



# Internal Revenue Service

DEPARTMENT OF THE TREASURY

## LB&I Concept Unit

<b>Unit Name</b>	Branch-Level Interest Tax Concepts
<b>Primary UIL Code</b>	9421.09 Branch-Level Interest Tax

Library Level	Title
<b>Knowledge Base</b>	International
<b>Shelf</b>	Business Inbound
<b>Book</b>	Jurisdiction to Tax Business
<b>Chapter</b>	Branch Level Interest Tax

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# General Overview

## Branch-Level Interest Tax Concepts

**Note:** This Practice Unit was updated to remove references to resources that are no longer current or available, to update the image of the form 1120-F, Section III on slide 14 to the 2023 version, and to correct minor typographical or formatting errors. It supersedes the 07/06/2015 Practice Unit of the same title.

- In general, a foreign corporation is subject to the branch-level interest tax if it is engaged in a U.S. trade or business (or it has gross income that is treated as effectively connected with such U.S. trade or business) and it has U.S. liabilities. The purpose of the tax is to subject all interest borne by the U.S. branch to withholding if the interest on the debt was owed to a foreign person. This places a branch in a similar position to a domestic corporation if it conducted that trade or business with the same debt. Therefore, because the source of the interest depends on the residence of the payor, and a U.S. branch is not a resident of the United States, IRC 884(f) was necessary to treat the payments as if they were made by a domestic corporation, which is a U.S. resident.
- Prior to the enactment of IRC 884 as part of the Tax Reform Act of 1986, interest paid by a foreign corporation with a U.S. branch to a foreign lender was wholly exempt from withholding taxes unless more than 50% of the corporation's worldwide gross income was effectively connected income (ECI) for the 3-year period ending at the end of the year prior to the payment of the interest. There was no tax on interest paid by the branch itself to direct lenders or to its home office. The disparity in the tax treatment of interest expense of a branch compared to interest expense of a U.S. subsidiary did not seem equitable to Congress. As such, IRC 884(f) was enacted to impose a 30% tax on the payment of all interest borne by a U.S. branch of a foreign corporation and paid to a foreign person.
- For purposes of the branch-level interest tax, "interest" includes all categories of interest under the Code, and the statutory tax rate is 30%. The branch-level interest tax is comprised of two parts: a withholding tax imposed on interest paid by a U.S. branch to a foreign person (referred to as "branch interest") and a tax imposed on the excess of the foreign corporation's interest allocable to income connected to ECI (need not be deductible) over its branch interest (referred to as "excess interest"). Branch interest, which is interest paid by a branch's U.S. trade or business, is considered U.S. source income and is subject to U.S. withholding tax at a rate of 30%, unless the tax is reduced or eliminated by a specific treaty or Code provision. For example, branch interest may qualify for a portfolio interest exemption if the recipient of branch interest is foreign but not a bank or related party. For more information about the portfolio interest exemption, please see the LB&I Transaction Unit "Portfolio Debt Exemption – Requirements and Exceptions" (under UIL 9424 – Financial Intermediary Payor – U.S. Withholding Agent)

# General Overview (cont'd)

## Branch-Level Interest Tax Concepts

- Additionally, to the extent a branch has interest allocated to it under Treas. Reg. 1.882-5 in excess of the interest actually paid by it to third parties, the excess is treated as interest paid by a U.S. subsidiary to the foreign corporate taxpayer on a notional loan on the last day of the taxable year. Excess interest can be reduced only by the foreign corporation's treaty.
- As mentioned previously, the operative Code section is IRC 884(f) which changes the source of these payments from foreign to U.S. by treating them as if they were paid by a domestic corporation. Under IRC 884(f)(1)(A), branch interest is treated as paid to the obligee, and the branch becomes a withholding agent if the interest is paid to a foreign person. Furthermore, branch interest is limited by the total amount of interest allocable under Treas. Reg. 1.882-5 (after any elections for liability reductions under Treas. Reg. 1.884-1(e)).
- Moreover, the interest is treated as U.S. source income for all purposes of the Code, e.g., for earnings stripping.

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**Treaty Implication:** Before beginning an audit of branch-level interest tax, please determine if the foreign corporation is a resident of a treaty country and if it qualifies for an exemption from tax under the "interest" article in that treaty by being a resident of that country and meeting the "limitation on benefits" article in the treaty, assuming there is one. If the corporation qualifies for an exemption from tax under the "interest" article, there is no point in auditing this issue. Many foreign banks are residents of treaty countries and will likely qualify for an exemption or reduced rate of tax under the "interest" article.

For corporations that are not residents of treaty countries, do not qualify for treaty benefits due to the "limitation on benefits" article, or qualify for a reduced rate of tax but not an exemption from tax under their treaty, a branch-level interest tax audit should be considered.

You may consult the Treaties Practice Network for assistance in determining the general treaty eligibility including the qualifications under a "limitation on benefits" article.

