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US – FRANCE TAX TREATY | CAN FOREIGN TAX CREDITS OFFSET NET INVESTMENT INCOME TAX?

This alert discusses recent developments with respect to the 3.8% U.S. net investment income tax ("**NIIT**") and the potential for U.S. citizens to use foreign tax credits ("**FTC**") to offset NIIT liability pursuant to the U.S.-France income tax treaty (the "**Treaty**").

On October 23, 2023, the U.S. Court of Federal Claims held that U.S. citizens are permitted pursuant to the Treaty to use FTC arising from French income tax liability to offset their NIIT liability. However, the U.S. government filed a notice of appeal in December 2023, so it remains to be seen what the final verdict will be on this issue.

WHAT IS THE NET INVESTMENT INCOME TAX (NIIT)?

Since 2013, pursuant to Chapter 2A of the U.S. Tax Code, the United States has imposed the 3.8% NIIT on the "net investment income" of certain U.S. taxpayers with income above specified thresholds. More specifically, the NIIT applies to individuals who are U.S. citizens or U.S. residents (including green card holders and tax residents), and to domestic trusts and estates that have both net investment income and income above specified thresholds.

For individuals, the NIIT is 3.8% of the lesser of:[1]

- Net investment income for the taxable year; or
- The excess of the individual's modified adjusted gross income, over the threshold amount. For 2024, the threshold amounts are as follows:

Filing Status	Threshold Amount
Married filing jointly	$250,000
Married filing separately	$125,000
Single	$200,000
Head of household (with qualifying person)	$200,000
Qualifying widow(er) with dependent child	$250,000

Net investment income can generally be divided into three categories of income:

1. Gross income from interest, dividends, annuities, royalties, and rent (except if the income is derived in the ordinary course of a trade or business);
2. Other gross income from a trade or business that is a passive activity or a trading business; or

[1] IRC § 1411(a)(1) and (b).

3. Net gain (to the extent taken into account in computing taxable income) from the disposition of property other than property held in a trade or business.

Income included in any of these three categories and earned by an individual, trust, or estate, either directly or through a pass-through entity for U.S. tax purposes, is included in calculating net investment income. However, net investment income does not include wages, unemployment compensation, nonpassive business income, Social Security benefits, alimony, tax-exempt interest, and distributions from some tax-preferred retirement accounts.

CHRISTENSEN V. UNITED STATES

On October 23, 2023, the U.S. Court of Federal Claims ruled in *Christensen v. United States*[2], that U.S. citizens are permitted to use FTCs arising from French income tax liability to offset their NIIT liability. Although FTCs cannot offset NIIT liability under U.S. domestic law, the Court concluded that the Treaty should be read to override the domestic rule, offering broader FTC coverage and protection against double taxation for U.S. citizens residing in France.

In 2015, the Christensens, married U.S. citizens residing in France, sold their shares in a French company and paid a 30% French income tax on capital gains. By virtue of their U.S. citizenship, they remained U.S. taxpayers required to report and pay U.S. income tax on their worldwide income, including the gain from their sale of the French shares. Consequently, the gain was also subject to U.S. federal income tax at the long term capital gain rate of 20% plus the additional 3.8% NIIT. To avoid being subject to double taxation on the gain, pursuant to the FTC rules under the U.S. domestic tax regime and the Treaty, the Christensens applied their FTCs to offset the 20% U.S. tax against the 30% French income tax. However, the couple also sought to offset their NIIT liability with the excess FTCs arising from the 30% French tax. While the IRS accepted that their FTCs could be used to offset the 20% U.S. tax, it denied use of the FTC to offset the 3.8% NIIT. This resulted in an effective tax rate of 33.8% on the gain (*i.e.*, the higher French tax plus the NIIT).

To claim the FTC against their NIIT liability, the Christensens relied on two paragraphs of Article 24 of the Treaty: Article 24(2)(a) and 24(2)(b). Article 24(2)(a) is a general provision providing that the U.S. will grant its citizens a credit against U.S. federal income tax for French income taxes paid "*in accordance with the provisions and subject to the limitations of the law of the United States*." Under U.S. domestic tax rules, FTCs are allowed as credits only against taxes imposed by Chapter 1 of the U.S. Tax Code (*i.e.,* regular income tax). Because the NIIT is administered under Chapter 2A of the U.S. Tax Code, and not under Chapter 1, the Court held that Article 24(2)(a) does not permit U.S. taxpayers to use FTCs to offset NIIT liability. This holding was consistent with holdings in two other recent cases that also addressed the interaction of FTCs and NIIT: *Toulouse v. Commissioner*, 157 T.C. 49 (2021)[3], and *Kim v. United States*, 2023 WL 3213547 (C.D. Cal. Mar. 28, 2023).

However, the Court turned its attention to Article 24(2)(b) which specifically addresses U.S. citizens residing in France and provides generally that the U.S. will grant such persons a credit against U.S. federal income tax for French income taxes paid. Importantly, unlike Article 24(2)(a),

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[2] *Christensen v. United States*, No 20-935T (2023).

[3] The Tax Court was not asked to consider Article 24(2(b) of the Treaty, focusing its analysis only on Article 24(2)(a) of the Treaty.

Article 24(2)(b) is not drafted to be interpreted "*in accordance with the provisions and subject to the limitations of the law of the United States*." On that basis, the Court held that because Article 24(2)(b) is not similarly restricted by the limitations under the U.S. Tax Code, Article 24(2)(b) should permit the taxpayers to use their FTCs to offset their NIIT liability.

Similar provisions granting FTCs to U.S. citizens residing abroad and which do not include an "in accordance with U.S. law" restriction can be found in several other U.S. tax treaties such as with the United Kingdom, the Netherlands and Germany. Consequently, the Christensen decision, if it holds on appeal, potentially offers expanded FTC relief covering NIIT liability for a broader group of U.S. citizens residing abroad.

On December 18, 2023, the United States filed a notice of appeal against the Christensen decision[4]. Therefore, it remains to be seen if the Christensen decision is the final word on this issue. While U.S. citizens residing in France or other treaty countries with similar treaty provisions may consider filing amended returns or protective refund claims under the 10 year extended statute of limitation for FTC claims, it is likely that the IRS will suspend the processing of any such claims until the appeal process is complete[5].

We continue to monitor these and other topical U.S. and cross-border tax issues, and would be happy to answer any U.S. tax questions you may have.

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[4] *Christensen v. United States*, 168 Fed.Cl. 263 (U.S. Ct. Fed. Claims 2023), appeal docketed, No. 24-1284 (Fed. Cir. Dec. 22, 2023).

[5] IRC § 6511(d)(3)(A).