Toulouse: No Treaty-Based Credit?

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In this article, Rosenbloom and Shaheen maintain that the U.S. Tax Court's decision in *Toulouse* — that U.S. tax treaties with France and Italy do not provide a treaty-based foreign tax credit against the net investment income tax — is mistaken.

The 13th chime of a clock is what is referred to in current parlance as a "tell": The errant chime is probably wrong, suggesting something may be amiss in the mechanism. A close inspection is in order.

The analogy came to mind in reading the Tax Court's opinion in *Toulouse*,[1] involving a claim by a U.S. citizen residing in France of a treaty-based foreign tax credit for income taxes paid to France and Italy against the net investment income tax (NIIT) imposed by section 1411 of the Internal

Revenue Code. In holding there was no credit, the Tax Court said the provisions for relief from double taxation in the U.S. tax treaties with France and Italy "expressly state that *any* allowable foreign tax credit is subject to the limitations of U.S. tax laws and must be in accordance with the Code" (emphasis added). "Accordingly, for petitioner to prevail on the basis of the provisions she cites, the Code must provide the credit if one exists," the court concluded. "It is immaterial that the Code does not affirmatively state that a foreign tax credit against the net investment income tax is disallowed," it added.

Reader, that does not sound right.

As the taxpayer conceded, the code does not provide an FTC against the NIIT.[2] It also does not prohibit an FTC against the NIIT. The taxpayer's point was that the treaties with France and Italy create an independent basis for a credit, and in the absence of a code prohibition, she should be entitled to rely on the treaties.

The taxpayer's position was clear. So was the court's response. Pointing to the language of both treaties that the United States shall allow an FTC "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 court held that the treaties "do not provide an independent basis" for an FTC against the NIIT.

I. Independent Treaty-Based Credit?

The structure of a tax treaty certainly suggests that it provides an independent basis for an FTC. Take, for example, the 2016 U.S. model income tax convention. Article 2 (taxes covered) identifies the counterparties' taxes that are the subject of the document and provides that the treaty also applies to "any identical or substantially similar taxes that are imposed after the date of signature of the [treaty] in addition to, or in place of, the existing taxes." Article 23 (relief from double taxation) contains measures to alleviate double taxation and cross-references article 2 to indicate the taxes that are the focus of the relief. For the United States, the method of relief is the FTC, which is provided "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)." Most U.S. tax treaties in force, including those with France and Italy, follow that pattern. It would appear the cited provisions amount to an independent treaty-based FTC.

The code envisions treaty-based FTCs as well. Section 6511(d)(3) addresses overpayments attributable to foreign taxes "for which credit is allowed against the tax imposed by subtitle A in accordance with the provisions of section 901 or the provisions of any treaty to which the United States is a party."

The very purpose of treaty provisions for relief from double taxation would be in question if the Tax Court's logic in *Toulouse* were correct. To see that, an examination of the court's opinion and relevant statutory and treaty provisions is necessary.

II. Analysis

A. Covered Taxes

The place to begin is article 2. The Italy-U.S. treaty includes in its article 2 the Italian Imposta Regionale Sulle Attività Produttive (IRAP), but only "that portion of such tax that is considered to be an income tax" under paragraph 2(c) of article 23. Under those rules, the amount of IRAP qualifying for the U.S. credit is computed with some deductions not allowed under Italian law. Under the prior Italy-U.S. treaty, the IRAP was declared creditable to a similar extent.[3]

The IRAP is similar to a VAT and does not generally allow deductions for interest or labor costs. It is almost certainly not a creditable income tax under the code,[4] which allows a credit for foreign "income, war profits, and excess profits taxes."[5] Statutory and regulatory rules addressing creditability do not contemplate that a portion of a non-creditable tax may be extracted and considered an income tax.[6] Thus, the treaties with Italy have long provided an FTC that is not provided by the code.

The IRAP is cited as an example, but it is not unique. There are other U.S. treaties that grant credits for otherwise non-creditable or possibly non-creditable foreign taxes.[7] Various foreign levies on extraction income have been covered in treaties when their status under statutory rules was dubious.[8] It is hard to see how those foreign taxes can be made creditable by treaties if *Toulouse* is correct.

