1968

Taxation: Federal Courts Not Bound by State Trial Court's Determination of Taxpayer's Property Interest

Minn. L. Rev. Editorial Board

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that the defendant have had the strategic advantages of a full
hearing in an adversarial context. If it is reasonable to conclude
as a practical matter that the defendant would have contended
an issue in the first action more vigorously and perhaps more
successfully had its importance been comparable to that of the
same issue in the second action, the court should not allow col-
lateral use of the first judgment. Similarly, it is submitted that
the courts should hesitate to give estoppel effect to a prior
judgment from which the defendant chose not to prosecute an
appeal where such failure might reasonably have been predi-
cated upon economic or other practical considerations. In any
event collateral estoppel effect should not be given to default or
consent judgments since they are not susceptible to a thorough
analysis of which issues were necessarily decided, and the de-
fendant has probably not litigated with full vigor.

Under the facts of DeWitt, the requirement of mutuality
would be productive only of additional and unnecessary litiga-
tion. Where a person has had the opportunity and the incentive
to litigate and has done so, and where the issues presented are
identical with those of the former action, the assertion of the
former judgment as collateral estoppel should be allowed. It
should be recognized, however, that abandonment of mutuality
may well increase the scope and furor, as well as the number of
lawsuits. More importantly, by substituting the test of “full
vigor” for the requirement of mutuality the court has increased
both the frequency and difficulty of determinations of whether
collateral estoppel is proper. Due to the apparent impracticability
of any detailed test for either identity of issues or full vigor, and
the fundamental unfairness which would result from an im-
proper determination of either, the courts should proceed with
caution in allowing the affirmative use of a prior judgment by
a nonparty.

Taxation: Federal Courts Not Bound by State Trial
Court’s Determination of Taxpayer’s Property Interest

The executor of decedent’s estate claimed a marital deduction
for the value of a trust, asserting that the surviving spouse pos-
sessed a general power of appointment over the corpus.¹ The

¹. In order for the trust to qualify for the marital deduction the
surviving spouse must possess a general power of appointment over
that portion of the trust from which she receives income. Int. Rev.
Code of 1954, § 2056 (b) (5).
Commissioner disallowed the claim on the ground that a release\(^2\) of the power executed prior to decedent's death was effective. While the action was pending in the Tax Court, a proceeding to determine the validity of the purported release was initiated in a state court. The state court held that the release of a contingent power was void and therefore decedent's wife retained her general power of appointment.\(^3\) The Tax Court accepted the holding as an authoritative exposition of state law and allowed the deduction.\(^4\)

In a second case,\(^5\) the executor of an estate had applied the state proration statute\(^6\) permitting the use of the marital deduction to determine the taxable estate. The application of the statute substantially reduced the size of the taxable estate, and was disallowed by the Commissioner. The executor sought a determination from a state court as to whether the proration statute should be applied.\(^7\) The court held that state law required the application of the proration statute to decedent's estate.\(^8\) On appeal, the state property decision was denied binding effect.\(^9\)

\(^2\) Commissioner v. Bosch, 363 F.2d 1009, 1010 (2d Cir. 1966).
\(^3\) Matter of Irving Trust Co., N.Y.L.J., Nov. 15, 1963. Of the twenty-two interested parties notified, only three filed briefs, all arguing the release to be void.
\(^4\) Estate of Herman Bosch, 43 T.C. 120 (1964), aff'd sub nom. Commissioner v. Bosch, 363 F.2d 1009 (2d Cir. 1966). The Tax Court reasoned that (1) the trial court had jurisdiction over the parties and its judgment was conclusive as to them; (2) the New York Supreme Court's decisions are precedent throughout the state; (3) the Commissioner had notice of the state proceedings; (4) the state court reached a reasoned and deliberate conclusion.
\(^5\) Second Nat'l Bank v. United States, 351 F.2d 489 (2d Cir. 1965).
\(^6\) CONN. GEN. STAT. ANN. § 12-401(a) (1960). The statute provides that both state and federal death taxes shall be equitably distributed among the persons interested in the estate unless the testator directs otherwise. However, in making this proration among the interested persons, any exemptions granted by the Act imposing the tax will be allowed first in order to determine the size of the taxable estate.
\(^7\) Notice was given to all interested parties, including the Commissioner, but only the guardian \textit{ad litem} of decedent's grandchildren, who assented to the application of the statute, appeared at the proceedings. For administrative and procedural reasons the Commissioner has found it impossible to appear at all state proceedings which may have an impact on future taxation assessment.
\(^8\) The state court held that the proration statute applied unless there were a clear and unambiguous directive to the contrary. In reviewing decedent's will the court could find no such directive. The decision was affirmed in Second Nat'l Bank v. United States, 222 F. Supp. 446 (D. Conn. 1963).
\(^9\) Second Nat'l Bank v. United States, 351 F.2d 489 (2d Cir. 1965).
The Supreme Court joined the cases because of the common issue and held\(^\text{10}\) that where a federal estate tax is imposed on a state defined property interest, the state trial court's determination of that interest is not binding on federal authorities. *Commissioner v. Bosch*, 387 U.S. 456 (1967).

