TOULOUSE OR NOT TOULOUSE? N.I.I.T.- PICKING THE REACH OF THE U.S. FOREIGN TAX CREDIT

Authors
Andreas Apostolides
Wooyoung Lee

Tags
Foreign Tax Credit
Net Investment Income Tax
Toulouse v. Commr.

> "There are three things that matter in [tax legislation]: location, location, location."
>
> – *adapted from the famous quote, apocryphally attributed to Lord Harold Samuel, about real estate.*

While a picture is worth a thousand words, the placement of just a few words in the Internal Revenue Code can sometimes cost taxpayers thousands of dollars in extra tax, particularly where foreign tax credits are involved. In *Toulouse v. Commr.*,[1] the U.S. Tax Court held that the foreign tax credit, which arises under §§27 and 901 of Chapter 1 of the Internal Revenue Code, as amended ("the Code"), cannot be used to offset a taxpayer's net investment income tax ("N.I.I.T."), a *sub rosa* tax increase of 3.8% that is applied to the taxpayer's net investment income in excess of certain thresholds defined in Code §1411. The N.I.I.T. appears in Chapter 2A of the Code.

While not surprising to some observers, and clearly consistent with the I.R.S.'s own published regulations, the case confirmed that taxpayers with assets and activities in more than one country can find themselves in a tricky situation with regard to the N.I.I.T., similar to parallel tax regimes sometimes set up by certain other countries, for which those countries argue that foreign tax credits are not available. Unfortunately, tax treaties' continuing ability to provide double tax relief in such circumstances is limited.

THE CASE

Catherine Toulouse was an American citizen living abroad. She correctly realized that she owed N.I.I.T. and reported it on her tax return. Ms. Toulouse also had unused foreign tax credits from taxes paid to France and Italy. She offset the N.I.I.T. with a portion of her otherwise unused foreign tax credits and paid nothing. The case centered around her claim of foreign tax credits to reduce the payment of the N.I.I.T.

Ms. Toulouse timely filed her 2013 Form 1040, U.S. *Individual Income Tax Return*, and proceeded to claim credits for income taxes paid to Italy and France against N.I.I.T. reported on her Form 8960, *Net Investment Income Tax — Individuals, Estates, and Trusts*, which she duly attached together with Form 8833, *Treaty-Based Return Position Disclosure under Section 6114 or 7701(b).* Because Ms. Toulouse recognized that the I.R.S. would disagree with a claim running flatly contrary to published regulations, she attached a Form 8275, *Disclosure Statement*, flagging to the I.R.S.'s attention that she was taking a position on her tax return contrary to published guidance. The benefit of attaching the form is to secure relief from

---

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

© Ruchelman P.L.L.C., 2021. All rights reserved.

accuracy-related penalties, assuming sufficient justification exists for claiming the position in the first place.[2]

The I.R.S. disagreed with the taxpayer's position and responded by mailing her a series of notices under its broad authority to assess and collect additional tax owing because of mathematical errors in the return.[3] Normally, a taxpayer's ability to challenge the I.R.S.'s assertion of additions to tax in Tax Court commences with the mailing of a statutory notice of deficiency by the I.R.S. In this case, the I.R.S.'s initial notices were not based on the issuance of a notice of deficiency.

C.A.P. VS. C.D.P.

The notice of deficiency is a prerequisite to a taxpayer challenging the I.R.S.'s assertion of additional tax due in Tax Court without having to pay the tax first.[4] In Ms. Toulouse's case the I.R.S. only issued the taxpayer with a notice of a mathematical error. As a result, the immediate avenue of relief for the taxpayer involved the I.R.S.'s internal process. There are two I.R.S. internal appeal processes worth noting in this regard, which work according to different rules and carry important implications for the taxpayer's ability to challenge the I.R.S.'s ultimate determination. One is the Collection Appeals Program ("C.A.P.") and the other is the Collection Due Process program ("C.D.P.").