Given that treaties have been used to allow U.S. FTCs independent of the statutory rules, the issue in *Toulouse* is more subtle than the Tax Court recognized. There is more to say about article 2 than the court's two brief sentences.[9] Because the issue is whether the treaties accord an FTC against the liability for NIIT, the threshold question is whether the NIIT, enacted after both the French and

Italian treaties were signed, is a covered tax under article 2. The answer depends on whether the NIIT is identical or substantially similar to the U.S. taxes enumerated in article 2 of the French and Italian treaties. The federal income taxes imposed by the IRC are named in article 2 of all U.S. treaties, including the French and Italian treaties.

On the question of being identical or substantially similar, the United States has been generous in appraising foreign taxes enacted after a treaty was signed.[10] It seems to approach the question by asking whether a new foreign tax is similar to specified income taxes in that it functions as a tax on income.[11] There are no authorities explicitly determining whether U.S. taxes enacted after a treaty was signed were identical to or substantially similar to U.S. taxes specified in a treaty. There is, however, no reason to believe the interpretive standard should be any different when the question involves a U.S., rather than foreign, tax enacted after a treaty was signed. In a string of decisions addressing the alternative minimum tax, it was assumed without discussion that the AMT qualifies.[12]

The NIIT, a tax on investment income, would appear to meet the test for both Italian and French treaties. After all, reg. section 1.1411-1(a) provides that except as otherwise provided, all IRC provisions that "apply for chapter 1 purposes in determining taxable income (as defined in section 63(a)) of a taxpayer also apply in determining the tax imposed by section 1411." Substantial similarity to the federal income tax is clear.

If the NIIT were not covered by the French and Italian treaties, the court's conclusion that creditability turns on what the code provides would surely be correct. If, however, the NIIT is a covered tax, analysis must turn to the articles on relief from double taxation (article 23 in the Italian treaty and article 24 in the French treaty).

B. Relief From Double Taxation

1. 'Shared Expectations'

Article 23 of the Italian treaty and 24 of the French treaty apply to income taxes. Italian article 23 explicitly cross-references article 2, and French article 24 has a clear, if not explicit, cross-reference, and the structure of both treaties strongly suggests the link. That means Italy and France have agreed to give credits for the NIIT against their covered income taxes.[13]

Tax treaties are contracts, painstakingly negotiated by sovereign countries and interpreted in accordance with the "genuine shared expectations of the contracting parties."[14] The views of the United States, one of those contracting parties, are relevant and important in interpreting a U.S. treaty, but they are not controlling.[15] It would be odd for a document interpreted in accordance with the shared expectations of the contracting parties to provide that France and Italy must give a credit for the NIIT against their income taxes, but the United States need not give credits for French and Italian income taxes against the NIIT.

2. The Treaty Obligation

What, then, is to be made of the fact that the United States' treaty obligation to credit French and Italian taxes is cabined "in accordance with the provisions and subject to the limitations" of U.S. law? That is the language the Tax Court relied on to reach its broad conclusion that "the Code must provide the credit if one exists." As noted, that statement cannot be correct as a general proposition. Consider, once again, the IRAP.

IRC section 901(a) provides in pertinent part that the tax imposed by chapter 1 of subtitle A of the code "shall, subject to the limitation of section 904, be credited with the amounts provided in the applicable paragraph of subsection (b)." Section 901(b) provides that for U.S. citizens (such as the taxpayer in *Toulouse*), the amount referred to in subsection (a) is "the amount of any [foreign] income, war profits, and excess profits taxes." As noted, the IRAP is not that kind of tax. Therefore, the IRAP is not a creditable foreign tax for section 901 purposes. In the absence of another code provision providing a credit for the IRAP, it must be concluded that the code does not provide a credit for the IRAP at all. It is a fact, however, that a credit for a portion of the IRAP does exist. How so?

Article 23(2)(a) of the Italy-U.S. tax treaty provides in pertinent 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 States shall allow to a resident or citizen of the United States as a credit against the United States tax on income the appropriate amount of *income tax* paid to Italy. [Emphasis added.]

Article 23(2)(b) then provides that a portion of the IRAP is considered an income tax for article 23 purposes.

As the U.S. Supreme Court has explained, when statute and treaty "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,"[16] and "no domestic legislation is required to give [a self-executing treaty] the force of law in the United States."[17] Article 23 of the Italian treaty provides a treaty-based credit for the IRAP. The code denies a section 901 credit for the IRAP, but it does not preclude any credit for the IRAP, and certainly does not preclude a treaty-based credit for the IRAP. Allowing a credit for the IRAP against U.S. income tax gives full effect to both code and treaty provisions without violating the language of either, and harmony is achieved. The same logic applies to article 24 of the French treaty and double taxation relief provisions of other treaties.

