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Brian Abbey is a managing director in the international tax services practice of Global Tax Management Inc. in Pittsburgh.

In this article, the author examines the mechanics of the U.S. foreign branch regulations as applied to the separate category of income.

The final foreign tax credit regulations (T.D. 9882) addressing sections 861, 904, 905, and 960 are in most respects similar to what was proposed last year (REG-105600-18). Widespread global intangible low-taxed income relief did not come to fruition. While the proposed regulations to exclude GILTI from research and development apportionment are taxpayer friendly, subjecting stewardship to GILTI, which likely involves smaller dollar amounts, is not.[1]

The final base erosion and antiabuse tax regulations (T.D. 9885) are also similar to the proposed regulations (REG-104259-18), and do not contain an exception for payments that are included in income as subpart F or tested income. The proposed BEAT regulations include relief to allow for the permanent waiving of deductible payments,[2] but that waiver might not be ideal because payments to a controlled foreign corporation can still create subpart F income or GILTI.

Enter the foreign branch category of income. Taxpayers could still be inclined — perhaps more so — to consider using first-tier branches to reduce or eliminate BEAT or convert lost excess GILTI credits to excess branch basket credits. That decision is not without a host of other considerations: Section 367 issues may arise, and the branch basket may be chronically excess credit because of the U.S. rate of 21 percent. Regardless, the branch basket should be evaluated as an alternative and modeled accordingly.

This article examines some of the mechanics of the foreign branch regulations and how they apply to the separate category of income.

I. Foreign Branch Definition

A. In General

The Tax Cuts and Jobs Act amended section 904(d) to provide a new foreign branch income category for the FTC. Foreign branch income is the business profit, excluding passive income, of a U.S. person attributable to qualified business units (QBU) as defined in section 989(a). A permanent establishment under a tax treaty between the United States and a foreign country is presumed to be a QBU for this purpose. Further, a branch with just disregarded payments is still a branch for section 904 purposes even if it is not a QBU for section 989 purposes, creating a dichotomy between those sections.

B. Books and Records

Profits are attributed to a foreign branch based on the branch's books and records. Here the final regulations add clarification to the proposed regulations by providing that the principles of the section 1503 dual consolidated loss regulations apply for the attribution. The section 1503

[1] *See generally* prop. Treas. reg. section 1.861-8 and 1.861-17.

[2] *See* prop. Treas. reg. section 1.59A-3(c)(6).

regulations rely heavily on section 864(c) and related regulations that provide the mechanics for determining what income is effectively connected to a U.S. trade or business. For the branch basket, the determination is what income resides at the branch versus at the foreign branch owner. With a foreign disregarded entity (FDE), the determination of what income is attributable to a branch should be relatively straightforward. However, for a true branch it may be necessary to attribute income to the branch using the asset test or material factor test of section 864(c). While the apportionment of income for a branch is not unique under the code or proposed regulations, the final regulations provide guidance in constructing books and records under section 904.

C. Disregarded Payments

The treatment of disregarded payments[3] in the final regulations is consistent with the proposed regulations. The concept of reconstructing section 904 categories through redetermining income because of disregarded payments is still in place.[4] That is where much of the complexity in the foreign branch category portion of the section 904 regulations lies. Expanding on that complexity is the necessary, albeit complicated, guidance on intercompany property transfers and disregarded payments between branches. That leaves companies in the position of balancing any benefits of making check-the-box elections for whatever reason with possibly applying the guidance in Treas. reg. section 1.1503(d)-5(c) to construct a branch's books, or redetermining foreign branch income to account for disregarded transactions.

1. Simple Example

As a reminder of how the reconstruction works in its simplest form, assume the following: A U.S. company (USP) owns 100 percent of an FDE that meets the definition of a foreign branch. For U.S. tax purposes, USP has $1,000 of U.S.-source income and $500 of foreign branch category income attributable to FDE. Also, FDE provides back-office support for USP and receives $10 from USP for those services.

The general rule provides that if the disregarded payment is allocable to the foreign branch (or branch owner, as the case may be), then the branch income is adjusted upward (or downward), and the branch owner's income is adjusted downward (or upward). Specifically, the income is redetermined by looking to see what income the deduction, if regarded, would reduce in applying the principles of Treas. reg. section 1.861-8-14T and -17. On the facts above, the $10 would reduce USP's U.S.-source general category income if the payment was regarded. Accordingly, USP must redetermine its total $1,500 of income by increasing the foreign branch category to $510 and decreasing the total U.S. income to $990. Of the $510 income attributable to the branch, $10 is U.S. source because the redetermination changes only the section 904 category; it does not change the total amount, character, or source of the U.S. person's gross income.

It is easy to envision the above scenario as companies grapple with BEAT and seek to structure themselves out of it. For example, the $10 could be payment to a shared service center or for contract R&D. Unfortunately, it is likely that the $10 payment may give rise to foreign tax, and because $10 of the branch income is U.S. source, it might be impossible to credit that tax in the United States. The BEAT might decrease in this scenario, but total worldwide tax could increase if a portion of the foreign taxes are not creditable.[5] Before checking the box, it is necessary to examine that possibility against any BEAT savings.

