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A ROLE FOR STATE COURT ADJUDICATIONS IN FEDERAL TAX CASES — A PROPOSAL

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INTRODUCTION

The role of state law in the federal system of taxation is obviously an important one. The Internal Revenue Code is phrased largely in terms of state law concepts.¹ More important than the terminology of the Internal Revenue Code, however, is the fact that the incidence of the federal tax is upon rights and duties of economic consequence that are, for the most part,² created and defined by state law.³

In adjudicating federal tax liability, the federal tribunal is likely to treat state law as if it were simply another fact in the case. If tax liability is deemed to turn upon state law,⁴ the salient principle is searched out from among the statutes and precedents of the appropriate jurisdiction. The prevailing principle of state law, once determined, is applied to facts of the case and upon the results of this application taxability *vel non* is made to depend.

This description of the tax case decision-making process is greatly simplified. Indeed, it is deceptively simple. In addition to its other deficiencies,⁵ this description of the process fails to contemplate that the taxpayer may bring to the tax proceeding a state court judgment or decree involving himself and based upon some of the very facts to be

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1. An obvious example is provided by INT. REV. CODE of 1954, § 61, which defines gross income to include "interest," "rents," "royalties" and "dividends." Obvious exceptions are "collapsible corporation," INT. REV. CODE of 1954, § 341 (a) (1) and "income in respect of a decedent," INT. REV. CODE of 1954, § 691 (a) (1).

2. INT. REV. CODE of 1954, § 61(a), includes as gross income "all income from whatever source derived. . . ." Thus income received by virtue of federal laws or the laws of foreign countries is also subject to the tax.

3. However, "the federal government can remold the types of kettles before it puts its long handled spoon in them." *United States v. Loo*, 248 F.2d 765, 767 (9th Cir. 1957).

4. Such liability may be imposed by "express language or necessary implication." *Burnet v. Harmel*, 287 U.S. 103, 110 (1932).

5. It fails to acknowledge the difficulty in determining when the federal taxing act is by necessary implication dependent upon state law. It fails too, to indicate that cases may arise in which the pertinent principle of state law is unclear.

considered by the federal tribunal.⁶

Before the Supreme Court's decision in *C.I.R. v. Estate of Bosch* and *Second National Bank of New Haven v. United States*,⁷ the rule that obtained could be simply stated. The state court adjudication would conclusively determine the federal tax issue and would be strictly binding upon the Commissioner and the federal tribunal. This rule would apply if purported to be a decision of issues regularly submitted to the state court; and if it was not collusively obtained by the taxpayer for the purpose of affecting the Government's right to additional tax.⁸

With the Court's decision in *Bosch*, the rule has become a more restrictive one, at least in cases involving the marital deduction. In cases of that kind, the decision of a state trial court as to an underlying issue of state law is not controlling in the federal tax litigation.

The purpose of this article is to examine, critically, the approach that federal courts have followed in dealing with state court judgments in federal tax cases. It is submitted that the rules, expressed in the terminology as stated above, have been subject to uncritical application with unsound decisions as a result. Likewise, it is suggested that the rules' phraseology and potential for misapplication are the cause of much needless litigation in both the federal and the state courts. This article will suggest an alternate manner of viewing state adjudications and the role that they ought to play in federal tax cases: the role of state judgments should be limited to that of conclusive evidence of rights and duties as of the time of their entry and presumptive evidence of the factual and legal determinations upon which they are based.

PREVAILING CASE LAW BEFORE BOSCH

Freuler v. Helvering

The Supreme Court first treated a state court judgment as conclusive in a federal tax case in 1934, *Freuler v. Helvering*,⁹ in which a decree of a California court had become a part of the case. A California testator had established a testamentary trust, creating life interests in income with remainders over in fee. The trustee had invested trust assets in depreciable property and paid all of the income to the income beneficiaries without making any deduction for depreciation. In reporting

6. Or, it may be the Commissioner who brings the state court action. See, e.g., Harry F. Shannon, 29 T.C. 702 (1958) (taxpayer was denied a deduction for her share of a partnership net operating loss because a state court had held that as a married woman she was without capacity to become a partner and was instead a creditor).

7. 387 U.S. 456 (1967).

8. *Freuler v. Helvering*, 291 U.S. 35 (1934).

9. *Id.*

their income from the trust, the income beneficiaries had deducted that part of the income resulting from depreciation of the trust assets.

