Can Foreign Tax Credits Offset Net Investment Income Taxes?

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Tax Court Holds that it Depends on the Treaty

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Taxpayers dislike paying taxes once, and they absolutely detest paying them twice. The good news is that U.S. individuals working and/or investing abroad can often mitigate "double taxation" thanks to a few mechanisms, including foreign tax credits ("FTCs") and bilateral tax treaties. Qualifying for these benefits can be tricky, of course. One controversial issue has been whether U.S. individuals can use FTCs to offset net investment income taxes ("NIITs"). A recent Tax Court case, *Toulouse v. Commissioner*, resolves that question in part, while expressly leaving open the possibility of different outcomes.[1]

Overview of Applicable Tax Provisions

Appreciating the reasoning and holdings in *Toulouse* requires some background. U.S. citizens and residents generally must pay U.S. income tax on their worldwide income; that is, all income, of all types, from all sources, both domestic and foreign.[2] There are exceptions to this broad rule. For instance, U.S. individuals can claim FTCs for certain amounts they were obligated to pay foreign countries.[3] More specifically, they can claim FTCs, subject to certain limitations, for any "income taxes" paid or accrued during the relevant year to any foreign country or to any U.S. possession.[4] The ability to obtain a dollar-for-dollar offset of U.S. income tax liabilities by applying FTCs often prevents U.S. individuals from being hit with "double taxation."

Nuances abound, as one would expect. The following two are important for purposes of this article. Section 27, which generally creates FTCs, expressly states that taxpayers can only use them to offset taxes "imposed by this chapter." This refers to Chapter 1 of the Internal Revenue Code, which encompasses "income taxes." Limitations on FTCs are also found in Section 901. This provision, likewise, says that it applies only to taxes "imposed by this chapter," again meaning Chapter 1 of the Internal Revenue Code.[5] The pertinent regulations feature the same language and restrictions.[6]

Other mechanisms, in addition to FTCs, can help taxpayers with foreign tax bills. Among these are tax treaties between the United States and other countries. The IRS and courts must consider the impact of relevant treaties when applying the Internal Revenue Code, and they cannot give preferential status to either legal authority.[7]

Section 1411 imposes NIITs on certain types of income ordinarily considered passive in nature, including, but not limited to, interest, dividends, annuities, royalties, rents, and proceeds from non-business property sales.[8] Importantly, the NIIT is located in Chapter 2A of the Internal Revenue Code, not in Chapter 1, and is characterized as an "unearned income Medicare contribution."

Analysis of the Case

Like most Tax Court cases, *Toulouse* is somewhat complicated, from both a procedural and substantive perspective. This article only examines the essential aspects, below.

Main Facts and Return Positions. The taxpayer is a U.S. citizen who resided in France. Although not discussed in the case, it appears that the taxpayer had lived abroad for an extended period, paying taxes in various foreign countries and accumulating a significant FTC carryover. The taxpayer filed a timely 2013 Form 1040 (U.S. Individual Income Tax Return). A line-by-line analysis of the Form 1040 is necessary to understand what, exactly, the taxpayer was trying to do.

- Line 44 showed that the taxpayer had a U.S. income tax liability of $63,632.
- Line 47 indicated that she was claiming an FTC of an equal amount, $63,632. How did she arrive at this FTC figure? According to the Form 1116 (Foreign Tax Credit) enclosed with her Form 1040, the taxpayer paid a total of $51,456 in income taxes in Italy and France in 2013, and she utilized a portion of an FTC carryover from earlier years to make up the difference.
- Line 60 is for reporting "other taxes," including NIITs shown on Form 8960 (Net Investment Income Tax - Individuals, Estates and Trusts). The taxpayer enclosed a Form 8960 with her Form 1040, declaring that she had $11,540 in NIITs in 2013. Apparently, she strongly disliked the thought of paying these because she customized Form 8960 by hand. She added a new line styled "Less Foreign Tax Credit" and then wrote $11,540. In short, the taxpayer unilaterally modified Form 8960 to her benefit, using a portion of her FTC carryover from earlier years to offset the NIITs, and then transferring a $0 to Line 60 of Form 1040.
- With no additional tax amounts to report, Line 61 of Form 1040 stated that the taxpayer had a total U.S. income tax liability of $0 for 2013.

