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Credit where credit is due

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Art 23 of the OECD and UN Model treaties are seldom exactly followed in state treaty practice. More often, the basic principles of relief by credit or exemption in arts 23A and B are tailored to meet specific requirements of contracting states. The United States is a case in point. Since it taxes its citizens on world-wide income regardless of residence or source of income, special rules are required.

The United States Court of Claims has recently ruled on entitlement of a US citizen who was resident in Canada to credit for Canadian income tax paid against the US Net Investment Income Tax ("NIIT") payable to the United States in *Paul Bruyea v United States*, No. 23-766T.

Such individuals are liable to tax on worldwide income in both countries.

Legal background

The NIIT is imposed in the United States as an "Unearned Income Medicare Contribution." Section 1411 of the Internal Revenue Code imposes an annual tax on individuals, in addition to any other tax, of broadly 3.8 percent of net investment income. There was no dispute that the NIIT was a United States tax within Article 2 of the Treaty.

Article 24(1) of the Canada- United States Income Tax Treaty provides the general entitlement to credit for US persons: *"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), the United States shall allow to a citizen or resident of the United States . . . as a credit against the United States tax on income the appropriate amount of income tax paid or accrued to Canada . . . .".*

Specific rules apply in the case of a US citizen who is Canadian resident under Article 24(2) which require Canada to give credit for US tax on US source income and for the United States to give credit for any remining Canadian tax payable.

Mutual Agreement Procedure

The taxpayer had presented a case for Mutual Agreement Procedure under Article 26(1) of the Treaty. The Canadian Competent Authorities considered that the US should give the credit but the US Competent Authorities declined to agree.

Domestic law limitations

The dispute about entitlement to credit, turned on the relationship between the Treaty and domestic law expressed by the proviso that, credit in Article 24(1) must be *"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)"*. This was styled by the US Court of Claims as the "US Law Limitation clause". Similar language is found in the treaty practice of other states but does not appear in the OECD or UN Model Treaties.

The US Internal Revenue Service argued that the US Internal Revenue Code only provides for foreign tax credits against income taxes contained in Chapter 1 of the Code. They argued that because the NIIT was enacted in Chapter 2A of the Code, no foreign tax credit may be applied against the NIIT. This argument was founded on two related limbs –the proviso in Article 24(1) and treaty override

The court rejected the IRS argument that a credit granted by treaty cannot exist independent from the Code as the "law of the United States." Instead, the court ruled that the US Law Limitation in Article 24(1) focused on computation of a treaty-based credit, but not on its existence. Thus, a treaty may provide for a tax credit notwithstanding that the domestic law does not provide for such a credit.

Treaty override

The NIIT was enacted after the Treaty. Under US law, treaties have equal value with Federal statutes. The IRS contended that this enactment subsequent to the Treaty in a separate part of the Code, without explicit provision to credit foreign tax, meant that there was no credit allowable against the NIIT. This followed from the "last-in-time rule" which allowed treaty rights to be amended by a later Code provision to the contrary. In further support they argued that Article 24(1) contemplates that US domestic law "may be amended from time to time," thereby extending the reach of the US Law Limitation to future Code provisions that conflict with a treaty.

In rejecting the IRS argument, the court observed that relevant domestic law can only be amended from time to time "without changing the general principle hereof". The court ruled that the general principle is that of eliminating or avoiding double taxation.

Furthermore, a treaty override required explicit statutory language. In the absence of such an explicit override the NIIT and the Treaty should be read harmoniously to give effect to both. The court found that the NIIT contains nothing specifically and expressly inconsistent with the Treaty-based foreign tax credit. Nothing suggested that enacting the NIIT outside Chapter 1 of the Code was intended to preclude a treaty-based credit.

Treaty interpretation

The court went through a detailed analysis of the principles of treaty interpretation. Non-US readers of the decision may be surprised by the absence of any reference to Articles 31-33 of the Vienna Convention on the Law of Treaties. The United States is a signatory to the convention but has not ratified it. Canada has ratified the convention. Other courts around the world have recognised those provisions as an authoritative codification of the principles of treaty interpretation.

Nonetheless, those principles do emerge from the case law cited by the court. US case law states that, in construing a treaty, its terms are given their ordinary meaning in the context of the treaty and in the way that best fulfils the purposes of the treaty. Notably, the court concluded that one purpose of the Treaty is to eliminate or avoid double taxation and, granting credit for Canadian tax paid against the NIIT, best gives effect to that purpose.

Extrinsic material

Extrinsic material was also considered by the court. Since the treaty language in question is not found in the OECD Model, there could be no recourse to the OECD Commentary (an issue not ventilated in the judgement) . The court referred to several US domestic instruments including the US Treasury Department Technical Explanation of the Treaty, which was cited by both parties. The Letter of Submittal from the President to the United States Senate, seeking its "advice and consent to ratification of the Treaty", the Congressional Joint Committee on Taxation's explanation of the Treaty and the Technical Explanation of the 2006 U.S. Model treaty, also all supported granting of the credit.

In other jurisdictions, such unilateral statements by one of the contracting states would not be acceptable interpretative materials (See e.g. *Macklin v HMRC* [2015] UKUT 39 (TCC) at [18] and [37]).

The US Court of Claims unsurprisingly declined to defer to US Treasury regulations following the US Supreme Court decision in *Loper Bright Enterprises v Raimondo*, — U.S. –, 144 S. Ct. 2244, 2266 (2024) to the effect that "agencies have no special competence in resolving statutory ambiguities" and that courts should resolve them by exercising independent legal judgment.

The parties agreed that questions regarding the computation of a foreign tax credit should be deferred until the Court resolved entitlement in principle to the foreign tax credit.

How far domestic law can encroach on the relief but while remaining consistent with the general principle remains to be determined.

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