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ESSENTIAL COMPLIANCE INSIGHTS

BRANCH OFFICE OR SUBSIDIARY? IT'S A CRITICAL CHOICE WHEN EXPANDING YOUR BUSINESS GLOBALLY

"Entering a new market may be exciting for a growing company, but it also means grappling with a whole host of unfamiliar rules and regulations."

It's time to expand your business overseas. Before you open your doors, you must make a critical choice — one whose impact is often underappreciated: Will you establish the new location as a branch office or a subsidiary?

While it may seem like a matter of semantics, a branch office, in legal terms, is wholly different from a subsidiary. And deciding on one entity over the other comes with substantial liability and compliance consequences. Opening an international office means asking complex questions about your company's tolerance for legal risk, how the enterprise might be taxed and what compliance challenges it might face.

Each market is distinct. Setting up a subsidiary or branch in Germany requires a far different approach than, say, in Brazil. Making the right decision about your office's legal status requires doing your homework not only about the financial potential of a particular location, but also about its politics, culture and legal system.

Herewith is an explanation of the basic entities available to companies when they organize new offices overseas, a few of the benefits (and potential pitfalls) of each and other factors to consider before making a final decision.

A DIRECT EXTENSION — REPRESENTATIVE AND BRANCH OFFICES

First, let's define our terms. Generally, companies have three options when they want to enter a foreign market: a representative office, a branch office and a subsidiary.

The representative office is, in essence, a beachhead. It is the simplest to establish as it only exists to allow the company's representatives to make contacts in the local market. Promotional activities are acceptable, but companies must take care not to step over the line. In most countries, a representative office cannot handle transactions or contractual matters.

A branch office, on the other hand, is a direct extension of the parent company and can engage in core activities like sales and contracts. It is designed to help generate revenue for the company and serves a particular geographic region.

Critically, however, it is not a separate legal entity from the parent company. As one international trade organization describes it, the branch office "is not able to independently participate in the general business transactions of the head office. It performs support and implementation-related tasks without having any individual business discretion and is entirely dependent on the head office."

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A DISTINCT ENTITY — A SUBSIDIARY

A subsidiary company is, legally speaking, more complex than a branch office. It is an entirely separate legal entity that has been established by another company to do business in a particular place. To qualify as a subsidiary, a parent company must own more than 50 percent of the entity's voting shares. A wholly-owned subsidiary is, as the name suggests, 100 percent-owned by another company. A subsidiary also can own shares in and control subsidiaries of its own.

Given the comparative complexity of a subsidiary versus a branch, why do so many companies choose it as the operating entity for their international offices? The key reason is the subsidiary's separateness. As a distinct legal entity, the subsidiary gives a parent company an additional layer of protection from liability.

Another advantage: Because a subsidiary is a separate legal entity it is subject to the tax laws of the country where it is domiciled. This allows the company to more effectively manage its tax burden, take advantage of favorable tax policies in a particular region or country or limit the impact of tax laws that may threaten the parent company's profits.

Consider the following scenario: Company X, LLC is a fast-growing U.S.-based financial technology company that's seeing a sharp increase in business with banks in Germany. The company's executives decide to open an office in Frankfurt to serve existing clients and expand Company X's European customer base. They decide to form a wholly-owned German subsidiary, Deutsche Company X, GmbH. (A GmbH is the German equivalent of a limited liability company or LLC.)

Though the subsidiary is controlled by the U.S. company, it is taxed by Germany and subject to Germany's laws and those of the European Union. The German entity can't be held liable for lawsuits filed against the parent company. At tax time, Deutsche Company X pays the rates established in Germany and does not owe tax on its earnings in the United States. And its parent company owes no taxes to Germany on revenue it earned outside the country.

Had Company X decided to open a branch office, any income earned by its outpost in Germany would be subject to U.S. taxes. And if the branch outpost ran afoul of the law in Germany, Company X could be held liable for any damages.

IS A BRANCH OFFICE EASIER?

