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Taxation--Federal Income Tax--Treatment of Nondistributable Capital Gains of Domestic Trust with Foreign Beneficiaries

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TAXATION—FEDERAL INCOME TAX—TREATMENT OF NONDISTRIBUTABLE CAPITAL GAINS OF DOMESTIC TRUST WITH FOREIGN BENEFICIARIES—Taxpayer, trustee of a domestic inter vivos trust, sued for a refund of United States income taxes paid on nondistributable capital gains of the trust. Trustee claimed that since all the beneficiaries of the trust were United Kingdom residents, this income was tax-exempt under the United States-United Kingdom tax convention provision that a United Kingdom resident "shall be exempt from United States tax on gains from the sale or exchange of capital assets."[1] On appeal by the United States from a district court judgment for the trustee, *held,* reversed. Although distributable gains are allowed the exemption,[2] long term capital gains realized by a domestic trust, and accumulated for later distribution, are considered income to the trust regardless of the beneficiaries' residence; the convention was not intended to override United States law which treats a trust as a separate taxable entity.[3] *Maximov v. United States,* 299 F.2d 565 (2d Cir.), *cert. granted,* 371 U.S. 810 (1962).

The most reasonable argument for the exemption of nondistributable capital gains sought in the principal case would seem to be that, since distributable gains are exempt[4] under the convention's article XIV, there is no logical reason for taxing gains which are accumulated for later distribution. On the facts as presented in the principal case, interests in both distributable and accumulated gains are vested in the beneficiaries, and neither is taxable to them in the United Kingdom,[5] though both would be taxable under United States law. Under the convention, as applied by the court, the only distinction between the two types of gain is in the lapse of time between receipt by the beneficiaries of distributed gains (when realized by the trust) and accumulated gains (upon termination of the trust)—a distinction which logically appears to be an artificial basis for radically different tax treatment. This reasoning, although arguably correct, does not compel a conclusion that the convention was to be applied on the basis of such apparent logic, or that a distinction for tax purposes between distributable and nondistributable capital gains was unintended.

The primary interpretative inquiry, therefore, must be directed to the purpose and nature of the convention. In the principal case, the trustee argued that the purpose of the convention was to establish strict equality

1 Convention With the United Kingdom Respecting Double Taxation and Taxes on Income and Protocol, April 16, 1945 and June 6, 1946, art. XIV, 60 Stat. 1384, T.I.A.S. No. 1546 [hereinafter cited as Convention]. Under article II [60 Stat. 1378 (1946)], the term "United Kingdom" includes Great Britain (England, Scotland and Wales) and Northern Ireland. Since ratification, the convention has been extended, as allowed under article XXII(1) [60 Stat. 1387 (1946)], to cover a total of twenty British overseas territories. See 4 CCH 1961 STAND. FED. TAX REP. ¶ 4279.035.

2 Income currently distributable to beneficiaries is allowed the article XIV exemption. See T.D. 5569, 1947-2 CUM. BULL. 100, § 7.519(c).

3 See INT. REV. CODE OF 1954, §§ 641(a)(1), 643(a)(3).

4 See note 2 *supra.*

5 See Jones v. Leeming, [1930] A.C. 415.

of tax treatment between residents of each country realizing income from sources in the other country. Since the United Kingdom imposed no capital gains tax, the trustee concluded that a strict equality approach required that the United States exempt this trust from a capital gains tax, the economic burden of which would fall on United Kingdom residents. The competing argument, accepted by the court, is based on the proposition that the differences in theory and terminology between the United States and United Kingdom tax systems make identical tax treatment impossible. Therefore, the convention should be literally interpreted and all taxes not explicitly removed or modified by the terms of the convention should remain in force under domestic tax laws.[6]

Despite the apparent logic of the trustee's contentions, the great difficulty in evaluating a particular United States tax in terms of a corresponding United Kingdom tax seems to point out the fallacy in his argument for equal tax treatment under the convention. This difficulty is particularly apparent in the setting of capital gains treatment. The United States income tax laws allow preferential capital gains treatment to gain from the sale or exchange of a "capital asset," which is defined as all property of the taxpayer, whether or not related to a trade or business, but excluding property dealt with in a particular manner, such as property held primarily for sale to customers, business property subject to a depreciation allowance, and real property used in a trade or business.[7] On the other hand, the United Kingdom does not employ a separate rate structure for income realized in particular types of transactions. Depending on the nature of the property sold or exchanged (as opposed to the method of dealing with it), income is considered either fully taxable or is entirely disregarded for income tax purposes.[8] Consequently, the United

[6] The literal interpretation of the convention applied by the court is as follows: article XIV exempts "a *resident* of the United Kingdom . . ." (emphasis added); article II(1)(g) defines "resident" as "any *person* . . . resident in the United Kingdom . . ." (emphasis added); the convention does not define "person," but article II(3) states that "in the application of the provisions of the present Convention by one of the Contracting Parties any term not otherwise defined shall, unless the context otherwise requires, have the meaning which it has under the laws of that Contracting Party relating to the taxes which are the subject of the present Convention"; under United States law [INT. REV. CODE OF 1954, § 7701(a)(1)], "trust" is included within the meaning of "person"; substituting "trust" for "resident" in article XIV, then, the exemption cannot apply because the trust is a resident of the United States. Convention, arts. XIV, II(1)(g), (3), 60 Stat. 1384, 1378, 1379 (1946). As to the trust being a United States resident, see Bence v. United States, 85 Ct. Cl. 701, 18 F. Supp. 848 (1937), and Estate of Cooper, 9 B.T.A. 21 (1927). See also PHILLIPS, UNITED STATES TAXATION OF NONRESIDENT ALIENS AND FOREIGN CORPORATIONS 166 (1952).

