THE MORE YOU KNOW, THE MORE YOU DON'T KNOW – U.S. TAX ISSUES ON A DISPOSITION OF A FOREIGN BUSINESS

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INTRODUCTION

When a U.S. person disposes of a business situated in a foreign country, the nature of the gain as capital or ordinary and the source of the gain may sound like simple issues that require simple tax advice. It may, however, turn out to be far more complex as one begins to review the relevant provisions of U.S. tax law in light of the facts and circumstances that exist. However, as a deep dive is made into the facts and the law, it is not uncommon for issues to pop up, one after the other and on a never-ending basis.

This article discusses the various U.S. Federal income tax issues that must be addressed by a U.S. seller in connection with a sale of a business as a going concern held indirectly through an entity that is treated as a disregarded entity for U.S. tax purposes. It does so in the context of a hospitality business.

FACTS

1. Mr. A is a U.S. citizen who is a successful entrepreneur.
2. He runs multiple grocery stores in the U.S. and is actively involved in the day-to-day management of the business.
3. He also owns a luxury boutique hilltop resort in Valencia, Spain that offers accommodation, food, beverages, spa, and other luxury services to its clientele ("Resort V").
4. Mr. A owns Resort V through a Spanish company ("S Co"). S Co is treated as a disregarded entity for U.S. tax purposes under the U.S. entity classification rules.
5. Because of the disregarded status of S Co, Mr. A is deemed to directly own the individual assets of Resort V and the profits earned or losses incurred in the business of operating Resort V are regularly reported on Schedule C of Form 1040, *U.S. Individual Income Tax Return*, filed by Mr. A.
6. Resort V has not yet reached the breakeven point. Mr. A's Form 1040 for Year 2020 reported accumulated losses from the business of $2 Million.
7. Mr. A sells the shares of S Co to a foreign buyer in Year 2021 for $10 Million.
8. Because S Co is treated as a disregarded entity for U.S. tax purposes, the sale of the shares of S Co is treated for U.S. tax purposes as if it were a direct sale by Mr. A of all the assets of Resort V.

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9. The business assets of Resort V include real property, tangible personal property, financial assets, and intangible property, whether or not reported on the balance sheet of the hotel business, such as self-generated goodwill.

POTENTIAL ISSUES

Mr. A would like to understand how gain from the sale of the shares of S Co should be treated for U.S. income tax purposes and how it will affect his U.S. income tax liability.

A careful analysis of the simple transaction entailing a sale of Resort V, effected by a sale of shares of a disregarded entity, will indicate an influx of several interesting tax issues that should be addressed to quantify Mr. A's U.S. income tax liability from the sale. The following issues that will be discussed in the article:

1. The manner in which the following tax items are determined:
    a. The character of the gain arising from the sale transaction, as either long-term capital gain or ordinary income,
    b. The manner of bifurcating the gain between those two categories,
    c. The tax rate applicable to each type of income category, and
    d. The source of the resulting long-term capital gain and ordinary income for purposes of applying the foreign tax credit provisions of U.S. tax law for income taxes paid to Spain in connection with the transaction.
2. The extent to which Mr. A may deduct the deferred losses from the Resort V business that have been reported on U.S. Federal income tax returns filed for each year in which Resort V was owned against the gain arising from the sale of the shares of S Co in view of the limitations imposed by the Passive Activity Loss rules under Code §469.
3. The extent to which Mr. A may deduct the deferred losses from the Resort V business that have been reported on U.S. Federal income tax returns filed for each year in which Resort V was owned against the gain arising from the sale of shares of S Co in view of the limitations imposed by the foreign tax credit rules under Code §904 and its regulations.
4. The extent to which U.S. Federal income tax may be reduced by the foreign tax credit for Spanish income taxes paid on the gain from the sale of shares of S Co.

DISCUSSION

For U.S. Federal income tax purposes, the sale of the shares of S Co will be viewed as a sale by Mr. A of each asset of the Resort V business

S Co is treated as a disregarded entity for U.S. Federal income tax purposes. A disregarded entity is an entity that is treated for U.S. income tax purposes as if it were not separate and distinct from its owner. In other words, the assets, liabilities, income, expense, profits, and loss of a disregarded entity are deemed to be owned,

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earned, and incurred by its sole member. Therefore, the sale of S Co will be treated as a direct sale by Mr. A of the business assets of Resort V, including real estate, tangible personal property, and goodwill, such as going-concern value of Resort V. Therefore, any gain or loss arising on the sale of business assets of Resort V, any income tax paid or withheld in Spain in connection with the sale of the shares of S Co will be reported by Mr. A on his personal U.S. Federal income tax return.

