



AMERICAN CITIZENS ABROAD
THE VOICE OF AMERICANS OVERSEAS

Adapting the U.S. Tax Code to the 21st Century

STOP DOUBLE TAXATION WITH NIIT

American Citizens Abroad recommends that Congress correct a drafting oversight in the Affordable Care Act which leads to legislated double taxation of Americans abroad under the Net Investment Income Tax (NIIT)

Problems with the current system

The Affordable Care Act introduced the 3.8% NIIT under Section 1411 in a new Chapter 2a of the Internal Revenue Code (IRC). It applies to individuals, estates and trusts.¹ Foreign tax credits, allowed under Section 901 of the IRC are applicable only to taxes raised under Sections 1 through 1400U of the IRC in Chapter 1 of the IRC. Section 901 states “The credit shall not be allowed any tax treated as a tax not imposed by this chapter under Section 26(b).”² The NIIT was put under a new Chapter 2. This oversight in drafting the Affordable Care Act leads to legislated double taxation for Americans residing overseas on their Net Investment Income (interest, dividends, capital gains including gains on distribution of mutual funds, rental income, royalties, non-qualified annuities and income from businesses involved in trading financial instruments and businesses that are passive activities.³ If the taxpayer’s modified adjusted gross income (MAGI) exceeds the thresholds of the law, \$125,000 for “married filing separately” \$200,000 for “single filers” and “head of household filers” and \$250,000 for “married filing jointly” and “qualified widow(er) with dependent children”, the NIIT may apply. MAGI is determined by adding back to Adjusted Gross income (AGI), on line 37 of the 1040, the amount of foreign earned income exclusion taken under Section 911(a)(1) less any directly attributable deductions or exclusions allowed under Section 911(d)(6).⁴ Taxpayers with income from foreign controlled corporations (CFC) or passive foreign investment companies (PFIC) may have other adjustments make to their AGI to determine the MAGI.

NIIT represents a major departure from U.S. practice to allow foreign tax credit against U.S. income tax liability. It is incoherent with the fairness principle as the NIIT is destined to finance health care programs in the U.S. Americans abroad pay for and access health care programs in their country of residence. Americans abroad are considered to have met the minimum essential coverage by virtue of meeting the bona fide resident or physical presence tests of the Section 911 exclusion, whether they use the exclusion or not.⁵

The double taxation of NIIT is particularly penalizing for Americans abroad since the U.S. does not recognize most foreign pension funds as “qualified” Hence, foreign pension annuities are subject to NIIT. Furthermore, a significant proportion of Americans abroad are married to foreigners and therefore file “married filing separately”. The low MAGI income threshold for this category of filers will pull many Americans abroad into the NIIT net, particularly since the thresholds are not indexed to inflation.

As PWC stated: “The NIIT appears to have the characteristics of an income tax as defined (for non-US taxes) in Regulation §1.901-2(a)(i). It is expected that many foreign countries should consider the NIIT to be a creditable tax for purposes of determining credits for US taxes paid on US source income. It would thus appear reasonable that the NIIT should be classified in the same manner as Chapter 1 taxes for purposes of the foreign tax credit.”⁶

Recommended Changes in the law

Section 901 should be amended to read. “The credit shall be allowed for any tax imposed by Chapter 1 under Section 26(b) and by Chapter 2a under Section 1411 of the Internal Revenue Code.”

An alternative legislative correction could be accomplished in §1411 by adding a statement that the NIIT should be considered a tax imposed by Chapter 1 for purposes of Sections 26 and 901.⁷

¹ The discussion in this paper focuses on individuals. Estates and Trusts are subjected to the NIIT if they have undistributed Net Investment Income and also have adjusted gross income at which the highest tax bracket for an estate or trust begins for such taxable year. For threshold details on trusts and estates, see IRS Frequently Asked Questions at <http://www.irs.gov/uac/Newsroom/Net-Investment-Income-Tax-FAQs>, reviewed and updated November 13, 2014, points 6 and 7. For a full discussion of the treatment of business units, see the PWC review of the Final Treasury Regulations relating to NIIT; go to http://www.pwc.com/en_US/us/asset-management/real-estate/publications/assets/pwc-net-investment-income-tax-regulations-real-estate-impact.pdf

² Ibid., Point 17, This is confirmed in the IRS Frequently Asked Questions, which states. "However, if the tax credit is allowed only against the tax imposed by Chapter 1 of the Code (regular income tax), those credits may not reduce the NIIT."

³ Ibid., Point 1.

⁴ For details on the deductions, exclusions and credits allowed under Section 911(d)(6), see <http://www.law.cornell.edu/cfr/text/26/1.911-6>. They are items which directly relate to the foreign earned income.

⁵ Americans living abroad are individuals required to maintain minimum essential coverage under the Act. This is defined in Sec. 1501 of the Act and 5000A of the IRC. Meeting the physical presence test or the bona fide residence test, defined in Section 911 of the IRC, is one of the ways to meet minimum essential coverage. Americans temporarily outside of the US (for a period of less than 12 months), certain snow birds and green card holders from non-treaty countries who spend more than 35/year in the US (and many do for work and family reasons) are required to meet minimum essential coverage through private or government health insurance or pay the shared responsibility fee. Minimum essential coverage can be met by purchasing foreign health insurance that has gone through the certification process described in the final regulations of 45 CFR § 156.604 before the Department of Health and Human Services.

⁶ PWC, « Comments on Proposed REG-130507-11, Net Investment Income Tax" August 1, 2013, published by Tax Analysts, Document Service, Doc 2013-19249

⁷ Ibid., p.1 PWC recommended in its letter to Treasury that the Regulations related to NIIT take this approach. Subsequently the Treasury Department specified that foreign tax credits would not be applicable to NIIT.