

## LB&I Concept Unit

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|-------------------------|-----------------------------|--------------------|
| <b>Unit Name</b>        | Branch Profits Tax Concepts |                    |
| <b>Primary UIL Code</b> | 9421.08                     | Branch Profits Tax |

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

|                                      |                                     |
|--------------------------------------|-------------------------------------|
| <b>Document Control Number (DCN)</b> | INT-C-197 (formerly RPW/C/08_02-01) |
| <b>Date of Last Update</b>           | Revised: 1/31/25                    |

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# Table of Contents

*(View this PowerPoint in “Presentation View” to click on the links below)*

[General Overview](#)

[Diagram of Concept](#)

[Detailed Explanation of the Concept](#)

[Index of Referenced Resources](#)

[Glossary of Terms and Acronyms](#)

[Index of Related Practice Units](#)

# General Overview

## Branch Profits Tax Concepts

**Note:** This Practice Unit was updated to remove references to resources that are no longer current or available and to correct minor typographical or formatting errors. It supersedes the 09/03/2014 Practice Unit of the same title.

- The branch profits tax provision under IRC 884(a) treats a U.S. branch of a foreign corporation as if it were a U.S. subsidiary of a foreign corporation for purposes of taxing profit repatriations. As such, IRC 884(a) puts the earnings and profits of a branch of a foreign corporation deemed remitted to its home office on equal footing with the earnings and profits of a U.S. subsidiary paid out as a dividend to its foreign parent.
- IRC 884(a) was enacted as part of the Tax Reform Act of 1986 as a substitute for “second-tier withholding on dividends” under IRC 861(a). Section 861(a) treated a foreign corporation as paying U.S. source dividends if more than 50% of the foreign corporation’s income was effectively connected with a U.S. trade or business for the three prior years. This second-tier withholding tax was difficult to administer because the foreign corporation became a U.S. withholding agent but the percentage of the dividend resourced depended on the percentage of its gross income that was effectively connected income (ECI) for the three prior years. Most U.S. income tax treaties in effect at that time exempted those dividends from U.S. withholding tax, and they did so based on the address of the foreign recipient. Prior to 1986, nearly all of the treaties lacked “limitation on benefits” articles. Thus, the second-tier withholding tax was not an effective means of collecting tax. A foreign corporation could transfer the profits of its U.S. branch to its home office without incurring any tax legally by treaty, or even absent a treaty, with little risk of being detected, because the withholding agent was a foreign corporation, not a domestic corporation. In contrast, a U.S. subsidiary would be subject to a dividend withholding tax on a payment to its foreign parent of at least 5% under a treaty, and 30% absent a treaty.
- As a result of the enactment of IRC 884(a), the branch profits tax is calculated and paid by the foreign corporation on a Form 1120-F (U.S. Income Tax Return of a Foreign Corporation). The tax applies regardless of whether the U.S. trade or business of the foreign corporation is substantial compared to its worldwide activities. It treats the U.S. trade or business of the foreign corporation as if it were incorporated as a subsidiary of the foreign corporation and deems the profits of the subsidiary to be remitted, pursuant to a formula, to the foreign corporation at the end of the year. It eliminates the competitive advantage in operating as a branch vis-à-vis a subsidiary with respect to repatriation of profits. Moreover, the branch profits tax computation’s formulary nature strongly discourages the use of branch operations because it takes away control of the timing of the payment of the dividend equivalent amount. For example, a subsidiary can declare and pay a dividend on any date during its taxable year, but a branch must pay it only at year end.

