Is Refund of State Imposed FIRPTA Tax Subject to US Federal Income Tax?

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Exploring the Boundaries of the Tax Benefit Doctrine

This article addresses the US federal income tax treatment of a refund of a state imposed FIRPTA tax.

If a foreign person sells stock in a US corporation and such corporation owns real property in California, the state of California may attempt to impose a FIRPTA tax on such sale of stock at the state level. It is possible that the foreign taxpayer may be able to achieve a refund of such tax by challenging the legitimacy of such tax. The US federal income taxation of the refund may depend upon the timing of a payment of the tax and a refund of the tax from the state as well as the application of so-called tax benefit doctrine and income tax treaty analysis.

Under the so-called tax benefit doctrine, an argument can be made that the tax character of the state imposed FIRPTA tax refund should be treated as ordinary income and not treated as capital gain for US federal income tax purposes. Depending upon the tax residency of the foreign taxpayer, the income tax treaty between the US and the foreign country where the foreign taxpayer resides may exempt such ordinary income from US federal income tax.

US FIRPTA Tax

If a foreign person (or entity) sells stock in a US corporation that owns US real estate, such foreign person may be subject to US tax on sale of the stock. US tax is generally not imposed on a foreign person's capital gain on the sale of property located in the US unless such gain is effectively connected with a trade or business conducted in the US. However, under the so-called FIRPTA rules, a foreign person's capital gain on the sale of a US real property interest (including an interest in a US real property holding corporation) is generally subject to US tax.

An equity interest in a US corporation generally qualifies as a US real property holding corporation ("USRPHC") if then US corporation holds US real property interests having an aggregate fair market value that equals or exceeds 50 percent of the fair market value of the corporation's real property and business assets (including goodwill) on certain determination dates over a 5 year period preceding the foreign person's disposition of an equity interest in the US corporation. US income tax treaties generally do not provide an exemption for the US taxation of the FIRPTA gain.

California FIRPTA Tax

US states, on the other hand, generally do not tax a foreign taxpayer's gain on the sale of stock of a USRPHC absent the foreign taxpayer having some nexus with the US (beyond the mere holding of stock in the USRPHC). However, the state of California has recently taken the position on a number of audits that it can tax a foreign taxpayer's gain on the sale of stock of a USRPHC (that owns property in California) despite the fact that the foreign taxpayer lacks nexus with the US.

Challenging California's FIRPTA Tax

There is authority to support an argument that the state of California lacks jurisdiction to tax a foreign taxpayer's gain on the sale of stock of USRPHC if such taxpayer lacks nexus with the US. For example, California law generally provides that a foreign corporation should only be included in a California Water's Edge tax combined report if the foreign corporation has taxable nexus with the US.

When a foreign taxpayer sells stock in a USRPHC, it can choose to not pay the California FIRPTA tax and be subject to the risk of prosecution by the state of California. If the state of California is successful in its claim, the taxpayer could be subject to interest as well as a substantial penalty.

Alternatively, a foreign taxpayer can chose to pay the tax to the state of California, contest the tax and submit a claim for a refund of the tax to avoid the risk of interest and penalties. It is not uncommon for the state of California and taxpayer to settle tax claims to avoid the hazards and costs of litigation. For example, the state of California could potentially agree to a refund of 40-to-60 percent of the tax to avoid the risk of losing in court. Likewise, a foreign taxpayer may agree to such settlement offer to avoid the costs of litigation and to avoid the state of California holding its refund hostage for a lengthy period of time.

US Federal Income Tax Treatment of State Tax Payment

The payment of the contested income tax to the state of California in the tax year of the sale can generally be treated as a deductible expense that can be used to offset a foreign taxpayer's FIRPTA gain for US federal income tax purposes. Pursuant to section 164(a) of the Internal Revenue Code, the character of a state income tax deduction should be treated as an ordinary deduction.

Conversely, if a foreign taxpayer does not pay the tax to the state of California, and has to make a subsequent payment to the state of California (as a result of a judgment or a settlement), it is possible that such expense may not be used to offset the FIRPTA gain for US federal income tax purposes. For example, a net operating loss can generally only be carried back two years. A current year deduction after the two-year period would have no value to a foreign taxpayer who does not generate taxable income in the US.

US Federal Income Tax Treatment of State Tax Refund (Application of the Tax Benefit Rule)

If the foreign taxpayer receives a refund from the state of California within the statute of limitations for a US federal income tax return (generally, three years), the foreign person may need to amend its tax return to account for a refund of the state income tax deduction. This would result in an increase in the US federal income tax owed on the gain in the stock of the USRPHC.

However, in the event that the refund is not received by the foreign taxpayer until after the statute of limitations for the US federal income tax return on which the FIRPTA gain was reported, the foreign taxpayer has to treat the refund as income in the year of receipt under the so-called tax benefit and *Arrowsmith* doctrines because the foreign taxpayer previously received a tax benefit (the prior deduction for the payment of state tax) which reduced its FIRPTA gain. The payment of state tax (for which a deduction was taken) is being refunded to the foreign taxpayer in later year after the statute of limitations has expired.

