations for disregarded service payments between branches or between the branch owner and its branch. In the case of a disregarded payment, gross income (U.S. or foreign) is allocated to or from the branch based on the way the disregarded expense would have been allocated under Code Sec. 861 if the payment had been made to a CFC. Particularly in the case of a branch that provides the U.S. parent with services that benefit the taxpayer's overall business, such as G&A support or R&D, this allocation rule may result in the branch basket being allocated significant amounts of U.S. source income. Even where the branch performs services entirely outside of the United States, the U.S. sourcing of the resulting income stream may preclude the taxpayer from crediting the branch's taxes.

Example 3 in the Final Regulations illustrates how the source of branch basket income is computed in the

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case of a disregarded service fee that specifically benefits foreign operations. In Example 3, the U.S. taxpayer earns $1,000 of general category income, $600 U.S. and $400 foreign. It pays its FDE a service fee of $400 that is allocated to general category income.[23] However, the Example assumes that the service fee is apportioned *entirely* to foreign income, presumably because the branch employees support the foreign revenue directly. The branch basket is allocated $400 of foreign source income.

What if the facts of Example 3 were changed to make the branch's services those that benefit the U.S. taxpayer's overall business? The expense allocation in that case might be based on overall gross income, and the branch might end up earning $240 of U.S. source income. The branch basket Code Sec. 904 limitation could be significantly limited, even before interest expense, R&D expense, and stewardship expenses are allocated to the branch basket. Analysis of the factual relationship test of Reg. §1.861-8 in the case of these branch allocations and potential restructuring solutions will be important.

Following tax reform, more taxpayers will find themselves in foreign branch structures and computing a separate limitation on foreign branch category income will be no small task.

Because of this push-down rule, many more taxpayers will need to apply tax treaties, where available, to re-source income and increase the Code Sec. 904 limitation. The Final Regulations also include guidance on the scope of treaty-based re-sourcing and the definition of separate items under Code Sec. 904(d)(6). Treaty-based re-sourcing is applied separately to each treaty under which the taxpayer re-sources its income.[24] Moreover, separate items of income under Code Sec. 904, such as passive basket income, are separately basketed under each per country limit. In this scenario, foreign tax credits and limitation on high- and low-taxed branches may not average out.

In one change from the Proposed Regulations, the Final Regulations provide that an allocation of gross income with respect to an R&D service is made by applying the "principles" of Reg. §1.861-17, without regard to exclusive apportionment to the geographic location of R&D. There are no examples in the Final Regulations as to how to allocate gross income with respect to R&D services performed by or for a foreign branch.

However, the rule turning off exclusive apportionment would seem to be taxpayer favorable, at least in the case of payments made by the U.S. owner to its foreign branch. For example, assume that U.S. Parent conducts business globally and earns general category income, which, based on sales, is 70% U.S. source income and 30% foreign source income. U.S. Parent converts a foreign subsidiary engaged in contract R&D to a disregarded entity. Under the "principles of Treas Reg. §1.861-17," contract R&D would be allocated based on the sales method to 85% U.S. source and 15% foreign source. The Final Regulations' removal of exclusive apportionment results in 70% U.S. source income being allocated to the branch for Code Sec. 904 purposes, although again, the general allocation of U.S. source income to the R&D branch may create limitation problems for the taxpayer.

Disregarded Transfers of Property

In a significant elaboration on the disregarded payments rules from the Proposed Regulations, the Final Regulations provide detailed rules to attribute income to/from the branch in the case of property transactions. Unlike in the case of services or royalties, where gross income is immediately re-allocated, the property transaction rules wait until the property is sold in a regarded transaction outside of the branch to allocate income between the branch and its owner. At that time, the income is attributed between the branch and its owner to produce results like those that would have applied if the branch were a CFC.

The operation of the property transfer rules is easiest to see in the sale of inventory between the branch owner and the branch. In Example 9, the U.S. owner manufactures tangible property in the United States and sells the property to FDE for $1,500 during year 1. In the same year, FDE resells the goods to a third party for $1,700. The U.S. tax return reflects COGS of $1,300, of which $1,200 were incurred by the branch owner and $100 were incurred by the branch. On the branch's sale of property, FDE recognizes $450 of gross income that is U.S. source in its entirety under new Code Sec. 863(b).