# General Overview (cont'd)

## Branch Profits Tax Concepts

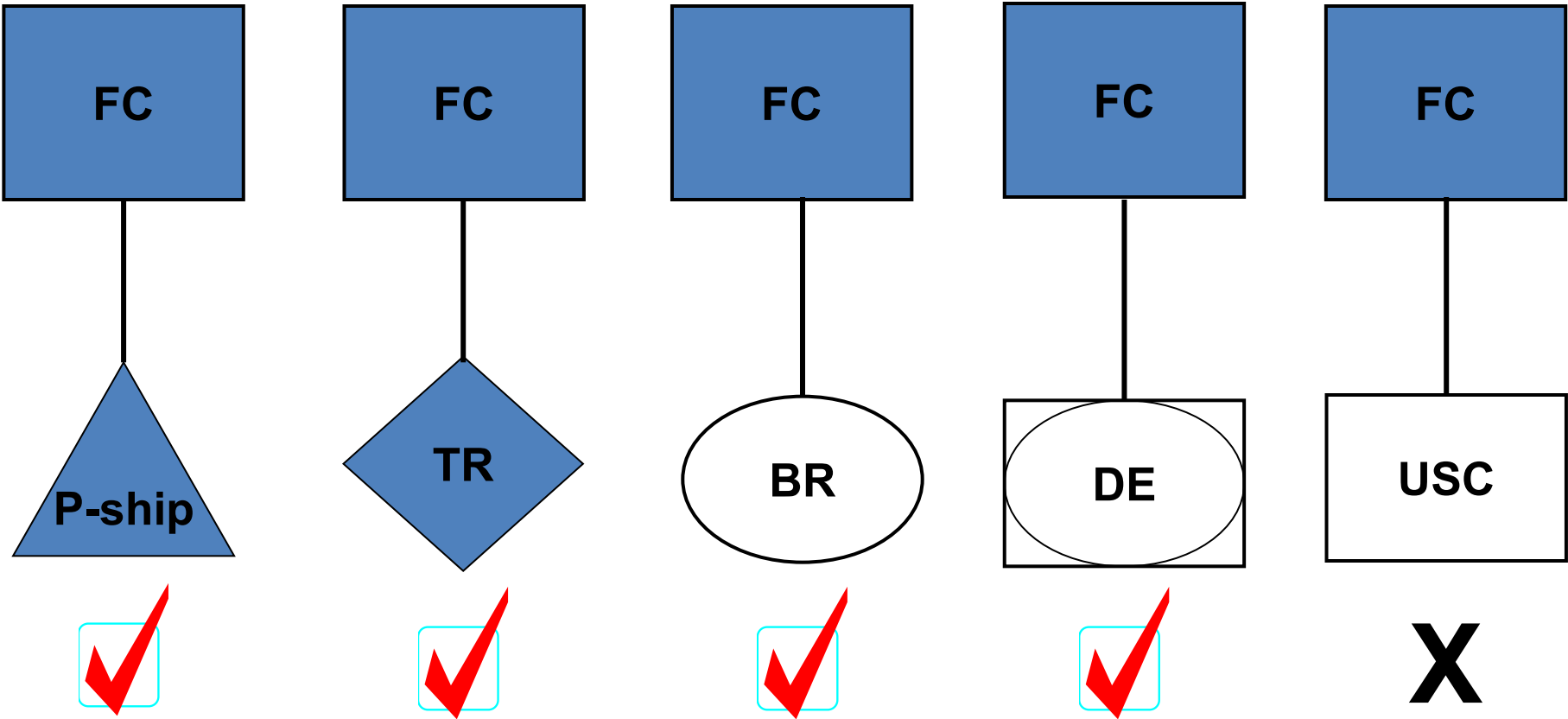
- Additionally, in many cases, if the foreign corporation conducts any business outside the U.S. a branch will be deemed to pay a larger dividend than a subsidiary even if it reinvests all of its profits back into the branch. Thus, shortly after the branch profits tax was enacted in 1986, many companies chose to reorganize and incorporate their U.S. branches or terminate them to avoid the complex rules that apply to determine the base on which the branch profits tax is imposed.
- It is important to understand the theory of the branch profits tax, which is to put the earnings and profits of a branch of a foreign corporation deemed remitted to its home office on equal footing with earnings and profits of a U.S. subsidiary paid out as a dividend to its foreign parent. Although it was quite a novel idea when enacted, since intra-company transfers are not respected for other purposes of the Code, there was precedent in other countries. IRC 884(a) imposes the same rate of tax on deemed remittances to a home office (30% or lower treaty rate) as on dividends paid by a U.S. subsidiary to a foreign parent.
- While it is simple to compute dividends declared and paid by a subsidiary, it is not so simple to measure the earnings and profits of a branch deemed remitted to its head office. Branches do not declare and pay dividends. Instead branches remit funds via intra-company transfers, which are similar to moving money from one pocket into another. Rather than tracking these intra-company remittances, however, Congress decided to impose the tax on a formulary basis, treating the branch as effectively operating with the same debt/equity ratio as the foreign corporation as a whole.
- Generally, a foreign corporation must be engaged in a U.S. trade or business to be subject to the branch profits tax and have ECI. Nonresident alien individuals and complex trusts are never subject to the branch profits tax. A foreign corporation can have ECI by either engaging in a U.S. trade or business itself, or electing to be treated as so engaged, (for example, a foreign corporation may elect under IRC 882(d) for its real property income to be treated as income from a U.S. trade or business). Even if a foreign corporation does not make the election under IRC 882(d), but owns U.S. real property, it will be subject to the branch profits tax if it has ECI under IRC 897 on the disposition of a U.S. real property interest, other than ECI from a gain from the sale of a U.S. real property holding corporation (USRPHC). Additionally, a foreign corporation that is a partner in a partnership, or beneficiary of a trust or estate, is subject to the branch profits tax if the partnership, trust, or estate is engaged in a U.S. trade or business to the extent of the foreign corporation's distributive share of income of the partnership, trust, or estate that is treated as ECI in its hands. If the branch profits tax is applicable, there is no additional tax on any dividend distributions made by the foreign corporation.