The tax benefit doctrine generally provides that where an item deducted by the taxpayer in one year is recovered by the taxpayer in a subsequent tax year (after the statute of limitations has expired for US federal income tax purposes), the recovery must be included as taxable income of the taxpayer in the tax year in which the recovery occurs.   Under the tax benefit doctrine, the "character" of the recovered income as ordinary income or capital gain follows the character of the prior deduction. The *Arrowsmith* doctrine (named for the US Supreme Court decision in *Arrowsmith v. Commissioner*) similarly provides that the character of a gain or loss transaction is to be determined by the character of the gain or loss recognized on related transaction in a prior tax year. In applying the tax benefit doctrine, regard should be given to the nature of the prior deduction itself (as ordinary or capital) rather than the character of the income that the prior deduction was offset against in an earlier year.

There is authority under the so-called tax benefit and *Arrowsmith* doctrines to support a position that the "character" of the state tax refund (which was treated as an ordinary deduction for US federal income tax purposes in an earlier tax year) is to be treated as ordinary income in the year of the refund.

For example, in PLR 200814019, the Internal Revenue Service (IRS) addressed whether the recovery of an item can be characterized as a type of income the deduction was taken against in the prior tax year. In this ruling, a regulated investment company (RIC) deducted overcharged transfer agency fees. The IRS treated the recovery of such fees in a subsequent tax year as ordinary income, but declined to characterize the income with reference to different types of income that the ordinary deduction was offset against in a prior tax year.

Moreover, if the Service attempted to assert that the character of a state income tax refund should be based upon the type of income that the ordinary state income tax deduction was offset against in the prior tax year (e.g., FIRPTA gain), US individual taxpayers would be able to rely on such assertion to take the position that the character of a state tax refund should be treated as capital if the ordinary deduction for a state income tax expense was offset against capital gain in a prior tax year on a US federal income tax return.

For example, a US individual taxpayer could sell property and be subject to both US federal income tax and state income tax on a capital gain. The US individual taxpayer can offset its capital gain on its US tax federal income return by the amount of the state income tax expense (which is an ordinary deduction on the US tax return). If there is a refund of a state income tax (because of an overpayment or for some other reason), the issue is whether the state tax refunds should be treated as ordinary income (consistent with the character of the deduction taken) or as capital gain (consistent with the character income that the deduction offset). Treating the state income tax refund as capital gain as opposed to ordinary income would result in the state income tax refund being taxed at lower individual tax rates for capital gains. The IRS, however, does not allow a taxpayer to treat the character of a state tax income refund as a capital gain in any context.

Accordingly, an argument can be made that the character of the state imposed FIRPTA tax refund should be treated as ordinary income and not treated as capital gain (nor as gain from the sale of the stock of a USRPHC) for US federal income tax purposes.

US Income Tax Treaty Analysis

Depending upon the tax residency of the foreign taxpayer, the income tax treaty between the US and the foreign country where the foreign taxpayer resides may exempt such ordinary income from US federal income tax provided that the foreign taxpayer does not have any nexus with the United States (beyond the mere holding of stock in the USRPHC). For example, if the selling taxpayer resides in the UK, there is authority under the US-UK tax treaty which supports the position that the refund payment should be treated as "other income" under Article 22 of US-UK income treaty. Such income is generally not taxable under the US-UK tax treaty. The same type of argument can be made under a number of US tax income tax treaties with other countries.

Tax Policy Considerations

The fact that a taxpayer may be able to reduce its US federal income tax liability when it receives a state tax refund (because is exempted from taxation by a US income tax treaty) should not change the result that the refund is characterized as ordinary income under the tax benefit doctrine.

The tax benefit doctrine seeks to achieve a rough parity in the context of the annual accounting system.

The purpose of the tax benefit doctrine is not to achieve a precise balance in the amount of tax reduction achieved in a prior year with an amount of a tax increase in a recovery year. To be sure, the tax benefit doctrine has been applied in cases where the tax rate in a recovery year is more or less than the tax rate in the tax year in which the tax benefit was realized. (See, *e.g.*, *Hillboro National Bank*, 460 U.S. 370(1983) and *Alice Phelan Sullivan Corp.*, 381 F.2d 399 (Ct. Cls. 1967).

As discussed above, the treatment of a state tax refund as ordinary income without a reference to the character (or type) of income against which the prior state income tax deduction was offset is actually favorable to the IRS in cases where a US individual taxpayer recognizes capital gain and offsets state income tax against such gain. The Service takes the position that a refund of state income tax is treated as ordinary income to the individual and taxes such income at a higher rate for ordinary income.

Finally, foreign taxpayers do not avoid the recognition of taxable income under this rule. A foreign taxpayer is required to recognize ordinary US source income in the year of the recovery. Such income is subject to US taxation absent an exemption under a US income tax treaty. Congress made a decision to specifically exempt such ordinary US source income when it negotiated income tax treaties with certain countries. Thus, an argument can be made that the ordinary US source income from the state tax refund should be exempt under applicable tax treaties.

Conclusion

If a foreign person (or entity) sells stock in a US corporation, consideration should be given to whether the US corporation qualifies as a USRPHC and whether the sale is subject to US FIRPTA tax. If the USRPHC owns real property in California, consideration should also be given to whether a California FIRPTA tax payment should be made to the state of California tax along with a request for a refund. Consideration should also be given to the timing of any payment of the state imposed FIRPTA tax and to the timing of any refund from the state of California. The timing of a payment could impact whether the foreign taxpayer's can deduct such payment against the FIRPTA gain for US federal income tax purposes and the timing of the refund could impact whether the refund is subject to US federal income tax. Finally, the tax residency of the foreign taxpayer will also be relevant.

If you need support for the authority set forth above or if you have a question on state tax or international tax issue, please contact John Buckun at 312-476-7515.

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