Allocation of sale consideration to specific business assets of Resort V in order to compute gain or loss on each asset

The gain from the sale of an asset is equal to excess of the sale consideration over the adjusted basis in the asset on the date of the transfer.[1] Because the form of the transaction is a share sale, but the U.S. tax treatment of the transaction is an asset sale, certain adjustments must be made to move from sale consideration to the amount realized. The most important adjustment to the consideration to the sale price is to increase the price to reflect debt on the balance sheet of S Co. This is balanced by the most important adjustment to the basis of asset, which is to look to the inside basis of the assets that are reflected on the balance sheet of the Form 8858, *Information Return of U.S. Persons With Respect to Foreign Disregarded Entities (FDEs) and Foreign Branches (FBs).* When the two adjustments are made, the analysis moves from looking at a sale of shares owned by Mr. A – the actual transaction – to looking at a sale of assets owned by Mr. A – the transaction that is realized for U.S. tax purposes. Consequently, in the balance of the discussion, the terms "sales price, "sales proceeds," and "consideration" each means the amount specified in the contract of sale plus the underlying debt of S Co. Similarly, the term "basis" means the basis in all the assets of S Co, not the shareholder capital that was contributed to S Co over the years by Mr A. For ease of illustration, we will refer to the amount of underlying debt of S Co as "$X."

"U.S. tax law provides that, in the case of a sale of a business as a going concern, the consideration received by the seller must be allocated sequentially among seven main classes of assets. . ."

Consequently, Mr. A will be required to undertake a purchase price allocation study allocating the sales proceeds to each class of assets that is part of the transaction. Under the study, the total consideration in the sale ($10 Million + $X) will be allocated to the assets of Resort V based on each particular asset's relative share of fair market value.

U.S. tax law provides that, in the case of a sale of a business as a going concern, the consideration received by the seller must be allocated sequentially among seven main classes of assets, in the following order:[2]

- Class I - cash and cash equivalents
- Class II: Actively traded personal property, certificates of deposit, and foreign currency
- Class III: Accounts receivables, mortgages, and credit card receivables
- Class IV: Inventory
- Class V: All assets not in classes I – IV, VI and VII (equipment, land, building)
- Class VI: Section 197 intangibles, except goodwill and going concern

[1] Code §1001(a).

[2] Code §1060.

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- Class VII: Goodwill and going concern (residuary sale consideration)

The amount allocated to an asset, other than a Class VII asset, cannot exceed its fair market value on the purchase date. This clearly attempts to close the door to asset allocations that inappropriately allocate too much of the proceeds to assets that would result in favorable tax treatment for the seller, such as assets that give rise to capital gain tax treatment for an individual. The transferee and transferor may agree in writing as to the allocation of the consideration, or as to the fair market value of the assets. Such agreement is binding on both parties unless the allocation or fair market value is proven to be unreasonable or inappropriate.[3]

Consideration received ($10 million + $X) should be allocated as follows:

- This amount is first allocated to cash and cash equivalents that make up Class I assets transferred
- The balance of the consideration is allocated to Class II assets, then to Class III, IV, V, and VI assets in that order.
    - The order of allocation reflects a policy that purchase price should be allocated first to classes in which assets can be valued more reliably because they tend to reflect a market price, or a recent transaction, or some other objective factor.
    - Within each class, allocate the consideration to the class assets in proportion to their fair market values on the purchase date.
- Allocate the remaining consideration to Class VII assets.

If an asset in one of the classifications described above can be included in more than one class, choose the earlier class in the list (for example, if an asset could be included in Class III or IV, choose Class III).

Additionally, both the purchaser and seller must file Form 8594, *Asset Acquisition Statement Under Section 1060*, when there is a transfer of a group of assets that makes up a trade or business and the purchaser's basis in the acquired assets is determined wholly by the amount paid for the assets. This applies whether the group of assets constitutes a trade or business in the hands of the seller, the purchaser, or both. The purchaser and the seller must attach a Form 8594 to its income tax return for the year in which the transfer occurred. No requirement mandates the buyer and seller to agree on the same allocation, but if they agree in writing to an allocation in the transaction document, the agreed allocation must be used on the Form 8594 filed by each. If a party to the transaction is not a U.S. person and not a controlled foreign corporation ("C.F.C.") for U.S. tax purposes,[4] no obligation exists to file the form. If the party is a C.F.C., the form is filed by any person that is a U.S. Shareholder[5] of the C.F.C.