The taxpayer in no way hid what she was doing from the IRS. On the contrary, she disclosed her position that she was entitled to use FTCs to eliminate NIITs in three different ways. First, she made the overt modifications to Form 8960, as explained above. Second, she enclosed with her Form 1040 a Form 8275 (Disclosure Statement) stating that she had used some of her carryover FTCs to offset NIITs. Third, she enclosed two different Forms 8833 (Treaty-Based Return Position Disclosure) explaining how the US-Italy Treaty and the US-France Treaty allegedly supported her position.[9]

Summary of Tax Procedures. It did not take long for the IRS to identify and challenge the taxpayer's position on her 2013 Form 1040. The IRS first sent the taxpayer a Notice of Math Error, informing her that she had omitted $11,540 in taxes and assessing the same. The taxpayer and IRS then exchanged some correspondence, the thrust of which was that the parties disagreed about whether FTCs can be used to eliminate NIITs. The taxpayer eventually filed a Protest Letter, which the Appeals Office rejected on grounds that FTCs cannot offset NIITs. The IRS also assessed late-payment penalties at some point because the taxpayer supposedly failed to pay the tax liability shown on her 2013 Form 1040.[10]

The IRS issued various collection-related notices throughout the process, culminating in a Final Notice of Intent to Levy and Notice of Your Right to a Hearing ("Pre-Levy Notice"). The taxpayer submitted a timely request for a collection due process ("CDP") hearing, challenging the underlying tax issues.[11] The taxpayer participated in the CDP hearing with the Appeals Office, which resulted in a Notice of Determination rebuking the taxpayer's position about the use of FTCs and deeming the Pre-Levy Notice appropriate.

The taxpayer, down but not yet defeated, filed a Petition with the Tax Court disputing the Notice of Determination. Both the taxpayer and the IRS eventually filed Motions for Summary Judgment, thereby asking the Tax Court to resolve the FTC issue without the need for a trial. The Tax Court did just that, as seen below.

Main Rulings by the Tax Court. The Tax Court began with some general comments about how the Internal Revenue Code, which comprises Title 26 of the U.S. Code, is organized. It described Subtitles, Chapters, Subchapters, Parts, Sections, Subsections, Paragraphs, Subparagraphs, and Clauses. It then explained that the two provisions establishing FTCs, Section 27 and Section 901, both expressly limit their application

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"the enactment of [NIITs] as part of Chapter 2A is a clear expression of congressional intent that [FTCs] not apply against the Section 1411 tax"

to taxes imposed by Chapter 1 of the Internal Revenue Code. Because Section 1411 imposes NIITs, and because Section 1411 is found in Chapter 2A instead of Chapter 1, FTCs cannot be used to offset NIITs, concluded the Tax Court. It also noted that the regulations under Section 1411 leave no doubt about this conclusion, stating that foreign income taxes allowed as FTCs under Section 27 and Section 901 "are not allowed as a credit against the Section 1411 tax."[12]

The Tax Court turned to the primary position of the taxpayer, which was that, notwithstanding the clear language in Section 27, Section 901, and Section 1411, she was entitled to use her FTCs to offset NIITs thanks to the US-Italy Treaty and the US-France Treaty. The Tax Court started by acknowledging that both the U.S. Constitution and the Internal Revenue Code provide that treaties have the same force and effect as any legislation passed by Congress. However, the Tax Court underscored that, when interpreting a treaty, it generally must give terms their ordinary meanings. The Tax Court then explained that the relevant provisions in both the US-Italy Treaty and the US-France Treaty state that FTCs should be allowed only "in accordance with the provisions and subject to the limitations of the law of the United States."[13] One such limitation, emphasized the Tax Court, was that FTCs could not offset NIITs pursuant to Section 27, Section 901, and Section 1411.

Resolution of Alternative Arguments. The Tax Court next dealt with several alternative arguments that the taxpayer must have raised in some fashion. These are somewhat unclear from the Opinion issued by the Tax Court, and the author lacks the benefit of reviewing the briefs filed by the parties. Accordingly, the following discussion is necessarily based on certain assumptions.