C.A.P. is typically available in a broader set of circumstances than a C.D.P. hearing, both before and after the I.R.S. files a Notice of Federal Tax Lien, or levies (*i.e.*, seizes) taxpayer property. C.A.P. is also available if the I.R.S. terminates, or proposes to terminate, an installment Agreement.[5] By contrast, C.D.P. is available only if the taxpayer receives a specific notice that is accompanied by imposition of a Federal tax lien, or the I.R.S. levies on the taxpayer's property. And while the C.A.P. program may cover a broader range of collection actions, only the latter procedure — the C.D.P. hearing — permits a taxpayer to resort to Tax Court after an unfavorable final determination by the I.R.S. Generally, the C.A.P. route forecloses ability to take advantage of a C.D.P. hearing.[6]

The C.D.P. hearing can be requested only within a statutory 30-day window after a notice for a right to a hearing has been received or after receiving a C.D.P. levy notice on forms such as Letter 1058 or Letter LT11. The request is made on Form 12153, *Request for a Collection Due Process or Equivalent Hearing*.[7]

---

[2] Generally, where a taxpayer adopts a return position contrary to published regulations, as opposed to other published guidance, the I.R.S. requires the position to be disclosed on Form 8275-R, *Regulation Disclosure Statement*. By so doing, a taxpayer meets one of the requirements to have a no-fault penalty abated.

[3] See Code §6213(b)(1).

[4] Code §6213(a).

[5] See Pub. 1660.

[6] However, if the underlying liability is not addressed by the C.A.P. appeal, it is possible that a C.D.P. hearing may still be requested under Code §6330(c)(2)(B). See *Mason v. Commr.*, 132 T.C. 301 (2009).

[7] A C.A.P. hearing is requested on Form 9423, *Collection Appeal Request*.

© Ruchelman P.L.L.C., 2021. All rights reserved.

Ms. Toulouse took advantage of the C.D.P. procedure to challenge the I.R.S.'s initial "mathematical" correction to her tax return. When that proved unsuccessful, filed a timely petition to the Tax Court.

N.I.I.T. – DEFINITION AND GENESIS IN LAW

N.I.I.T. arises under Code §1411 – as a standalone Code section in Chapter 2A, titled "Unearned Income Medicare Contribution" which contains no other sections. Enacted by the Health Care and Education Reconciliation Act of 2010,[8] the tax applies to "net investment income," defined statutorily as the excess (if any) of

- gross income from interest, dividends, annuities, royalties, and rents, other than such income which is derived in the ordinary course of a trade or business which is not a passive activity or financial instrument or commodity trading business;
- other gross income derived from a passive activity or financial instrument or commodity trading business; and
- net gain to the extent taken into account in computing taxable income attributable to the disposition of property other than property held in a trade or business which is not a passive activity or financial instrument or commodity trading business;

— *less* —

- (the deductions allowed by this subtitle properly allocable to such gross income or net gain).[9]

The words "this subtitle" above refers to subtitle A of the Internal Revenue Code applicable to income taxes and includes Code §§1 through 1564. The N.I.I.T. relies on a common architecture applicable to income taxes including self-employment income (Chapter 2), Unearned Income Medicare Contribution (N.I.I.T.), Withholding Tax on Nonresident Aliens and Foreign Corporations (Chapter 3), F.A.T.C.A. penalties (Chapter 4), repealed excise taxes formerly applicable to certain outbound transfers (Chapter 5),[10] and consolidated return regulations under Chapter 6.[11]

Notwithstanding the comparisons to non-income taxes in the Code, many of the terms to which N.I.I.T. refers (net income, adjusted gross income, and deductions,

---

8 Pub. L. No. 111-152.

9 See Treas. Reg. §1.1411-1(d)(8), defining net investment income as defined in Code §1411(c) and Treas. Reg. §1.1411-4, as adjusted in Treas. Reg. §1.1411-10(c). Initially, proposed regulations defined it as a positive amount only but this view was not carried through in the 2012 final regulations. Treas. Reg. §1.1411-4(f)(1).

10 Former Code §§1491 through 1494. With respect to foreign trusts, the Taxpayer Relief Act of 1997, Pub. L. No. 94-455, replaced Chapter 5's former 35% excise tax with a new gain recognition regime under Code §684, located in Chapter 1.

11 Subtitle A contains all the income taxes in the Code, and most of the 6 chapters share a common concern with clear reflection of income. For example, Code §1502 provides that the Secretary may issue regulations governing the taxable income of affiliated corporations filing a consolidated income tax return, "in such a manner as clearly to reflect the income-tax liability [of the affiliated group]."

among others) are terms used in common with the income tax; at a high level, in addition to the familiar concept of a net income base (gross income less deductions), N.I.I.T. shares other basic features with Chapter 1 tax, such as exclusions from income[12] and progressivity. For example, similar to regular taxable income, net investment income has a concept of "excluded income," defined by Treas. Reg. §1.1411-1(d)(f) as any income excluded under Chapter 1, in addition to additional items that are excluded under Treas. Reg. §§1.1411-4 and 1.1411-10, and any other items specifically excluded by Code §1411, the regulations thereunder, or the Internal Revenue Bulletin. In addition, because net investment income is traditionally earned by higher-income taxpayers who earn a higher proportion of their income from investments in stocks and bonds rather than from wages, the tax is progressive.