[7] INT. REV. CODE OF 1954, § 1221. Depreciable property and real property used in a trade or business are actually given more favorable treatment than a capital asset. Under INT. REV. CODE OF 1954, § 1231, income from a sale or exchange of these properties is taxable at capital gains rates, while losses are fully deductible from gross income.

[8] This nonrecognition of the capital asset, as such, encompasses several features distinctly unfavorable from the American point of view: no deduction is allowed for losses incurred in property sold or exchanged, and natural resource depletion allowances and annual property or machinery depreciation allowances (until actual replacement) are

Kingdom, using a completely different theory of classification, taxes at ordinary income rates many gains which would receive the more favorable capital gains treatment in the United States. Conversely, the United States imposes a capital gains tax on some transactions which would be subjected to no income tax whatever in the United Kingdom.[9] Considering the impact of United Kingdom income tax laws on some transactions which would receive capital gains treatment in the United States, and the additional burden of a gross receipts stamp tax on securities transactions in the United Kingdom, it has been stated that neither tax system is more favorable than the other in regard to overall capital gains treatment.[10] Apart from such a generalization, it seems clear that the dissimilar approaches in tax structure make a comparative study necessarily unreliable as a foundation for any logical inferences.

The foregoing comparison suggests the unsoundness of the trustee's contention that the United Kingdom does not tax capital gains; more importantly, it indicates that the convention's article XIV exemption (under which the trustee claims) was not given by the United States simply to match a pre-existent United Kingdom exemption.[11] It would appear that the contracting parties did not attempt a point-by-point alignment of the two tax systems. Emphasis was placed on relief from elements in both systems which singly, or in combination, appeared most burdensome to international trade. As the systems themselves differed, likewise the unfavorable elements requiring modification were not the same in each country. The convention sought to balance these elements through a series of reciprocal compromises. Realization that the convention's promises were bargained for in this manner, as opposed to "across the board" tax equalization, leads to a realistic evaluation of the convention's purposes. Abolition of double taxation was, without question, its primary aim. Although

not allowed. See MAGILL, PARKER & KING, A SUMMARY OF THE BRITISH TAX SYSTEM 20 (1935).

9 *Ibid.* A typical example of untaxed gains would be the individual trader's income from sale or exchange of securities having no connection with his trade or business. The United Kingdom test is known as the "adventure-in-trade" concept. Where a certain type of property is neither capable of an income yield or enjoyment to its owner, its sale or exchange results in ordinary income or loss. See Income Tax Act of 1952, ch. 10, §§ 122, 123 (schedule D, case I), 526, in 31 HALSBURY'S STATUTES 112, 116, 489 (2d ed. 1952). See also Jones v. Leeming, [1930] A.C. 415; MAGILL, PARKER & KING, *op. cit. supra* note 8, at 20(g), and Brudno & Hollman, *The Taxation of Capital Gains in the United States and the United Kingdom*, 1958 BRIT. TAX REV. 26, 40-41. In the setting of securities, however, it should be noted that the United Kingdom ad valorem stamp tax renders this tax advantage to the individual trader somewhat illusory. This 2% ad valorem tax is equivalent to the United States tax on a long-term capital gain of 9% of cost. Gains above this level would be progressively taxed in the United States up to 25%. Brudno & Hollman, *supra* at 43-44.

10 Brudno & Hollman, *supra* note 9, at 43-44.

11 See *Hearings Before the Subcommittee on the Convention Between the United States, Great Britain and Northern Ireland Respecting Income and Estate Tax of the Senate Committee on Foreign Relations*, 79th Cong., 1st Sess. 56, 62 (1945) [hereinafter cited as 1945 *Hearings*], regarding Convention, art. XX, 60 Stat. 1389 (1945).