# General Overview (cont'd)<sup>2</sup>

## Branch-Level Interest Tax Concepts

- Additionally, it is important to note that a foreign corporation that has no dividend equivalent amount for any reason is precluded from making an election to reduce its liabilities solely to reduce its tax on branch interest or excess interest. See Treas. Reg. 1.884-1(e)(3)(iii).
- Furthermore, if a foreign corporation repays or otherwise decreases its U.S. liabilities and one of the principal purposes of such decrease is to artificially decrease its U.S. liabilities on the determination date (end of year), then such decrease shall not be taken into account for purposes of computing net equity. See Treas. Reg. 1.884-1(e)(4).
- Please also be aware that branch interest is subject to the anti-conduit financing Regulations under IRC 881 and is also subject to IRC 894(c) which denies treaty benefits for certain payments made to hybrid entities. The rules under IRC 884(f) also apply to stapled entities where a foreign corporation is stapled to a U.S. corporation under IRC 269B. See Treas. Reg. 1.884-4(d).
- Moreover, according to Treas. Reg. 1.884-4(b)(8)(v) if the foreign corporation is a partner in a partnership that has ECI, all interest paid by the partnership is treated as branch interest.



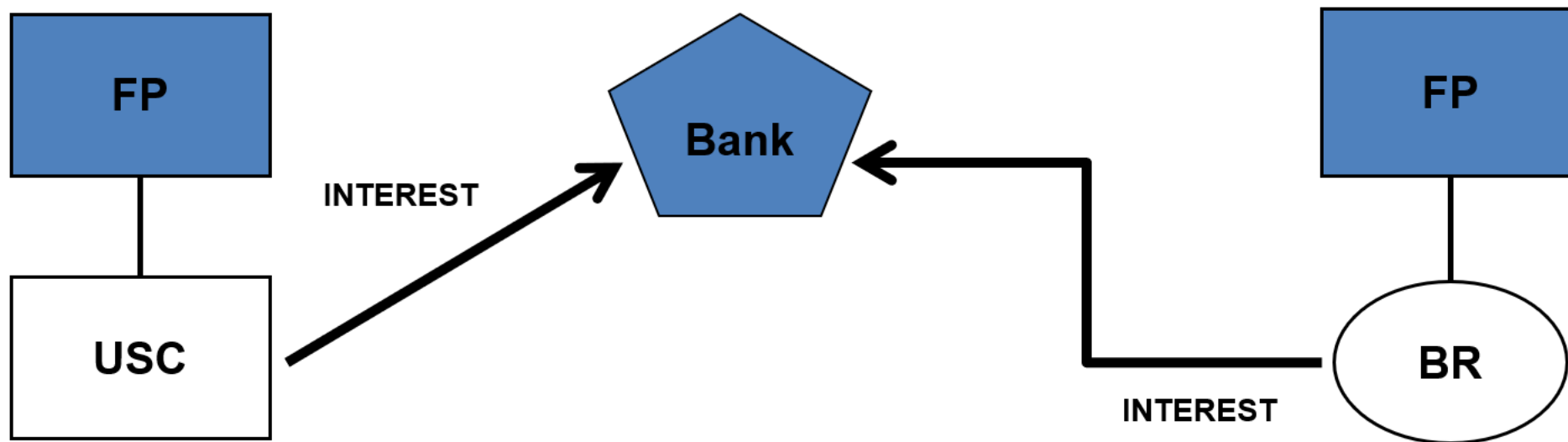
**CONSULTATION:** If the foreign corporation is itself a hybrid entity or is engaged in business through a hybrid entity, contact local Counsel and Branch 1 of Associate Chief Counsel International (ACCI). If the foreign corporation is a bank and qualifies for the benefits of a treaty that incorporates the Authorized OECD Approach (2010 OECD Model Article 7), contact local Counsel and Branch 5 of ACCI.

# Diagram of Concept

## Branch-Level Interest Tax Concepts

### Diagram of Concept

#### Pre-1986 Tax Reform Act (TRA) Branch Advantage



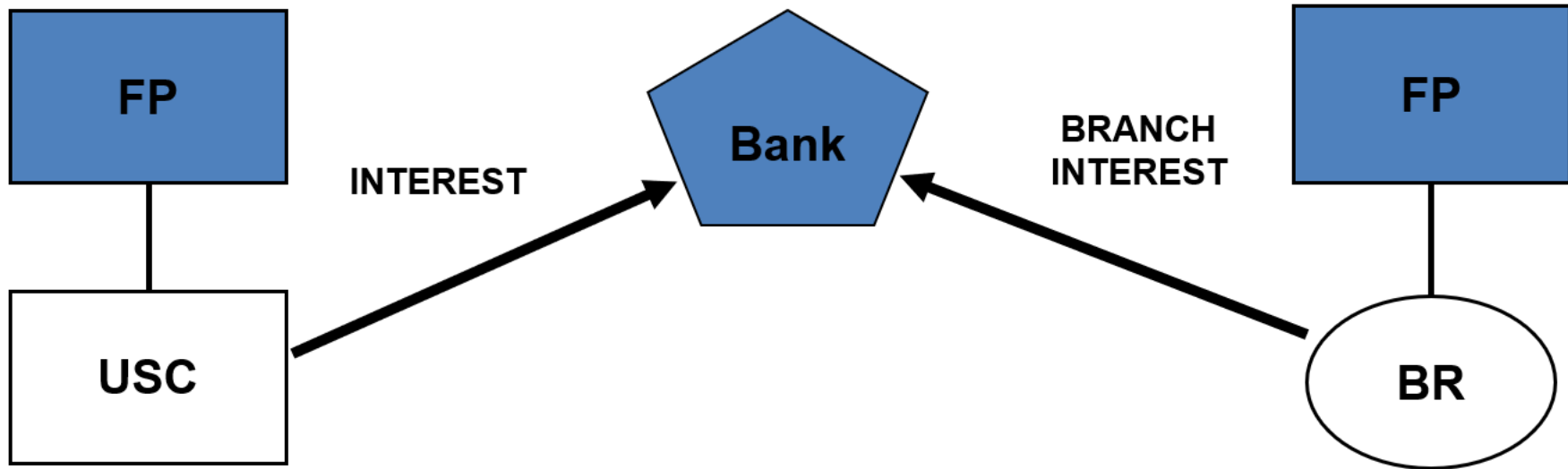
- A foreign bank loans money to a U.S. subsidiary. The U.S. subsidiary pays interest to the foreign bank. Payments are subject to withholding under IRC 1441 and 1442.
- A foreign bank loans money to FP (not a bank), which uses the cash entirely to support its U.S. branch. The U.S. branch was permitted to deduct a portion of the interest in computing its ECI. The U.S. branch wired the interest on the loan directly to the bank. None of the payments by the branch to the bank are recognized or subject to withholding. FP, however, is considered to have made all the interest payments to the foreign bank. Some or all of the interest considered paid by FP to the bank may be U.S. source interest subject to withholding, if more than 50% of FP's worldwide gross income is ECI for the prior 3-year period. The portion depends on the percentage of FP's income that is ECI. If the ECI threshold is met, FP would be the withholding agent, not the branch.