Class I (Cash) and Class III assets (Accounts Receivable) do not generate any gain. However, if the U.S. Dollar is not the functional currency of the Q.B.U. embodied in S Co (which will likely be the case), gain or loss could arise based in part on the

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[3] Code §1060(a).

[4] Code §957(a).

[5] Code §951(b).

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movement of currency values.

Once the sales proceeds denominated in Euros are allocated to Class I and Class III assets, the balance of the consideration will be allocated among Class V and Class VII assets (goodwill), if any.

Character of income and gain, tax rate, and source of income arising from the sale of the Resort V assets

The character of income determines the tax rate that will be imposed on Mr. A in the U.S. The source of income determines whether a taxpayer will obtain a benefit under the foreign tax credit of U.S. tax law. The foreign tax credit can be used as an offset to the U.S. Federal income tax imposed on the portion of the tax that is imposed on foreign source income.[6]

Gain from the sale of a capital asset is defined as the excess of the sale price allocated to the asset over its adjusted basis. As mentioned earlier, although the form of the transaction involving Mr. A and S Co is cast as a stock sale, because S Co is a disregarded entity, U.S. tax law treats the sale as an asset sale. Consequently, the gain from the sale of the land, buildings, improvements, P.P.E., intangible assets such as the Resort V trademark will be equal to the excess of the allocated sale price to each such asset over that asset's adjusted basis. The adjusted basis of a capital asset is equal to the amount of its original purchase price plus capital expenditures made to improve the asset and reduced by accumulated depreciation (amortization in case of an intangible asset) claimed under U.S. tax accounting concepts. The amount of the depreciation and amortization deductions and adjusted basis with respect to the assets as on December 31, 2020 can be approximated by reviewing the U.S. Federal income tax return of Mr. for 2020. Necessary downward adjustments should be made to the adjusted basis to provide for depreciation and amortization deductions for Year 2021 up to the date of sale.

Tax Treatment of the Gain from the Sale of Buildings and Land Improvements

Because depreciation deductions reduce basis, a portion of the gain is not attributable to market appreciation in the value of the asset measured from the date of original purchase. Rather, it is attributable to depreciation deductions that have reduced basis over time. To the extent the gain from the sale of the buildings is attributable to depreciation deductions, that portion of the gain is treated as ordinary income.[7] This is commonly referred to as depreciation recapture. This portion of the gain is taxed in the U.S. at the rate of 25% for an individual. Land typically is not depreciable. Consequently, no depreciation recapture exists for land. The gain in excess of depreciation recapture is treated as capital gain, and is taxed at 20% (plus the Net Investment Income tax (N.I.I.T.) at the rate of 3.8%).

A capital gain arising from the sale of a real property situated outside the US is a foreign source income.[8] Therefore, the capital gain from the sale of land on which Resort V is built is foreign source income. In addition, Mr. A will be eligible to offset his U.S. Federal income tax liability arising from the sale of the real property by a credit for the amount of the Spanish taxes paid. Benefit under the credit may be

[6] Code §901(a).

[7] Code §1250(a).

[8] Code §862(a)(5).

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limited by the foreign tax credit limitation, which is discussed later.

Tax Treatment of the Gain from the Sale of P.P.E. (Personal Property)

Like building and land, the character and source of gain from the sale of P.P.E. also will depend on the extent to which the gain is attributable to accumulated depreciation deductions claimed through the day prior to the sale.

Depreciation Recapture on P.P.E.

The gain will be recaptured as ordinary income and taxed at the level of Mr. A as ordinary income at the rate of 37% to the extent of the accumulated depreciation claimed on P.P.E. over the years.[9] The balance of the P.P.E. gain will be treated as long term capital gain taxed at 20% plus the Net Investment Income Tax at 3.8%.

Source of the Gain from the Sale of P.P.E.

