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The Tax Court's Erroneous Decision in Toulouse

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In the recent case *Toulouse v. Commissioner*,[1] the Tax Court held that a U.S. citizen resident abroad was not entitled to claim a foreign tax credit to offset U.S. tax paid under §1411 [2] on net investment income (NII). Because the Tax Court framed the issue incorrectly, it reached the wrong decision. This note will reframe the issue in the hope that the decision will be revisited, if not by the Tax Court then by some other court.

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[1] 157 T.C. No. 4 (Aug. 16, 2021).

[2] All section references are to the Internal Revenue Code, as amended ("the Code"), or the Treasury regulations thereunder, unless otherwise indicated.

The taxpayer in this case was a U.S. citizen resident in a foreign country who paid creditable income taxes to France and Italy. She applied foreign tax credit (FTC) carryovers to zero out her liability for U.S. tax on NII imposed by §1411. The IRS reassessed the NII tax without benefit of the FTC, and the taxpayer ultimately sought relief in the Tax Court. The taxpayer conceded that the Code does not provide an FTC against the NII tax, as the relevant provisions apply the credit only against taxes imposed by Chapter 1 of the Code, whereas the NII tax, enacted in 2010, appears in a new Chapter 2A.[3] The taxpayer argued that the "Relief from Double Taxation" articles of the U.S. tax treaties with France and Italy[4] provided "a foreign tax credit independent of the Code." The Tax Court held that these articles "do not provide an independent basis for a foreign tax credit against the net investment income tax" and thus that the taxpayer was not entitled to claim the FTC against her NII tax.

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[3] Pub. L. No. 111-152, §1402(a)(1), added Code §1411, effective for taxable years beginning after December 31, 2012.

[4] Article 24(2)(a) of the U.S.-France treaty and Article 23(2)(a) of the U.S.-Italy treaty (hereafter, the "RFDT articles").

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The proper question in *Toulouse* was not whether a treaty may provide an "independent basis" for the FTC. Rather, the proper question was whether the treaty ***requires*** the United States to grant the FTC on the facts of this case, regardless of U.S. domestic law. Once the issue is properly characterized, the answer is clear: The tax treaties in question require the United States to provide the taxpayer with the FTC.

All U.S. tax treaties contain a "Taxes Covered" article that describes the types of taxes the treaty addresses. The language of that article is virtually identical in all U.S. treaties, including the French and Italian treaties. It provides that the taxes that are the subject of the treaty include, in the case of the United States, ***the Federal income taxes imposed by the Internal Revenue Code*** . The Taxes Covered article also states that the treaty shall equally apply to "any identical or substantially similar taxes that are imposed after the date or signature" of the treaty that are in addition to, or in place of, taxes in existence at the time the treaty was signed.[5]

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[5]*See, e.g.*, Article 2(2) of the France-U.S. tax treaty.

There is no question that the NII is an income tax imposed by the Code, and the Tax Court did not suggest otherwise. A tax on "net" investment income is a tax on income. Under Reg. §1.1411-1(a), provisions of the Code that apply for purposes of computing taxable income under Chapter 1 generally also apply for purposes of computing NII.[6] Interestingly, the deductions taken into account in computing NII include the §164 deduction for foreign taxes paid.[7] The regulation that affirms this result states that the deduction is not allowable if the taxpayer claims an FTC in the same year. The purpose of this rule was almost certainly to address a comment that the IRS received with respect to prior proposed regulations, to the effect that although the §164 deduction and the FTC are mutually exclusive under the Code, a taxpayer might take the position that the tax on NII is a separate tax from that in Chapter 1, and claim the §164 deduction for the NII tax while claiming an FTC for the Chapter 1 tax.[8] Such an approach would treat taxpayers whose NII is foreign source more favorably than those whose NII is domestic source. To preclude such a result, the Treasury regulations do not treat the NII as a separate tax.

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[6] Because the NII tax is an income tax, the IRS had to devise complex rules and elections to deal with the fact that NII overlaps with the Code's rules for controlled foreign corporations and passive foreign investment companies. *See* Reg. §1.1411-10.

[7] Reg. §1.1411-4(f)(3)(iii).

[8]*See* New York State Bar Association Tax Section Report No. 1284, "Report on the Proposed Regulations Under Section 1411," at pages 33–34 (May 15, 2013) ("NYSBA Report").