# Diagram of Concept (cont'd)

## Branch-Level Interest Tax Concepts

### Diagram of Concept

#### Post-1986 Tax Reform Act (TRA) Branch Equalization



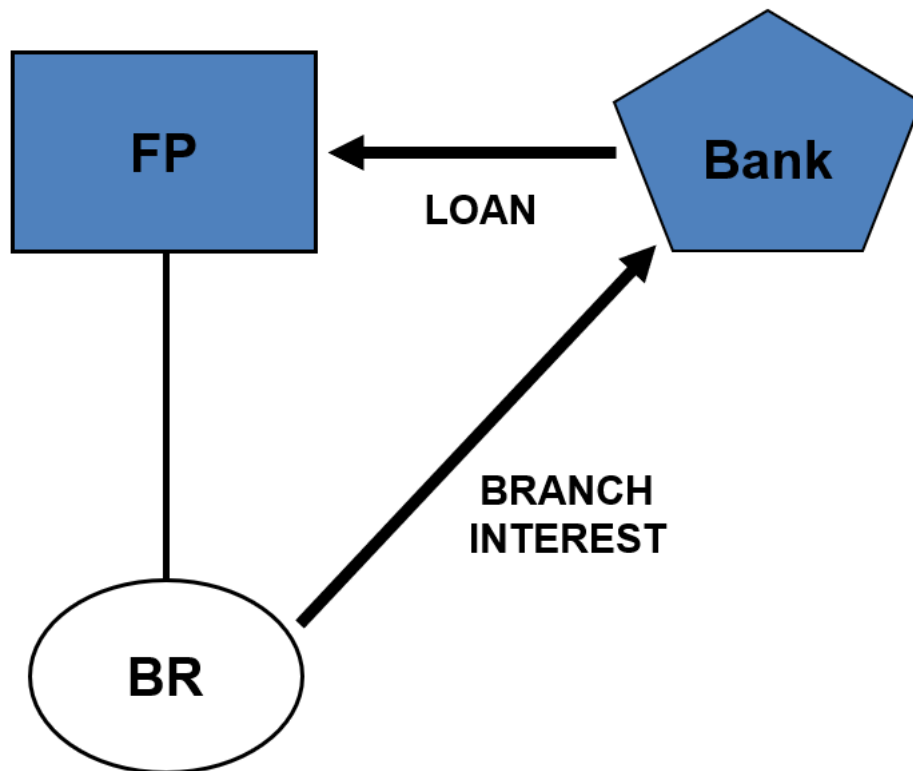
- Under IRC 884(f)(1)(A) interest payments made by the U.S. branch are generally treated as if paid by a U.S. corporation directly to the recipient (branch interest).
- If the recipient is a foreign person, those payments are subject to withholding under IRC 1441 and 1442.

# Diagram of Concept (cont'd)

## Branch-Level Interest Tax Concepts

### Diagram of Concept

#### Tax on Branch Interest



- “Branch interest” equals interest paid on:
  - “U.S. booked liabilities”, plus
  - Liabilities “specifically identified” on the foreign books (for non-banks), plus
  - Accrued but unpaid interest that FP elects to treat as paid.
- If 80% of FP’s assets are U.S. assets, then generally all interest paid by FP is treated as branch interest.
- If branch interest exceeds allocable interest, apply the scale-back rule. There is no withholding on any excess of branch interest over allocable interest. See Treas. Reg. 1.884-4(b)(6).