# Diagram of Concept

## Branch Profits Tax Concepts

### Diagram of Concept

Does the branch profits tax apply?

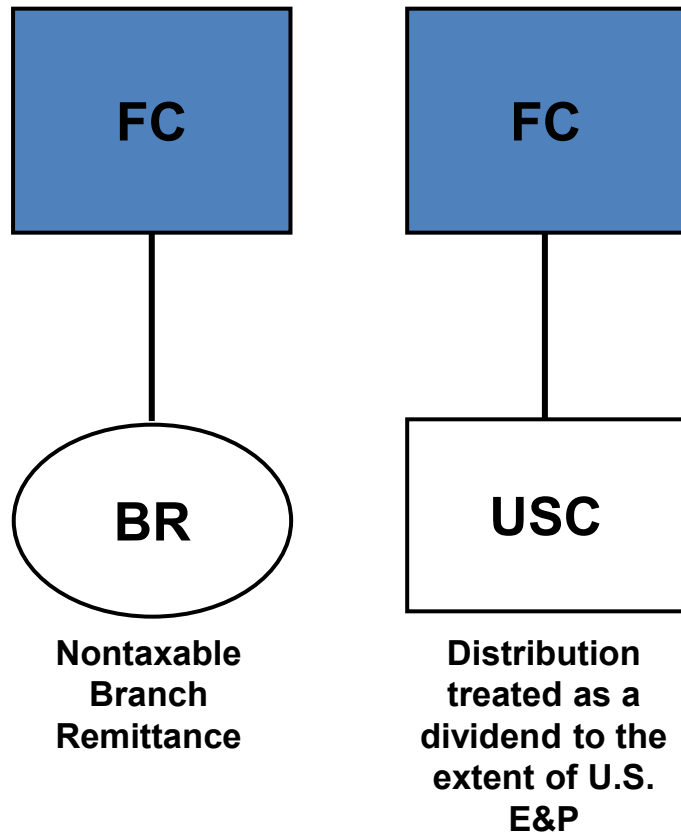


# Diagram of Concept (cont'd)

## Branch Profits Tax Concepts

### Diagram of Concept

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



- Investment in branch form was especially favorable pre-86 TRA

#### Subsidiary – 2 Levels of Tax

- Earnings taxed under IRC 11 or 55.
- Dividend to FC subject to withholding under IRC 1441/1442.

