IS THE N.I.I.T. AN INCOME TAX, A SOCIAL SECURITY TAX, OR NEITHER? DOUBLE TAXATION OF INCOME HANGS IN THE BALANCE

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BACKGROUND

Congress enacted the N.I.I.T. in 2012 as part of a 2010 law amending the Affordable Care Act ("A.C.A."), more popularly known as "Obamacare." Its creation corresponded to a 0.9% increase in the Medicare tax, which is imposed on wages and self-employment income. With the increase in tax on earned income, Congress wanted a parallel tax on unearned income and capital gains.

The N.I.I.T. is a 3.8% tax on a taxpayer's investment income, broadly equivalent to passive income. This includes income from interest, dividends, annuities, royalties, and rents. It also is imposed on capital gains. The N.I.I.T. does not tax investment income that is not otherwise included in Federal gross taxable income. Individuals are subject to the tax if their income is above certain thresholds. For 2023, the thresholds are $200,000 for single filers and $250,000 for married taxpayers filing jointly.

The N.I.I.T. applies to individuals, estates, and trusts. Individuals who are neither U.S. citizens nor U.S. residents for income tax purposes of the U.S. are exempt from the tax.[1] U.S. citizens who reside abroad are subject to the N.I.I.T. in addition to U.S. income tax. They also may be subject to income tax in the country where they reside. U.S. tax law provides no statutory relief from the N.I.I.T. for such taxpayers. The N.I.I.T. is due and the position of the I.R.S. is that the N.I.I.T. cannot be reduced by a foreign tax credit and may or may not be eliminated by a Social Security Totalization Agreement.

This article addresses recent experiences of U.S. citizens resident abroad when computer-generated tax returns provide no relief that can reduce the N.I.I.T.

TAX TREATIES AND FOREIGN TAX CREDITS

U.S. citizens or green card holders who have connections to multiple countries through citizenship or residence may find themselves subject to tax in more than one country with regard to the same item of income. Where that occurs relief may be available under the foreign tax credit of U.S. domestic law or an applicable income tax treaty. Both provide for a foreign tax credit. With limited exceptions that vary among treaties, all U.S. treaties provide that the limitations of the foreign tax credit under U.S. tax law control the application of foreign tax credit relief under treaty. In either event, the principle is simple: U.S. taxpayers should be taxed only once on an item of income rather than twice or not at all.

[1] Treas. Reg. §1.411-2(a)(1).

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Despite the N.I.I.T.'s name as well as its location in Subtitle A (Income Taxes), the foreign tax credit provisions of income tax treaties do not provide relief against the N.I.I.T. The mechanics of the foreign tax credit rules in the U.S. limit the scope of relief granted by tax treaties. U.S. tax law allows a foreign tax credit, but it provides relief only for taxes imposed by Chapter 1 of the Internal Revenue Code of 1986, as amended (the "Code").[2] Regrettably for taxpayers, the N.I.I.T. is a tax that appears in Chapter 2A of the Code. Consequently, regulations issued by the I.R.S. under the N.I.I.T.[3] disallow credits that can be taken against Chapter 1 taxes – specifically the foreign tax credit – from reducing the amount of N.I.I.T. due. Exceptions apply only if the Chapter 1 credit specifically states that it may be claimed to reduce the amount of N.I.I.T. due and payable. Currently no credit in Chapter 1 contains that language.

While domestic law does not provide a foreign tax credit, it is theoretically possible an income tax treaty provides such authority.[4] Indeed, the Treasury Department and I.R.S. leave open this possibility. But in doing so, they caution that treaties with language substantially similar to Article 23(2) of the U.S. Model Income Tax Treaty do not provide a basis for taking the foreign tax credit against the N.I.I.T.[5] In the 2016 version of the Model Treaty, that provision reads:

> 2. 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 applicable to residents and citizens:
>
> > a) the income tax paid or accrued to __________ by or on behalf of such resident or citizen; and
> >
> > b) in the case of a United States company owning at least 10 percent of the voting stock of a company that is a resident of __________ and from which the United States company receives dividends, the income tax paid or accrued to __________ by or on behalf of the payor with respect to the profits out of which the dividends are paid.
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> For the purposes of this paragraph, the taxes referred to in subparagraph (a) of paragraph 3 and paragraph 4 of Article 2 (Taxes Covered) shall be considered income taxes.