Generally, U.S. tax law provides that gain arising from the sale of a personal property (movable assets) is sourced in the country of residence of the seller.[10] However, an exception exists with respect to depreciable personal property, which will be explained below:[11]

- Gain is treated as U.S.-source income to the extent of the depreciation deductions that were allowable in computing U.S. source taxable income.[12] As with depreciable real property, the gain is converted to ordinary income that will be taxed at rates of up to 37%. The 25% tax rate for depreciation recapture applicable to real estate gains is not applicable for P.P.E. gains The foreign tax credit cannot be used to reduce the U.S. tax on this recapture.
- Gain is treated as foreign-source income to the extent of the depreciation deductions that were allowable in computing foreign source taxable income.[13] The gain will be treated as ordinary income and taxed at rates of up to 37%. The foreign tax credit can be used to reduce the U.S. Federal income tax on this recapture income.
- The foregoing rules are further modified for property used predominantly outside the U.S.[14] The entire depreciation recapture is allocated to foreign source income in these circumstances. If this occurs, the foreign tax credit is available to offset the U.S. tax imposed on this recapture income.
- Any gain in excess of the depreciation adjustments is sourced as if the property were inventory property.[15] This means that if title to the property passes to the purchaser outside the U.S., the gain is foreign source gain.

Mr. A confirmed that P.P.E. of the Resort V business was only used in the resort

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[9] Code §1245.

[10] Code §865(a).

[11] Code §865(c).

[12] Code §865(c)(1).

[13] Code §865(c)(1).

[14] Code §865(c)(3)(B)(ii).

[15] Code §§865(c)(2) and 862(c)(6).

business located in Spain from the date of acquisition and have never been used in a U.S. trade or business. Therefore, the full amount of gain to the extent allocable to depreciation recapture should be treated as foreign source income. Similarly, the balance of the gain amount from the sale of P.P.E. should also be treated as foreign source income because title to the P.P.E. passes to the purchaser outside the U.S. As a result, the Spanish taxes on the gain and recapture should be available to offset the U.S. imposed on both those items, within the limitations of Code § 904.

Tax Treatment of the Gain from the Sale of Goodwill, if Any

The excess of the sale consideration over the fair market value of all assets under Class I, III, and V will be treated as goodwill. Goodwill is generally defined as the value of a trade or business attributable to the expectancy of continued customer patronage and that this expectancy may be due to the name or reputation of a trade or business or any other factor.[16] In Rev. Rul. 59-60, the I.R.S. describes goodwill in the following words:

> In the final analysis, goodwill is based upon earning capacity. The presence of goodwill and its value, therefore, rests upon the excess of net earnings over and above a fair return on the net tangible assets. While the element of goodwill may be based primarily on earnings, such factors as the prestige and renown of the business, the ownership of a trade or brand name, and a record of successful operation over a prolonged period in a particular locality, also may furnish support for the inclusion of intangible value.

The gain arising from the sale of goodwill will be treated as a capital gain subject to U.S. Federal income tax at the rate of 20% (plus Net Investment Income Tax at 3.8%). In addition, the source of goodwill is generally determined based on the location where the business activity is conducted which results in the generation of goodwill. Since the goodwill is associated with the Resort V business conducted outside U.S., goodwill from the sale of the business should be treated as foreign source income.[17] Therefore, Mr. A should be eligible to claim a credit of the Spanish taxes paid on the sale of goodwill against his U.S. Federal income tax liability arising from the same transaction.

Extent to which Mr. A can Offset the Unused Losses of $2 Million Against the Gain from the Sale of Individual Assets of Resort V Under the Passive Activity Loss Limitation Rules

Mr. A has been reporting the Resort V business as a passive activity under Code §469 on his income tax return for U.S. Federal income tax purposes.

An activity is a passive activity if the participation of a taxpayer in the activity of the business is not continuous and regular, and the individual does not materially and

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16 Treas. Reg. §1.197-2(b)(1).