#### Branch – 1 Level of Tax

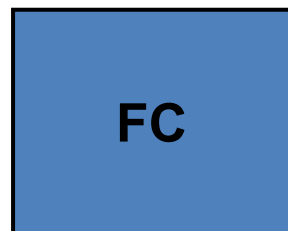
- Earnings taxed under IRC 882.
- Remittance to FC not subject to tax.

# Diagram of Concept (cont'd)

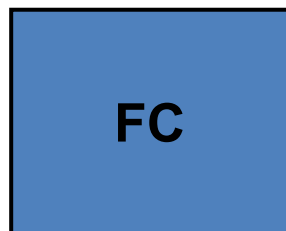
## Branch Profits Tax Concepts

### Diagram of Concept

#### Post-1986 Tax Reform Act Branch Equalization



**Taxable  
Dividend  
Equivalent  
Amount**



**Distribution  
treated as a  
dividend to the  
extent of U.S.  
E&P**

- Equalizes the tax treatment of FC's U.S. investment through a subsidiary and through a branch.
- Imposition of 30% branch profits tax on the dividend equivalent amount (DEA) – may be reduced by a treaty.
- Branch profits tax applies in addition to IRC 882 tax imposed on branch's effectively connected taxable income (ECTI).

# Detailed Explanation of the Concept

## Branch Profits Tax Concepts

### Analysis

- Because of the enactment of IRC 884(a), foreign corporations with U.S. branches are subject to two levels of tax: at the entity level when the U.S. branches earn income, and at the shareholder level when the earnings are repatriated. The purpose of IRC 884(a) is to impose a second-level tax on branches of foreign corporations in addition to the usual tax imposed on income effectively connected with a U.S. trade or business under IRC 882.
- The branch profits tax imposes a 30% tax on the after-tax earnings of a foreign corporation's U.S. trade or business that are not reinvested in such U.S. trade or business. The branch profits tax is equal to 30% (or lower treaty rate) of the "dividend equivalent amount" or DEA. As such, the branch profits tax provision treats a U.S. branch of a foreign corporation as if it were a subsidiary of a foreign corporation. The DEA is a U.S. branch's effectively connected earnings and profits (ECEP) for a taxable year reduced by the increase in a U.S. branch's U.S. net equity (USNE) or increased by a U.S. branch's decrease in USNE. USNE equals U.S. assets minus U.S. liabilities. The DEA is similar to dividends paid by a subsidiary either out of current E&P not yet invested or out of accumulated E&P invested in subsidiary assets. The DEA, therefore, can be eliminated only if the USNE increases by the amount of the ECEP of the branch each year. There are two ways to increase USNE: use the profits to purchase additional U.S. assets or elect to reduce U.S. liabilities. Branch income that is reinvested in qualifying branch (U.S.) assets is not considered repatriated to the foreign home office. On the other hand, if branch income is not reinvested in qualifying U.S. assets, then it is deemed repatriated. If a foreign corporation has no other business besides its U.S. business, then the management of the DEA is not difficult. If it does have other assets and liabilities that are not U.S. assets or U.S. liabilities, the formulary nature of USNE makes it extremely hard to continuously increase USNE by the amount of ECEP for the taxable year.

### Resources

# Detailed Explanation of the Concept (cont'd)

## Branch Profits Tax Concepts

### Analysis

- As stated previously, foreign corporations that have a trade or business in the U.S. may be subject to tax under IRC 882, which imposes tax at the normal corporate tax rates under IRC 11. A foreign corporation has ECI if it is engaged in a trade or business within the U.S. and has income connected to that trade or business. A foreign corporation that performs services in the U.S. is engaged in a trade or business in the U.S. and has ECI. Additionally, a foreign corporation that sells products on a regular and continuous basis in the U.S. is engaged in a trade or business in the U.S., but in order for its income to be ECI, title of the products must pass to the buyer in the U.S., or the sale must be attributable to a U.S. office.
- Generally, ECI must be from U.S. sources. Certain foreign source income may be ECI, but only if it is described in IRC 864(c)(4)(B). Effectively connected taxable income (ECTI) (ECI less expenses) is taxed at U.S. graduated rates per IRC 11. Deductions are allowed to the extent connected to the business of foreign corporations pursuant to IRC 882(c).
- If a foreign corporation is a resident of a treaty country and otherwise qualifies for treaty benefits (meets a "limitation on benefits" article, if any), it will not be taxed on its ECI unless it has, or is deemed to have, a permanent establishment (PE) in the U.S. Generally, a foreign corporation has a U.S. PE if it has a fixed place of business in the U.S., a construction site in the U.S. that lasts a certain number of months, or it carries on business through a dependent agent authorized to enter into contracts in the name of the foreign corporation. If the foreign corporation does not have a PE in the U.S., it will not be subject to the branch profits tax.