The relevant paragraphs of Article 2 that identify taxes covered by the Model Treaty state the following:

> 3. The existing taxes to which this Convention shall apply are:
>
> > a) in the case of [name of treaty partner]: * * *[;]

[2] Code §27.

[3] Treas. Reg. §1.1411-1(e).

[4] See the preamble published by the I.R.S. at the time Treas. Reg. §1.1411-1 was adopted, T.D. 9644.

[5] *E.g.*, Switzerland-U.S. Income Tax Treaty Art. 23(2).

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> b) in the case of the United States: the Federal income taxes imposed by the Internal Revenue Code (which do not include social security and unemployment taxes) and the Federal taxes imposed on the investment income of foreign private foundations.
>
> 4. This Convention also shall apply to any identical or substantially similar taxes that are imposed after the date of signature of this Convention in addition to, or in place of, the existing taxes. The competent authorities of the Contracting States shall notify each other of any significant changes that have been made in their taxation laws or other laws that relate to the application of this Convention.

The U.S. Tax Court confirmed the position in *Toulouse v. Commr.*,[6] where the I.R.S. disallowed a foreign tax credit claimed to reduce N.I.I.T., and the Court upheld the disallowance.

"In broad terms, S.S.T.A.'s are to social security taxes as income tax treaties are to income taxes."

In comparison, the I.R.S. recognizes that tax treaties with a dual-resident article can provide relief from N.I.I.T. for a dual-resident individual (other than a U.S. citizen) electing to be treated solely as a resident of the treaty partner country. That individual will be exempt from the N.I.I.T.[7] When the dual resident individual is a green card holder, electing relief under the dual-resident article may not be attractive for reasons unrelated to the N.I.I.T.

S.S.T.A.'S

Another, less prominent form of international tax agreement is the Social Security Totalization Agreement ("S.S.T.A."). In broad terms, S.S.T.A.'s are to social security taxes as income tax treaties are to income taxes. S.S.T.A.'s generally allow covered taxpayers to eliminate exposure to double social security taxation, while aggregating coverage under the social security system of each country for purposes of qualifying for benefits. This enables an individual who pays social security taxes to one country for a period of time and then to the other country for a period of time to bundle the coverages for purpose of determining benefits. At that point, only a *pro rata* payment is made by a country based on the periods for which social security taxes were actually paid.

The default rule under S.S.T.A.'s is that employees are taxed by the country where they are employed, not the country where they reside or their employer is based. Self-employed individuals are taxed based on residence. An exception known as the detached-worker rule allows migrating workers who expect to return to their home country within five years to be taxed only by their home country.

From the U.S. side, S.S.T.A.'s explicitly cover taxation under the Federal Insurance Contributions Act ("F.I.C.A.") and the Self-Employed Contributions Act ("S.E.C.A."). These are known as "payroll taxes" because they are levied on wages. F.I.C.A. applying to employee payrolls and S.E.C.A. applying a mirror tax on the income of

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[6] 157 T.C. 49 (2021). For a full discussion of the issues addressed in *Toulouse*, see Andreas A. Apostolides and Wooyoung Lee, "Toulouse or not Toulouse? N.I.I.T.-Picking the Reach of the U.S. Foreign Tax Credit," Volume 8 No. 6 *Insights* (November 2021): p.28.

[7] Treas. Reg. §1.1411-2(a)(2).

self-employed individuals. The S.E.C.A. tax is the sum of the employee's share of social security tax and a percentage of the employer's share of that tax. The base is generally net income from self-employment, and most of the tax is capped. Each tax is split into social security and Medicare portions that fund Social Security and Medicare benefits.

Some practitioners believe that S.S.T.A.'s cover the N.I.I.T. The scope of S.S.T.A.'s is not necessarily limited to the enumerated taxes. They also cover legislation which amends or supplements the listed taxes. To illustrate, Paragraphs 1 and 3 of Article 2 (Material Scope) of the Switzerland-U.S. Social Security Totalization Agreement provide:

> 1. For the purpose of this Agreement, the applicable laws are:
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> * * *
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> b. as regards the United States of America, the laws governing the Federal old-age, survivors, and disability insurance program:
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> -- Title II of the Social Security Act and regulations pertaining thereto, except sections 226, 226A and 228 of that title, and regulations pertaining to those sections,
>
> -- Chapters 2 and 21 of the Internal Revenue Code of 1986 and regulations pertaining to those chapters.[8]
>
> * * *
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> 3. Except as provided in the following sentence, this Agreement shall also apply to legislation which amends or supplements the laws specified in paragraph 1. This Agreement shall apply to legislation or regulations which extend the existing laws to other categories of beneficiaries or which involve a new branch of Social Security only if both Contracting States so agree.