"It does not appear illogical to argue that the 3.8% surtax is fundamentally an income tax unlike its sister 0.9% Medicare tax. Hence, the question of whether N.I.I.T. is a covered tax for treaty purposes is more nuanced than either taxpayer or the I.R.S. may have intimated . . ."

While progressive, the 3.8% tax applies in a manner quite different from the Chapter 1 income tax: it is imposed only to the extent of the lesser of the taxpayer's net investment income, or the extent to which modified adjusted gross income exceeds applicable thresholds.[13] This may explain why some commentators refer to the 3.8% tax as a surtax.[14] Part of the ambiguity as to what the 3.8% tax is best characterized as may relate to the absence of helpful legislative history. The provision was added to a House version of a 2010 revenue bill during the legislative wrangling over Republican attempts to repeal the Affordable Care Act, and reflected in a version of that bill reported out as part of the reconciliation process.[15] This was after rumors in 2009 that a new Code §1411 was under consideration after an increase to the Code §1 rate tables was legislatively defeated.

The first public mention of N.I.I.T. was an Obama-era presidential proposal which referred to a 2.9% tax on interest, dividends, annuities and most investment income — together with the additional 0.9% Medicare tax; the two provisions are in some respects mirror images since they apply above similar thresholds and are designed such that the Medicare tax applies to wages (which are excluded income for N.I.I.T. purposes) and N.I.I.T. is defined to apply to most passive income streams. Chapter 2A's official name (Unearned Income Medicare Contribution) to which the Tax Court gives significant weight in its analysis in the *Toulouse* opinion, to which we turn next, suggests that the tax was meant to supplement Medicare tax; on the other hand, the Joint Committee on Taxation clarified that N.I.I.T. revenue would go to the Treasury's General Fund rather than the Medicare Trust Fund.

It does not appear illogical to argue that the 3.8% surtax is fundamentally an income tax unlike its sister 0.9% Medicare tax. Hence, the question of whether N.I.I.T. is a covered tax for treaty purposes is more nuanced than either taxpayer or the I.R.S. may have intimated in the recent case, to which we turn next.

---

[12] Notable exclusions include wages, unemployment compensation, Alaska Permanent Fund Dividends, alimony, and Social Security Benefits

[13] These thresholds are $250,000 for married taxpayers filing a joint return, $125,000 for married taxpayers filing separate returns, and $200,000 for single taxpayers. The fact that such thresholds are not indexed to inflation would tend to make the N.I.I.T. *less* progressive over time.

[14] See M.B. Kofsky & Bryan P. Schmutz, "What a Long Strange Trip it's Been for the 3.8% Net Investment Income Tax."

[15] H. Rep. No. 111-448.

© Ruchelman P.L.L.C., 2021. All rights reserved.

PLACEMENT IN THE CODE VERSUS CHARACTER AS A TAX ON NET INCOME

While the statutory text providing for the N.I.I.T. is silent as to the question of foreign tax credits, the I.R.S. has clearly provided that such credits may not be claimed to reduce N.I.I.T in its published regulations:[16]

> Amounts that may be credited against only the tax imposed by chapter 1 of the Code may not be credited against the section 1411 tax imposed by chapter 2A of the Code unless specifically provided in the Code. For example, the foreign income, war profits, and excess profits taxes that are allowed as a foreign tax credit by section 27(a), section 642(a), and section 901, respectively, are not allowed as a credit against the section 1411 tax.

Before getting to the regulation's language, however, the Tax Court first looked to the Code. The statutory source of the foreign tax credit is Code §27, which demarcates the credit's limits by incorporating Code §901. Code §901 allows the credit to be used against "tax imposed by this chapter [1]." The N.I.I.T., on the other hand, is part of chapter 2A. The Tax Court came to the straightforward conclusion that the foreign tax credit was inapplicable to N.I.I.T. Ms. Toulouse might have found a glimmer of hope in the Treasury Regulations. Treas. Reg. §1.411-1(a) allows all Code provisions that are applicable to determining a taxpayer's taxable income for chapter 1 purposes to "also apply in determining the tax imposed by §1411." The court was not swayed. The regulation crucially defined taxable income as under Code §63(a). Code §63 defines taxable income as gross income less deductions and does not mention tax credits. Since Code §63 does not cover tax credits, the court concluded, neither does Code §1411.