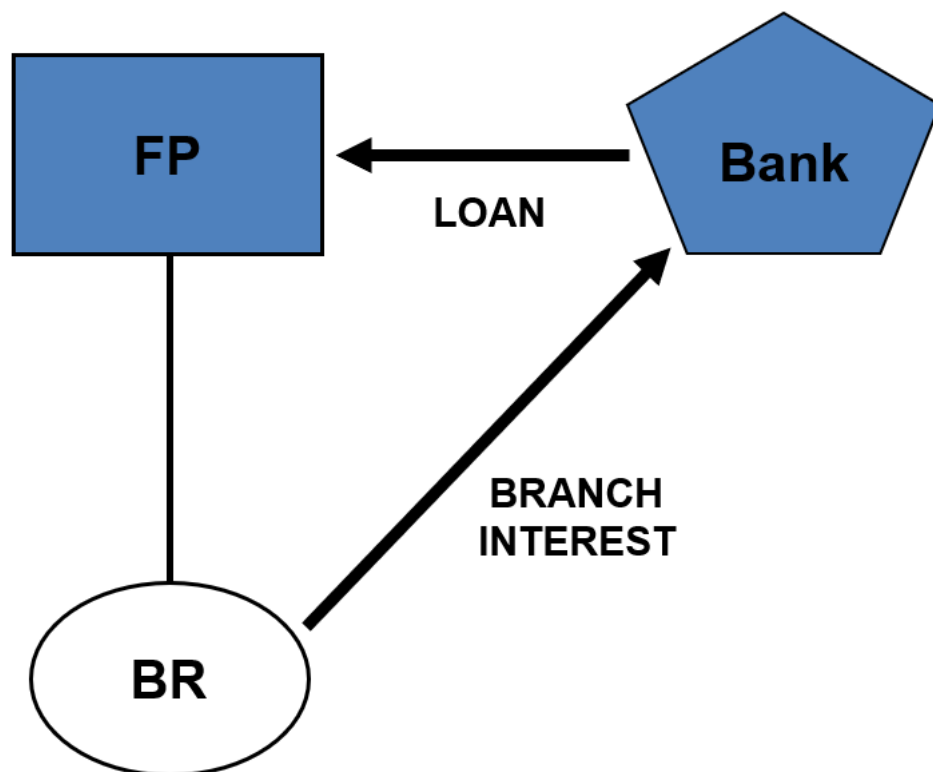


# Diagram of Concept (cont'd)

## Branch-Level Interest Tax Concepts

### Diagram of Concept

#### Tax on Branch Interest



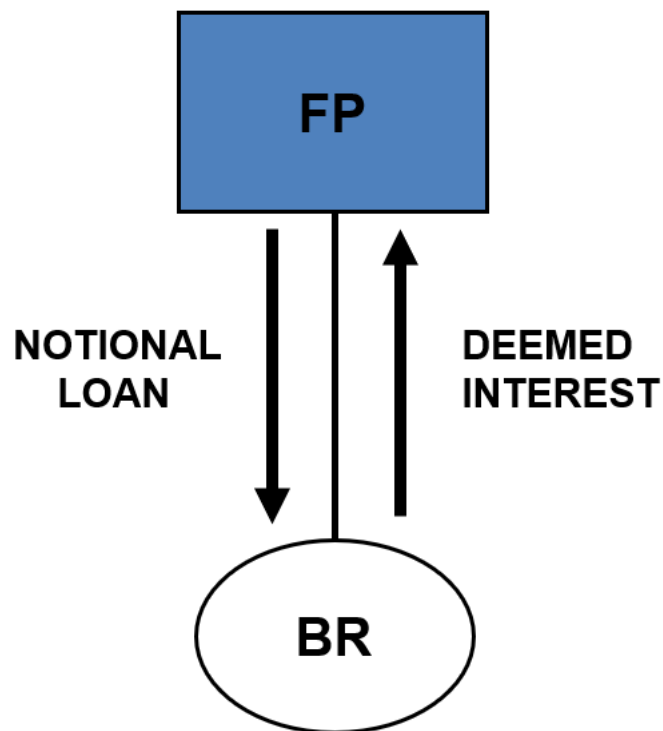
- Withholding on branch interest:
  - FP may apply either its treaty rate, or the lender's treaty rate, whichever is lower.
- But FP or Bank (lender) must meet requirements of a treaty "limitation on benefits" article. If there is no "limitation on benefits" article, FP must be a qualified resident under Treas. Reg. 1.884-5.

# Diagram of Concept (cont'd)

## Branch-Level Interest Tax Concepts

### Diagram of Concept

#### Tax on Excess Interest



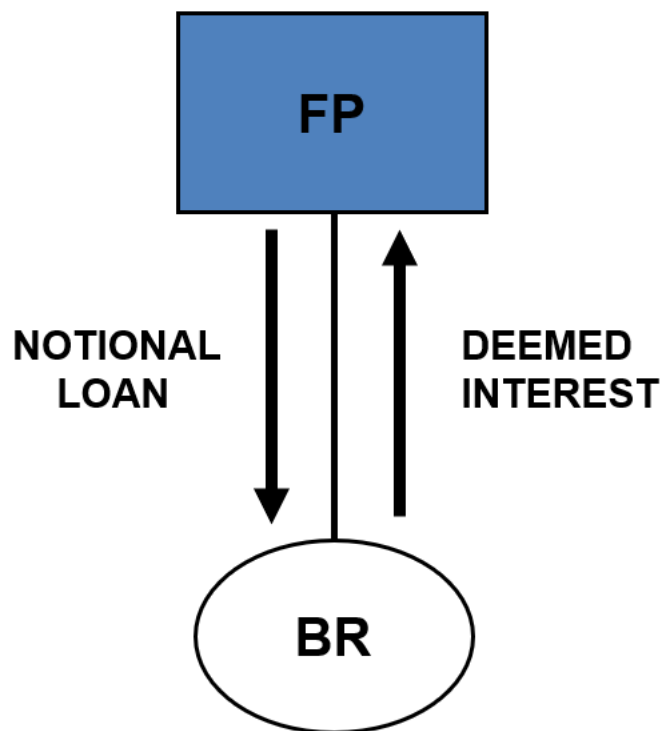
- Determine allocable interest under Treas. Reg. 1.882-5.
- Subtract “branch interest” paid to third parties. The remainder is treated as interest paid on a notional loan to FP (called excess interest).
- If the branch interest exceeds allocable interest, see Treas. Reg. 1.884-4(b)(6). There is no withholding on this excess amount.
- Excess interest is treated as if paid by a U.S. subsidiary to FP on the last day of the year.
- Excess interest is subject to a 30% tax under IRC 881(a) and is reportable on Form 1120-F, unless FP qualifies for a reduced treaty rate.