17 The considerations that caused the sale of a franchising business conducted outside the U.S. in *International Multifoods Corporation and Affiliated Companies v. Commr.,* 108 T.C. 25 (1997) are not present here. In *International Multifoods*, the taxpayer was in the business of licensing franchises. The value of the goodwill was inextricably tied to the trademarks and know-how that were sold. Gain from the sale those assets generated domestic source income. The case is discussed elsewhere in this edition of *Insights*.

actively participate in the day-to-day business operations.[18] An individual is treated as materially participating in an activity if:[19]

- Participation by the individual in the activity is for more than 500 hours during the year
- Participation by the individual in the activity is substantially all of the participation in the activity of *all* individuals (including non-owners) for the year. There is no indication of the meaning of "substantially all."
- Participation by the individual in the activity is for more than 100 hours provided it is not less than that of any other individual (including non-owners).
- The activity is a significant participation activity and participation in all such activities for the year exceeds 500 hours. A significant participation activity is a trade or business in which the individual participates for more than 100 hours per year, but does not materially participate under any of the other tests.
- Material participation occurred (under one of the other six tests) in the activity in any five (not necessarily consecutive) of the ten preceding years.

  The activity is a personal service activity and material participation occurred in any three preceding years (not necessarily consecutive). Unlike the test above, involving prior year participation, this test does not require that the prior year participation qualify under one of the other tests. A personal service activity consists of performing services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting or performing service in any other trade or business in which capital is not a material income-producing factor.
- Based on all of the facts and circumstances, the individual participates on a regular, continuous, and substantial basis during the year. For purposes of this test, services performed in the management of an activity are not taken into account unless
  - no other person receives compensation for performance of management services, and
  - no other person performs more management services than the taxpayer when measured in terms of hours.

  In addition, the individual must participate for more than 100 hours.

"The classification of a business as a passive activity becomes relevant when the business generates operating losses."

The classification of a business as a passive activity becomes relevant when the business generates operating losses. The losses arising from a passive activity are subject to the passive activity loss limitation rules of Code §469. The rules provide that a passive activity loss can be offset only against passive activity income.[20] In other words, even if a taxpayer realizes nonpassive activity income, such as salaries from employment or income from an actively managed business, a passive activity

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[18] Code §469(c)(1).

[19] Treas. Reg. §1.469-5T(a).

[20] Code §469(a);(d).

loss cannot reduce the nonpassive taxable income. As a result, a taxpayer ends up paying U.S. Federal income tax on nonpassive activity income despite suffering losses in a passive activity in the same year. Note that any excess loss from a passive activity is not permanently lost. Rather, the loss is indefinitely suspended. The accumulated passive activity loss becomes available at the final disposition of the passive activity that generated the loss, provided that the gain from the disposition is fully taxable in the U.S. When that occurs, the suspended losses can be used to offset the gain arising from such disposition.[21]

Mr. A's 2020 U.S. Federal income tax return reported $2 Million of accumulated losses from the Resort V business. As discussed above, the sale of shares of S Co viewed as the sale of each asset will be fully taxable in the U.S. Accordingly, the final disposition of the assets of the Resort V business will free up the suspended passive losses of $2 Million. The freed-up losses will become available to offset the gain from the sale of the Resort V business.

Extent to which Mr. A can Utilize the Unused Losses of $2 Million (as Reported on Mr. A's 2020 U.S. Federal Income Tax Return) to Offset the Gain from the Sale of Shares of S Co Under the Foreign Tax Credit Rules

Until this point, the article addressed the source of gain and recapture income from the sale of each asset of Resort V and Mr. A's ability to utilize the unused loss of $2 Million under the Passive Activity Loss rules to reduce the taxable income that will be generated by the sale of S Co. We will now address how the foreign tax credit rules of U.S. tax law are applied to the contemplated gain and recapture income in order to eliminate double taxation.

Broadly speaking, the foreign tax credit rules impose three main limitations on a taxpayer's ability to claim a benefit from the credit for foreign taxes paid.

- The foreign tax credit benefit is limited so that it can be used to set off only the portion of U.S. Federal income tax that is imposed on net foreign source income determined under U.S. tax law.

- In order to prevent U.S. taxpayers from cross-crediting high foreign tax on business income against the U.S. tax on other items of income and gain from foreign sources, Code §904(d) categorizes income and foreign taxes into several baskets. The U.S. Federal income tax on income in a particular basket can be reduced only by foreign income taxes imposed on the income in that basket. As a result, foreign taxes in one basket cannot be used to offset U.S. Federal income tax on income in another basket. Where a taxpayer reports foreign income in more than one category, the foreign taxes must be allocated among the baskets.[22] After 2017, five foreign tax credit baskets exist: (i) general, (ii) passive, (iii) foreign branch, (iv) G.I.L.T.I., and (v) income resourced under a provision of an income tax treaty.