To determine the income allocated to the branch, the U.S. taxpayer attributes gross income between the

branch and the owner to achieve results similar to those that would arise if FDE were a CFC. Namely, the U.S. branch owner records gross income of $300 and the branch records $150. The branch's $150 of gross income remains U.S. source by the application of Code Sec. 863(b) to the combined item of income of the owner and FDE.

In the case of a branch transfer of non-inventory property, the Final Regulations, as noted above, adopt a deferred accounting system like Reg. §1.1502-13. In Example 4, the U.S. owner sells non-depreciable property, which has a basis of $200, to the branch for $500. The branch uses the property in its trade or business and then in a later year sells the property to a third party for $600. For attributing income to the branch and its owner, the $400 of regarded gain is split between the owner and the branch to allocate to the branch owner the $300 it would have earned had the branch instead been a CFC.

This allocation of gross income has no effect on the source of income earned by the branch. In the example, the income is treated as foreign source under Code Sec. 865(e)(1). The income continues to be sourced by reference to its source in the hands of the branch.

Example 5 illustrates how these inter-branch accounting rules apply in the case of depreciable property. Specifically, the example assumes that the branch owner sells a depreciable asset with a $200 basis to the branch for $500. The branch then depreciates the asset, as it is used to generate foreign branch and passive category income. For U.S. tax purposes, the asset gives rise to $20 of depreciation a year. However, if the branch transfer had been regarded, the branch would have been entitled to $50 of depreciation annually. As under Reg. §1.1502-13, the additional depreciation of $30 that would have been generated by a regarded sale "burns off" as the branch depreciates the asset under its method of accounting. The $30 gives rise to an allocation of $30 of gross income from the branch to its owner, to reflect the tax deduction that is attributable to the sale price of the asset to the branch.

Then, on a sale of the depreciable asset, the remaining disregarded gain of $270 (*i.e.*, the original disregarded gain of $300, less than $30 taken into account through prior year depreciation, is taken into account.

Unlike deferred intercompany transactions under Reg. §1.1502-13, inter-branch transactions may have an immediate impact on the taxpayer on a year-by-year basis as the property is depreciated or amortized. To the extent that the taxpayer claims a foreign tax credit, the above rules will need to be applied annually and tracked. Moreover, taxpayers with foreign disregarded entities are already accustomed to applying other international tax rules, such as the DCL rules under Code Sec. 1503(d) and foreign currency translation rules of Code Sec. 987. The DCL rules generally do not give effect to disregarded transactions.[25] The Code Sec. 987 branch translation rules reconstruct disregarded payments as remittances and contributions between the branch and its owner.[26] Now, for Code Sec. 904 purposes, the branch owner and branch must compute the U.S. taxable income as if disregarded transactions were regarded transactions with a CFC. Taxpayers may find the preparation and filing of Form 8858 and Form 1116/1118 to reflect branch category income to be a whole new adventure.

Netting/Ordering for Multiple Payments

Acknowledging that a FDE may be party to multiple disregarded transactions, the Final Regulations provide ordering rules for which disregarded transactions are taken into account first.[27] Specifically, for computing income attributable to a foreign branch, inter-branch payments are taken into account first, followed by payments from a branch to its owner, and lastly, by payments from a foreign branch owner to a foreign branch.[28] In allocating income to a foreign branch owner, income is first allocated to match payments from the owner to the foreign branch, followed by inter-branch payments, and lastly, by payments from the branch to the owner.[29]

Notably, offsetting payments between *a branch and its owner are not netted*. Instead each payment is allocated against the owner's or branch's gross income to which it relates for purposes of applying Code Sec. 904. In many cases, this gross-to-gross allocation will shift foreign income from the branch to the general category, exacerbating a taxpayer's branch category Code Sec. 904 limitation. For example, Example 10 illustrates a case where the U.S. owner and the branch each provide services to the other related to the other's third-party service agreement. The owner's U.S. office records $5,000 of U.S. source, general basket income from performing services for a third party. The branch earns $3,400 of foreign source services income from a separate third-party agreement that is recorded on FDE's books and records. In addition, the U.S. office and FDE perform $300 of services for each other. The disregarded payment from FDE to the parent is taken into account first and results in $300 of the branch's foreign source income being reattributed from the branch basket to the general basket. Next, $300 of the

parent's U.S. source gross income is reattributed to the branch basket. All else equal, these crossing allocations of U.S. and foreign source gross income may impair the taxpayer's foreign tax credit limitation.[30]

