VARIETY IS THE SPICE OF LIFE: ALTERNATE TAX STRUCTURES FOR A U.S. INDIVIDUAL DISPOSING OF FOREIGN REAL PROPERTY

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While some activities are limited when working from home during a global lockdown, there are still a variety of tax-efficient options available to sell foreign real property. This article discusses the U.S. Federal income tax consequences of several options available to a U.S. individual disposing of foreign real property.

LAYING DOWN THE BASICS

The facts that drive this article are as follows:

- Mr. A is a U.S. tax resident (*i.e.*, an individual who is either a U.S. citizen, a lawful permanent resident of the U.S. for immigration purposes, or a U.S. resident for income tax purposes under the Substantial Presence Test).
- He resides in the U.S. and is gainfully employed in the U.S.
- He owns the stock of a Spanish corporation ("F Co."), which in turn owns a parcel of undeveloped real property in Spain.
- Mr. A is a nonresident for Spanish tax purposes.
- Mr. A invested in the property in 2010 with a goal of long-term appreciation.
- The property has substantially increased in value, and Mr. A is now proposing to sell it at a significant gain.
- F Co. is a controlled foreign corporation ("C.F.C.").

Very simply, a foreign corporation is a C.F.C. if more than 50% of its voting rights or value is owned by one or more U.S. Shareholders.[1] A U.S. Shareholder, *inter alia*, includes an individual who is a U.S. citizen who owns at least 10% of the voting rights or value of a foreign corporation.[2] Since, Mr. A owns all of the voting rights and value of F Co., he meets the definition of U.S. Shareholder, and F Co. is a C.F.C.

ALTERNATE TAX STRUCTURES[3]

Option 1: F Co. Sells the Property and Distributes Dividends to Mr. A

One of the easiest ways to dispose of the real property is a direct sale of the property by F Co.

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[1] Code §957(a).

[2] Code §951(b).

[3] The article briefly discusses the basic Spanish capital gain tax and personal income tax regime for purposes of background only.

First Level of Tax: Spanish Corporate Income Tax on F Co. on Capital Gains

Spain will treat the excess of the sale proceeds over the adjusted basis of the real property as a capital gain, which will be subject to tax in the hands of F Co. at the corporate rate of 25%.

Second Level of Tax: Spanish Personal Income Tax on Mr. A on Dividends Distributed by F Co.

Mr. A will be subject to Spanish personal income tax on the dividends distributed by F Co. F Co. will be responsible for withholding tax at the time the payment is made to Mr. A. As a result, he will be eligible to claim the benefit of a lower tax rate on Spanish-source dividends. Article 10 of the Spain-U.S. Income Tax Treaty provides for a 15% withholding tax on dividends paid by a Spanish company to an individual.

Third Level of Tax: U.S. Federal Income Tax on Subpart F Income

For U.S. Federal income tax purposes, F Co. is a C.F.C. and Mr. A is a U.S. Shareholder. The capital gain in the hands of F Co. will be treated as Subpart F[4] Income in the hands of Mr. A, who will be taxed on the Spanish company's Foreign Personal Holding Company Income even if it is not distributed by F Co. Subpart F Income is treated as ordinary income, and therefore, Mr. A will be subject to U.S. Federal income tax at a rate of up to 37%. Mr. A will not be subject to additional U.S. tax when F Co. makes an actual distribution of the dividends.[5]

Eligibility of Mr A to Claim Credit for Income Taxes Paid in Spain

When computing the U.S. tax liability of a U.S. individual for income tax purposes, the Code allows a taxpayer to claim a foreign tax credit for the foreign income taxes paid or accrued with regard to the foreign income that is taxed. In broad terms, this allows the U.S. tax to be reduced by the foreign taxes paid. However, the foreign tax credit reduces only the portion of U.S. tax imposed on foreign-source income.[6] Broadly, an individual is allowed to claim a credit of the taxes paid to a foreign country only if, *inter alia*, the following conditions are satisfied:

- The individual is the person on whom the foreign jurisdiction imposes the legal liability to pay the income tax ("Technical Taxpayer Rule").[7]
- The foreign levy is an income tax in the U.S. sense.[8]
- The income is foreign-source income.[9]

Typically, a foreign income tax paid by a foreign entity treated as a corporation under U.S. income tax rules for characterizing entities,[10] is not considered to be the legal

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4 Code §954(c)(1)(B)(iii). In particular, the gain will be treated as a Foreign Holding Personal Company Income, which is one category of Subpart F Income.