# Diagram of Concept (cont'd)

## Branch-Level Interest Tax Concepts

### Diagram of Concept

#### Tax on Excess Interest



- For banks, a portion of its excess interest may be treated as interest on deposits under Treas. Reg. 1.884-4(a)(2)(iii) provided that a substantial part of its business in the U.S. and the other countries in which it operates consists of receiving deposits and making loans and discounts. If so treated, the interest is exempt from withholding under IRC 871(i)(2)(A). (analogous to the election to designate liabilities for non-banks).
- The portion of the excess interest treated as interest on deposits is equal to the product of the excess interest and the greater of the ratio of the amount of interest bearing deposits as of the close of the taxable year to the amount of all interest bearing liabilities as of such date or 85%.

# Facts of Concept

## Branch-Level Interest Tax Concepts

### Facts of Concept

- A foreign corporation must file a Form 1120-F (U.S. Income Tax Return of a Foreign Corporation) to report the income, gains, losses, deductions, credits, effectively connected with its trade or business.
- A foreign corporation does not have to file a Form 1120-F if any of the following exceptions apply:
  - 1) It did not engage in a U.S. trade or business during the year, and its full U.S. tax was withheld at source,
  - 2) Its only U.S. source income is exempt from U.S. taxation under 881(c) or (d), or
  - 3) It is a beneficiary of an estate or trust engaged in a U.S. trade or business but would itself otherwise not need to file.
- In general, if a foreign corporation is not certain whether it is engaged in a trade or business, it may file a protective return under Treas. Reg. 1.882-4, in order to preserve its ability to deduct its expenses. It must file the protective return on a timely basis in accordance with those Regulations.

# Facts of Concept (cont'd)

## Branch-Level Interest Tax Concepts

### Facts of Concept

- In computing its effectively connected taxable income (ECTI), it is allowed expenses connected to that income, including interest. In general, the amount of interest connected to its effectively connected gross income is determined under Treas. Reg. 1.882-5. This amount may be different if it qualifies for the benefits of certain tax treaties that allow alternate methods of computing allocable interest.
- If any interest expense is allocated to ECI, in the case of a non-treaty resident, or allocated to the business profits of a permanent establishment in the case of a treaty resident, it is subject to the tax under IRC 884(f)(1)(A) and (B). If the foreign corporation has allocable interest in excess of branch interest (excess interest), the foreign corporation must treat that interest as if paid by a wholly owned domestic corporation to itself and report such interest on Section III, Part II of the Form 1120-F, which is shown on the following page of this unit. If it has no excess interest, and only branch interest, it becomes a U.S. withholding agent with respect to any branch interest paid to a foreign person and subject to the rules of chapter 3 of the Code. Interest allocable to ECI is not required to be deductible in order for the branch-level interest rules to be triggered. Thus, it applies even where interest is capitalized or deferred under IRC 267(a)(3) or 163(j).

# Facts of Concept (cont'd)

## Branch-Level Interest Tax Concepts

### Facts of Concept

Form 1120-F (2023)

Page **7**

#### SECTION III – Branch Profits Tax and Tax on Excess Interest

##### Part I – Branch Profits Tax (see instructions)

<b>1</b>	Enter the amount from Section II, line 29 . . . . .	<b>1</b>	
<b>2</b>	Enter total adjustments to line 1 to get effectively connected earnings and profits. (Attach required statement showing the nature and amount of adjustments.) (See instructions.) . . . . .	<b>2</b>	
<b>3</b>	Effectively connected earnings and profits. Combine line 1 and line 2 . . . . .	<b>3</b>	
<b>4a</b>	Enter U.S. net equity at the end of the current tax year. (Attach required statement.) . . . . .	<b>4a</b>	
<b>b</b>	Enter U.S. net equity at the end of the prior tax year. (Attach required statement.) . . . . .	<b>4b</b>	
<b>c</b>	Increase in U.S. net equity. If line 4a is greater than or equal to line 4b, subtract line 4b from line 4a. Enter the result here and skip to line 4e . . . . .	<b>4c</b>	
<b>d</b>	Decrease in U.S. net equity. If line 4b is greater than line 4a, subtract line 4a from line 4b . . . . .	<b>4d</b>	
<b>e</b>	Non-previously taxed accumulated effectively connected earnings and profits. Enter excess, if any, of effectively connected earnings and profits for preceding tax years beginning after 1986 over any dividend equivalent amounts for those tax years . . . . .	<b>4e</b>	
<b>5</b>	Dividend equivalent amount. Subtract line 4c from line 3. If zero or less, enter -0-. If no amount is entered on line 4c, add the lesser of line 4d or line 4e to line 3 and enter the total here . . . . .	<b>5</b>	
<b>6</b>	<b>Branch profits tax.</b> Multiply line 5 by 30% (0.30) (or lower treaty rate if the corporation is a qualified resident or otherwise qualifies for treaty benefits). (See instructions.) Enter here and include on line 3, page 1. <b>Also complete item W on page 2</b> . . . . .	<b>6</b>	