- If a taxpayer reports foreign source expenses in one basket in excess of the income in that basket, the net loss is called Separate Limitation Loss

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[21] Code §469(g)(1).

[22] This is done by multiplying the foreign income tax related to more than one category by a fraction. The numerator of the fraction is the net income taxed by the foreign country in the relevant foreign tax credit basket. The denominator is the total net income taxed by the foreign country.

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("S.L.L.").[23] An S.L.L. can be transferred to reduce the net income in one or more other baskets. Where an S.L.L. in one basket is transferred under this rule in a particular year, adjustments to the foreign tax credit baskets are required in subsequent years to reverse the effect of the transfer of losses. Income in subsequent years in the original loss basket is re-categorized as income in the basket to which the losses were transferred previously.[24] A re-characterization affects only the income in the basket, not the foreign taxes paid on the income in the basket.[25]

For example, if a passive category S.L.L. offsets income in the general category, then future passive category income will be re-characterized as general category income in subsequent years until the prior loss is fully recaptured.

In view of the last limitation discussed above, Mr. A will be eligible to reduce the gain from the sale of shares of S Co treated as a sale of business assets for U.S. purposes by the full amount of unused losses of $2 million if the gain and the loss fall under the same foreign tax credit category. If it is determined that the gain and the loss belong to different foreign tax credit categories, Mr. A can still offset the gain by the amount of full losses, however, it will result in the creation of an S.L.L. under the relevant foreign tax credit basket.

Prior to 2018, there were only two foreign tax credit categories for foreign tax credit purposes, general and passive. The 2017 Tax Cuts and Jobs Act introduced, *inter alia*, a new category, called the foreign branch category. Therefore, separate discussions are required to understand the category in which the losses in the Resort V business fall pre-2018 and post-2017.

Pre-2018: In the Absence of an Election Made by Mr. A, the Unused Passive Losses from the Resort V Business Incurred Through the End of 2017 are Attributable to General Category for Foreign Tax Credit Purposes

The 2017 U.S. Federal income tax return of Mr. A reported unused passive losses of $1.8 Million. The Resort V business is an active business for foreign tax credit purposes. Consequently, income, gains, losses, and foreign taxes should be reported in the general basket. It is of no consequence that for purposes of preventing Mr. A from deducting the losses from the Resort V business, the losses arise from a passive activity. In the absence of any election by Mr. A, the loss of $1.8 Million incurred through the end of 2017 can be used to offset any income earned in 2018 and subsequent years under the general category.

The gain from the sale of the shares of S Co treated as the sale of business assets will be reported in the general foreign tax credit basket.[26] Therefore, since the pre-2018 unused loss of $1.8 Million and the gain from the sale of the Resort V business fall under the same foreign tax credit basket, Mr. A will be eligible to reduce income and long-term capital gain in that foreign tax credit basket by the amount of unused losses. In other words, Mr. A will not be liable to pay any tax in the U.S. on the gain from the sale of the Resort V business to the extent of the unused losses as report-

[23] Treas. Reg. §1.904(f)-7(b)(3).

[24] Code §904(f)(5).

[25] Code §904(f)(5)(C); Treas. Reg. § 1.904(f)-8(b).

[26] Reg. §1.904-4(f)(2)(iv)(A).

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ed on December 31, 2017.

If, for any reason, it is determined that the gain from the sale of the S Co should be reported in the foreign branch foreign tax credit basket, Mr. A may elect to treat the net operating loss carryforward ($1.8 Million) under the foreign branch foreign tax credit basket so that the losses reduce taxable gain in the foreign branch basket.[27]

Post-2017: The Loss Incurred from the Operations of Resort V in 2018 and Following Years up to the Date of Sale will be Reported in the Foreign Branch Foreign Tax Credit Basket

As mentioned above, the 2017 Tax Cuts and Jobs Act introduced a new foreign tax credit basket effective Jan 1, 2018, namely, foreign branch foreign tax credit basket. Therefore, a determination should be made as to whether the loss from the operations of the Resort V business in post-2017 years continues to fall under the general foreign tax credit basket or under the new foreign branch foreign tax credit basket.