5 Code §959(a).

6 Code §904(a).

7 Treas. Reg. §1.901-2(f).

8 Treas. Reg. §§1.901-2(a)(1)(ii), 1.901-2(a)(3)(i).

9 Code §904(a).

10 Treas. Reg. §§301.7701-2 and 301.7701-3.

liability of its shareholder. Therefore, Spanish taxes paid by F Co. on its capital gain arising from the sale of the real property is not treated as being imposed on Mr. A. The legal liability test is not met. Thus, Mr. A fails the Technical Taxpayer condition and, accordingly, is not eligible to claim a credit for the Spanish foreign taxes (25%) paid by F Co. on the gain.

As for the Spanish personal income tax paid by Mr. A on the dividends distributed by F Co., the character of the Foreign Personal Holding Company Income is passive, as is the tax imposed by Spain on dividend income. Although the actual dividends paid should be treated as previously taxed income that is not subject to further U.S. tax, because the income is passive, Mr. A will be eligible to claim a credit for the foreign taxes (15%) withheld by F Co. that offsets the U.S. tax on the Foreign Personal Holding Company Income recognized and taxed in the U.S. This will allow Mr. X to offset his U.S. Federal income tax liability (37%) on the income taxed under Subpart F. In effect, the total tax liability in both countries amounts to 62% (25%+ 37%) plus Net Investment Income Tax ("N.I.I.T.") of 3.8%, which is due at the time of receipt of the actual dividend.

If the dividend is paid in a subsequent year, the tax may be creditable, but there may not be any income in the passive foreign tax credit limitation basket. If the foreign tax cannot be claimed as a credit in the year paid because of insufficient foreign tax credit limitation, the tax may be carried back one year and then carried forward ten years in an attempt to find a year in which sufficient limitation exists to absorb the previously unused credits.[11] If the actual dividend is deferred, the N.I.I.T. is deferred in the absence of an election to pay the tax currently.[12]

High-Tax Exception

Subpart F Income does not include any item of income earned by a C.F.C. if such income is subject to an effective rate of foreign income tax that is greater than 90% of the maximum U.S. corporate tax rate under Code §11.[13] Consequently, if the income is subject to foreign income tax of more than 18.9% (90% of 21%), the income is excluded from the definition of Subpart F Income. This rule is known as the high-tax exception.

A taxpayer electing the high-tax exception gets the benefit of deferring the U.S. Federal income tax liability until an actual distribution is made by the C.F.C. The actual distribution may be treated as a qualified dividend subject to a reduced rate of up to 20% if the U.S. has an income tax treaty with the country in which the C.F.C. is organized and the C.F.C. would be entitled to full benefits under the treaty were it to receive income from U.S. sources. Otherwise, the distribution is treated as an ordinary dividend that is subject to tax at rates of up to 37%. In either case, the individual is subject to the N.I.I.T. of 3.8%. The individual is eligible to claim a foreign tax credit for the taxes withheld in the foreign country at the time the C.F.C. distributes dividends. The foreign tax credit does not apply to offset the N.I.I.T.

Coming back to the facts of Mr. A, the capital gain earned by F Co. on the sale of the real property is subject to the 25% Spanish corporate income tax. Since the foreign tax on Subpart F Income exceeds 18.9%, Mr. A is eligible for the high-tax exception.

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11 Code §904(c).