##### Part II – Tax on Excess Interest (see instructions for this Part and for Schedule I (Form 1120-F))

<b>7a</b>	Enter the interest from Section II, line 18 . . . . .	<b>7a</b>	
<b>b</b>	Enter the inverse of the total amount deferred, capitalized, and disallowed from Schedule I, line 24g (that is, if line 24g is negative, enter as a positive number; if line 24g is positive, enter as a negative number) . . . . .	<b>7b</b>	
<b>c</b>	Combine lines 7a and 7b (amount must equal Schedule I, line 23) . . . . .	<b>7c</b>	
<b>8</b>	<b>Branch interest</b> (see instructions for definition): Enter the sum of Schedule I, line 9, column (c), and Schedule I, line 22. If the interest paid by the foreign corporation's U.S. trade or business was increased because 80% or more of the foreign corporation's assets are U.S. assets, check this box <input type="checkbox"/> . . . . .	<b>8</b>	
<b>9a</b>	<b>Excess interest.</b> Subtract line 8 from line 7c. If zero or less, enter -0- . . . . .	<b>9a</b>	
<b>b</b>	If the foreign corporation is a bank, enter the excess interest treated as interest on deposits (see instructions for rules for computing this amount). Otherwise, enter -0- . . . . .	<b>9b</b>	
<b>c</b>	Subtract line 9b from line 9a . . . . .	<b>9c</b>	
<b>10</b>	<b>Tax on excess interest.</b> Multiply line 9c by 30% (0.30) (or lower treaty rate if the corporation is a qualified resident or otherwise qualifies for treaty benefits). (See instructions.) Enter here and include on line 3, page 1. <b>Also complete item W on page 2</b> . . . . .	<b>10</b>	

# Detailed Explanation of the Concept

Branch-Level Interest Tax Concepts	
Analysis	Resources
<ul style="list-style-type: none"><li>▪ The theory of the branch-level interest tax is to put interest allocable or borne by a U.S. branch of a foreign corporation on equal footing with interest payments by a U.S. subsidiary (corporation) of a foreign corporation. The purpose of IRC 884(f) is to impose a tax on interest payments by U.S. branches of foreign corporations, similar to those which are in effect for interest payments by U.S. subsidiaries of such foreign corporations.</li><li>▪ IRC 884(f) treats all interest allocable to the branch in computing its ECTI as if it were paid by a domestic corporation and from sources within the U.S. Thus, such interest is subject to a 30% tax if paid to a foreign person, unless a Code or treaty exemption applies.</li></ul>	

# Detailed Explanation of the Concept (cont'd)

Branch-Level Interest Tax Concepts	
Analysis	Resources
<p><u>Branch Interest</u></p> <ul style="list-style-type: none"><li>▪ IRC 884(f)(1)(A) applies to “branch interest.” Branch interest is treated as paid to the actual lender by the U.S. branch. Branch interest equals interest paid on “U.S. booked liabilities” plus liabilities “specifically identified” on the foreign corporation’s books (for non-banks). Branch interest also includes accrued interest that the foreign parent elects to treat as interest that is paid. Branch interest is subject to withholding under IRC 1441 and 1442, as a procedural matter. The branch interest treaty rate can be either the payor’s country rate, i.e., the foreign parent, or the lender’s country rate, whichever is more beneficial. This means that the foreign parent can claim the treaty rate for interest under either the foreign parent’s treaty or the foreign bank’s treaty with the U.S. As such, if the foreign bank is a resident of a tax haven country, the foreign bank may still claim a reduced treaty rate on interest under the U.S. treaty with the foreign parent per Treas. Reg. 1.884-4(b)(8).</li><li>▪ To determine whether the interest is paid by a U.S. trade or business, it is necessary to look at the status of the underlying liability. Branch interest consists only of interest paid with respect to one of three categories of liabilities listed in the Regulations. The first category of liabilities is “U.S. booked liabilities.” Branch interest is interest that is paid by a foreign corporation with respect to U.S. booked liabilities. U.S. booked liabilities are defined in Treas. Reg. 1.882-5(d)(2) as liabilities that are “properly reflected on the books of the U.S. trade or business.”</li></ul>	



# Detailed Explanation of the Concept (cont'd)

Branch-Level Interest Tax Concepts	
Analysis	Resources
<ul style="list-style-type: none"><li>▪ In general (for non-banks), such assets are properly reflected if they are predominately secured by a U.S. asset of the foreign corporation, or the foreign corporation enters the liability on a set of books relating to an activity that produces ECI. The liability must be entered on these books at a time reasonably contemporaneous with the time at which the liability is incurred. Special considerations apply for banks. See Treas. Reg. 1.882-5(d)(2)(iii).</li><li>▪ The second category of liabilities are liabilities “specifically identified” as a liability of a U.S. trade or business of a foreign corporation not later than the date on which interest is first paid on the liability. A liability is specifically identified only if it is shown on the records of the U.S. trade or business, or the liability is identified as a liability of a U.S. trade or business on other records of the foreign corporation provided that the three conditions under Treas. Reg. 1.884-4(b)(1)(ii) are met. These conditions apply only to corporations other than banks and are as follows:<ol style="list-style-type: none"><li>1) The interest does not exceed 85% of the interest that would be considered excess interest before taking into account interest treated as branch interest,</li><li>2) The foreign corporation files a return under IRC 6049 (e.g., Form 1099-INT) with respect to such interest or sends a notice to the recipient of the interest which states that the interest is U.S source income, and</li><li>3) The interest is not derived from a liability incurred in the ordinary course of a foreign business or secured by foreign assets.</li></ol></li></ul>	