As if to banish any further doubt, the court pointed out that the language of Treas. Reg. §1.1411-1(e), quoted above, specifically disallowed taking the foreign tax credit against the N.I.I.T. The regulation provides that credits that can only be taken against a Chapter 1 tax (*e.g.*, the foreign tax credit) require a specific statutory authorization to also be creditable against the Code §1411 tax. The regulation further specifies that the "foreign tax credit… [is] not allowed as a credit against the [Code] §1411 tax."

In the end, the court ended up restating the I.R.S.'s view, consistent with the 2013 final regulations, which places decisive significance on the express language of the foreign tax credit provisions itself, limiting relief to taxes under Chapter 1. In the preamble to the 2013 regulations, the I.R.S. stated that:

> The Treasury Department and the IRS also received comments asking whether United States income tax treaties may provide an independent basis to credit foreign income taxes against the section 1411 tax. 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

[16] Treas. Reg. §1.1411-1(e).

© Ruchelman P.L.L.C., 2021. All rights reserved.

> 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***. (emphasis supplied).[17]

Clearly aware of the unfriendly nature of the domestic legislation, Ms. Toulouse urged the court to look to the treaties instead. In her brief, she appears to have placed emphasis on the treaties' principle of eliminating double taxation. The court acknowledged that treaties should be interpreted liberally to give effect to their goals but warned that plain meaning would take precedence. This proved fatal for the taxpayer's case. The income tax treaties with France and Italy restricted the credit to the extent allowed by U.S. law, which led the court back to the analysis of the Code.

Next, Ms. Toulouse turned to congressional intent, an area which offers taxpayers less than firm ground. She claimed that legislative history gave no indication that Congress did not want the credit to be applicable or, more broadly, wanted to override the principle of eliminating double taxation. Relying on dictionary definitions, the taxpayer argued that any limits had to be specified and affirmed as such by Congress. She concluded that the placement of the N.I.I.T. in chapter 2A instead of chapter 1 was a coincidence. The court disagreed. The credit was not something that existed by default, requiring only affirmative disallowance to be inapplicable. Rather, the treaties themselves delineated the credit's limits (*i.e.*, U.S. law). The court added that the treaties were not meant to nor attempted to completely eliminate double taxation. The court supported its argument with some textual evidence, including that Code §1411 is the only section of Chapter 2A, which itself was a fairly new chapter when the N.I.I.T. was introduced. Creating a new chapter in the Code is never a coincidence.[18]

While Ms. Toulouse attempted to portray the treaties as an independent source of authorization for the foreign tax credit, unfettered by the details of domestic statute, she claimed that there would be no point in tax treaties if a credit requires a Code provision to be valid. It is possible that the taxpayer may have had greater success if her brief focused on the N.I.I.T.'s basic character as a tax on net income. The resolution of the case thus turned on whether placement in Chapter 2A is properly considered a "limitation" of U.S. law, similar to Code §904's income basket limitation and other key components of the U.S. domestic foreign tax credit regime.[19]

---

[17] T.D. 9644 (April 1, 2014).

[18] According to the court's view, the technical explanation to the treaties also confirmed that credits were subject to the "limitations" of U.S. law.

[19] Another element in tension with the I.R.S.'s approach to N.I.I.T. is the fact that deductions for foreign taxes are permitted, and a specific allocation mechanism is provided to ensure that taxpayers do not deduct foreign taxes against both the tax under Chapter 1 and the tax under Chapter 2A. See Treas. Reg. §1.1411-4(f)(3)(iii). This clause was added in a correction to the 2013 final regulations in 73 Fed. Reg. 72,394, which came with no explanation or preambulatory language of its own but accompanied by a note titled "Need for Correction" and stating that "[a]s published, the final regulations (TD 9644) contain errors that may prove to be misleading and are in need of clarification."

© Ruchelman P.L.L.C., 2021. All rights reserved.

While the words chosen by Congress and the I.R.S., together with the placement of N.I.I.T. within the broader Code, are clearly important, the possibility that Chapter 2A's N.I.I.T. should be a covered tax under relevant treaty provisions because it is substantially similar to an income tax, or whether the above preambulatory text provides sufficient grounds to support the I.R.S.'s approach in Treas. Reg. §1.1411-1(e), are matters that were simply not addressed.[20]

In the end, the court focused on the difference between not providing for a credit versus expressly disallowing a credit and concluding that the plain language in Treas. Reg. §1.1411-1(e) ended the analysis. While the court may be right about the significance of the N.I.I.T.'s placement within the Code, Ms. Toulouse lost when the court decided that whether Treas. Reg. §1.1411-1(e) constituted a limitation under U.S. law was the key issue, rather than whether N.I.I.T. was fundamentally an income tax under Subtitle A and therefore should be characterized as a covered tax for treaty purposes.