Because it is an income tax, the NII tax is subject to the treaty. It is irrelevant whether the tax is set out in Chapter 1 or Chapter 2A of the Code. So why is that significant?

A treaty is a contract. The question in *Toulouse* was whether that contract required the United States to grant a taxpayer a credit for the French and Italian taxes imposed. This is not semantics, but fundamental to the purpose and operation of tax treaties. A tax treaty sets out detailed rules prescribing which country may tax which income of persons who would otherwise be subject to tax in both countries (either because of dual residence or, more commonly, because one country taxes based on source and another based on residence). Each treaty country has a compelling sovereign

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interest in ensuring that income of a taxpayer that the treaty allows it to tax is not subject to taxation a second time in the other country. France's right to tax income it regards as having a French source, or as belonging to a French resident, would be undermined if the United States were permitted to tax that same taxpayer on the same income, and vice versa.

The RFDT article is contained in all treaties. It is the mechanism through which double taxation of the same income is avoided and is central to the manner in which a tax treaty functions. In the RFDT article, the United States had promised its treaty partner that it will provide an FTC for that country's taxes on income, subject to the limitations of the Code described below. Since the NII is an income tax covered by the tax treaties, the United States is required to grant a credit for any foreign tax paid on NII. Although the language and coverage of the RFDT article varies from treaty to treaty, as applied to a simple case such as *Toulouse* it is virtually identical in all U.S. tax treaties. The article begins by stating “It is agreed that double taxation ***shall*** be avoided in accordance with the following paragraphs of this Article.” The RFDT article appearing in the U.S.-Italy treaty is typical and provides in relevant part:

> In accordance with the provisions and subject to the limitations of the law of the United States (as it may be amended from time to time without changing the general principle hereof), the United States ***shall*** allow to a resident or citizen of the United States as a credit against the United States tax on income the appropriate amount of income tax paid to Italy. . . . Such appropriate amount shall be based upon the amount of tax paid to Italy, but shall not exceed the limitations of the law of the United States (for the purpose of limiting the credit to the United States tax on income from sources without the United States). (Emphasis added)

The foregoing analysis leads in a straightforward way to the conclusion that the United States must grant an FTC in respect of an otherwise creditable foreign tax imposed on NII. This short piece should end here. But the Tax Court, pointing to the qualifying phrase “[i]n accordance with the provisions and subject to the limitations of the law of the United States,” concluded that “the plain text of the treaty provisions on which petitioner relies subject the terms of the Treaties, and thus any allowable credit to the provisions and limitations of the Code.”[9] The court interpreted that qualifying phrase to mean ***that the FTC must be allowed by U.S. domestic law***. Since U.S. tax law allows an FTC only for taxes imposed by Chapter 1, and the NII was enacted as a new Chapter 2A, the Tax Court concluded that the RFDT article did not apply to the NII tax.

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[9] 157 T.C. No. 4 at p. 15.

If this were correct, then the United States could avoid its treaty obligations by the simple expedient of enacting new income taxes in new Chapters of the Code, in direct violation of the provisions of U.S. tax treaties that make them applicable to identical or substantially similar taxes imposed after the date or signature of the treaty that are in addition to, or in place of, taxes in existence at the time the treaty was signed. Fortunately, such a ludicrous result is not mandated by the qualifying phrase cited in the court's decision. If the qualifying language is instead interpreted, as it must be, in the context of the overall purpose of a tax treaty and with an understanding of how the U.S. FTC rules operate, a very different meaning is evident.

Here we must digress to the subject of how the U.S. FTC rules operate. As all countries that negotiate tax treaties with the United States become aware (if they were not already), the United States relieves double taxation only by granting an FTC. The United States does not grant a full dollar-for-dollar FTC

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in respect of any creditable foreign tax paid. Instead, §904 limits the credit to the proportion of the U.S. tax against which the credit is taken that the taxpayer's foreign-source income (as computed using U.S. tax principles) bears to his or her worldwide income. Even then, this limitation is applied separately as among four different "baskets" of income. And even then, foreign-source income is reduced by allocating deductions in a manner that can cause the amount of the credit to be far less than the amount of income subject to foreign tax, even where the foreign tax is imposed at a low rate.[10]

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[10] Because the Tax Court did not consider the manner in which the Code's FTC rules operate, it overlooked that fact that nothing in §1411 precludes the tax on NII from being considered a U.S. income tax for purpose of computing the §904 limitation. For a discussion of the result of treating it as such, see NYSBA Report at 35.