12 Treas. Reg. §§1.1411-10(c)(1)(i)(A)(1) and (g).

13 Under Code §954(b)(4).

If Mr. A makes a timely election on his personal U.S. income tax return for the year in which the C.F.C. earns Subpart F Income, he will not be subject to any tax on such income. Nonetheless, Mr. A will be subject to U.S. Federal income tax at the rate of 20% (qualified dividends since U.S. has an income tax treaty with Spain) when F Co. makes actual distribution of dividends. The Spanish tax withheld by F Co. on the dividends will be allowed as a credit against Mr. A's U.S. Federal income tax liability on the dividend. As a result, the total tax liability of both countries amounts to 48.8% (25%+ 20% + 3.8%)!

Option 2: F Co. Sells the Property and Distributes Dividends and Mr. A Makes a Code §962 Election

Code §962 was introduced with the objective of placing U.S. individuals making foreign investments through a C.F.C. at tax parity with U.S. corporations for Subpart F purposes while the income remains undistributed. Under Code §962, an individual shareholder of a C.F.C. can elect to be taxed on Subpart F Income as if it formed a U.S. corporation and the U.S. corporation invested in F Co. The income of the hypothetical U.S. corporation is computed in a separate silo of the U.S. individual's tax return. The income of the hypothetical U.S. corporation is taxed at 21% as opposed to a maximum of 37%. An indirect foreign tax credit may be claimed by the hypothetical U.S. corporation for the Spanish income taxes paid by F Co. The Technical Taxpayer Rule applies at the level of F Co.

First and Second Levels of Tax: Spanish Income Taxes

The first and second levels of taxation, related to the tax in Spain, remain unchanged.

Third Level of Tax: U.S. Federal Income Tax on Subpart F Income

If Mr. A makes a timely Code §962 election on his personal U.S. income tax return for the year in which F Co. earned the capital gain, it will have the following effects:

- Mr. A's share of Subpart F Income will be taxed at the corporate rate of 21% while the funds remain in F Co.
- Mr. A will be eligible to claim a credit for the foreign taxes paid by F Co. on the gain (25%) in Spain against his U.S. Federal income tax liability (21%) on Subpart F Income.
- The excess credit cannot be used to reduce U.S. tax on other foreign source income of Mr. A.

Fourth Level of Tax: U.S. Federal Income Tax on Actual Distributions

Although a Code §962 election comes with tax benefits while the proceeds of the sale remain in F Co., it results in a second level of U.S. taxation at the time of an actual distribution to the U.S. Shareholder. When F Co. distributes the earnings derived from the sale of the property, Mr. A will be required to include in his gross income the amount of the actual distribution from F Co. to the extent that it exceeds the U.S. tax previously paid on the Subpart F inclusion, computed to take into account the benefit of the indirect foreign tax credit. The dividend is treated as a dividend from F Co., and if F Co. qualifies for full benefits under the Spain-U.S. Income Tax Treaty, the dividend is treated as a qualified dividend subject to a tax of at a rate of up to 20%. Additionally, Mr. A will be subject to the N.I.I.T. of 3.8%.

In sum, the election approximates the result if a domestic corporation had directly earned the distributed income, suffered U.S. tax (reduced by the foreign tax credit) on the income, and distributed the income net of the tax to the individual shareholder.

Option 3: Mr. A Disposes of the F Co. Stock

Option 3 entails an indirect transfer of the ownership interest in the real property by selling the stock of F Co. to the buyer.

Notably, a disposition of the stock of the foreign company that owns the real property comes with its own advantages and disadvantages. It may not be the first choice for a potential buyer of real property to acquire stock of a company because there are several unknown variables. With the acquisition of the stock, a buyer acquires the entire balance sheet. In other words, the buyer not only acquires the assets but also the liabilities of the company. It typically is not viewed by M&A lawyers as the preferable approach. Although, clients often view a stock sale as an easier transaction to consummate.

First Level of Tax: Spanish Personal Income Tax on Mr. A on the Capital Gain Arising from the Sale of the Stock of F Co.

"Spain imposes a personal income tax of 24% on the gain arising from the sale of the stock of a Spanish corporation if the seller is nonresident in Spain and resident outside the European Union."

