The Impact Of An Installment Sale And The Potential Branch Profits Tax Liability For Any Foreign Corporation Doing Business In The U.S.

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In prior editions of the *Caribbean Today*, the very complex and potentially costly branch profits tax ("BPT") provisions have been summarized. Simply put, any foreign corporation that is engaged in business in the U.S. can be subjected to the BPT in a particular year if the foreign corporation has effectively connected earnings and profits ("ECEP") for the particular year. The potential BPT often generates "surprise," especially in situations where the foreign corporation has incurred losses in prior years, which loss carryforwards eliminate any regular corporate income tax for the year in question.

Generally speaking, if a domestic corporation pays a dividend to a foreign shareholder, for instance from a Caribbean country, the 30% U.S. withholding tax will be imposed and is required to be collected at the source by the payor domestic corporation. The 30% withholding tax may be reduced or eliminated if the foreign recipient is from a country having an income tax treaty with the United States. Therefore, any foreign shareholder should consider whether or not he or she comes from a treaty country and whether or not said treaty reduces or eliminates the otherwise applicable U.S. withholding tax.

Prior to the enactment of the BPT effective January 1, 1987, many foreign corporations that generated ECEP applied some very complex rules to argue that all or part of such corporation's annual earnings and profits: (1) were not necessarily "effectively connected" with the corporation's U.S. trade or business activities, and (2) could be invested in a manner that potentially gave rise to either U.S. tax-free gains or U.S. tax-free income.

The "intention" of the BPT is to require the foreign corporation to re-invest its annual ECEP consistent with IRS regulations. The regulations permit a deferral of any year's potential BPT to the extent such year's ECEP are properly re-invested in the foreign corporation's U.S. trade or business. The regulations make it more difficult than did pre-1987 law for a foreign corporation that generates U.S. trade or business income to invest such income in a manner where the income or gains resulting from such investments can avoid U.S. income tax. Most taxpayers believe that tax obligations are an expense that should reduce a particular year's ECEP. However, those familiar with the annual "earnings and profits" concept understand that earnings and profits are calculated using a cash versus accrual basis concept. As an illustration, suppose a foreign corporation engaged in a U.S. trade or business sells real estate for a substantial profit on the installment basis (i.e., meaning payments will take place over 2 or more years). The “future” tax liability attributable to the deferred payments cannot be used to reduce the current year’s ECEP.

In a recent tax case dealing with the corporate accumulated earnings tax (i.e., a tax intended to force corporations to pay out ordinary income dividends versus unreasonably retain earnings and profits in order to generate more favorably taxed capital gain when the corporation is either sold or liquidated), the corporate taxpayer filed its income tax return and in considering its accumulated earnings tax potential, it took the position that in connection with an installment sale, it was entitled to an income tax deduction for the full tax liability attributable to the deferred payments. The taxpayer lost and although we believe it has always been clear that a foreign corporation’s installment tax liability could not be deducted in full for purposes of the BPT, this recent corporate accumulated earnings tax decision reinforces the conclusion. Thus, any foreign corporation engaged in a U.S. trade or business that is entering into a profitable installment sale should consider the impact of the BPT and understand that a current deduction will not be allowed for any future year’s income tax liability.

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