The Commissioner, taking the position that the income attributable to depreciation was distributable trust income, had proposed to tax it as income to the income beneficiaries and had determined a deficiency in their tax. The will creating the trust made no mention of the manner in which the trustee should treat depreciation. No California statute or appellate decision provided guidance as to whether the income beneficiaries or the remaindermen should bear the depreciation of trust assets. The Commissioner contended that in the absence of such a provision in the will or the California statutes and case law, the general law of trusts should obtain; the remaindermen should bear the depreciation of trust assets, and the income representing depreciation was distributable to the income beneficiaries and taxable to them under section 219(d) of the Revenue Act of 1921.¹⁰

While the case was pending before the Board of Tax Appeals, the trustee filed his first account in a California court having jurisdiction over the trust. Objection to the account, particularly to the trustee's payment of income to the income beneficiaries without deduction for depreciation, was made by the remaindermen. The California court sustained the objection and decreed that the income beneficiaries repay the amounts representing depreciation received theretofore to the trustee.

The Supreme Court held that the California court's decree was binding upon the Commissioner; and that it conclusively established that proceeds from the depreciation of trust assets were not distributable income for the purpose of section 219 of the Revenue Act of 1921.¹¹

The real significance of the Court's holding is not clear. To be sure, it was dispositive of the case at hand, but it provided little in the way of guidance for the future. At one point the Court stated, "[W]hat the law as announced by that California court adjudges distributable is, we think, to be so considered in applying § 219 of the Act of 1921."¹²

The Court may have meant nothing more than this: in its decree the California court has announced the law of California as it relates to who shall bear the burden of depreciation of trust assets; its statement of the California law is conclusive, and since there is no dispute about the facts of the case, we concur in the conclusion that the depreciation proceeds were not properly distributable to the income beneficiaries.

This interpretation of the Court's holding finds some support in the Court's statement that :

10. NOW INT. REV. CODE OF 1954, § 652 (a).

11. *Freuler v. Helvering*, 291 U.S. 35, 45 (1934).

12. *Id.*

[T]he decision of that California court, until reversed or overruled, establishes the law of California respecting distribution of the trust estate. It is none the less a declaration of the law of the State because not based on a statute or earlier decisions. . . .¹³

At another point the Court stated, "[T]he decree was a judgment which fixed the rights of the remaindermen and the obligations of the life tenants. . . ." ¹⁴ This statement suggests that the Court's rationale in according conclusiveness to the California court's decree was that the parties' rights and obligations upon which the tax is predicated were conclusively determined by the decree; that the rights and obligations could not be other than as set out in the decree; and that the Commissioner should not be permitted¹⁵ to proceed upon the assumption that the parties' rights and obligations could be different from those recited in the decree.

Finally, the Court in *Freuler* stated that the California court's decree was conclusive "as to what was *in fact and in law* income distributable to the beneficiaries under the trust."¹⁶ This language would indicate that the Court considered the California court's findings of fact as well as its announcement of the California law binding upon it.

Blair v. Commissioner

The *Freuler* case was cited as authority in *Blair v. Commissioner*,¹⁷ a case presenting similar issues. The issues in *Blair* as they related to local law were whether the trust of which the taxpayer was an income beneficiary was a spendthrift trust. If it was a spendthrift trust, the taxpayer's attempted assignments of a part of his interest in it constituted assignments of income which remained taxable to the taxpayer.¹⁸ If the trust was not a spendthrift trust, the assignments were of equitable interests in the trust corpus, and the taxpayer was not taxable on the income received by the assignees.

The trustees of the trust involved in *Blair* had the will creating the trust construed by the appropriate Illinois court. That court, pursuant to a mandate from an Illinois intermediate appellate court, had decreed that the trust was not a spendthrift trust under the laws of the State of

13. *Id.*

14. 291 U.S. at 46.

15. Perhaps as a matter of logic or perhaps as a matter of due process. *Cf. Burnet v. Wells*, 289 U.S. 670, 678 (1933), and Mr. Justice Sutherland's dissenting opinion therein at 683-85.

16. 291 U.S. at 47 (emphasis added).

17. 300 U.S. 5 (1937).

18. *Burnet v. Leininger*, 285 U.S. 136 (1932); *Lucas v. Earl*, 281 U.S. 111 (1930).

Illinois and that the taxpayer's assignments of his interest in it were valid.

As it had done in *Freuler*, the Court in *Blair* held the decree of the Illinois court to be conclusively determinative of the nature of the trust. The Court did little in *Blair* to clarify or limit the basis of its rationale in *Freuler*. It added simply:

[T]o derogate from the authority of that conclusion of the Illinois appellate court and of the decree it commanded, so far as the question is one of state law, would be wholly unwarranted in the exercise of federal jurisdiction.¹⁹

This statement indicates that comity may have been one of the reasons for according conclusiveness to the state court's decree. But it fails to indicate what aspect or aspects of the decree shall be accorded conclusive effect.