It appears that the taxpayer advanced the later-in-time-controls argument, pointing out that Section 1411, which imposes NIITs, was enacted *after* the US-Italy Treaty and the US-France Treaty took effect. The taxpayer presumably contended that, if Congress wanted NIITs to be excluded from the FTC realm, it could have expressly said so. The Tax Court acknowledged that Section 1411 was introduced well after the US-Italy Treaty and the US-France Treaty came into existence, but indicated that this timing issue was "not determinative." The Tax Court then underscored that both treaties expressly state that they will continue to apply to "any identical or substantially similar taxes which are imposed [by the United States or the other country] after the date" on which the treaties entered into force.[14]

The taxpayer also suggested that Congress had placed Section 1411 in Chapter 2A of the Internal Revenue Code, instead of in Chapter 1 with the income taxes, as a matter of "happenstance" or as a meaningless "clerical choice." Therefore, went the taxpayer's reasoning, the inability to use FTCs to offset NIITs solely because of the location of the latter should be ignored. The Tax Court displayed little patience with this purported logic. It observed that Congress specifically created Chapter 2A, Section 1411 is the only provision in Chapter 2A, and Chapter 2A is titled "Unearned Income Medicare Contribution," not "income taxes." Based on these realities, the Tax Court rejected the taxpayer's argument, putting this final point on it:

> *The placement of Section 1411 in a newly created Chapter was not happenstance. An enumerated Chapter of the [Internal Revenue] Code to impose a distinct and separate tax is part of the [Internal Revenue] Code's fundamental structure.*[15]

1 *Toulouse v. Commissioner*, 157 T.C. No. 4 (2021).
2 Section 1(a), (d); Section 61(a); Treas. Reg. § 1.61-1(a).
3 Section 27.
4 Section 901(a) and (b)(1); Treas. Reg. § 1.901-1(a) and (b); Treas. Reg. § 1.901-2(a); Section 904.
5 Section 901(a).
6 Treas. Reg. § 1.901-1(f) (stating that "[t]he credit for taxes shall only be allowed against the tax imposed by Chapter 1 of the Code . . .")
7 Section 894(a)(1); Section 7852(d)(1).
8 Section 1411(a) and (c).
9 Convention between the Government for the United States of America and the Government of the Italian Republic for the Avoidance of Double Taxation with Respect to Taxes on Income and the Prevention of Fraud and Fiscal Evasion (August 25, 1999), as supplemented by Protocol dated August 25, 1999; Convention between the Government for the United States of America and the Government of the French Republic for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital (August 31, 1993), as supplemented by Protocols on December 8, 2004, and January 13, 2009.
10 Section 6651(a)(2).
11 Taxpayers can only challenge the underlying tax liability in CDP hearings in situations where they did not have a prior opportunity to do so. Despite the earlier Notice of Math Error, exchange of correspondence, Written Protest filed by the taxpayer, and consideration given by the Appeals Office, the IRS told the Tax Court that the taxpayer did not have an opportunity to dispute the FTC and NIIT issues before the CDP hearing. The reason for this, as well as the overall dispute procedures in this case, are unclear. *See* Section 6330(c)(2)(B) and *Toulouse v. Commissioner*, 157 T.C. No. 4 (2021), Slip Opinion, pg. 9.
12 Treas. Reg. § 1.1411-1(e).
13 Article 23(2)(a) of the US-Italy Treaty; Article 24(2)(a) of the US-France Treaty.
14 Article 2(3) of the US-Italy Treaty; Article 2(2) of the US-France Treaty
15 *Toulouse v. Commissioner*, 157 T.C. No. 4 (2021), Slip Opinion, pg. 17.

As explained above, the relevant provisions in both the US-Italy Treaty and the US-France Treaty state that FTCs should be allowed only "in accordance with the provisions and subject to the limitations of the law of the United States."[16] The taxpayer, faced with such clear language, tried to weave. Specifically, she contended that Section 1411 is not a "limitation" for these purposes because that would require some type of "affirmative statement" by Congress to this effect. The Tax Court swiftly dispensed with this argument, emphasizing that the taxpayer focused solely on the word "limitation," while ignoring the fact that the treaties only allow FTCs to be claimed "in accordance with the provisions . . . of the laws of the United States." The Tax Court held that it is immaterial that the Internal Revenue Code does not affirmatively state that using FTCs against NIITs is prohibited. It then explained that Section 1411 expressly allows for some deductions in computing the amount subject to NIITs, but contains no language permitting any type of credits. The Tax Court ended this part of its analysis resolutely, stating that "the enactment of [NIITs] as part of Chapter 2A is a clear expression of congressional intent that [FTCs] not apply against the Section 1411 tax."[17]