In general, if income or loss qualifies as foreign branch income, the income or loss is reported in the foreign branch basket for foreign tax credit purposes. Foreign branch income includes income attributable to a foreign branch of a U.S. person held directly or indirectly through disregarded entities.[28] A foreign branch means a Q.B.U., or qualified business unit, that is a separate and clearly identified unit of a trade or business located in a foreign country for which the taxpayer maintains separate books and records.[29]

Resort V is indirectly owned by Mr. A through S Co which is a disregarded entity for U.S. tax purposes. Resort V is a separate and clearly identified unit that conducts a hospitality business in Spain. It also maintains separate books of accounts that record transactions and business income and losses on a regular basis. Therefore, it qualifies as a Q.B.U. Accordingly, any income or loss from the operations of Resort V will be treated as a foreign branch income for foreign tax credit purposes. Therefore, the losses in 2018 through the date of the sale will fall under the foreign branch category for foreign tax credit purposes.

The balance of the gain after setting off the unused net losses of $1.8 Million as on December 31, 2017, can be further reduced by the losses accumulated in 2018 and 2019 and incurred up until a day prior to the sale of shares of S Co in 2020. However, as discussed above, a cross basket offsetting of losses, results in the creation of an S.L.L. Since post-2017 losses fall under the new foreign branch foreign tax credit basket and the gain fall under the general category foreign tax credit basket, the offsetting of the loss will result in the creation of an S.L.L. account in the foreign branch basket with respect to general category basket.

For ease of understanding, let's assume that the accumulated losses incurred in the Resort V business for 2018 through a day prior to the sale of the shares of S Co is $500,000. In such case, a reduction of the gain by $500,000, will result in the creation of an S.L.L. account in foreign branch foreign tax credit basket with respect to general category foreign tax credit basket. As a result, any future income earned by Mr. A in the foreign branch category to the extent of $500,000 should be

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[27] Treas. Reg. 1.904(f)-12(j)(4).

[28] Treas. Reg. §1.904-4(f)(1)(i)(A).

[29] Code §904(d)(2)(J); and Treas. Reg. § 1.989(a)-1(b)(2)(ii).

re-characterized as general category income for foreign tax credit purposes.

As mentioned above, only income is recharacterized. Foreign taxes on the income are not recharacterized.[30] Therefore, while any future income earned by Mr. A that qualifies as foreign branch basket income will be recharacterized as income under the general basket to the extent of $500,000, it will not recharacterize the foreign taxes paid on the foreign branch income into the general basket. Because foreign taxes in one basket cannot be used to offset U.S. tax on income in another basket, Mr. A will not be eligible to offset the U.S. tax on the recharacterized general category income by the foreign taxes that fall under the foreign branch basket that are paid on the recharacterized general category income.

When the rule is looked at one way, this will result in double taxation of the same income in the future. When the rule is looked at another way, this rule simply reverses the use of cross basket losses that reduced U.S. income and taxes for the year of the sale. If no foreign branch income is earned by Mr. A in the future, the S.L.L. account in the foreign branch category with respect to the general category will remain suspended until the full amount of loss is recaptured. On the other hand, if Mr. A derives highly taxed foreign source income in the general basket and low-tax income in the branch basket in future years, the transfer of income from the branch basket to the general basket may provide a benefit.

Eligibility of Mr. A to Claim a Credit for the Spanish Taxes Paid on the Gain from the Sale of Shares of S Co Against his U.S. Federal Income Tax Liability Arising from the Same Income

When computing the amount of tax that must be paid to the U.S. on an individual's worldwide income, a taxpayer is entitled to reduce the taxes owed to the U.S. by a credit for income taxes paid to a foreign government. However, the foreign tax credit can reduce only the portion of the U.S. income tax liability that is imposed on net foreign source income, as computed under U.S. Federal income tax concepts.

Let's assume Mr. A is subject to a Spanish income tax of 19% on the gain arising from the sale of shares of S Co. Mr. A will be able to reduce only the portion of his U.S. tax on the income and gain that is properly characterized as foreign source income. In principle, because most, if not all, of the gain and depreciation recapture will be treated as foreign source income (discussed above), most, if not all, of the U.S. income tax can be offset by Spanish income taxes paid. In practice, there will be some slippage. Also, to the extent the U.S. tax rate for long-term capital gains (20%) is higher than the Spanish tax rate (19%), a portion of the U.S. tax will exceed the Spanish tax, assuming income and gain are computed alike in Spain and the U.S. In addition, no foreign tax credit is allowed to reduce Net Investment Income Tax. Hence, the full 3.8% tax will be owed in the U.S.

