U.S. Claims Court Allows Foreign Tax Credit on NII Tax Liability

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By Michael Smith

The Court of Federal Claims has allowed a U.S. couple residing in France to use the France-U.S. tax treaty to claim a foreign tax credit against their net investment income tax liability.

In an October 24 decision in *Christensen v. United States*, the court held that article 24(2)(b) of the France-U.S. treaty provides a treaty-based FTC that is not subject to the FTC restrictions in the IRC.

“This is a big defeat for the IRS because most of the important treaties have provisions like the provision of the French treaty relied on by” the Christensens, so the IRS might want to appeal, Jeffrey Gould of Youngstein & Gould told *Tax Notes* in an email. If it doesn't appeal, the IRS will “have to modify Form 1040 so that foreign tax credit claims against NII [tax] are not bounced automatically” because there will likely be other amended returns making similar claims, he added.

Matthew and Katherine Kaess Christensen are married U.S. citizens who resided and continue to reside in France. In January 2020 the couple filed an amended tax return for 2015, requesting a $3,851 refund for NII tax liability stemming from foreign-source investment income under the France-U.S. treaty. The IRS rejected the return in February 2020 as untimely. While it eventually acknowledged that the amended return was timely, the IRS rejected the request, claiming an FTC could not be allowed because the NII tax is outside chapter 1 of the IRC. As a result, the IRS denied a credit under the relevant FTC provisions.

The taxpayers relied on a two-pronged argument. They claimed article 24(2)(a) provides an FTC to offset the NII tax because denying the credit because of a new income tax would contravene general treaty principles. Alternatively, they argued that article 24(2)(b) provides an independent FTC for the French income tax paid to offset the U.S. income tax “after calculation of the credit due against French tax on account of income tax due to the United States.”

The court accepted the latter argument, noting that it was relying on "the principles of treaty interpretation . . . concerning when potential conflict occurs between treaty and statutory language." It used a liberal reading of the treaty and statutes to find that treaty-based FTCs may be creditable independent of the restrictions in the IRC.

The court said there are two distinct groups of FTCs. The statutory credits described under sections 27 and 901(a) may be used against chapter 1 taxes. The treaty-based FTCs are defined by treaties and “are not bound by the restrictions on foreign tax credit availability set forth in the I.R.C. unless the terms of those treaties so provide,” according to the court.

Toulouse

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The claims court reached a different result than the Tax Court did in *Toulouse v. Commissioner*, 157 T.C. No. 4, a case that involved similar facts. In its August 2021 decision, the Tax Court held that an FTC is not allowed under the IRC to offset a taxpayer's NII tax liability. It analyzed article 24(2)(a) of the France-U.S. treaty and determined that because the NII tax was placed in chapter 2, an FTC was not allowed because sections 27 and 901 limit the creditability of an FTC to taxes in chapter 1.

Some practitioners have criticized the *Toulouse* decision, arguing that the Tax Court's analysis was wrong. Others have theorized that taxpayers may be able to claim relief under totalization agreements or under other provisions in the treaty network.

The Tax Court said that "other provisions of the Treaties may well provide for credits that are unavailable under the Code." The claims court cited *Toulouse* and followed that line of reasoning, holding that article 12(2)(b) provided for an independent FTC against NII tax not subject to limitations in the IRC.

"The decision is clearly correct, but I'm disappointed the Court of Claims said it agreed with the Tax Court's decision in *Toulouse* (based on a different provision of the same treaty)," Gould said. "The Court of Claims' recognition of the principle that treaties are to be interpreted liberally seems to me to cut against the result in *Toulouse*, and I trust there will be an opportunity to challenge that decision in the future."

John Harrington of Dentons said that the main difference between *Toulouse* and *Christensen* is in the reading of article 24(2)(b), which traditionally is understood to implement the "three bites" rule when dealing with both jurisdictions taxing an individual as a resident.

"I have always read this provision narrowly, consistent with its intent," Harrington said. Finding an independent treaty-based credit outside of the normal FTC restrictions is an overbroad reading of article 24(2)(b), according to Harrington. However, he added, "I can see the appeal of a simple, literal reading of the treaty provision" because the article is "convoluted and conceptually difficult."

The petitioners in *Christensen v. United States*, No. 20-935T, were represented by Stuart E. Horwich. The defendant was represented by Jason Bergmann, David I. Pincus, David A. Hubbert, and Mary M. Abate.

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