ANOTHER TAXPAYER ALLOWED TREATY-BASED FOREIGN TAX CREDIT AGAINST N.I.I.T.

Author
Wooyoung Lee

Tags
Foreign Tax Credit
Net Investment Income Tax
Tax Treaty

The application of the foreign tax credit to the net investment income tax ("N.I.I.T.") has been a recurring battle in courtrooms in recent years. In the most recent installment, the taxpayer in *Bruyea v. U.S.*[1] prevailed in claiming a foreign tax credit under the Canada-U.S. income tax treaty.

BACKGROUND

N.I.I.T. and the Foreign Tax Credit

The N.I.I.T. is a 3.8% tax on certain items of passive income that is levied on U.S. individuals whose gross income is above certain thresholds. Passive income that is subject to N.I.I.T. includes dividends, interest, rents, royalties, and capital gains.

In the international context, N.I.I.T. has drawn attention because of the potential for double taxation. A U.S. individual residing in another country could owe N.I.I.T. to the U.S. by virtue of his or her citizenship and tax to the foreign country by virtue of his or her residence. The U.S., like most countries, offers a foreign tax credit that can be used to offset U.S. income tax by the amount of foreign tax, thereby alleviating double taxation in many cases.

Statutory organization means that the N.I.I.T., unlike regular U.S. income tax, is not offsetable by the foreign tax credit under U.S. law. This is because the Code provides that the foreign tax credit is only usable against "the tax imposed by this chapter."[2] The foreign tax credit and regular income tax are both located in Chapter 1 of the Code. The N.I.I.T., on the other hand, is located in Chapter 2A, a chapter created solely for the N.I.I.T.

The N.I.I.T. regulations confirm this result:

> 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 [the N.I.I.T.] 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.[3]

Because domestic law does not provide relief, taxpayers have sought other avenues to avoid double taxation. Some commentators have argued that Social Security

---

1 No. 23-766T

2 Code §901(a).

3 Treas. Reg. §1411-1(e).

© Ruchelman P.L.L.C., 2025. All rights reserved.

Totalization Agreements allow an exemption from N.I.I.T. for U.S. individuals residing in certain foreign countries. A more common approach has been for taxpayers to invoke income tax treaties to claim foreign tax credits. Income tax treaties between the U.S. and other countries often provide relief from double taxation by requiring the treaty countries to offer foreign tax credits to residents of treaty countries.

Earlier Cases

Previously, the Tax Court in *Toulouse* disallowed the foreign tax credit under the U.S.'s tax treaties with France and Italy.[4] The court found that the treaty provisions that the taxpayer relied on required U.S. domestic law to allow for a foreign tax credit to be allowed. For example, the taxpayer cited Article 24(2)(a) of the French tax treaty, which allows a foreign tax credit to U.S. taxpayers for French income tax. But the court observed that the credit's allowance was "[i]n accordance with the provisions and subject to the limitations of the law of the United States[.]" This language is found in most tax treaties with the U.S. and is also contained in the Italian treaty. The court interpreted this clause to mean that, for a foreign tax credit to be allowed, the credit must be authorized by domestic law. And domestic law clearly does not allow for the foreign tax credit to be applied against N.I.I.T. The court concluded as follows:

> [F]or petitioner to prevail on the basis of the provisions she cites, the Code must provide the credit if one exists * * * There is no provision for any credits against the section 1411 tax [the N.I.I.T.].

Similar reasoning saw a taxpayer, relying on the South Korea-U.S. tax treaty, defeated in *Kim*.[5]

In *Christensen*,[6] the taxpayers, also relying on the French treaty, prevailed by citing a different provision of the French treaty: Article 24(2)(b), which is specific to individuals who are U.S. citizens residing in France. The *Toulouse* taxpayer had not cited Article 24(2)(b), and the court there never discussed it. The Court of Federal Claims found that the second treaty provision did not rely on domestic law to be operative and independently authorized the foreign tax credit. This was because this subparagraph did not subject the foreign tax credit to the limitations of U.S. law. But the court seemed to agree with the *Toulouse* court's interpretation of Article 24(2)(a).

BRUYEA: A NEW APPROACH

Paul Bruyea is an American citizen residing in Canada. In 2015, Mr. Bruyea paid both Canadian income tax and N.I.I.T. on gains from the sale of real estate. Although he did not initially claim a foreign tax credit, he did so on filing a claim for a refund. He based his claim on Article XXIV (Elimination of Double Taxation) of the treaty with Canada. Paragraph 1 of that article 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

[4] 157 T.C. No. 4 (2021).

[5] 664 F. Supp. 3d 1062 (2023).

[6] 664 F. Supp. 3d 1062 (2023).

© Ruchelman P.L.L.C., 2025. All rights reserved.

> States shall allow to a citizen or resident of the United States…as a credit against the United States tax on income the appropriate amount of income tax paid or accrued to Canada * * *

For U.S. citizens resident in Canada, paragraph 4(b) further provides as follows:

> [F]or the purposes of computing the United States tax, the United States shall allow as a credit against United States tax the income tax paid or accrued to Canada * * *

"United States tax" is defined elsewhere in the treaty as "taxes on income and on capital…irrespective of the manner in which they are levied," including the following:[7]

- The Federal income taxes imposed by the Internal Revenue Code of 1986
- Any taxes identical or substantially similar to those taxes to which the Convention applies which are imposed after March 17, 1995 in addition to, or in place of, the taxes to which the treaty applies

It appears that the N.I.I.T., although enacted in 2010 and thus after the treaty came into force and effect, is covered by this definition. The court's starting point was that the treaty allowed for a credit against N.I.I.T.