In Case of the Gain from a Disposition of an Asset that would Otherwise be Treated as Foreign Source Gain or Income, a Taxpayer is Required to Re-Source the Foreign Source Gain to U.S. Source to the Extent of the Overall Foreign Loss Account

If a taxpayer consistently reports foreign source expenses in excess of foreign source income on an aggregate basis for all foreign tax credit baskets, the taxpayer

[30] Code §904(f)(5)(C); Treas. Reg. § 1.904(f)-8(b).

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will report what is commonly called an overall foreign loss ("O.F.L."). An O.F.L. is the excess of deductions allocated and apportioned to gross income and gain from all foreign sources over the amount of that gross income.[31] If a taxpayer has taxable income from U.S. sources for a year for which he incurs an O.F.L., he is entitled to reduce his U.S. taxable income by the amount of O.F.L. As a result, the taxpayer receives a benefit from the O.F.L. in so far as he is not liable to pay U.S. tax on U.S. source income to the extent of the O.F.L.

In the absence of a provision to the contrary, if in a subsequent year, he reports net foreign source income and pays foreign tax on that income, the tax payable to the U.S. can be reduced by the foreign tax credit. This results in is a second tax benefit. The O.F.L. rule is designed to prevent the second benefit. It does so by resourcing all or a portion of the foreign source income in subsequent years into U.S. source income for foreign tax credit purposes.[32] As a result, the portion of the U.S. tax that can be offset by a credit for foreign income taxes is automatically reduced. When the second benefit is reduced, the reduction is generally referred to as a recapture.

The recapture generally works as follows. For each year after an O.F.L. has reduced U.S. source income, a taxpayer must recapture the O.F.L. by treating a portion of foreign source income as domestic source income. The amount recaptured is equal to the lesser of the following:[33]

- 50% of taxable income from foreign sources
- The O.F.L. not recaptured in prior years

In addition, if a taxpayer recognizes foreign source gain in a separate foreign tax credit basket on the disposition of an asset that was predominantly used in a foreign trade or business, and a balance exists in the O.F.L. account after a recapture according to the above formula with regard to that basket, a portion of such balance is further recaptured by treating the foreign source gain as domestic income. Again, the amount recaptured is the lesser of

- 100% of the foreign source taxable income recognized on the disposition that has not been previously characterized, and
- the remaining balance in the O.F.L.

With regard to the sale of shares of S Co, it is treated as a disposition of all assets of Resort V (owing to the disregarded nature of S Co) predominantly used in a trade or business in Spain. Therefore, if some portion of the losses from the Resort V business reduced Mr. A's U.S. source income in years prior to the year of sale, the O.F.L. provisions will apply, and he will be required to recapture some portion of the gain from the sale of shares of S Co as U.S. source income.

The losses in Spain arising from the Resort V business were properly treated as passive activity losses. Therefore, as discussed above, they could only be used in prior years to reduce passive activity income. To that extent, the Resort V losses, that were actually deducted to reduce U.S. passive activity income in prior years, will be recaptured as U.S. source income for purposes of computing the foreign tax

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[31] Code §904(f)(2).

[32] Code § 904(f)(5)(A).

[33] Code §904(f)(1)(B).

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credit limitation. To the extent the passive activity losses were deferred, they will simply reduce the foreign source income in the appropriate foreign tax credit basket for 2020.

CONCLUSION

The provisions relating to passive activity loss, separate limitation loss, and overall foreign loss typically become relevant in businesses that have a long gestation period resulting from a substantial initial capital investment. Because of the capital-intensive nature of the hospitality industry, a business more likely than not reports losses in initial years due to depreciation expense and lower profits. In such fact pattern, tax practitioners should not ignore the application of the separate limitation and overall foreign loss rules because it not only affects the taxation in the year of disposition but also future years until the income is fully recaptured.

The best place to start the tax analysis of a disposition of a business is to review the U.S. tax return of the seller that will indicate the characterization of the foreign entity that owns the business (Form 8858, *Information Return of U.S. Persons With Respect to Foreign Disregarded Entities (FDEs) and Foreign Branches (FBs),* in the present case) whether the business activity is characterized as a passive activity for Code section 469 purposes, whether the business is loss making and therefore has accumulated losses, etc. The more you come to know on a review, the more you will realize how little you know.

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