After its decision in *Blair*, the Supreme Court did not again seriously consider the treatment of state court adjudications until its decision in *Bosch*.²⁰ From 1937 until 1967, then, the law in the area was shaped by the lower federal courts. These courts followed the rule announced in *Freuler* and *Blair* and gave state court adjudications conclusive weight unless collusively obtained by the taxpayer.

But in the myriad of lower court cases²¹ which have followed *Blair*, we have found no clear articulation of what it is to which the courts may accord conclusiveness: whether to the state court's determinations of fact; to its announcement of state court law; to its adjudication of relationships between parties to the state court proceeding; or to a combination of all or less than all of these. However, the courts, for the most part, appear to accord conclusiveness to state court "judgments" and "decrees" and, possibly, to all that those terms may conceivably encompass.

THE BOSCH CASE

Both *C.I.R. v. Estate of Bosch* and *Second National Bank of New Haven v. United States*²² involved the estate tax marital deduction.²³

19. 300 U.S. at 10.

20. The problem was raised, but not seriously considered by the Court, in *Sharp v. Commissioner*, 303 U.S. 624 (1937) (mem. dec.); and *Helvering v. Ballard*, 303 U.S. 297 (1937). See Colowick, *The Binding Effect of a State Court's Decision in a Subsequent Federal Income Tax Case*, 12 TAX L. REV. 213, 214 (1957).

21. For a good bibliography of lower court cases involving state court judgments in federal tax cases, see Berger, *Tax Consequences of Non-Tax Proceedings*, 17 INST. ON FED. TAX. 87, 105n. 77 (N.Y.U. 1959).

22. 387 U.S. 456 (1967).

23. INT. REV. CODE OF 1954, § 2056(a).

In the former case, a state court adjudication would, if given effect, have granted a marital deduction which the Commissioner was unwilling to allow. In the latter case a state court adjudication would have resulted in a larger deduction than the Commissioner was willing to allow. In its opinion disposing of both cases the Supreme Court held that the federal taxing authority was not bound by the state trial courts' determinations of property interests.

The Impact of Bosch

The scope of *Bosch's* impact upon the rule of *Freuler v. Helvering* is not altogether clear at this time. Surely state trial court adjudications no longer conclusively determine federal tax issues involving the marital deductions, even in the absence of collusion. But whether they will continue conclusively to determine other federal tax issues remains to be seen.

Arguably, the restriction in *Bosch* upon *Freuler* and *Blair* is only applicable to state adjudications which affect the marital deduction. In its majority opinion, the Court in *Bosch* did not expressly overrule its decisions in either *Freuler* or *Blair*,²⁴ neither of which involved the marital deduction. Further, in concluding that the federal courts were free to disregard the trial courts' determinations of property interests, the Court relied heavily upon Congress' expressed intent that the marital deduction should be strictly construed²⁵ and that " 'proper regard' not finality, 'should be given to interpretations of the will' by state courts and then only when entered by a court 'in a bona fide adversary proceeding.' "²⁶

Without regard to the exact scope of its impact upon *Freuler* and *Blair*, however, *Bosch* appears to teach that in some cases state court adjudications may be disregarded.

Under *Freuler* and *Blair* and the lower court cases which have followed in their wake, state adjudications may conclusively determine the federal tax issue. And in cases controlled by *Bosch* they may be disregarded altogether. It is this all or nothing approach to which we object and for which we propose an alternate approach.

A PROPOSAL FOR REFORM

An Alternate Approach

Mr. Justice Cardozo, speaking in dissent in *Freuler v. Helvering*,²⁷

24. The Court did, however, distinguish *Blair* on the ground that it had involved the decision of an intermediate appellate court.

25. S. REP. No. 1013, 80th Cong., 2d Sess. 4 (1948).

26. 387 U.S. at 464.

27. 291 U.S. 35, 47 (1934).

suggested the manner in which state court adjudications ought to be regarded in federal tax proceedings: "The order is no more than evidence of pre-existing rights and duties."²⁸ From the context in which his statement is made, the word "pre-existing" appears to refer to the respective rights and duties of the parties as they had existed after the state court's order had been entered, but before its import had been modified by an agreement. From his dissenting opinion it appears, also, that Mr. Justice Cardozo was willing to regard the order as conclusive evidence of the parties' rights and duties.²⁹ Thus, without doing violence to its contextual setting, the statement might be paraphrased to read: The order is no more than conclusive evidence of rights and duties as they existed at the time of its entry.

This, we submit, is the proper function of a state court judgment or decree in a federal tax case. When treated as something more they assume an exaggerated importance; their importance *qua* judgments and decrees becomes greater than the sum of their constituent parts. The ease with which the apparent tax problem may be solved through their application may obscure, to litigants and to courts alike, the real nature of the tax problem. What might more aptly be treated as but one piece of evidence in the case assumes what might be called the aura of judgment.