The government conceded that N.I.I.T. fits the definition but argued that a foreign tax credit was nonetheless impermissible. It brought two main arguments. First, under the "last-in-time" rule, the government argued that the manner in which Congress enacted the N.I.I.T. signaled its intent for the tax to not be offsetable by a treaty-based credit.

Under the last-in-time rule, in the context of treaties, a treaty provision is given effect unless a later-enacted domestic law directly contradicts the treaty provision.[8] But for the rule to come into play, a conflict must exist. The court found that the government had not shown a conflict existed. The government's main argument was that by placing N.I.I.T. in its own chapter of the Code, separate from regular income tax, Congress indicated it did not want a treaty-based credit to be usable against N.I.I.T. The court disagreed with the government's interpretation. It did not find evidence of such an intent.

The government faced further difficulty when the court cited further interpretive principles:

> Where a treaty and a statute "relate to the same subject, the courts will always endeavor to construe them so as to give effect to both, if that can be done without violating the language of either."[9]

Based on this premise, the court raised the burden on the government with the assumption that later laws were not intended to repeal a treaty.[10] The court asked

---

[7] Canada-U.S. Income and Capital Tax Treaty Art. III(1)(d) and Art. II(2)(b) and (3).

[8] This rule is codified under Code §7852(d).

[9] Citing *Kappus v. Commr.*, 337 F.3d 1053 (2003).

[10] *Id.*

the government to show “crystal clear” language showing an intent to abrogate the treaty, which the government failed to do.

The government’s second argument was familiar from the *Toulouse* case. If the foreign tax credit was “[i]n accordance with the provisions and subject to the limitations of the law of the United States,” then no foreign tax credit could be claimed unless authorized by U.S. domestic law. Notably, the government applied this limitation not only to Paragraph 1 but also to Paragraph 4.

Here, the court found the government’s argument inconsistent. In spite of the government’s blanket application of Paragraph 1’s limitation, the government conceded that there were other provisions of Article XXIV that conflicted with U.S. law. For example, Paragraphs 3 and 6 contain sourcing rules that could yield different results than under sourcing rules in the Code. When asked to reconcile these positions, the government argued that the other provisions were more specific in their intent to contradict domestic law. The court was not convinced.

At the outset of its opinion, the court observed that treaty interpretation was somewhat unique because “courts are encouraged to consider a treaty’s purpose, as well as extrinsic evidence of the intent of the parties to the treaty.” Here, the court found that the purpose of Article 24 was to eliminate double taxation. It found no conflict between this principle and the later enactment of N.I.I.T.

Extrinsic Evidence

The court then concluded that even if all of Article XXIV were subject to the limitations of U.S. law, it would still not preclude a credit for the taxpayer. The court cited the Technical Explanation to the treaty and found that the limitations of U.S. law applied for a much more specific purpose:

> The direct and deemed-paid credits allowed by paragraph 1 are subject to the limitations of the Code as they may be amended 28 from time to time without changing the general principle of paragraph 1. Thus, as is generally the case under U.S. income tax conventions, provisions such as Code sections 901(c), 904, 905, 907, 908, and 911 apply for purposes of computing the allowable credit under paragraph 1. In addition, the United States is not required to maintain the overall limitation currently provided by U.S. law. [11]

Therefore, the limitations of U.S. law applied for the much narrower and mechanical purpose of calculating the amount of the credit.

Other language from the Technical Explanation bolstered the taxpayer’s case:

> Paragraph 1 provides a credit for these specified taxes whether or not they qualify as creditable under Code section 901 or 903.

This showed that even Paragraph 1, the only paragraph of Article XXIV that is unambiguously subject to the limitations of U.S. law, could provide relief not provided for in the Code. The court found that allowing for the credit was consistent with the principal purpose of the treaty, which was to reduce or eliminate double taxation.[12]

---

[11] Emphasis added by the court.

[12] Citing the Senate report.

© Ruchelman P.L.L.C., 2025. All rights reserved.

It was also consistent with another treaty-interpretation principle: if a treaty provision yields two reasonable interpretations, the interpretation offering more rights is to be preferred.[13]

CONCLUSION

The taxpayer prevailed again in the Court of Federal Claims, but the taxpayer's route to victory took a very different one than in *Christensen*. *Christensen* seemed to accept the *Toulouse* argument that foreign tax credits that are provided subject to U.S. law cannot provide relief not already provided for by U.S. law. The *Christensen* taxpayers won because they found a credit not subject to U.S. law.

The *Bruyea* court, relying much more than the *Toulouse* court on outside evidence, found that being subject to the limitations of U.S. law is a much narrower restriction than what the *Toulouse* court found. A credit provided subject to U.S. law does not have to conform exactly to domestic law.

It is unclear how permanent this relief will be. *Bruyea* clearly contradicts *Toulouse*. There is a good chance that the government, which has already appealed *Christensen*, will appeal *Bruyea*. That may lead to an appeals court resolving the conflict between *Toulouse* and *Bruyea*, or it could lead to a circuit split. For now, the picture remains uncertain.

"There is a good chance that the government, which has already appealed Christensen, will appeal Bruyea."

[13] Citing *U.S. v. Stuart*, 489 U.S. 353 (1989).

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.*