Subject to several exceptions,\(^\text{11}\) the federal estate tax is imposed on property interests as defined by the common law of the individual states.\(^\text{12}\) However, the federal courts have been in conflict as to whether the determination of a taxpayer's property interests by a lower state court is an authoritative declaration of state law binding on federal tax authorities.\(^\text{13}\)

The Supreme Court first considered the question in *Freuler v. Helvering*,\(^\text{14}\) in which it held a state probate court decree ordering an income beneficiary of a trust to repay an improperly distributed share of the trust earnings conclusive on a federal court for purposes of tax assessment. In so holding the Court

\(^{10}\) Justices Douglas, Harlan, and Fortas dissenting.

\(^{11}\) See Gallagher v. Smith, 223 F.2d 218 (3d Cir. 1955); Braverman & Gerson, The Conclusionness of State Court Decrees in Federal Tax Litigation, 17 Tax L. Rev. 545 (1962). Braverman and Gerson outline three categories in which state court decrees enter into federal taxation litigation: (1) a state decision on an issue ancillary to the tax question but not involving a determination of the taxpayer's property interest upon which the federal tax is imposed; (2) a decree rendered in an area where the federal tax statute has established the criterion of taxation; (3) a state decree determining the taxpayer's property interests on which the federal tax is to be imposed. The first two types of state court decrees have no effect upon a federal court in a subsequent proceeding; the scope of this Comment is limited to the third type.

\(^{12}\) Morgan v. Commissioner, 309 U.S. 78 (1940).


Nor are the commentators in agreement as to a reasonable solution. J. MERTENS, THE LAW OF FEDERAL GIFT AND ESTATE TAXATION §§ 10.10-.23 (1959); 1 R. PAUL, FEDERAL ESTATE AND GIFT TAXATION § 1.11 (1942); Braverman & Gerson, supra note 11, at 545; Cardozo, Federal Taxes and the Radiating Potencies of State Court Decisions, 51 YALE L.J. 783 (1942); Colowick, The Binding Effect of a State Court's Decision in a Subsequent Federal Income Tax Case, 12 Tax L. Rev. 213 (1957); Oliver, The Nature of the Compulsive Effect of State Law in Federal Tax Proceedings, 41 CALIF. L. REV. 638 (1953); Stephens & Freeland, The Role of Local Law and Local Adjudications in Federal Tax Controversies, 46 MICH. L. REV. 223 (1961). The implications of the demands of the expanding federal fisc upon federalism are discussed in Cahn, Local Law in Federal Taxation, 52 YALE L.J. 799 (1942).

\(^{14}\) 291 U.S. 35 (1934).
denied the Commissioner's contention that the state proceeding was collusive and, therefore, not a valid declaration of state law binding on the federal court. The decision has been cited for establishing the principle that unless a state proceeding is found to be collusive, it is binding on federal authorities. The Freuler approach was affirmed in Blair v. Commissioner, in which the Commissioner attacked the finding of an intermediate state appellate court that the petitioner had validly assigned his right to trust income to his sons. The Supreme Court held the state court's determination to be conclusive on federal authorities, denying without extensive comment that the state proceedings were collusive.

Although Freuler and Blair established a "collusive-noncollusive" test for determining the effect to be given a lower state court's determination of the property rights upon which federal taxation turns, neither case set forth viable standards for the application of that test. The result has been a great deal of inconsistency among the courts as to which factors will be considered as evidence of collusion in the state proceedings and

15. The Commissioner argued that the state court proceeding was collusive in the sense that the parties had joined to obtain a decision adverse to him.

We cannot so hold. . . . Notice was given to the interested parties. Objections to the account were presented, and the matter came on for hearing in due course, all parties being represented by counsel. The decree purports to decide issues regularly submitted and not to be in any sense a consent decree. The court ruled against the remaindermen on one point, and in their favor on another. . . .