### Resources

# Detailed Explanation of the Concept (cont'd)

| Branch Profits Tax Concepts                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                         |           |
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| Analysis                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                            | Resources |
| <ul style="list-style-type: none"><li>▪ If a foreign corporation has a PE, but its ECI is not entirely attributable to the PE, the branch profits tax will apply to only the ECEP attributable to the profits of the PE, and not to any other profits. As noted above, U.S. income tax treaties generally reduce the rate of the branch profits tax to the same rate that applies to direct dividends. This rate is generally 5% unless the U.S. has negotiated a treaty or protocol since 2002 that reduces the direct dividend rate to zero (very limited number of treaties). To qualify for the full exemption, the foreign corporation must meet not only the treaty's "limitation on benefits" article but also additional requirements in the dividend or branch profits tax articles. For the few treaties that have not been renegotiated since January 1, 1987, the foreign corporation must be a qualified resident within the meaning of Treas. Reg. 1.884-5. Those regulations provide analogous tests to prevent treaty shopping as do "limitation on benefits" articles. If a foreign corporation is a qualified resident under a treaty, no branch profits tax will apply because the tax was effectively acknowledged by the regulations as violating the non-discrimination article of the treaties, unless the treaty already allowed the other state to impose its branch profits tax. See Treas. Reg. 1.884-1(g).</li><li>▪ A taxpayer must file a Form 8833 (Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b)) with its Form 1120-F to disclose the basis on which it is claiming a reduced rate or exemption from the branch profits tax under a tax treaty (but not under IRC 884). If a taxpayer fails to file a Form 8833 a penalty of \$10,000 is imposed under IRC 6712.</li></ul> |           |

# Index of Referenced Resources

| Branch Profits Tax Concepts |
|-----------------------------|
| Form 1120-F                 |
| Form 8833                   |
| IRC 11                      |
| IRC 55                      |
| IRC 861                     |
| IRC 864                     |
| IRC 882                     |
| IRC 884                     |
| IRC 1441                    |
| IRC 1442                    |
| IRC 6114                    |
| IRC 6712                    |
| IRC 7701                    |
| Treas. Reg 1.884-1          |
| Treas. Reg. 1.884-5         |
| Tax Reform Act of 1986      |

# Glossary of Terms and Acronyms

| Term/Acronym | Definition                                  |
|--------------|---------------------------------------------|
| BR           | Branch                                      |
| DE           | Disregarded Entity                          |
| DEA          | Dividend Equivalent Amount                  |
| ECI          | Effectively Connected Income                |
| ECEP         | Effectively Connected Earnings and Profits  |
| ECTI         | Effectively Connected Taxable Income        |
| FC           | Foreign Corporation                         |
| FIRPTA       | Foreign Investment in Real Property Tax Act |
| PE           | Permanent Establishment                     |
| P-ship       | Partnership                                 |
| TR           | Trust                                       |
| TRA          | Tax Reform Act                              |
| USC          | U.S. Corporation                            |
| USNE         | U.S. Net Equity                             |
| USRPHC       | U.S. Real Property Holding Corporation      |

# Index of Related Practice Units

| Associated UIL(s) | Related Practice Unit                                                          |
|-------------------|--------------------------------------------------------------------------------|
| 9421              | Gross Effectively Connected Income (ECI) of a Foreign Corporation (Non-Treaty) |