Toulouse v. Commissioner, 157 T. C. No. 4 (2021)

In Toulouse v. Commissioner, the U. S. Tax Court ruled that U. S. citizens residing abroad cannot use foreign tax credits to offset the Net Investment Income Tax (NIIT) under U. S. income tax treaties with France and Italy. The decision clarifies that treaty-based credits are subject to the limitations of U. S. tax law, which does not provide for such credits against NIIT, impacting how international taxpayers manage their tax liabilities.

Parties

Catherine S. Toulouse, the petitioner, was a U. S. citizen residing in France during the relevant period. She filed her petition against the Commissioner of Internal Revenue, the respondent, challenging the assessment of the Net Investment Income Tax (NIIT) under I. R. C. sec. 1411 for the tax year 2013 and an addition to tax under I. R. C. sec. 6651(a)(2) for failure to pay.

Facts

Catherine S. Toulouse, a U. S. citizen residing in France, filed her 2013 federal income tax return claiming a foreign tax credit carryover to offset her regular tax liability. She also attempted to use this credit to offset her NIIT, which is a 3. 8% tax on net investment income imposed under I. R. C. sec. 1411. Toulouse reported a net investment income tax of $11,540 on Form 8960 but modified the form to reflect a foreign tax credit of the same amount, resulting in no NIIT due. She based her claim for the offset on Article 24(2)(a) of the U. S. -France Income Tax Treaty and Article 23(2)(a) of the U. S. -Italy Income Tax Treaty, asserting that these treaty provisions independently allowed for a foreign tax credit against the NIIT.

Procedural History

Following the filing of her 2013 return, the IRS issued a notice of a math error to Toulouse, adjusting her return by $11,540 due to the disallowed foreign tax credit against the NIIT. Toulouse contested this assessment, but the IRS upheld its position that no such credit was allowable. Subsequently, the IRS assessed the NIIT and an addition to tax under I. R. C. sec. 6651(a)(2) for failure to pay the tax shown on her return. Toulouse received notices of intent to levy and federal tax lien filing, leading her to request a Collection Due Process (CDP) hearing under I. R. C. secs. 6320 and 6330. After the hearing, the IRS issued a notice of determination sustaining the levy action but not the lien filing. Both parties filed cross-motions for summary judgment in the U. S. Tax Court, with Toulouse conceding that the Internal Revenue Code does not provide for a foreign tax credit against the NIIT but arguing that the treaties did.

Issue(s)

Whether Article 24(2)(a) of the U. S. -France Income Tax Treaty and Article 23(2)(a) of the U. S. -Italy Income Tax Treaty entitle a U. S. citizen residing abroad to use a foreign tax credit to offset the Net Investment Income Tax imposed under I. R. C. sec. 1411?

Rule(s) of Law

The Internal Revenue Code, under I. R. C. sec. 27 and sec. 901, provides for a foreign tax credit against the regular tax imposed by chapter 1 but does not extend this credit to the Net Investment Income Tax under chapter 2A. The treaties with France and Italy, while intended to reduce double taxation, subject any allowable foreign tax credit to the provisions and limitations of U. S. tax law, as per Article 24(2)(a) of the U. S. -France Treaty and Article 23(2)(a) of the U. S. -Italy Treaty.

Holding

The U. S. Tax Court held that Toulouse was not entitled to use a foreign tax credit to offset the Net Investment Income Tax under the provisions of the U. S. -France and U. S. -Italy Income Tax Treaties, as these treaties are subject to the limitations of U. S. tax law, which does not provide for such a credit against the NIIT.

Reasoning

The court's reasoning focused on the plain text of the treaties, which expressly state that any foreign tax credit must be in accordance with and subject to the limitations of U. S. law. The court found that the Internal Revenue Code clearly allows a foreign tax credit only against taxes imposed under chapter 1, not chapter 2A, where the NIIT is located. The court rejected Toulouse's argument that the treaties provide an independent basis for a credit, emphasizing that the treaties' language ties the credit to U. S. law's provisions. The court also considered the legislative history and structure of the Internal Revenue Code, noting that the placement of the NIIT in a separate chapter was a deliberate legislative choice that did not extend the foreign tax credit to this tax. The court further analyzed the Treasury Department's Technical Explanation of the U. S. -France Treaty, which reinforced that the terms of any credit are determined by U. S. statutory law. The court concluded that since the Code does not provide for a foreign tax credit against the NIIT, the treaties could not independently provide such a credit.

Disposition

The court denied Toulouse's motion for summary judgment and granted the Commissioner's motion for partial summary judgment on the issue of the foreign tax credit against the NIIT. The court did not resolve the issue of the addition to tax under I. R. C. sec. 6651(a)(2), finding a dispute of material fact as to whether Toulouse's failure to pay was due to reasonable cause.

Significance/Impact

This case is significant for its clarification of the interaction between U. S. income tax treaties and domestic tax law, particularly concerning the application of foreign tax credits against the Net Investment Income Tax. It underscores the principle that treaty-based credits are not independent of U. S. tax law but are instead subject to its provisions and limitations. This ruling may impact U. S. citizens residing abroad who seek to use foreign tax credits to mitigate their U. S. tax liabilities, particularly with respect to the NIIT. The decision also highlights the importance of the specific language in treaties and how it is interpreted in light of domestic law, potentially affecting future cases involving the interplay between treaties and the Internal Revenue Code. Subsequent treatment by other courts and practical implications for legal practice will depend on how taxpayers and the IRS navigate the complexities of international taxation and treaty interpretation.