"equality" was mentioned in the Senate hearings on this treaty, it does not appear to have been used in the context of specific tax alignment.[12] The legislative history provides abundant evidence that the convention negotiations were characterized by tightly worded concession and compromise—and that its provisions were to be literally applied.[13] This evidence of closely circumscribed bilateral negotiation militates for a strict application by the courts; the courts should recognize that the convention does not—nor was it intended to—cover every transaction having a source of income in one country and a recipient of that income in the other.[14]

Assuming that the United Kingdom does tax capital gains, and that the convention's purpose was not to achieve a strict equality of tax treatment, the question remains whether nondistributable capital gains of the trust can be brought within the article XIV exemption. On facts identical to those in the principal case, the Ninth Circuit held, in *American Trust Co. v. Smyth*,[15] that such gains are tax-exempt. Since the "economic burden" of the tax fell on United Kingdom residents,[16] the exemption was held to apply regardless of the United States concept of trust entities. The word "exempt" in article XIV, said the court, should be construed to mean "release from economic burden." However, such a construction appears to contradict the specific nature of the convention's terms. It is construction based on the same premises that was argued by the trustee in the principal case, viz., strict equality of tax treatment and the absence of a United Kingdom capital gains tax. If these ostensibly false premises are ignored, and if the intent to limit the coverage of the convention is recognized, it would seem more appropriate to apply domestic law provisions as dictated by article II(3) of the treaty. "Economic burden," as a test, received no

12 "Equality" is mentioned in the Senate hearings many times, but is used in only two contexts in the convention. In article XXI it is required that nationals of one country living in the other be taxed equally with the other country's citizens. The other category concerns transactions which were previously subject to double taxation; the convention permits each country to share revenues equally by reducing proportionately the specific tax each applies—the aim being to tax the parties involved but once. These types of equality have nothing to do with the tax imposed in the principal case, for no double taxation problem is present. See 1945 *Hearings* 2, 3, 24, 61.

13 *Id.* at 2.

14 The definition of "resident" in the Convention, art. II(1)(g), 60 Stat. 1378 (1946) ["any person . . . who is resident in the United Kingdom for purposes of United Kingdom tax and not resident in the United States for purposes of United States tax"], creates an ambiguity in many situations because a person may be considered a "resident" under the laws of both countries, and therefore not entitled to convention relief based on residence. Under article II(3), which expressly reserves the definition of terms not defined in the convention to each country's laws, it appears not only that the convention failed to cover many transactions, but that it directed the manner by which these omissions would be handled—namely, by resort to domestic law. See note 5 *supra*. See also Alexander, *The Income Tax Convention with the United Kingdom*, 2 TAX L. REV. 295, 297 (1947); 71 HARV. L. REV. 1163 (1958).

15 247 F.2d 149 (9th Cir. 1957), *reversing* 141 F. Supp. 414 (N.D. Cal. 1956).

16 The court reasoned that since the tax would diminish the distributive shares that the beneficiaries would take upon termination of the trust, these beneficiaries were "economically burdened" by the tax. *Id.* at 153.

mention in the convention itself. It can hardly be implied, considering the many transactions which the convention does not cover and the many instances where taxation at the source of income was retained.[17]

Despite apparent inequities, it is not the role of the courts to extend the convention beyond its literal terms. Only the negotiating arm of the contracting parties can formulate, in a comprehensive and consistent manner, the intent of the convention. Moreover, the courts of England consider the convention as only an addition to their national tax laws.[18] These laws are applied in a strict, literal manner. English courts do not search for equity in taxation, believing that any modification or extension should originate in the legislative body which initially fashioned the law.[19] American courts should adopt a similar practice in regard to the tax convention, not only as a means of achieving consistency with the strict application of the English courts, but, more importantly, as a recognition of the bargaining processes out of which the convention agreement evolved. If the taxation of nondistributable capital gains is deemed inequitable by the negotiating parties, it would seem most appropriate to resolve the problem through the same method of concession and compromise which characterized the convention's original negotiations. The value of the holding in the principal case is that it points to a need for some means of periodic, bilateral revision of the convention. This would provide a proper remedy for conflicts which inevitably arise. Other tax conventions entered into by the United States have expressly provided for settlement of future controversies through mutual agreement.[20] Such a procedure, if incorporated into the United States-United Kingdom convention, either by amendment or by necessary implication, would answer the need for implementation by proper representatives of each of the contracting countries.[21]

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17 The "economic burden" test is not mentioned in the 1945 *Hearings* either. It would appear that this test is solely attributable to the Ninth Circuit.

18 See KOCH, THE DOUBLE TAXATION CONVENTIONS 19-20 (1947).

19 *Id.* at 21.

20 See PHILLIPS, *op. cit. supra* note 6, at 309-10.

21 If any bilateral modification of article XIV is forthcoming, it seems probable that greater restriction or even elimination of this exemption will be sought, as opposed to extension of its coverage. This contention draws support from the fact that in subsequent tax conventions entered into by the United States, the capital gains exemption has not been given. This exemption has proved to be an objectionable feature of the convention from the American viewpoint, and some writers feel it has created a "tax discrimination" in favor of United Kingdom residents. It has been further suggested that the essential reason for granting the exemption to nonresident aliens was the great difficulty in tracing the income of these persons, and collecting the tax; the increased exchange of tax information between countries has removed this difficulty. See Kanter, *The United States Income Tax Treaty Program*, 7 NAT'L TAX J. 69, 80-81 (1954). See also EHRENZWEIG & KOCH, INCOME TAX TREATIES ¶ 211, at 206 (1949).