The provision is generally understood to require that a tax be a social security tax to be covered by an S.S.T.A. Whether the N.I.I.T. can be considered a social-security tax is at the heart of this ambiguity. In the context of Switzerland, the N.I.I.T. appears in Chapter 2A of the Code, not Chapter 2 or 21 tax.

CLAIMING A FOREIGN TAX CREDIT TO REDUCE N.I.I.T.

Congressional Intent

There seems little doubt that amending or supplementing the Medicare tax (*i.e.*, the Medicare portions of F.I.C.A. and S.E.C.A.) was the Congressional intent for enactment of the N.I.I.T. That would place the N.I.I.T. within the literal language of most S.S.T.A.'s. The N.I.I.T. was brought into existence by the Health Care and Education Reconciliation Act of 2010 (H.C.E.R.A.). With the new health care law calling for

[8] Chapters 2 and 21 contain S.E.C.A. and F.I.C.A., respectively. The N.I.I.T. is located in Chapter 2A.

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an expansion of Medicare, Congress presumably believed increased funding was required. One of the first mentions of the N.I.I.T. is a 2010 legislative proposal of the Obama Administration to institute a 2.9% tax on unearned income for individuals reporting taxable income above certain thresholds. The proposed tax revenues were to fund Medicare.

As if to further underscore the point, Chapter 2A of the Code is entitled "Unearned Income Medicare Contribution," and Code §1411 is the only section that appears in Chapter 2A. This was an important distinction for the court in *Toulouse*, which looked to the location within the Code to conclude that the social security tax imposed by the foreign country was not an income tax that could be claimed as a foreign tax credit against taxable income. The court stated the following:

> The Code is divided into subtitles, and subtitles are divided into chapters, which impose separate and distinct taxes. Section 1, which is in chapter 1, subtitle A, Income Taxes, of the Code, imposes a tax on the taxable income of individuals (regular tax). Compare ch. 1, sec. 26(b) (referring to tax imposed by section 1 as "regular tax liability") with ch. 23, sec. 3301 (imposing a tax on employers on wages that they pay to their employees).
>
> Of relevance here, section 27 provides a credit for "[t]he amount of taxes imposed by foreign countries * * * against the tax imposed by this chapter to the extent provided in section 901." Section 901 provides a foreign tax credit against regular tax. It clearly states that "the tax imposed by this chapter [1] * * * [is] credited" with specified amounts. Thus, both sections 27 and 901 clearly provide that the foreign tax credit allowable under the Code reduces only tax imposed under chapter 1, such as the section 1 regular tax. See also sec. 61 (defining gross income for purposes of the section 1 regular tax); sec. 63(a) (defining taxable income for those purposes).
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> Section 1411 is in chapter 2A, subtitle A, Income Taxes. Thus, the foreign tax credit under section 27—which applies to "the tax imposed by this chapter [1]"—does not by its terms apply to offset net investment income tax.
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> * * *
>
> Congress has allowed a foreign tax credit only against taxes imposed under chapter 1. There is no Code provision for a foreign tax credit against the net investment income tax. * * * [The relevant income tax treaties] do not provide an independent basis for a foreign tax credit against the net investment income tax.

In Practice

While the N.I.I.T.'s initial purpose is unambiguous, it is much less clear whether the N.I.I.T. is functionally a social-security tax. A distinctive feature of payroll taxes is that their revenues flow to specially earmarked funds for Social Security and Medicare. By contrast, the U.S. Federal income tax feeds into the Treasury Department's general fund. Despite the recommendation of the Obama Administration, the N.I.I.T. does so as well. This may have been a result of congressional mandates for new legislation to be revenue neutral, leading to the need to treat the N.I.I.T.

as an increase in general income tax in order to match expenditures.[9] In its 2021 Greenbook announcing a legislative agenda for the year, the Treasury Department acknowledged that the N.I.I.T. feeding into the Treasury Department's general fund is inconsistent with the fact that F.I.C.A., S.E.C.A., and N.I.I.T. are intended for the same purpose.[10] Nonetheless, the effect is that, today, the N.I.I.T. looks less like a social-security tax and more like an income tax.