The taxpayer seems to have suggested that the US-Italy Treaty and US-France Treaty guarantee that U.S. individuals will not be subject to "double taxation." Therefore, went the logic, the taxpayer must be able to use FTCs to offset NIITs, regardless of what certain provisions in the Internal Revenue Code provide. The taxpayer essentially asked what good are the US-Italy Treaty and US-France Treaty if they result in her being exposed to taxation, on the same amounts, in more than one country?[18] The Tax Court offered several observations here, all of which were unfavorable to the taxpayer. For example, the Tax Court clarified that the US-Italy Treaty and US-France Treaty generally grant protection against double taxation, but "their purpose is not to provide absolute protection."[19] It also emphasized that the specific provisions of each relevant treaty, in each case, must be analyzed and applied as written. The Tax Court also pointed out that both the US-Italy Treaty

and US-France Treaty feature so-called "Savings Clauses," which grant the United States supremacy in taxing U.S. citizens, period. The US-Italy Treaty states the following in this regard: Notwithstanding any provision to the contrary, the United States, with certain limited exceptions, "may tax its citizens by reason of citizenship as if there were no [US-Italy Treaty]."[20] Finally, whether at the urging of the taxpayer or on its own accord, the Tax Court mentioned that the Preamble to the regulations under Section 1411 supports its reasoning, too. In a segment of the Preamble titled "Availability of Tax Credits to Reduce Section 1411 Tax," the IRS explains that (i) the express language of Section 27 and Section 901 state that foreign taxes are not creditable against U.S. taxes, other than those imposed by Chapter 1 of the Internal Revenue Code, and (ii) Treas. Reg. § 1.1411-1(e) expressly states that FTCs cannot be used to offset NIITs.[21]

Penalty Matters. The penalty matters in *Toulouse* can be broken into two categories, accuracy-related penalties, which the IRS never assessed, and late-payment penalties, which the IRS might have trouble obtaining.

Accuracy-Related Penalties. The IRS can assert an accuracy-related penalty on a tax underpayment if it is attributable to certain types of misconduct by the tax-

16 Article 23(2)(a) of the US-Italy Treaty; Article 24(2)(a) of the US-France Treaty.

17 *Toulouse v. Commissioner*, 157 T.C. No. 4 (2021), Slip Opinion, pg. 18.

18 The Tax Court described this argument more diplomatically, explaining that the taxpayer "questions the purposes of the Treaties if there is no independent, treaty-based credit and a credit is allowable only if it is provided in the Code." *Toulouse v. Commissioner*, 157 T.C. No. 4 (2021), Slip Opinion, pg. 21.

19 *Toulouse v. Commissioner*, 157 T.C. No. 4 (2021), Slip Opinion, pg. 19.

20 Article 1(2)(b) of the US-Italy Treaty.

21 Treasury Decision 9644 (Dec. 2, 2013), Preamble.

22 Section 6662(a).

23 Section 6664(c).

24 Section 6662(d)(2)(B)(ii); Treas. Reg. § 1.6662-4(e)(1).

25 Treas. Reg. § 1.6662-4(f)(1); Treas. Reg. § 1.6662-4(f)(2); Rev. Proc. 2008-14.

26 Section 6651(a)(2).

27 The Tax Court hinted that the taxpayer might have been able to salvage the FTCs under different Articles in the US-Italy Treaty and US-France Treaty, but she failed to cite them. It said "[o]ther provisions of the Treaties may well provide for credits that are unavailable under the [Internal Revenue] Code. Petitioner, however, relies on provisions that by their express terms do not." *Toulouse v. Commissioner*, 157 T.C. No. 4 (2021), Sip Opinion, pg. 21.

28 Treasury Decision 9644 (Dec. 2, 2013), Preamble. It states that any bilateral U.S. treaty containing language similar to that in the 2006 Model Income Tax Convention about FTC limitations "would not provide an independent basis for a credit against the Section 1411 tax."