291 U.S. 35, 45 (1934). It should be noted that the Court's definition of collusive is in no way limited to fraudulent conduct by the taxpayer.


17. The Court in answering the Commissioner's argument that the suit was collusive recalled that the state appellate court had reviewed the lower court's decision and had reached a deliberate conclusion.

18. For a complete discussion of the federal courts' approaches to the problem, see Braverman & Gerson, supra note 11.

19. E.g., Blair v. Commissioner, 300 U.S. 5 (1937) (whether the state decree was a consent decree); Stallworth's Estate v. Commissioner, 260 F.2d 760 (5th Cir. 1958) (the time at which the state proceeding was initiated); Estate of Sweet v. Commissioner, 234 F.2d 401 (10th Cir. 1956), aff'd 24 T.C. 488 (1955) (the language of the decision); Gallagher v. Smith, 222 F.2d 218 (3d Cir. 1955) (whether there was actual fraud); Saulsbury v. United States, 199 F.2d 578 (5th Cir. 1952) (whether the state proceeding was adversary); Kelly's Trust v. Commissioner, 168 F.2d 198 (2d Cir. 1948) (whether an appeal was taken); Commissioner v. Masterson, 127 F.2d 252 (5th Cir. 1942) (whether the Commissioner was notified); Estate of Charles Elson, 28 T.C. 442 (1957) (the deliberate nature of the court's conduct). Whether each of these factors is itself a vital consideration or merely evidence of the adver-
the relative weight to be given such evidence. The factor most frequently considered is the adversary nature of the state court proceedings. A majority of the courts have deemed a finding that the state court decision was rendered in an adversary proceeding determinative of the question of collusion, on the theory that this characteristic insures that the state decision is an accurate declaration of state law. A minority of the courts, however, have refused to consider the adversary character of the state proceeding conclusive evidence, apparently because of a notion that a strict adversary requirement may invalidate many otherwise valid decrees. The showing of actual fraud in these state proceedings is apparently necessary in order to establish collusiveness. The Tax Court has ostensibly adhered to the adversary requirement as the criterion for determining collusiveness, distinguishing on very narrow grounds adverse decisions from the minority circuits. However, the problem is obviated by the decision of the Supreme Court in the instant case denying conclusive effect to all such lower state court determinations.

20. See, e.g., Old Kent Bank & Trust Co. v. United States, 362 F.2d 444 (6th Cir. 1966); Pierpont's Estate v. Commissioner, 336 F.2d 277 (4th Cir. 1964), cert. denied, 380 U.S. 908 (1965); Faulkerson's Estate v. United States, 301 F.2d 231 (7th Cir.), cert. denied, 371 U.S. 887 (1962); Estate of Sweet v. Commissioner, 234 F.2d 401 (10th Cir. 1966); Third Nat'l Bank & Trust Co. v. United States, 228 F.2d 772 (1st Cir. 1956); Newman v. Commissioner, 222 F.2d 131 (6th Cir. 1955).

21. See, e.g., Flitcroft v. Commissioner, 328 F.2d 449 (9th Cir. 1964); Estate of Peyton v. Commissioner, 323 F.2d 438 (8th Cir. 1963); Gallagher v. Smith, 223 F.2d 218 (3d Cir. 1955).

22. E.g., Estate of Peyton v. Commissioner, 323 F.2d 438 (8th Cir. 1963).


24. Estate of Charles Eson, 28 T.C. 442 (1957). The adversary requirement has not been uniformly indorsed by the commentators. See Braverman & Gerson, supra note 11 (the state proceeding must be adversary with numerous factors considered as evidence of this quality); Cardozo, supra note 13 (state court decisions should be given only their proper weight as precedent from which the federal court may make an independent examination of state law); Stephens & Freeland, supra note 13 (district court judges should be seated as nonvoting advisors on the Tax Court as to matters of local law, along with a procedural technique permitting certification of a question of state law to the highest state court); Note, Effect of State Court Decrees in Federal Tax Litigation, 30 U. Chi. L. Rev. 569 (1963) (unless the Commissioner's position is advocated at the state proceeding the federal authorities are not bound by same). See also authorities cited note 13 supra.
and rejecting the collusive-noncollusive analysis which had developed from *Freuler* and *Blair*.\textsuperscript{25}

The Court developed three separate lines of reasoning to support its holding. First, citing *Freuler*, it denied that the Commissioner was bound by either res judicata or collateral estoppel since, in neither case, was he a party to the state action.\textsuperscript{26} Second, the Court relied on legislative history and the statutory language to argue that the marital deduction should be narrowly construed.\textsuperscript{27} and that Congress, having foreseen the instant problem, intended a state court's determination to be afforded only proper regard, not conclusiveness.\textsuperscript{28} From these premises, it reasoned that the legislative intent to protect the federal fisc from taxpayers who obtain favorable, but perhaps inaccurate, determinations of state law from state trial courts can best be implemented by denying conclusive effect to those state trial court decrees.