What might the "in accordance with" and "subject to the limitations" references mean? The U.S. Treasury Department's official technical explanations of treaties carry considerable weight.[18] That should be especially true when the treaty language interpreted in a technical explanation is devised by the Treasury for a commitment of the United States. The model technical explanation of the 2006 U.S. model convention — Treasury's most recent model technical explanation — suggests that the reference is:

> to the various limitations of U.S. law (see, *e.g.,* Code sections 901-908). For example, the credit against U.S. tax generally is limited to the amount of U.S. tax due with respect to net foreign source income within the relevant foreign tax credit limitation category (see Code section 904(a) and (d), and the dollar amount of the credit is determined in accordance with U.S. currency translation rules (see, *e.g.*, Code section 986).[19]

Treasury has also taken the position that statutory rules reducing the credit amount from 100 percent of the foreign tax paid to a lower percentage fall within the cited language.[20]

What, then, are the various limitations of U.S. law and of IRC sections 901 to 908? They are limitations on the amount of taxes that are eligible for the credit. The treatment of the IRAP makes clear that not all elements of the code that define the scope of the statutory FTC are limitations for that purpose. Under section 901(b), only foreign income, war profits, and excess profits taxes are creditable taxes for the section 901 credit. If the definition of what is creditable were a limitation of U.S. law, the U.S. obligation under article 23(2)(a) of the Italian treaty would have been subject to it, and the IRAP would not be creditable.

It seems the phrase "in accordance with the provisions and subject to the limitations of the law of the United States" does not refer to domestic rules pertaining to the kind of taxes eligible for the credit. That is presumably what the model technical explanation means by the statement that although the treaty provides for an FTC, "the terms of the credit are determined by the provisions, at the time a credit is given, of the U.S. statutory credit." It is hard to see how a treaty could provide for an FTC if the kind — as opposed to the amount — of tax is subject to domestic law limitations.

Regarding the distinction between the phrases "in accordance with" and "subject to the limitations of," the first cannot be superfluous and is probably intended to expand, rather than limit, the treaty-based credit. The model technical explanation states that "U.S. law applies to determine carryover periods for excess credits and other inter-year adjustments."[21] The U.S. model and U.S. treaties in force say nothing specific about carryovers. Without the "in accordance with" language, treaties could be interpreted as not contemplating carryovers.

Toulouse involved a claim of credits for Italian and French taxes paid by the taxpayer in years before 2013 and carried forward and claimed for 2013, the year at issue. Consistent with the technical explanation, the IRS did not argue that the taxpayer could not prevail because the claimed treaty-based credit involved carryovers. That may have been based on the realization that treaty credit obligations incorporate the statutory carryover benefit under the "in accordance with" language.

The question of an independent treaty-based FTC against the NIIT is similar to that of the independent treaty-based credit for the IRAP. Section 901(a) provides an FTC against the tax imposed by chapter 1 of subtitle A of the code. The NIIT is imposed by chapter 2A. Therefore, section 901(a) does not allow a section 901 credit against the NIIT, just as section 901(b) does not allow a section 901 credit for the IRAP. There is no code provision allowing an FTC against the NIIT, nor is there one allowing an FTC for the IRAP. There is, however, no code provision that denies a treaty-based credit against the NIIT, just as there is none denying a treaty-based credit for the IRAP.

The preamble to the section 1411 regulations suggests that section 27 constitutes a limitation on the FTC that the treaty-based credit obligation is subject to. Section 27, however, says nothing beyond what section 901 says. In its entirety, it provides that the "amount of taxes imposed by foreign counties and possessions of the United States shall be allowed as a credit against the tax imposed by [chapter 1 of subtitle A of the code] to the extent provided in section 901." The current purpose of section 27 seems to be a mere reference to section 901.

3. 'Without Changing the General Principle'

There is another reason the treaty language that credits under U.S. treaties are allowed "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)" does not preclude a treaty-based credit against the NIIT. Importantly, the model technical explanation interprets those words to mean that credits under U.S. treaties are allowed "in accordance with the provisions and subject to the limitations of U.S. law, as that law may be amended over time, *so long as the general principle of the Article, that is, the allowance of a credit, is retained*" (emphasis added).

The parenthetical treaty language above prevents the "in accordance with . . . and subject to the limitations of" wording from impugning the allowance of a credit. Imposition of the NIIT without allowing a treaty-based credit against it would not retain the principle of allowing a credit for the NIIT.