2. Disregarded Payments Between Branches

The final regulations also provide a new example on how to apply the disregarded payment provisions on multiple payments, including payments between two FDEs. Similar to when the U.S. parent pays its branch or the branch pays the U.S. parent, the income is categorized at the recipient level based on the income the payment would reduce at the payer level if the payment were regarded. There is also an ordering

[3] Disregarded payment is a defined term. *See* Treas. reg. section 1.904-4(f)(3)(v).

[4] There are some exceptions to that requirement, with interest payments being the biggest.

[5] That statement assumes that before any check-the-box election, USP could credit some or all of the taxes associated with the $10.

rule if there are payments between branches and the U.S. parent. In that scenario, the payment between branches is redetermined before the disregarded payment with the parent.

3. Disregarded Property Transactions

The real complexity of the disregarded transaction rules lies in the treatment of disregarded property transactions. That concept, which is not new, was in the proposed regulations; however, the final regs greatly expand the mechanics by adding a series of definitions and examples. Generally, disregarded payments for non-inventory property transactions are allocable to the same income category as regarded gain on the property, up to the adjusted disregarded gain. Adjusted disregarded gain is the lesser of the adjusted disregarded basis of the property less the regarded adjusted basis at the time of the transfer, or any gain attributable to the regarded sale or exchange of the property. Adjusted disregarded basis is the tentative disregarded basis reduced by disregarded cost recovery deductions and increased by disregarded section 1016(a)(1) expenditures (luckily, there are examples illustrating those definitions). Tentative disregarded basis is the basis the property would have if the disregarded payment made for the property were regarded.

Disregarded cost recovery deductions are basically phantom depreciation deductions that would result if the purchase price created actual basis in the purchaser's hands, provided the deduction would be allocable to the gross income attributable to the foreign branch or branch owner (depending on who received the property) reduced by actual depreciation deductions for the transferred property if the deduction is allocable to the gross income of the foreign branch or branch owner (again depending on who received the property).

a. Depreciable Property

Example 4 in the regulations illustrates the mechanics. P, a U.S. corporation, owns 100 percent of FDE, a disregarded foreign branch. P sells Asset A to FDE for $500. At the time of the sale, the adjusted basis is $200. No adjustments under section 1016 are made for A. In year 3, FDE sells A in a regarded transaction for $600. For U.S. tax purposes, FDE recognizes $400 of gain ($600 amount realized less $200 of adjusted basis). The gain is foreign source under sections 865(e)(1) and 904(d)(2)(B)(i).

Absent the final regulations, P would have $400 of foreign-source branch income. However, the disregarded property transaction regulations modify that result. The original transaction, if regarded, would create $500 of basis in A in FDE's hands. The adjusted disregarded gain is the lesser of $300 and $400. The $300 represents the difference between FDE's adjusted disregarded basis ($500) and P's adjusted basis at the time of sale ($200), and the $400 is the regarded sale gain.

Accordingly, FDE's $400 is adjusted downward by the adjusted disregarded gain of $300. The source and separate category of the adjustment is allocable in proportion to the source and category of the regarded gain — in this case, the foreign-source branch basket. As a result, P's general basket foreign-source income is increased by $300 and the branch basket foreign-source income is decreased by $300.

Example 5 is the same as Example 4, with the added complexity of the property being depreciable. P is entitled to a $20 depreciation deduction in year 2. Under the rules of section 861, $18 of that deduction is allocated and apportioned to general category income and $2 is allocated and apportioned to passive income. If, however, the sale of Asset A was regarded for U.S. tax purposes, FDE would have a $50 depreciation deduction (split 90 percent to general limitation and 10 percent to passive limitation). The difference between the $20 deduction and phantom $50 deduction creates a disregarded cost recovery deduction of $30. FDE also has $350 of income in year 2, of which $315 is non-passive basket and $35 is passive basket.

In determining the branch basket income for the year, the non-passive category income of $315 is reduced by $27 ($30 disregarded cost recovery deduction * 90 percent general category allocation and apportionment) to $288. P's general category income increases by $27. The passive income of $35 is unchanged because that income cannot be foreign branch category income. What results is maintaining two separate depreciation calculations. Although A must be depreciated using the alternative depreciation system when it is used predominantly outside the United States,[6] starting in the year of sale, P must maintain a separate phantom basis for A to determine the disregarded cost recovery deduction and assess the tax implications of a sale in year 3, as the example illustrates.

In year 3, FDE sells A for $600, resulting in $420 of gain ($600 amount realized less $180 of basis). $42 of the gain is passive under the 90/10 assumption in the example. In redetermining that gain, it is necessary to determine the adjusted disregarded basis. FDE would have $500 of basis (tentative disregarded basis as defined in the regulations) if the purchase in year 1 were regarded. However, that $500 is reduced by the $30 of disregarded cost recovery deduction, resulting in an adjusted disregarded basis of $470. Thus, the adjusted disregarded gain is $270 ($470 adjusted disregarded basis less $200 of adjusted basis at the time of sale in year 1). Accordingly, FDE's income is adjusted down by $270 and P's income is increased by $270.