# Detailed Explanation of the Concept (cont'd)

<b>Branch-Level Interest Tax Concepts</b>	
<b>Analysis</b>	<b>Resources</b>
<ul style="list-style-type: none"><li>▪ In addition, all interest is treated as branch interest where U.S. assets constitute 80% or more of a foreign corporation's assets. In such a case all the interest paid and accrued by a foreign corporation (except interest on liabilities incurred in the ordinary course of a foreign business or secured by non-U.S. assets) is treated as paid by the branch (branch interest). However, the branch interest cannot exceed the interest allocable to ECI under Treas. Reg. 1.882-5. See Treas. Reg. 1.884-4(b)(6).</li></ul>	

# Detailed Explanation of the Concept (cont'd)

Branch-Level Interest Tax Concepts	
Analysis	Resources
<ul style="list-style-type: none"><li>▪ In summary, the definition of branch interest generally includes liabilities on the books of the branch plus any liabilities that are properly designated as giving rise to branch interest. It is important to note that this can cause confusion for foreign lenders of a foreign parent who may not realize that their liabilities give rise to U.S. source branch interest since they may only be dealing with the foreign parent.</li></ul> <p><u>Excess Interest</u></p> <ul style="list-style-type: none"><li>▪ IRC 884(f)(1)(B) applies to excess interest, which is calculated by taking all interest allocable to ECI and subtracting branch interest. Excess interest is treated as paid to the foreign parent by a U.S. subsidiary on the last day of the tax year and is payable by the foreign parent in Section III of the Form 1120-F. Excess interest also includes interest accrued but not paid on U.S. booked liabilities, unless the foreign parent elects to treat it as paid and subject to withholding under IRC 1441 and 1442. The treaty rate for excess interest is always the interest rate of the foreign corporation.</li><li>▪ In cases where the interest deduction allowed to the foreign corporation under Treas. Reg. 1.882-5 exceeds the interest paid by the branch (branch interest), such excess is deemed to have been paid to the foreign corporation by a wholly owned domestic corporation. Excess interest is taxable to the foreign corporation under IRC 881(a) and the tax is payable by the foreign corporation with its Form 1120-F (subject to estimated tax payments) and treated as if paid on the last day of the taxable year to the foreign parent corporation. Accordingly, the U.S. branch is not required to file Forms 1042 and 1042-S to report excess interest. It is also important to note that the portfolio interest exemption does not apply to excess interest because excess interest is considered to be paid to a related party, i.e., the foreign parent corporation. See IRC 871(h)(3).</li></ul>	

# Detailed Explanation of the Concept (cont'd)

Branch-Level Interest Tax Concepts	
Analysis	Resources
<ul style="list-style-type: none"><li>▪ If the interest is accrued in a taxable year before the year of the payment, the interest could potentially be taxed twice: once as excess interest and once as branch interest. Similarly, if the interest is paid in a taxable year prior to the year in which it is accrued and deducted by a foreign corporation, the interest could be potentially taxed twice.</li></ul>	

# Detailed Explanation of the Concept (cont'd)

Branch-Level Interest Tax Concepts	
Analysis	Resources
<ul style="list-style-type: none"><li>▪ To alleviate this timing problem, Treas. Reg. 1.884-4(c)(1)(i) allows taxpayers to elect to compute its excess interest as if the branch interest were paid on the last day of the taxable year in which it accrues, and not in the taxable year in which it was actually paid. As a condition of making this election, the interest is treated as paid in the year of accrual, not just for branch tax purposes, but also for withholding under IRC 1441 and 1442 in the earlier year, rather than when actually paid. See Treas. Reg. 1.884-4(b)(7). This election does not apply to branch interest that accrues in a taxable year and is paid during an earlier year if the branch interest reduced excess interest in the earlier year. However, a foreign corporation may amend its tax return for such earlier taxable year of interest accrual so that the branch interest does not reduce excess interest in such year. A foreign corporation can make this election by attaching a statement, indicating that it elects the provisions of Treas. Reg. 1.884-4(c)(1), to its original or amended Form 1120-F tax return. Alternatively, taxpayers may also provide a written notice to the IRS Commissioner during an examination.</li></ul>	

# Detailed Explanation of the Concept (cont'd)

Branch-Level Interest Tax Concepts	
Analysis	Resources
<p><b>T</b> <b>TREATY IMPLICATION:</b> Treaty benefits for branch interest may be available to a foreign corporation (engaged in a trade or business within the U.S. through a branch) under a treaty with either the payor's country of residence or the payee's country of residence. See Treas. Reg. 1.884-4(b)(8). Therefore, if the branch-level interest tax is imposed on branch interest the recipient of the interest income may be eligible for treaty benefits regardless of whether the recipient is entitled to benefits under a U.S. income tax treaty. These treaty benefits apply only if the foreign corporation is a qualified resident of the treaty country, or in cases where a new treaty or protocol entered into effect after January 1, 1987, it contains a "limitation on benefits" article and the foreign corporation meets the requirements of such article. This issue may also arise with regards to audits involving U.S. partnerships or disregarded entities. Please be aware that branch interest is determined differently when a partnership is involved. Furthermore, a foreign person (other than a foreign corporation) that receives branch interest may be entitled to claim benefits under the provisions of a U.S. income tax treaty. With regards to claims for treaty benefits on excess interest only the foreign parent's treaty will apply.</p>	