APPLICATION OF S.S.T.A.'S TO N.I.I.T.

The N.I.I.T. also differs from F.I.C.A. and S.E.C.A. mechanically. The latter two laws include statutory provisions that allow overrides by S.S.T.A.'s.[11] None exists for the N.I.I.T. This could prove a technical barrier to claiming an exemption from the N.I.I.T. under an applicable S.S.T.A. instead of claiming a foreign tax credit against the N.I.I.T.

Government Position

It is more likely that the I.R.S. views the N.I.I.T. as an income tax for which no foreign tax credit is allowed and not a social-security tax. As cited earlier, the I.R.S. did not rule out the idea that income-tax treaties might provide relief against the N.I.I.T. If the I.R.S. thought the N.I.I.T. was not an income tax, it would presumably eliminate this possibility. Internal agency documents also indicate that the I.R.S. does not think the N.I.I.T. is covered by S.S.T.A.'s.[12]

Most S.S.T.A.'s predate the N.I.I.T., and some practitioners surmised that the failure of S.S.T.A.'s to explicitly cover the N.I.I.T. was merely a timing issue. But no S.S.T.A. that was signed or came into force after March 2010 (when the H.C.E.R.A. was enacted) or December 2012 (when the N.I.I.T. came into force) mentions the N.I.I.T.

RESOLUTION

Some tax advisers have reportedly advised taxpayers to take the position that an applicable S.S.T.A. exempts U.S. citizens and green card holders from the N.I.I.T., provided the individuals reside outside the U.S. and expressly identify the issue on an income tax return on Form 8833 (Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b)). Some of those advisers report that tax returns on which the treaty-based position was taken were reviewed in the course of I.R.S. examinations, and the issue was not raised. One case where the I.R.S. did not ignore this position as to S.S.T.A.'s is now the subject of refund litigation. A taxpayer who

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[9] Changes to other taxes during the H.C.E.R.A.'s drafting meant that its final projected revenue was far lower than initially projected, which was a problem because certain congressional rules require legislation to be revenue neutral. Congress added the N.I.I.T. to the H.C.E.R.A. but had to direct its revenue toward the general fund in order to make up the shortfall. Kofsky and Schmutz, "What a Long Strange Trip It's Been for the 3.8% Net Investment Income Tax," 78 Md. L. Rev. Online 14 (2019): p. 26-32.

[10] General Explanations of the Administration's Fiscal Year 2022 Revenue Proposals.

[11] Code §§3101(c), 3111(c), 1401(c).

[12] Social Security and Self-Employment Tax Obligations of U.S. Individuals Working Outside the United States, I.R.S. Nationwide Tax Forum 2019.

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was a U.S. citizen and South Korean resident paid $600,000 in N.I.I.T. before later filing an amended return claiming a refund, based on the S.S.T.A between the U.S. and Korea. The I.R.S. has proposed disallowing the claim.

Taxpayers are not the only ones to have noticed the discrepancy between intent and practice, as the 2021 Greenbook indicated. The Greenbook proposed redirecting N.I.I.T. funds into the same Medicare fund as F.I.C.A. and S.E.C.A. Were this step taken, the N.I.I.T. would seem to be the functional equivalent of a social security tax. However, coverage by an S.S.T.A. may not be automatic. Each S.S.T.A. contains its own provisions calling for extension of the agreement to reflect new categories of beneficiaries. As mentioned above, the Switzerland-U.S. S.S.T.A. requires both countries to agree on the extension. In comparison the Netherlands-U.S. S.S.T.A. provides for automatic extension unless notification is given to the other country within three months of enactment that extension of the agreement is not intended.[13] The U.S.-U.K. S.S.T.A. provides that it applies to:

> * * * any identical or substantially similar taxes that are imposed after the date of signature of this Convention in addition to, or in place of, the existing taxes.* * *[14]

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[13] Netherlands-U.S. S.S.T.A. Art. 2(3).

[14] U.K.-U.S. S.S.T.A. Art. 2(4).

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