Spain imposes a personal income tax of 24% on the gain arising from the sale of the stock of a Spanish corporation if the seller is nonresident in Spain and resident outside the European Union. Mr. A is a U.S. citizen residing in the U.S. Therefore, as a nonresident of Spain, he will be subject to Spanish tax of 24% on the capital gain.

Second Level of Tax: U.S. Federal Income Tax on the Disposition of the Stock of F Co.

Typically, a gain from the sale of stock of a corporation is treated as a capital gain. However, a sale of the stock of a C.F.C. is governed by a special rule codified under Code §1248, which recharacterizes the gain to dividend income to the extent of underlying earnings arising while the seller was a U.S. Shareholder and the target company was a C.F.C. To that extent, the gain is recharacterized as a dividend, and if the dividend is treated as a qualified dividend under the standards described above, it is subject to a reduced Federal income tax rate of 20%. Otherwise, the divided is taxed at ordinary rates, which range between 10% and 37%. The dividend is treated as foreign-source income for foreign tax credit purposes. To the extent the gain is treated as a capital gain, it is subject to a tax rate of up to 20%, and it is treated as domestic-source income for a U.S. person residing in the U.S. Rules for determining the source of the gain are discussed in greater detail, below. Both the dividend element and the gain element are subject to N.I.I.T of 3.8%.

Corporation Does Not Have Any Earnings When the Real Property Is Not Income Producing and Is Held for Investment Purposes

A foreign corporation organized as a holding company of real property with the objective of earning profits from appreciation will likely not earn any income until the sale of the property. As a result, the foreign corporation will not have any earnings. Generally, a distribution from a corporation is treated as a dividend to the extent of its earnings.[14] In the absence of any earnings, no amount of the gain can be treated as a dividend. Therefore, Code §1248 will not have any effect on the disposition of

[14] Code §316(a).

the stock of a C.F.C. in the absence of any earnings. In such a case, all of the gain from the sale of the stock will be treated as a capital gain.

Mr. A, in our example, bought the real property for investment purposes, and F Co. did not generate revenue during the time it held the property. This type of investment is often referred to as "land banking." Therefore, F Co. is not expected to have any earnings. As a result, despite the application of Code §1248, all of the gain from the sale of the stock of F Co. will be treated as capital gain. U.S. income tax will be imposed at rates of up to 20% plus 3.8% N.I.I.T.

<u>Foreign Tax Credit for Spanish Personal Tax Paid on Sale of F Co. Stock – Determining Source of the Gain</u>

If Mr. A is a U.S. citizen, he is therefore subject to U.S. Federal income tax on his worldwide income. As previously mentioned, when computing the U.S. Federal income tax liability of a U.S. taxpayer, the Code allows the taxpayer to claim a credit for the foreign income taxes paid or accrued with regard to that income.[15] However, the foreign tax credit offsets only the U.S. tax on foreign-source income. The U.S. retains the primary right to tax its citizens and residents. Consequently, if both the U.S. and a foreign country treat the same item of income as domestic-source income, there is no opportunity for a U.S. taxpayer to reduce U.S. tax on that income by a foreign tax credit.

Code §865 provides that the taxation of the gain on the sale of personal property (including stock of a company) depends on the residence of the seller. Any gain from the sale of personal property by a U.S. resident is a U.S.-source income and is therefore subject to U.S. Federal income tax.[16] On the other hand, any gain from the sale of a personal property by a U.S. nonresident is foreign-source income. An individual is a U.S. resident for foreign tax credit purposes if he is a U.S. citizen who does not have a tax home[17] in a foreign country.[18]

For the purposes of our example, Mr. A is a U.S. citizen who resides and is employed in the U.S. Therefore, he is said to have a tax home in the U.S. Accordingly, for foreign tax credit purposes, he is a U.S. resident. Thus, the capital gain arising from the sale of the stock of F Co. is U.S.-source income. As such, Mr. A is not eligible to claim a credit for Spanish personal income taxes paid by him on the capital gain arising from the sale of the stock of F Co. since the gain is not a foreign-source income for foreign tax credit purposes. Therefore, in absence of any relief under the Spain-U.S. Income Tax Treaty, Mr. A will not only be subject to a 24% tax in Spain but also a total of 23.8% tax in the U.S., thereby bringing his total tax liability of both countries to 47.8%

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15 Note that various technical rules apply when computing the foreign tax credit limitation. In many instances, those rules limit the amount of foreign taxes that can be credited in any particular year. This memorandum does not address those rules.