The analysis does not stop there, though. Because 10 percent of the total regarded gain of $420 is passive income, only 90 percent of the $270 is recharacterized as foreign-source general category income. $42 of the gain remains passive income.

b. Inventory Transactions

Similar rules apply to inventory transactions. In those scenarios, cost of goods sold (COGS) equals the adjusted basis, and the disregarded gain is determined by comparing the recognized gross income with the difference between the disregarded payment made for the property and the seller's COGS.

Example 9 illustrates the concept. P manufactures portable electronic devices and sells them to FDE for $1,500. At the time of sale, P has COGS of $1,200. FDE incurs another $100 of COGS and sells the products to customers for $1,750. As a result, P has $450 of gross income, which is recorded on FDE's books and records and is U.S. source under the modified section 863(b) rules. The redetermination is calculated by comparing the $450 (regarded gross income) with $300 ($1,500 payment by FDE to P, less P's $1,200 COGS). P's U.S.-source gross income increases by $300 and FDE's gross income decreases by $300.

A similar rule would apply in reverse — that is, FDE manufactures and sells to P. Assume the same facts as above except FDE manufactures and sells to P. The income is foreign-source section 863(b) income. The redetermination results in P increasing its branch income by $300 and decreasing its general basket income by the same amount.

The table helps illustrate that with a simple example, along with some hypothetical deductions.

Example: FDE Sale to P

	No Redetermination	
	P (General)	**FDE (Branch)**
Sales	$1,750	-
COGS	$1,300	-
Gross Income	$450	-
Deductions	($100)	($50)
Net Income	$350	-
Separate Limitation Loss	($50)	$50
FTC Limit	**$63**	**-**
	Redetermination	
	P (General)	**FDE (Branch)**
Sales	$1,750	-
COGS	$1,300	-
Gross Income	$450	-
Redetermination*	($300)	$300
Revised Gross Income	$150	$300
Deductions	($100)	($50)
Net Income	$50	$250
FTC Limit	**$10.5**	**$52.50**
*Computed as the lesser of the $450 or $300 ($1,500 less $1,200)		

A few observations. First, in my example the branch basket has $50 of deductions, creating a separate limitation loss (SLL) without the redetermination. That assumption might not be

[6] *See* section 168(g)(1)(A).

accurate if gross income is being used to allocate and apportion expenses. In other words, the $50 could increase with an additional $300 of branch basket income. The preamble to the final regulations says Treasury and the IRS intend to issue guidance on the allocation and apportionment of expenses to the branch category, noting specifically the possible consequences that redetermining income may have on section 861.

Second, although total foreign-source income is unchanged, there has been a significant shift from one basket to the other. That shift changes not only creditability of current-year taxes, but possibly other attributes as well, such as overall foreign loss and SLL.

Finally, I have not yet mentioned the separate category to which taxes are allocated and apportioned, and an in-depth examination is beyond the scope of this article.[7] At a high level, for a disregarded payment from the foreign branch to its owner, the payment is considered to come ratably from all the branch's after-tax income and is divided among the separate categories in proportion to the branch's assets.

For a payment from the owner to the foreign branch, the payment is assigned to the residual category, but the section 904 regulations provide FTC rules. Specifically, for reattributed income, foreign taxes will be allocated to the same category as the redetermined income.[8]

c. Intangible Property

One of the more unexpected aspects of the 2018 proposed regulations was the application of section 367(d) to disregarded intangible property transfers. That rule was slightly modified in the final regs to grandfather transactions that occurred before December 10, 2019, and to provide a transitory ownership exception. As a result, in applying the redetermination provisions discussed above, it is necessary to adjust gross income between a foreign branch and its owner (or another foreign branch, as the case may be) for deemed royalties under section 367(d). It is also necessary to apply section 482 principles for that purpose. If companies are revisiting their supply chains as part of any post-TCJA check-the-box planning, it will be necessary to consider that provision as well.

II. Conclusion

The takeaway from the examples is that disregarded transactions that are typically viewed as a "tax nothing" can come with major quantitative headaches when determining FTC limitations while operating in branch form. Navigating BEAT and GILTI issues through check-the-box planning should still be considered, taking other tax considerations into account (for example, section 367 and overall foreign loss). The downside is that redetermined income may cause excess credits in another section 904 category, and that possibility should be part of any analysis.

A capital contribution rather than disregarded sale may simplify things for non-inventory property transfers. Unfortunately, that approach might not increase the asset basis for foreign purposes, and transactions in which the property is purchased are often simpler to implement than equity contributions for an FDE. For an intangible property transfer, even a capital contribution will not alleviate possible problems.

If taxpayers want to make check-the-box elections and envision asset movement as part of that planning, they should anticipate the complexity of operating in branch form and model out the permutations accordingly. ■

[7] *See* prop. reg. section 1.861-20.

[8] *See* Treas. reg. section 1.904-6(a)(2) and prop. reg. section 1.904-6(b)(2). If the branch owner is a CFC, the taxes may not be creditable at all. *See* prop. reg. section 1.861-20(d)(3)(ii)(B).