The Tax Court dismissed that argument, saying that imposing the NIIT "is not a change to the general principles of U.S. tax laws." That, however, is the wrong reference. The question is not whether imposing the NIIT without a credit would change the general principles of U.S. tax laws but whether imposing the NIIT without a credit would retain the general principle of the allowance of a credit. The answer appears to be no.

III. Final Remarks

There is considerably more to *Toulouse* than appears in the Tax Court's opinion. It is true that creditability of a foreign tax against a nonspecified U.S. tax presents a different question than creditability of a nonspecified foreign tax against the U.S. income tax. The first question raises issues regarding how the intricate U.S. rules for limiting the credit and allowing for carryovers apply when the statutory mechanisms are lacking. The second question presents less difficulty because the familiar statutory rules limiting creditable foreign taxes can easily apply to nonspecified foreign taxes. The distinction does not, however, present a convincing rationale for denying a treaty-based FTC in the first case. It certainly does not answer the question why the United States may refuse to credit specified French and Italian taxes against a nonspecified U.S. tax when France and Italy agree to give credit for that same nonspecified U.S. tax against their income taxes.

In concluding, it is worth identifying two pink herrings that swim into the analytical picture. The Tax Court professes not to be saying that "there is no independent, treaty-based credit and a credit is allowable only if it is provided in the Code."[22] It said, "Other provisions of the Treaties may well provide for credits that are unavailable under the Code." Really? One may fairly wonder what those other provisions might be. If they are not found in the treaty article on relief from double taxation, where would one look? Those articles have been essentially stable in content at least since the first U.S. model income tax convention in 1976.

The Tax Court said the taxpayer in *Toulouse* "relies on provisions that by their express terms do not" provide tax credits. However, no other articles could possibly provide credits. If the court's holding is correct, it is reasonable for the taxpayer to question the purpose of articles 24(2) and 23(2) of the French and Italian treaties, respectively. In fact, the court's approach renders those articles meaningless regardless of whether other provisions exist, and that cannot be right. It is an established maxim of law that "words cannot be meaningless, else they would not have been used."[23] At any rate, the court's reference to other provisions does not count for much in the absence of any indication of what those provisions are.

The court noted that the preamble to the section 1411 regulations "explains that an analysis of each U.S. income tax treaty would be required to determine whether the United States has an obligation under the treaty to provide a foreign tax credit against the section 1411 tax." That statement certainly suggests acceptance of the concept of a treaty-based FTC. But what does the statement mean? If it means only that a future treaty might explicitly allow an FTC against the NIIT, it is hard to take exception. Anything is possible in the future. On the other hand, if the statement is intended to suggest that examining existing treaties might yield results different from the one the court reached for the French and Italian treaties, the preamble is misleading. Virtually all U.S. treaties are similar to the ones the Tax Court examined and for which it held there is no treaty FTC against the NIIT.

There is, of course, no question that in enacting a new tax after a treaty has been signed, Congress can provide that there is no FTC allowed against the new tax by the code or any treaty. The supremacy clause of the U.S. Constitution, which gives the same legal status to treaties and statutes, so provides. However, Congress did not do that in enacting the NIIT, which can easily be harmonized with the allowance of a treaty-based FTC.[24] The core problem with the Tax Court's decision in *Toulouse* is that it did not mention, or apparently consider, that kind of harmonization as an option.

FOOTNOTES

[1] *Toulouse v. Commissioner,* 157 T.C. No. 4 (2021).

[2] Section 901 provides for an FTC against the tax imposed by chapter 1 of subtitle A of the code. The NIIT is imposed by section 1411, which is in chapter 2A of subtitle A of the code. No code provision provides for an FTC against the NIIT.

[3] In a March 1998 release on the prior treaty (IR-INT-98-6), the IRS said "the United States does not believe it is required to provide a tax credit for IRAP under the Current Treaty," but added that "in accordance with the provisions and subject to the limitations of the law of the United States (as it may be amended), the United States shall allow as a credit against the United States tax on income a portion of the amount of IRAP paid or accrued, and this portion shall be considered income tax for purposes of determining creditability." It said the United States "does not consider IRAP to be an income tax or an 'in lieu' tax within the meaning of section 901 or 903 of the Internal Revenue Code and the Income Tax Regulations thereunder."

[4] *See* Joint Committee on Taxation, "Explanation of Proposed Income Tax Treaty and Proposed Protocol Between the United States and the Italian Republic" (JCS-9-99), at article 23 ("Because the IRAP tax base does not permit deductions for labor and, in certain cases interest, it is not likely to be a creditable tax under U.S. internal law.").