As a final note, commentators have observed that, in 2013, the year in which Ms. Toulouse's contested tax arose, the I.R.S. placed the line for reporting N.I.I.T. on Forms 1040 and 1041 (income tax returns for individuals and estates and trusts, respectively) below the line for claiming foreign tax credits, consistent with its view that the two cannot offset.[21] The 2020 Form 1040 and the instructions make this clearer still by moving N.I.I.T. to Schedule 2, together with Medicare tax. Because the Tax Court and I.R.S. both gave short shrift to the taxpayer's attempt to modify Form 8960 by adding additional lines, permitting her to offset tax that was "blocked" on Form 1040. While the Tax Court appears unimpressed by this amendment of the form, the notice that she provided to the I.R.S. of her return position by attaching Form 8275 likely prevented her from suffering additional penalties.

IMPLICATIONS

As *Toulouse* illustrates, in the case of the N.I.I.T., policy rationale will usually take a back seat to statutory mechanics. It is notable that Chapter 2 and 21 taxes have specific provisions that relieve tax liability to the extent provided for in social security totalization agreements ("S.S.T.A.'s"). The N.I.I.T. lacks this. Beyond that, however, the statute and regulations do not provide many clues. A much more ambiguous question than the one at the heart of *Toulouse*, and consequently one carrying greater hope for the taxpayer, is whether N.I.I.T.'s fundamental character as an income tax could mean that the I.R.S.'s position is incorrect. However, as noted by some,

[20] The court simply references Articles 2(2) and 2(3) of the France-U.S. and Italy-U.S. Income Tax Treaties without analyzing the issue.

[21] On the 2013 Form 1040, N.I.I.T. (referenced as "Taxes from . . . [b] Form 8960") is on Line 60, whereas foreign tax credits are stated on Line 47. This is different from the 2020 income tax return which has been reduced to 38 lines, where "Other Taxes" on Schedule 2 (including Medicare and N.I.I.T.) feed into "other taxes" on line 23.

© Ruchelman P.L.L.C., 2021. All rights reserved.

a statutory amendment by Congress may be required before F.T.C.'s can properly be claimed; or, in the alternative to specifically tag N.I.I.T. as a social security tax, permitting relief under S.S.T.A.'s.[22]

And, similar to certain "parallel" tax regimes set up by certain other countries for which foreign tax credits are unavailable, the N.I.I.T. creates problems for double tax relief under existing treaty architecture. The problem of such exceptional mini tax regimes is that the protections which income tax treaties were designed to provide are steadily eroded in a manner that the treaty drafters sought to account for when providing that their treaties should apply to "substantially similar" taxes.[23]

In the case of the N.I.I.T., a combination of ambiguity and prudence should push taxpayers in a cautious direction. Like with the foreign tax credit itself, the weight of words may prove most relevant, meaning that taxpayers are advised to await for further action by Congress before taking a position against the I.R.S.'s expressed view.

"In the case of the N.I.I.T., a combination of ambiguity and prudence should push taxpayers in a cautious direction."

---

[22] As the Treasury's May 2021 Green Book specifically suggests the N.I.I.T. revenue could be directed to the Hospital Insurance Trust Fund similar to F.I.C.A. and S.E.C.A. revenues; see "General Explanation of the Administration's Fiscal Year 2022 Revenue Proposals," at p. 72; presumably accompanied with changes to the self-employment tax regime, this might permit crediting of foreign taxes against N.I.I.T. under S.S.T.A. provisions.

[23] For example, Italy imposes "substitutive tax" of 26% on certain foreign source financial income of Italian long-term residents, including dividends, interest, and capital gains earned outside a trade or business, and refuses to accord a credit or deduction for income taxes paid in the foreign country (*e.g.*, the U.S.), based on the view that the substitutive tax is neither an income tax, nor a substantially similar tax, to which the treaty can apply.

Disclaimer: *This article has been prepared for informational purposes only and is not intended to constitute advertising or solicitation and should not be relied upon, used, or taken as legal advice. Reading these materials does not create an attorney-client relationship.*