Yet isn't a branch office, by its very nature, easier to open and operate? Not necessarily. Any company making a foray into a foreign market will face regulatory hurdles — whether via a subsidiary, branch or representative office.

The U.S. State Department calls Germany one of the most reliable countries in the world for business. But it notes that the legal, accounting and regulatory requirements can be complex and recommends that "investors pay attention to their legal obligations."

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For instance, before creating a new subsidiary, like a GmbH, companies in Germany must register in public directories. The commercial register (Handelsregister) and the trade office register (Gewerberegister) are the two most important, the State Department says. The commercial register includes the names of partners and managing directors, capital stock, liability limitations, and bankruptcies. Applications for registration at the commercial register are filed through a civil law notary, a highly trained lawyer required by statute to intervene in important transactions.

Companies opening a branch office get to skip the commercial register, but they must register with the local trade office, according to Germany Trade and Invest, a government-backed trade group. Documentation can be rather extensive.

The trade office may require the following: a copy of the parent company's Certificate of Incorporation; a copy of its Certificate of Good Standing (less than a month old); a copy of the parent company's memorandum and articles of association; and a resolution by the parent company's board giving evidence about the decision to create a branch office, among other paperwork.

Tax and accounting requirements for the branch may also vary depending on the state where it is located.

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PROS AND CONS BETWEEN BRANCH OFFICES AND SUBSIDIARIES

Branch offices and subsidiaries both offer benefits and challenges for a growing company. Let's tackle first a few of the pros and cons involved in choosing a branch office:

Branch office pros and cons

Speed (pro): A branch office can be set up relatively quickly — though, as we've noted, it is not without its bureaucratic hurdles. Some companies use a branch office as an interim step, using it to gain local knowledge and make sales before acquiring or establishing a subsidiary.

Oversight (pro): A branch is a part of the parent company and is dependent upon it. Management decisions flow directly from company headquarters, offering executives a greater measure of direct control.

Cost (pro): Branch offices tend to be smaller in size, reducing overhead costs.

Liability (con): Because they are not separate entities, branch offices provide no liability protection for a parent company. The parent is on the hook for any legal issues that may arise.

Tax worries (con): Depending on the applicable tax laws, companywide profits may be exposed to taxation in the country where the branch is located.

Subsidiary pros and cons

On the subsidiary side, pros and cons may include the following:

Protection (pro): Because a subsidiary has its own legal status, it provides a parent company with an additional layer of protection from liability.

Tax Limitations (pro): Subsidiary companies are taxed under local laws on their own income, thus shielding the parent company's profits from taxes in a foreign country.

Credibility (pro): A subsidiary may open access to capital from banks and investors more comfortable with investing in a local company.

Compliance (con): Because a subsidiary is a separate entity, it may require multiple government registrations and may need to maintain a minimum level of capital to operate. It is also likely to face more stringent local regulations and annual reporting requirements.

Political Exposure (con): As the tariff disputes pitting the United States against China and others have shown, a company's subsidiaries may be exposed to political risks beyond their control. As tariffs rose, some domestic manufacturers felt the effects because they owned a subsidiary in a country that had been penalized.

CONCLUSION

Without proper due diligence, a company may choose an entity that stifles rather than encourages overseas growth. Executives need to be aware of the compliance, tax and liability issues that accompany a branch office or subsidiary and choose the one that will help them avoid expensive surprises.

Whatever entity your business chooses, it shouldn't act alone. Entering a new market may be exciting for a growing company, but it also means grappling with a whole host of unfamiliar rules and regulations. Choosing a trusted and experienced global corporate compliance partner can allow your company to smoothly navigate a host of compliance issues, provide insights on planning for an international location and help you create and register a legal entity when you've chosen the right one for your company.

To learn more about how we can help you better manage your global compliance needs, contact a CT representative at 855-444-5358 (toll-free U.S.).

28 Liberty Street | New York, NY 10005 | 844-855-5358 | www.ctcorporation.com