[5] Section 901 and reg. section 1.901-2(a).

[6] Reg. section 1.901-2(a)(1) (with some exceptions not relevant here, "a tax either is or is not an income tax, in its entirety, for all persons subject to the tax").

[7] *See*, *e.g.*, Notice 2008-3, 2008-2 IRB 253 (regarding the Mexican Impuesto Empresarial a Tasa Única).

[8] *See, e.g.*, the Netherlands-U.S. tax treaty (covering "de vennootschapsbelasting (company tax), including the government share in the net profits of the exploitation of natural resources levied pursuant to the Mining Act (Mijnbouwwet)"); and the Norway-U.S. tax treaty (covering "the national and municipal taxes on income (including contributions to the tax equalization fund), and the special tax administered under section 5 of the Act of 13 June 1975, No. 35, relating to the taxation of submarine petroleum resources").

[9] *See Toulouse*, 157 T.C. No. 4, at 16-17.

[10] *E.g.*, Rev. Rul. 2002-16, 2002-15 C.B. 740 (Dutch schedular taxes).

[11] If the new tax is similar to a specified foreign tax that is not an income tax, the inquiry would presumably be somewhat different.

[12] *Lindsey v. Commissioner*, 98 T.C. 672 (1992), *aff'd*, 15 F.3d 1160 (D.C. Cir. 1994); *Jamieson v. Commissioner*, T.C. Memo. 1995-550, *aff'd*, 132 F.3d 1481 (D.C. Cir. 1997) (unpublished); *Pekar v. Commissioner*, 113 T.C. 158 (1999); *Kappus v. Commissioner*, T.C. Memo. 2002-36 (2002), *aff'd*, 337 F.3d 1053 (D.C. Cir. 2003); *Jamieson v. Commissioner*, T.C. Memo. 2008-118, *aff'd*, 584 F.3d 1074 (2009).

[13] France can exempt U.S.-source income, but if and to the extent it does not, it must provide a credit for covered U.S. taxes against its income tax. *See* article 24(1).

[14] *See, e.g.*, *Maximov v. United States*, 299 F.2d 565, 568 (2d Cir. 1962), *aff'd* 373 U.S. 49 (1963); *Lozano v. Montoya Alvarez*, 572 U.S. 1, 12 (2014) ("It is our 'responsibility to read the treaty in a manner "consistent with the *shared* expectations of the contracting parties."'" (emphasis in original)); *National Westminster Bank PLC v. United States*, 512 F.3d 1347, 1353 (Fed. Cir. 2008); and *Eshel v. Commissioner*, 831 F.3d 512 (2016).

[15] *North West Life Assurance Co. of Canada v. Commissioner*, 107 T.C. 363, 379 (1996) ("The Supreme Court has consistently held that we must consider the expectations and intentions of *both* signatories." (emphasis in original)).

[16] *Whitney v. Robertson*, 124 U.S. 190, 194 (1888).

[17] *Trans World Airlines Inc. v. Franklin Mint Corp.*, 466 U.S. 243, 252 (1984).

[18] *See*, *e.g.*, *North West Life*, 107 T.C. 363.

[19] Similar language is in the technical explanations of the treaties with Italy and France.

[20] See, e.g., Treasury's technical explanation of the Italy-U.S. 1999 income tax convention, article 23(2), referring to the quoted language and saying, "The alternative minimum foreign tax credit generally is limited in accordance with U.S. law to 90 percent of alternative minimum tax liability."

[21] The same language is found in the technical explanation of the Italian treaty.

[22] *Toulouse*, 157 T.C. No. 4, at 21.

[23] *United States v. Butler*, 297 U.S. 1, 65 (1936).

[24] One commentator has argued that enacting the NIIT without allowing a statutory FTC is a treaty override. Reuven S. Avi-Yonah, "Is the Net Investment Income Tax a Treaty Override? Reflections on *Toulouse*," *Tax Notes Int'l*, Oct. 4, 2021, p. 41. The IRS dismissed that argument in its briefs in *Toulouse*, and we consider it foreclosed. The law is clear: The question of override does not arise if harmonization is possible. *See* H. David Rosenbloom and Fadi Shaheen, "Treaty Override: The False Conflict Between *Whitney* and *Cook*," 24 *Fla. Tax Rev.* 375 (2021).

END FOOTNOTES

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