# Detailed Explanation of the Concept (cont'd)

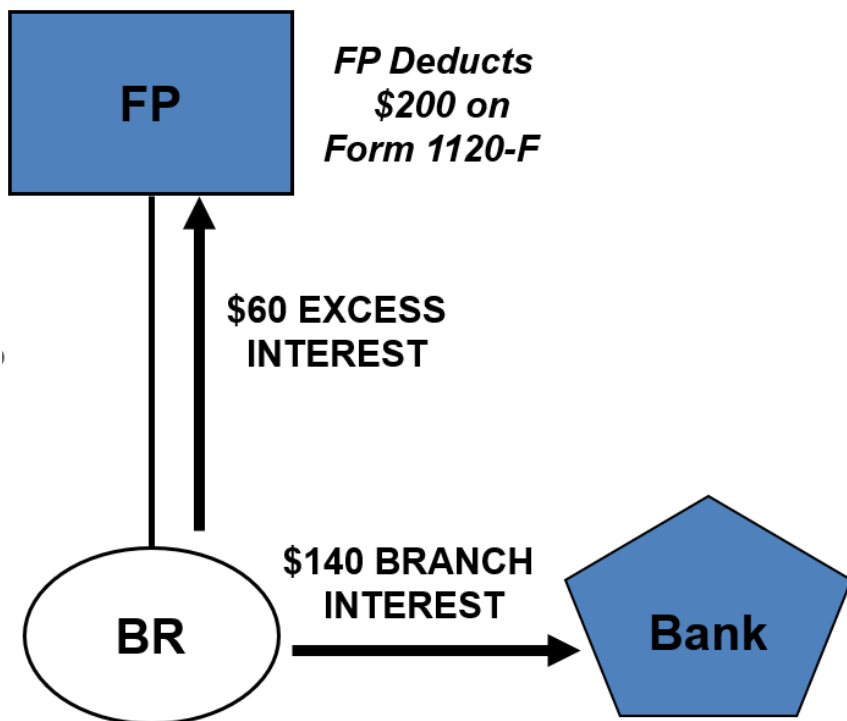
Branch-Level Interest Tax Concepts	
Analysis	Resources
<p><u>Notice 89-80 and Taiyo Hawaii, 108 T.C. 590 (1997)</u></p> <ul style="list-style-type: none"><li>▪ Notice 89-80, 1989-2 C.B. 394, provides that the treatment of excess interest with respect to a branch is the functional equivalent of interest paid on parent debt funding with respect to a subsidiary. Thus, subjecting such interest to tax under IRC 884(f)(1)(B) is not prohibited by the permanent establishment paragraph in any “non-discrimination” article in any income tax treaty to which the United States is a party.</li><li>▪ Taiyo was a Japanese corporation with real estate in Hawaii. It had net operating losses and did not want to pay a 10% tax on its excess interest as a result of having accrued but unpaid interest to its parent. Aside from a debt/equity claim, it argued that, because it could not deduct the interest under IRC 267(a)(3), the tax on excess interest could not be imposed. It also attempted to challenge the non-discrimination holding of Notice 89-80 but failed to timely raise that argument. The court held for the IRS on all grounds, although it never reached the treaty argument because it was not raised timely.</li></ul>	

# Examples of the Concept

## Branch-Level Interest Tax Concepts

### Diagram of Concept

#### Tax on Excess Interest



- Facts
  - Treas. Reg. 1.882-5 allocates \$200 of interest to the U.S. branch. The U.S. branch has branch interest of \$140.
- Issue
  - Allocable interest of \$200 exceeds branch interest of \$140 by \$60. How is this amount taxed?
- Resolution
  - Under IRC 884(f)(1)(B), this amount is deemed to be paid to the foreign parent and is subject to a 30% tax unless the foreign parent qualifies for treaty benefits. The rate may be reduced to the rate in a treaty article on interest only if the foreign parent is entitled to benefits of a U.S. tax treaty, i.e., meets the requirements of a “limitation on benefits” article of a U.S. income tax treaty. Of the 60 plus U.S. income tax treaties, about 25 allow for an exemption for certain types of interest and about 30 allow for a reduced rate.



# Index of Referenced Resources

## Branch-Level Interest Tax Concepts

IRC 163(j)

IRC 267(a)(3)

IRC 269B

IRC 871(h)(3)

IRC 881

IRC 884

IRC 1441

IRC 1442

IRC 6049

Treas. Reg. 1.882-5

Treas. Reg. 1.884-1(e)

Treas. Reg. 1.884-4

Treas. Reg. 1.884-5

Notice 89-80, 1989-2 C.B. 394

Taiyo Hawaii, 108 T.C. 590 (1997)

Form 1042

Form 1042-S

Form 1120-F

# Glossary of Terms and Acronyms

Acronym	Definition
BR	Branch
ECI	Effectively Connected Income
ECTI	Effectively Connected Taxable Income
FP	Foreign Parent Corporation
TRA	Tax Reform Act
USC	U.S. Corporation

# Index of Related Practice Units

Associated UIL(s)	Related Practice Unit
9421	Effectively Connected Income (ECI) Fundamentals
9421	Gross Effectively Connected Income (ECI) of a Foreign Corporation (Non-Treaty)
9421	Interest Expense of a Foreign Corporation engaged in a US Trade or Business (Non-Bank, Non-Treaty)
9421	Branch Profits Tax Concepts