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# Americans Living Abroad Face Double Taxation in 2013

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In this article, the authors analyze whether the foreign tax credit or the U.S. model treaty reduce the effect of the tax on net investment income and conclude that they likely do not.

The Patient Protection and Affordable Care Act of 2010 (PPACA) included new section 1411, which imposes a 3.8 percent tax on net investment income (NII) on U.S. citizens and residents. This article analyzes whether the foreign tax credit or the U.S. model treaty reduces the effect of this tax and concludes that they likely do not.

## Foreign Tax Credit

The FTC is granted under section 27, which states: "The amount of taxes imposed by foreign countries and possessions of the United States shall be allowed as a credit against the tax imposed by this chapter to the extent provided in section 901." The words "this chapter" refer to chapter 1 of the code, which spans sections 1 through 1400U. Section 1411 appears in new chapter 2a of the code. On its face then, it seems that foreign taxes paid on NII may not reduce the tax imposed by section 1411, potentially resulting in double taxation on that income.

The IRS appears to agree with this analysis. On January 18 *Tax Notes Today* reported that an IRS official, speaking at an American Institute of Certified Public Accountants webcast, concluded that the NII tax is not creditable.[1]

That result is surprising. It is a long-standing American policy to eliminate double taxation through an FTC regime. A comprehensive tax treaty network with 66 countries enshrines that policy and makes it reciprocal. The section 1411 tax closely resembles the sort of taxes to which that treaty network applies. Even the proposed Treasury regulations unveiled last December generally impose the ordinary chapter 1 principles and rules in determining the tax under section 1411. To change that policy with nary a word in the legislative history is hard to believe (although Congress does have a history of inadvertently stepping on treaty obligations). We now turn to the U.S. model treaty to see how treaties would generally apply to section 1411.

## U.S. Model Treaty

A principal purpose of the U.S. model treaty is to eliminate double taxation as much as possible. Although many treaty benefits are denied to U.S. citizens under the saving clause of article 1(4), relief from double taxation under article 23 is not one of them. The model states in article 23(1) that "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 applicable to residents and citizens" certain taxes paid to a foreign country. It is unclear whether the NII tax is an amendment to U.S. law that avoids "changing the general principle" of article 23(1).

An additional area of uncertainty is whether the section 1411 tax qualifies as an income tax under the model's definition. Article 2(1) provides that the treaty applies "to taxes on income . . . irrespective of the manner in which they are levied." Article 3(b) provides that the existing taxes to which the treaty applies includes "the Federal income taxes imposed by the Internal Revenue Code (but excluding social

[1]Shamik Trivedi, "Foreign Tax Credits Cannot Offset Net Investment Income, IRS Official Says" (Jan. 18, 2013), *Doc 2013-1255*, *2013 TNT 13-2*.

security and unemployment taxes).'' The specific exclusion of Social Security and unemployment taxes suggests that other unnamed income taxes should be included as taxes covered by the treaty.

There is a rich case law concerning which *foreign* taxes may qualify for an FTC. (It will soon be even richer, when the Supreme Court decides *PPL Corp. v. Commissioner*.[2]) Perhaps these cases will clarify the meaning of income tax under article 2 of the treaty. If the same standards that have been applied to foreign taxes were applied to the NII, a court would almost surely find that the NII tax is an income tax and therefore covered by the treaty.

But determining that the treaty provides a different result than the code is problematic. The United States is unique in not recognizing the primacy of treaties over domestic law. Although the later-in-time rule ostensibly means that the PPACA supersedes existing treaties, the courts are loath to repeal a treaty provision by virtue of implication.[3] Rather, the courts first attempt to harmonize the apparent conflict. Given the lack of discussion of the PPACA's treaty effects in its legislative history or the text of the bill, repeal by implication is the only argument for overriding existing treaties. It would seem that courts faced with choosing between repeal by implication or harmonizing a treaty and statute would strongly favor harmonization (even if that harmonization was necessarily clumsy).

How might harmonization be accomplished? One avenue would be to simply hold that the NII tax in not an income tax under article 2. That may not be the best reading of article 2, but it is better than going down the route of repeal by implication.

However, courts do not interpret model treaties; they interpret actual treaties. Because treaties are individually negotiated, the texts of tax treaties vary considerably. Consider the oldest tax treaty in the U.S. tax treaty network: the income tax treaty enacted with Greece in 1950. Article 1 of that treaty is simple in its drafting:

> 1. the taxes which are the subject of the present Convention are:
>
> a. in the case of the United States of America: the Federal income tax, including surtaxes (hereinafter referred to as United States tax).
>
> 2. the present Convention shall apply to any other taxes of a substantially similar character imposed by either Contracting State subsequently to the date of signature of the present Convention.

There are two reasons the Greek treaty is problematic for a harmonization argument. One is that the broadly written language encompasses income taxes and surtaxes. Moreover, unlike later treaties, the language of article 23(1) of the U.S. model limiting the FTC to the provisions and limitations of U.S. law (even as later amended) doesn't appear in the Greek treaty.

The second reason is that the Greek treaty was enacted in 1950. The Internal Revenue Code of 1954 expressly proclaimed that it did not apply when in conflict with any treaty in existence at the time of its enactment.[4] The FTC-granting language of sections 27 and 901 was first enacted in the 1954 code (as sections 33 and 901).[5] Arguably, to the extent the 1954 code limited the scope of article 1 of the Greek treaty, the 1954 code didn't apply. Further, the Technical Corrections Act of 1988 provided that the 1986 tax reform was not to override existing treaties by implication. It would thus be difficult for a court to find that the NII tax is not an income tax or surtax under the Greek treaty or to find that either sections 27 or 901 limits the FTC, contrary to the Greek treaty. And that is promising news for Americans resident in Greece.

### Conclusion

For the rest of the expatriate American population, however, the prudent course is to gird for foreign taxes not being creditable against the NII tax. Because tax is typically not withheld at the source on investment income, U.S. persons living abroad may need to make quarterly estimated tax payments.

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[2]Sup. Ct. Dkt. No. 12-43, 665 F.3d 60 (3d Cir. 2011), *Doc 2011-26933*, *2011 TNT 247-6*.

[3]*See, e.g.*, *Posadas v. National City Bank*, 296 U.S. 497, 503 (1936).

[4]That provision now appears in section 7852(d)(2).

[5]An FTC was provided in section 131 of the Internal Revenue Code of 1939, but it did not have any sort of ''by this chapter'' limiting language.

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