Net Investment Income Tax and the Foreign Tax Credit Conundrum

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For tax years beginning on or after January 1, 2013, individuals, estates and trusts became subject to the Net Investment Income Tax (' NIIT'). NIIT is a tax of 3.8% on the net investment income of taxpayer's who's modified adjusted gross income (' MAGI') exceeds $200,000 (single) or $250,000 (married filing jointly).* Form 8960 is required to be filed by U.S. residents who's MAGI exceeds these thresholds, to determine whether there is a NIIT liability or not.

NIIT can result in foreign-sourced income being taxed twice - once outside of the U.S. and a second time by the IRS within the U.S. This is due to the domestic law limitation on using foreign tax credits (' FTCs'): section 27 of the Code limits the use of FTC's to meeting tax imposed under Chapter 1 of the Code, while section 1411 (the section imposing the 3.8% NIIT) is in Chapter 2A.

One way of minimizing this double-tax is by deducting foreign income taxes paid; this unfortunately reduces the benefit of each dollar of foreign tax paid to approximately 30% (as credits are applied dollar for dollar against U.S. tax payable, whereas deductions reduce the gross taxable income subject to tax). Another, more efficient way to minimize the double-tax is to claim a FTC by relying on a tax treaty (' Treaty'): it is on this point that the U.S. government and Mr. Bruyea disagreed in Bruyea v. United States (No. 23-766T).

Bruyea v. United States

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In 2015, Mr. Bruyea, a U.S. citizen resident in Canada, sold Canadian real property, resulting in a $7,000,000 capital gain. He reported the gain on his Canadian income tax return and paid Canadian income tax of $2,000,000. He filed his U.S. Form 1040 and claimed an FTC of $1,400,000 against his U.S.income tax liability on the capital gain. He subsequently filed a Form 1040-X, claiming a refund of $263,523 - the 3.8% NIIT paid on the capital gain. His refund claim was based on

Article 24 of the U.S. Canada Tax Treaty, via which he sought to claim an FTC for Canadian taxes paid.

The government argued that Mr. Bruyea's refund claim must fail, as:

1. The Code only allows FTC's to be claimed against taxes within Chapter 1; the NIIT is in Chapter 2A. As the NIIT was introduced after the Treaty, the government argued that the 'last-in-time rule' applied, which requires a later-enacted statute to control over a directly conflicting treaty provision, and;
2. The U.S. law limitation prohibits a treaty-based credit against NIIT.

The Claims Court disagreed with both positions.

The Claims Court reasoned that the Treaty will give way to the Code only where a later-enacted statutory provision directly conflicts with the Treaty or where the Treaty (by its terms) defers to the Code - this was not the case in Mr. Bruyea's situation. The Claims Court then determined that the 'last-in-time rule' must harmonize the Treaty and the Code. Ultimately, the Claims Court concluded that nothing in the NIIT language was inconsistent with a Treaty-based FTC and therefore that the last-in-time rule did not apply; the application of the Treaty-based tax credit did not conflict with, and therefore was not precluded by, the NIIT or any other Code provision.

In considering whether U.S. law limitation prohibits a Treaty-based credit against NIIT, the Claims Court found that clauses 2 and 3 of paragraph 1, Article 24, refer to the 'general principle of eliminating or avoiding double taxation.' The Claims Court also noted that paragraph 3(a) of Article 2 states that the Treaty applies to 'taxes identical or substantively similar to taxes to which the Convention applies under paragraph 2 of Article 2;' this wording would cover the NIIT.

The Claims Court also looked to the technical explanation of the Treaty for support and observed that '[p]aragraph 1 of Article [24] contains no suggestion that it was intended to limit in any way the type of United States tax to which a foreign tax credit might apply.'

Lastly, the Claims Court noted that the Treasury and IRS stated in the final regulation:

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.

The Claims Court therefore concluded that:
The clear and necessary implication is that a treaty-based credit may apply to the NIIT and, thus, that the NIIT's placement in Chapter 2A of the I.R.C. (i.e., outside of Chapter 1) does not preclude a foreign tax credit.

Ultimately, the Claims Court concluded that, 'so long as the NIIT qualifies as a 'United States tax', the Treaty provides for the claimed credit.'

It remains to be seen whether the government will challenge the Bruyea decision and if they do, how the Appeals Court may address the issue.
* There is no inflation adjustment for the NIIT gross income thresholds.