The third, and critical rationale was based on an analogy with the effect to be given a state trial court's interpretation of state law in diversity cases. Under the *Erie*\textsuperscript{29} rule, a federal court sitting in a diversity case is bound by a declaration of state law

\begin{itemize}
\item \textsuperscript{25} It is disconcerting that the Court distinguishes *Blair* on the ground that it was an appellate court decision, while *Freuler*, a case which seems to also involve a state trial court proceeding, is cited as authority only on a collateral point.
\item \textsuperscript{26} However, the Commissioner had received notice of both actions. See notes 4 & 7 supra.
\item \textsuperscript{27} This appears to be consistent with the general rule. See *Jackson v. United States*, 376 U.S. 503 (1964). However, three weeks prior to the instant decision, the Court, in *Northeastern Penn. Nat'l Bank & Trust Co. v. United States*, 387 U.S. 213 (1967), argued that the marital deduction should be broadly construed in holding that it was not necessary for the widow's share of trust income to be expressed in a fraction or percentage to satisfy the specific portion requirement of the statute. Furthermore, the Court supports its decision with considerations unique to the marital deduction, yet articulates a rule of tax law to be applied beyond this provision.
\item \textsuperscript{28} “[P]roper regard should be given to interpretations of the will rendered by a court in a bona fide adversary proceeding.” S. Rep. No. 1013, 80th Cong., 2d Sess. pt. 2, at 4 (1948).
\item The Court's reading of the legislative history is debatable. It has been argued that if the legislative history supports any conclusion, it reveals an intent that bona fide adversary state proceedings are conclusive on the federal authorities. In dissent, Justice Harlan points out that the Report is at best equivocal and that, from the language of the Report, it may also be argued that “proper regard” means conclusive if the state proceeding is noncollusive and adversary. 387 U.S. at 475 n.3; see *Old Kent Bank & Trust Co. v. United States*, 362 F.2d 444 (6th Cir. 1966)
\item \textsuperscript{29} *Erie R.R. v. Tompkins*, 304 U.S. 64 (1938).
\end{itemize}
only from the state’s highest court. Since the underlying substantive rule involved is based on state law in both diversity and federal tax cases, the Court maintained that the same rules for determining state law ought to apply. Hence lower state court decisions are not controlling as to state law when the state’s highest court has not spoken.  

The Court’s holding eliminates the difficulty of articulating the collusive-noncollusive test or otherwise defining and applying a formal test to each state decision to determine whether it truly reflects the law of the state. More importantly, however, by permitting the federal court to weigh the trial court’s declaration of state law against that of the state’s highest court, the substance of the trial court’s decision is evaluated, rather than the form of the proceeding which may or may not reflect the accuracy of the substantive decision. In addition, the decision affords the maximum amount of protection to the federal fisc by providing the Commissioner an opportunity to litigate the substantive issue.

There are, however, alternative methods for protecting the federal fisc less drastic than that adopted by the Court. Rather than deny conclusive effect to all lower state court proceedings, it would seem more desirable to utilize the traditional collusive-noncollusive test to deny effect to only those proceedings which were likely to give rise to inaccurate declarations. While it is true that a degree of uncertainty was involved in the former

31. In addition, a formal test of collusiveness may be used as a cloak for permitting the courts to look to the accuracy of the decision, and then, depending on its approval or disapproval, labeling it collusive or noncollusive.
32. There is undoubtedly a rational connection between the quality of the decision and the level of the court. This follows from the competence of the high court judges, the number of judges hearing and deciding a question, the mechanical aids available to the high courts, and the fact that the opinion once made is published.
33. This consideration becomes particularly germane if it is assumed that the primary conflict in a distribution of property in the state court is between the Commissioner and the potential distributees. See Note, Effect of State Court Decrees in Federal Tax Litigation, 30 U. Chi. L. Rev. 569 (1963).
34. This approach is advocated by the dissent, a number of commentators and courts, and counsel for the government. In addition to its desire to protect the federal fisc, the majority’s apparent reason for ignoring this authority is that the uncertainty incidental to defining a “collusive” suit is dispelled. 387 U.S. at 463; see also J. MERTENS, supra note 11; R. PAUL, supra note 11; Braverman & Gerson, supra note 11; Cahn, supra note 11; cases cited note 20 supra.
approach, some of this uncertainty could have been eliminated by a definitive explanation of whether nonadversariness was the essential element of collusion.\textsuperscript{35} Moreover, it is arguable that while the holding may eliminate the uncertainty of the prior test, it introduces uncertainty in tax planning by requiring local attorneys to predict what the determination of local law by a foreign court will be.\textsuperscript{36}

