Why Multinationals Prefer an Incorporated Subsidiary, Not Just a Branch

By John P. Gordon
President, USA Corporate Services Inc.

In this white paper, we will look into the issue of why foreign multinational companies set up domestic subsidiaries instead operating through local branches of the parent company. This paper assumes that the reader is not an international tax practitioner, and will know that this paper is not intended to give the reader legal or accounting advice. Further, it is critical to know that the content herein is extremely simplified and generic, and that the tax law aspects could (and does) take up several hundred pages of rules, exceptions and explanations. Finally, it is also assumed for the sake of simplicity that the domestic subsidiary is a bona fide company, properly capitalized and utilized for its stated purpose, and has not been set up as a sham to evade taxes. The primary reason for the complexity of US tax law relating to international business transactions is to create and maintain a level playing field for domestic and foreign firms, by reducing opportunities for tax avoidance and tax evasion by foreign firms or by US firms that set up foreign subsidiaries solely for tax purposes.

A **branch** is an unincorporated extension of a foreign parent company operating a plant, retail network, sales office or other income producing activity in the United States. A **domestic subsidiary** is a wholly-owned or mostly-owned incorporated entity such as a business corporation or limited liability company formed in one of the 50 States or the District of Columbia. For federal tax purposes, corporate entities formed in a US possession, such as the Virgin Islands, Puerto Rico, Guam or the Mariana Islands, are foreign entities.

Foreign multinational companies with substantial activities in the USA set up domestic subsidiaries, instead of just conducting business directly through a branch, or a branch network, as a means of asset protection. Since a branch is merely an extension of the parent company, the parent company is fully exposed to any and all business risk inherent in doing business in the United States. Just like the small business owner who incorporates to protect his personal assets from the risks of doing business, a foreign firm also benefits from setting up an incorporated entity to carry out business operations in the United States.

For the foreign firm with permanent operations in the US, the potential benefits of an incorporated subsidiary include:

- Protecting the parent (foreign) company from potential liabilities of doing business in the USA.
- To simplify bookkeeping and accounting, make tax compliance less costly and more efficient.
- Managing local operations more efficiently, including the handling of state and local employment compliance, banking and other day to day matter.
- Potentially, to qualify as a local company when bidding on certain contracts.

By utilizing a domestic subsidiary, whether a business corporation or a limited liability company (LLC), a foreign-based company is able to limit the exposure of the parent company to the amount of capital investment in the domestic subsidiary. These potential

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liabilities include product liability and various torts, such as slip and fall accidents, negligence, environmental and cleanup litigation, employee and labor litigation and general liabilities. If the parent company decides to leave the US market, it may also be far easier to close down and liquidate a local subsidiary cleanly than to just stop doing business as a foreign company.

Whether an operation is a branch or incorporated subsidiary, the profits are either reinvested in the company or sent back to the foreign parent in the form of dividends. Like interest and royalty payments, dividends are subject to 30% withholding tax, payable by the branch or subsidiary directly to the US government. (To further complicate the matter, this withholding tax may be reduced or eliminated by a tax treaty between the United States and the country of residence of the parent company). The withholding tax cannot be reduced through the deduction of expenses, the way income tax can.

For income tax purposes, a foreign company is more or less on an equal basis with a domestic company. However, because a foreign company is considered to have many more opportunities to conceal income and otherwise avoid income or withholding taxes, a foreign company doing business through a branch is subject to special taxes and bookkeeping requirements. Known as Branch Profits Tax and Branch Interest Tax, these requirements require the branch to perform very complex bookkeeping in order to effectively determine the true after-tax profits of the branch, before profits are sent back to the parent by one means or another. A domestic corporation subsidiary is not subject to the Branch Profits or Branch Interest Taxes, but a single-member LLC subsidiary may be considered a branch for tax purposes, and therefore subject to the branch taxes.

Foreign multinationals also like using a subsidiary to isolate the US transactions from the rest of their worldwide business, and thereby not subject the books and records of the parent company to IRS audits. In order to pursue compliance with the branch taxes, the IRS may demand access to all the accounting records of the parent company in order to determine which transactions are attributable to the branch. By using a domestic corporation, all the bookkeeping and accounting would be conducted locally, and even the payment of withholding taxes on dividend or interest payments to the parent would be handled by the subsidiary.

Further, all US tax returns must be based on financial information denominated in US dollars. Consolidating all US transactions through a subsidiary helps to simplify the currency aspect of bookkeeping and accounting. This way, there is stability in the accounting of income and expenses in dollars, instead of having to do currency conversions.

An incorporated subsidiary, whether a corporation or an LLC, also has the benefit of (relatively) easy transferability. The equity can be readily transferred to another owner far more easily and cleanly than an unincorporated branch network, whether by transfer of shares or transfer of assets.

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Since the USA-PATRIOT Act was enacted after the terrorist attacks of September 11, 2001, banking regulations were tightened considerably. Bank managers are under strict rules of knowing their clients, and often will not allow the opening of accounts for non-resident companies. Bankers are much more comfortable working with a domestically registered, locally authorized company than with a branch of a foreign company.

In summary, there are several advantages to using a domestic subsidiary. The larger the operation the greater the benefit. If the commitment to the US market is small, there may not be a need for the expense of incorporating. If there are large scale plans to operate in the USA, then a domestic subsidiary corporation is logical. A middle-ground solution is the use of a single-member LLC, which is a branch for tax purposes and therefore subject to branch profit and branch interest taxes, but otherwise is a separate entity for legal purposes.

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