29 Treasury Decision 9644 (Dec. 2, 2013), Preamble.

30 *Toulouse v. Commissioner*, 157 T.C. No. 4 (2021), Slip Opinion, pg. 19.

the taxpayers, the IRS, and the Tax Court will need to perform a treaty-by-treaty analysis

payer, such as negligence.[22] The IRS may *not* assert such penalty, though, if the taxpayer can show that there was "reasonable cause" for errors or oversights.[23] Moreover, in situations that do not involve "tax shelters," taxpayers can avoid accuracy-related penalties if they properly disclose their position to the IRS, they have a reasonable basis for the position, and they maintain adequate books, records, and other support for the position.[24] Disclosure in this context is made by enclosing a Form 8275 or Form 8275-R (Regulation Disclosure Statement) with the relevant Form 1040.[25]

In *Toulouse*, the taxpayer openly revealed her position regarding the relationship between FTCs and NIITs by enclosing with her 2013 Form 1040 a Form 8960 showing her modifications, two Forms 8833 describing the alleged effect of the US-Italy Treaty and US-France Treaty, a Form 8275 containing her reasoning, and a Form 1116 announcing the source and amounts of the FTCs. Although the Tax Court does not discuss this issue, one might suppose that the IRS never asserted accuracy-related penalties for 2013 for these reasons.

Late-Payment Penalties. The IRS was not feeling so charitable that it let the taxpayer completely off the hook. Indeed, the IRS asserted a late-payment penalty against the taxpayer, which usually applies in situations where a taxpayer fails to fully pay the tax liability reported on the relevant tax return, such as a Form 1040, by the deadline.[26] In the case of the 2013 Form 1040 filed by the taxpayer, the IRS was expecting its money by April 15, 2014. The issue in *Toulouse* is interesting because, based on her theory that she could use FTCs to offset NIITs, the taxpayer declared a tax liability of $0 on her 2013 Form 1040. This normally would lead to a late-payment penalty of $0. The IRS seems to have raised a novel argument, though, taking the position that the penalty should be based on the $11,540 of NIITs shown on her Form 8960 (which was enclosed with the Form 1040), instead of the $0 liability reported on her Form 1040. The taxpayer argued that she had a tax liability of $0 for 2013 after applying the FTCs to eliminate the NIITs. She further contended that, even if this were not the case, penalties would not apply because she had "reasonable cause" for her legal position.

The Tax Court found that it remains unclear whether the taxpayer had "reasonable cause" for the position she took on her 2013 Form 1040, so it refused to dispense with this issue via the Motions for Summary Judgment. It will be interesting to see whether the parties proceed, and incur the significant expenses associated with Tax Court litigation, solely for purposes of determining whether the taxpayer must pay a rather small penalty, equal to 25 percent of the unpaid NIITs.

Far From the Last Word

Based on the strong decision by the Tax Court in *Toulouse*, some readers probably believe that the question of whether taxpayers can use FTCs to offset NIITs has been decided, end of story. They might be right when it comes to FTCs derived from Italy or France, but they would be wrong otherwise.[27] The Preamble to the regulations under Section 1411 explains that this issue remains open with respect to other countries, provided that they do not have treaties with the United States that expressly limit usage of FTCs based on Section 27 and Section 901.[28] The Preamble also explains that the taxpayers, the IRS, and the Tax Court will need to perform a treaty-by-treaty analysis:

> The Treasury Department and the IRS do not believe that these regulations are an appropriate vehicle for guidance with respect to specific treaties. An analysis of each United States income tax treaty would be required to determine whether the United States would have an obligation under that treaty to provide a credit against the Section 1411 tax for foreign income taxes paid to the other country.[29]

> The Tax Court in Toulouse was cognizant of this reality, explaining that the relevant provisions of each treaty, in each case, must be analyzed and interpreted as written.[30]

Conclusion

Toulouse resolves the question, at least for the moment, of whether U.S. individuals can utilize FTCs linked to Italy or France to offset NIITs. The fights are far from over, though. The Preamble to the regulations under Section 1411, as well as the Tax Court, note that different taxpayers, paying tribute in different countries, might yield different results. Consequently, taxpayers with global connections and their advisors should be following this important issue as it evolves. ●