Conclusion

Following tax reform, more taxpayers will find themselves in foreign branch structures and computing a separate limitation on foreign branch category income will be no small task. Given the likelihood for branches to be high taxed, claiming foreign tax credits will be important. Such taxpayers will now find themselves grappling with the byzantine branch accounting rules to properly comply with the foreign tax credit limitation. At the same time, such taxpayers will often have to maintain parallel calculations for Code Sec. 987, DCL and branch loss recapture purposes under Code Sec. 91. May the force be with you!

ENDNOTES

1 T.D. 9882 (Dec. 16, 2019).
2 Notice of Proposed Rulemaking REG-105600-18 (Dec. 7, 2018) (hereafter, the "*Proposed Regulations*").
3 *See* Code Sec. 904(d)(2)(J)(i) (defining the category as the income attributable to "*1 or more* qualified business units … in *1 or more* foreign countries") (emphasis added).
4 Reg. §1.904-4(k).
5 Reg. §1.904-4(f)(3)(vii)(A).
6 *See* Reg. §1.987-1(b)(7), Example 1.
7 Reg. §1.904-4(f)(3)(vii)(B).
8 Reg. §1.904-4(f)(3)(vii)(C). In the case of a foreign branch that does not maintain separate books and records, the taxpayer would have to reconstruct books and records of the foreign branch under the principles of the ECI rules. *See id*. (directing the taxpayer to apply Reg. §1.1503(d)-5/(c)).
9 Reg. §1.904-4(f)(3)(viii).
10 Reg. §1.904-4(f)(1)(i)(B).
11 Reg. §1.904-4(f)(2)(i).
12 Code Sec. 904(d)(2)(J)(ii).
13 Reg. §1.904-4(f)(2)(iii)(A).
14 An exception to this rule is provided for a branch that is a financial services entity, in recognition of the fact that interest in the hands of such an entity is business income. *See* Reg. §1.904-4(f)(2)(v).
15 Reg. §1.904-4(f)(2)(iv). Compare the approach taken for determining the Code Sec. 960 category of a CFC's taxes on a sale of a disregarded entity, whereby taxes imposed on the sale of a foreign disregarded entity are characterized by reference to the assets held by the disregarded entity. *See* Proposed Reg. §1.861-20(g)(12), Example 11.
16 Reg. §1.904-4(f)(2)(iv)(B)(1) & (2).
17 Code Sec. 250(b)(3)(A)(i)(VI).
18 Proposed Reg. §1.250(b)-1(c)(11).
19 Such an inbound liquidation or reorganization generally would be tax-free under Code Sec. 367(b), except to the extent that the CFCs has had an "all E&P amount" that was not eligible for Code Sec. 245A. Under the newly final BEAT regulations, such a Code Sec. 332 liquidation does not itself give rise to a base erosion payment.
20 *See* Code Sec. 250(b)(3)(A)(i)(VI).
21 Reg. §1.904-4(f)(2)(vi)(D)(2).
22 Reg. §1.904-4(f)(2)(vi)(D)(3).
23 Note that the amount of the disregarded payment in Example 3 includes the markup on the disregarded payment, as determined under Code Sec. 482 principles. Reg. §1.904-4(f)(2)(vi)(E). This is unlike the rules of Code Sec. 987, where any profit component on a disregarded transaction is treated as a contribution or remittance from the branch.
24 *See* Reg. §1.904-4(k)(1).
25 *See* Reg. §1.1503(d)-5.
26 *See* Reg. §1.987-5.
27 Reg. §1.904-4(f)(2)(vi)(F).
28 *Id.*
29 *Id.*
30 Interestingly, Example 10 assumes that the U.S. owner's income is entirely U.S. source under Code Sec. 861(a)(3), even though the FDE's foreign personnel contribute to performance of services to the U.S. owner's customers. Likewise, the branch income is assumed to be entirely foreign source even though the U.S. owner performs services.

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