Furthermore, there may be a genuine hardship to the taxpayer since the state proceeding is binding on the taxpayer as to his property interests irrespective of the decision of the federal court for federal tax purposes.\textsuperscript{37} If the federal court disregards the state determination and clothes the taxpayer with a greater property interest, he may be taxed for a property interest he does not possess.\textsuperscript{38} Such inconsistent results between state and federal courts with respect to state law are likely to impair local policies and destroy uniformity in local law. This fear is particularly relevant to the area of federal taxation, because of its far-reaching impact.\textsuperscript{39} It is unlikely that the Court anticipated such a result in defining the method of determining state law for diversity purposes.\textsuperscript{40}

The dissenting Justices advocated the retention of the collusive-noncollusive test,\textsuperscript{41} defined by the adversary nature of the proceedings, as an adequate means of protecting the respective interests of the parties.\textsuperscript{42} Accordingly, the federal interest

\textsuperscript{35} The dissent, if accepted, would eliminate the fundamental conflict between the circuits over the importance of adversariness in defining collusion.


\textsuperscript{37} In both Freuler and Blair this fact was deemed to be material. See note 25 supra.

\textsuperscript{38} For example, the state court could find that a widow had no interest in a trust created by her husband's will, the interest passing directly to the children, and the federal court making an independent determination could find that the widow had a special power of appointment which was taxable.

\textsuperscript{39} See Note, The Competence of Federal Courts to Formulate Rules of Decision, 77 Harv. L. Rev. 1084, 1087 (1964). The problem is illustrative of an inherent dilemma of federalism: the desire and need for uniform application of national laws, and the often conflicting interests of legitimate local policies whose existence the system protects. See authorities cited note 13 supra.

\textsuperscript{40} King v. United Commercial Travelers, 333 U.S. 153 (1948).

\textsuperscript{41} 387 U.S. 456, 470; see Gallagher v. Smith, 223 F.2d 218 (3d Cir. 1955).

\textsuperscript{42} Justice Harlan sees the state interests as: uniform application of state law, protection of the states' constitutionally defined areas of discretion, and recognition of the superior ability of state judges to
would be adequately protected by requiring the state proceeding to be genuinely adversary, thus insuring an accurate declaration of state law. The solution would afford a greater recognition to the legitimate interests of the taxpayer and state peculiar to the problem, and reconcile these interests with that of the federal fisc.

Although the test is a formal one, which may not be responsive to a particular fact situation, there is a rational connection between the adversary character of a proceeding and the correctness of the decision. Adversariness is a fundamental characteristic of our legal system, and is presumed to insure a fair and accurate determination of law and fact. Furthermore, there is support for the proposition that the adversary test is capable of practical application. It is true that the test would require an ad hoc application of the collusive-noncollusive test thus perhaps introducing uncertainty. However, the redefinition of the test in terms of an adversary requirement would eliminate the kind of uncertainty that existed prior to the instant case.

The Court's analysis of the problem does provide an easily administered test which goes to the substance of the problem. However, in reaching its decision the Court ignored a substantial body of authority and relied on construction of a statute whose relevance to the broad issue of the effect of state trial court decisions is questionable. Furthermore, while the application of diversity principles may be appropriate, significant distinctions between that area of the law and the determination of property interests for federal tax purposes are left unexplained by the Court. The adversary requirement, advocated by the dissent and a majority of the federal courts, is surely more responsive to the demands of both the taxpayer and the state while protective of the federal fisc, despite its difficulty of definition and application.

declare state law. The federal interest, according to Harlan, is solely the fair administration of federal revenue statutes. 387 U.S. at 477-78.


44. 44 A.B.A.J. 1159, 1160-61 (1958).

45. As evidenced by previous cases in which the courts have used the adversary test to evaluate the state proceeding. See notes 20 & 23 supra. Also the fact that the Commissioner advocated the adversary test indicates that test is not completely impractical. See note 34 supra.