



## NEWSLETTER II 2020

### Conducting business in U.S.: representative office, branch or subsidiary: pros and cons.

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#### **Abstract**

A foreign company (to the US) interested in conducting business in the US may have the choice to do so through a US representative office, a branch office or a US subsidiary. This choice has various legal (and tax) consequences.

#### **A.1. Representative Office**

A representative office (rep. office) is not a separate legal entity from the parent (foreign) company. In practical terms, a rep. office is generally a physical office (with one or more promoters), a showroom, and/or a warehouse. The activities conducted by the rep office should be very limited in scope and generally must revolve around the promotion, market research, and marketing of the goods and services of the parent company. The limitations on rep. offices are similar to those imposed on branch offices.

#### **A.2 Branch office.**

A branch office is not a separate entity from the parent (foreign) corporation and has no separate legal identity. A branch office is generally considered a physical office with agents conducting business in the US (namely selling goods and/or services in the US).

In conducting US trade and business, the US branch has to file, report, and pay (if any) corporate taxes to the IRS (and state taxing authorities where necessary), and the parent foreign company is fully liable for all risks, taxes, and activities managed by the branch office. Therefore, any claim that involves the branch office affects the company's parent in the home country.

For tax purposes, a 30% withholding Branch Profit Tax applies on any ECI that is transferred to the beneficial owner<sup>1</sup> of the payment.

The tax applies to the gross amount paid to the beneficial owner for distributive shares of the effectively connected income (ECI). The beneficial owner must fill out form W-8BEN to declare the taxable amount and claim an exception for certain types of income that are not subject to withholding tax.<sup>2</sup>

First introduced in a 1986 tax reform, the Branch Profit Tax has the purpose to collect income taxes from any profitable activities in the U.S.

Moreover, a parent foreign company that sells products in the US through a US branch office may still be liable under product liability laws or consumer protection laws. Should a civil case arise due to product liability, US courts may hold the parent foreign company responsible for compensatory and punitive damages. Compensatory damages have the purpose to restore plaintiffs for injuries they have suffered and are divided into two categories: economic losses (such as medical expenses, cost of disability, loss of wages, property or loss repair) and non-economic losses (such as physical or emotional suffering).

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<sup>1</sup> The beneficial owner of income is the person who is required under U.S. tax principles to include the

payment in gross income on a tax return (source IRS: <https://www.irs.gov/pub/irs-pdf/iw8ben.pdf>, page 3).

<sup>2</sup> Exceptions under IRS1441.



Punitive damages are exemplary damages intended to punish the defendant in order to deter him/her from engaging in the same conduct in the future.

**A.3 Subsidiaries.**

A subsidiary is a fully incorporated US legal entity with more than 50% of its voting stock belonging to the foreign parent corporation. For liability, tax, and regulatory purposes, a subsidiary and its parent remain separate legal entities. Accordingly, the parent foreign corporation is not exposed to the risks incurred by the subsidiary.

A subsidiary is considered “wholly owned” when the parent company owns all of its common stock. For liability, tax, and regulatory purposes, a wholly owned subsidiary also remains a separate legal entity even if directly managed from its parent.

A subsidiary operating as a corporation is taxed at the flat 21% corporate tax rate.

**B. Some final considerations**

Setting up a foreign company in the US requires careful planning and consideration. The benefits of a Representative office or Branch Office are the reduced corporate costs and flexible structure. Branch losses can be carried back and over for a limited number of years against the foreign parent corporations. On the other hand, the absence of the limited liability shield should be a concern for companies concerned about risk in US operations.

Running US business through a subsidiary creates a safer environment for the foreign parent, despite higher corporate and administrative costs in the US.

For tax purpose, the application of withholding taxes on interest and dividends makes subsidiaries a sound alternative.

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