16 Code §865(a)(1).

17 An individual has a tax home at a particular place if it is the individual's regular place of business or, if there is more than one regular place, if it is the principal place of business. If an individual does not have a principal place of business, the tax home is at the person's regular place of abode in a real and substantial sense. Code §911(d)(3) and Treas. Reg. §301.7701(b)-2(c)(1).

18 Code §865(g).

Possible Relief Under the Spain-U.S. Income Tax Treaty

In a rather complicated and indirect way, the Spain-U.S. Income Tax Treaty revises the source rule of U.S. domestic tax law in connection with a U.S. person's sale of shares of a company owning mainly Spanish real estate. It does this in the following way:

- Paragraph 4 of Article 13 (Capital Gain) of the Spain-U.S. Income Tax Treaty grants Spain a right to tax the gains arising from the disposition of shares of a Spanish corporation that entitles its shareholder the rights to enjoy immovable property situated in Spain.
- Paragraph 3 of Article 1 (General Scope) provides a saving clause that generally allows the U.S. to impose tax on its citizens and residents, as determined under the treaty, as if the treaty had not come into effect.
- However, Paragraph 3 of Article 1 (General Scope) provides an exception to the saving clause for the purposes of Article 24 (Relief from Double Taxation).

In a nutshell, this means that if Spain can impose tax on the gain from a sale of shares of a real estate company, the U.S. will treat the gain as foreign-source income, thereby allowing a full foreign tax credit for the Spanish tax.

This result is supported by language in the Treasury Technical Explanation of the Spain-U.S. Income Tax Treaty, which was prepared by the U.S. Treasury Department at the time the treaty was submitted to the Senate for ratification in 1990:

> Thus, to the extent that gains from the alienation of shares in a Spanish corporation[[19]] derived by a U.S. person are taxed by Spain under the provisions of paragraph 4, *such gains will be sourced in Spain for purposes of allowing a foreign tax credit*. The reference that the resourcing is for purposes of avoiding double taxation is intended to bring this provision within the exception to the saving clause for Article 24 (Relief from Double Taxation), provided in paragraph 4(a) of Article 1 (General Scope) [emphasis added].

In view of the above, Mr. A may rely on the treaty provision to claim a credit for the Spanish tax paid on the capital gain arising from the sale of the stock when computing his U.S. Federal income tax liability. As a result, Mr. A will be subject to a 24% tax in Spain, which will be used to set off the 20% capital gains tax in the U.S. No credit will be available against the N.I.I.T. of 3.8%. Therefore, the total tax liability in both countries is limited to 27.8% (24% + 3.8%), plus state and local taxes in his state of residence in the U.S.

CONCLUSION

In sum, several options are available for consideration when planning a dispositions of a direct or indirect interest in Spanish real property. Each option contains several

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[19] The protocol to the Spain-U.S. Income Tax Treaty, which came into effect in 2019, expands the right of Spain to impose tax on shares of real estate companies to income companies formed both within and outside Spain. See Paragraph 1 of Article VII of the protocol.

variables. Also, U.S. state and local tax consequences must be taken into account when advising a client.

Option 3, which involves the sale of the stock of F Co., appears to be the most tax-efficient way to sell the real property. Nonetheless, several other factors must be taken into account when making a realistic evaluation of its feasibility. Factors include (i) the difficulty in finding a buyer willing to buy the stock rather than real property, (ii) reduction in the sale price that may be required in order to convince a purchaser to acquire stock, and (iii) possible exposure to ad valorem taxes on the transfer of the stock, which typically is borne by the seller. Regrettably, no structure can be determined to be most efficient without running actual numbers on a spreadsheet to see the final tax liability in both countries.