The §904 limitations are what the treaty is referring to in the clause "subject to the limitations of the law of the United States." ***What that clause does not and logically cannot refer to is a provision of U.S. law that purports to treat an income tax covered by the treaty as not being subject to the RFDT article of the treaty***. Moreover, no provision of the Code purports to do any such thing. It is irrelevant that U.S. domestic law would not provide an FTC against the NII tax in non-treaty cases. There is no inconsistency in the fact that when a treaty applies, the treaty governs. No one would maintain that when a treaty reduces the U.S. withholding tax rate on dividends from 30% to 15%, there is an inconsistency with U.S. domestic law. The present case is no different.

The Tax Court cited the preamble to the final §1411 regulations[11] for the proposition that any FTC benefit provided by a tax treaty would need to be addressed on a treaty-by-treaty basis, saying that is exactly what the court attempted to do. Putting aside the problem that the Tax Court's decision did not correctly frame the treaty analysis, a reliance on language in a preamble that conflicts with the clear mandate of a treaty is unwarranted.

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[11] T.D. 9644.

The preamble first stated that "The Treasury Department and the IRS do not believe that these regulations are an appropriate vehicle for guidance with respect to specific treaties." It should have stopped there. The preamble stated that an analysis of each U.S. 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. If, however, a United States income tax treaty contains language similar to that in paragraph 2 of Article 23 (Relief from Double Taxation) of the 2006 United States Model Income Tax Convention, which refers to the limitations of United States law (which include sections 27(a) and 901), then such treaty would not provide an independent basis for a credit against the section 1411 tax.

The statement that the limitations of U.S. law include §27(a) and §901 — with its implicit inference that no tax would ever be creditable against a tax imposed by Chapter 2A — is clearly wrong as a matter of treaty interpretation. The claim that a treaty-specific analysis would be required should be interpreted as referring only to the question whether the foreign tax was in fact imposed on the same NII subject to U.S. tax and is considered to have a foreign source. These issues are relevant to application of the limitations imposed by §904. Some treaties do have specific "resourcing" rules that might be relevant in a particular case. But the *Toulouse* case did not present any such special issues.

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The Tax Court appears to have sensed that its holding would conflict with the clear requirement of the treaties in question. The court approached this problem as whether legislation — in this case the addition of the NII tax — could "override" or "abrogate" a treaty. But properly understood, this case had nothing to do with a treaty override at all; certainly a preamble to Treasury regulations cannot abrogate a treaty. The treaty is not inconsistent with the Code; all the Tax Court was required to do in order to arrive at the correct answer in *Toulouse* was to apply the treaty.

That the Tax Court lost sight of this simple analysis is evident from its failure to even mention whether the French and Italian taxes paid by the taxpayer were imposed on her NII. Presumably they were, since the government did not claim otherwise, and if they had not been, the case would have been unnecessary. Similarly, the court failed to ask whether the NII in question had a foreign source under U.S. rules, which is a question required to be answered in order to determine what portion of the underlying taxes are creditable. The Tax Court did not analyze the manner in which the FTC rules operate and how those rules relate to the requirements of the treaties in question.[12]

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[12] It did not help matters that in this case, the taxpayer claimed the FTC in the wrong way. Rather than simply claiming the FTC on the line provided for that purpose on her tax form, she netted out the credit against her NII tax only. Apparently she believed that because the Code does not permit an FTC for taxes not contained in Chapter 1, this roundabout approach, coupled with a claim for treaty relief, was required. In doing so, she made the same mistake that the Tax Court made, treating the treaty as being inconsistent with the Code in this respect.

One cannot help thinking that the taxpayer would have been better off seeking "competent authority" relief under the treaties.[13] There is no question that if Italy and France had been asked whether the United States was required to grant an FTC, both countries would have vociferously maintained that it was — and would have prevailed. Granted, competent authority cases can take years and are ill-suited to individual taxpayers — and this case, involving two foreign countries, would have required two separate proceedings. But the next taxpayer in Ms. Toulouse's situation might consider this worth the trouble.

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[13] All U.S. tax treaties provide an avenue for taxpayers to appeal to the "competent authorities" of the contracting states where a violation of the treaty is alleged. *See, e.g.*, Article 26.1 of the France-U.S. tax treaty.

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