Inadequacies of the Present Decision-Making Process

Conclusiveness of State Court Adjudications

Mr. Justice Cardozo, in his dissent in *Freuler v. Helvering*,³⁰ advanced an opinion that the majority of the Court had been led into error by the presence of the California court's order in the case. The California court had ordered the income beneficiaries to return the depreciation theretofore received to the trustee, so that it could be added to the trust corpus and ultimately distributed to the remaindermen. Following the entry of the California court's order, the income beneficiaries, with the consent of the presumptive remaindermen, had discharged their obligations under the order by giving the trustee their non-interest bearing notes, payable upon termination of the trust.

Under this state of the facts, opined Justice Cardozo, although the income beneficiaries did not receive the full amount of trust income representing depreciaton, they did receive the value of its full and uninhibited use and enjoyment between the dates of receipt and ter-

28. *Id.* at 50.

29. *Id.* at 49; see Colowick *supra* note 20 at 215 n.8.

30. 291 U.S. at 47.

mination of the trust.³¹ And that value has become distributable income by agreement of the parties. Although the California court's order did conclusively determine, at the time of its entry, the rights of the parties, its effect was undone by the subsequent agreement.

We shall not presume to pass upon the correctness of the result reached by the majority in *Freuler v. Helvering*. It does appear, however, that in its preoccupation with the California court's order, the majority failed to consider fully whether the value of the use and enjoyment of depreciation proceeds had become income distributable to the income beneficiaries. The fact of the subsequent agreement and its possible significance were raised and argued by the Commissioner and considered by the Court.³² But the Court's consideration of the subsequent agreement, so far as the opinion discloses, was limited to whether it impugned the integrity, and consequently the conclusive effect, of the California court's order.³³ Having concluded that it did not, the Court failed to go on and consider whether the value of use and enjoyment of depreciation proceeds had become distributable income by agreement. The Commissioner was precluded by the state court's order.

Freuler v. Helvering illustrates a potential danger. If state judgments are not treated as evidence, albeit conclusive evidence, of rights and duties as of the time of their entry, but rather are accorded some greater and undefined significance, the aura of judgment may well lead litigants or courts, or both, to overlook some important post judgment fact.

Another potential danger—that presented by semantic similarity—is illustrated by *Estate of Chism*,³⁴ which concerned a controversy over the nature of withdrawals made by a majority stockholder from a closely held corporation. The taxpayer contended that they were loans and so were not taxable as income, while the Commissioner contended that they were taxable as dividends. A Nevada probate court had agreed with the taxpayer.

During the later years of his life, E. W. Chism, a majority shareholder in a Nevada corporation, had made substantial cash withdrawals from the corporation. Following his death, the corporation submitted a creditor's claim, in the amount of the withdrawals, to his estate. The claim was allowed as an enforceable claim against the estate and ordered paid.

31. *Id.* at 51-52.

32. *Id.* at 45-46.

33. *Id.* at 46-47.

34. T. C. Mem. 1962-6, 21 C.C.H. TAX CT. MEM. 25 (1962).

In the Tax Court proceeding that followed,³⁵ the taxpayer took the position that allowance of the corporation's claim by the Nevada probate court conclusively characterized the withdrawals as loans for federal income tax purposes. The Commissioner disagreed, asserting that the probate adjudication was collusively obtained, or was at best non-adversary, and was not conclusive of the federal tax question.

Issue was joined over the nature of the probate proceeding. The Tax Court held that the probate adjudication was not binding upon it,³⁶ either because of the non-adversary nature of the proceeding, or perhaps because it considered the proceeding collusive. On appeal to the Ninth Circuit,³⁷ the same arguments were presented. The Commissioner argued that only adjudications in adversary proceedings may be conclusive, and also that the adjudication in issue had been obtained solely for the purpose of affecting federal tax liability.³⁸ The taxpayer urged that in order to be conclusive the adjudication need not be the result of a proceeding in which one party has said "yes" and another has said "no," and that the adjudication had not been obtained solely for the purpose of affecting federal tax liability.³⁹

Upon allowance of the claim, the estate *was* obligated to repay the amount of the withdrawals to the corporation. But whether the withdrawals were taxable as dividends was also dependent upon whether the parties to the "loans" intended to enforce and discharge that obligation.⁴⁰ Certainly the Nevada probate court had not purported to pass upon the parties' intent in this regard. There is no reason to believe that, in determining that the withdrawals were loans rather than dividends, the Nevada court had applied this peculiar criterion to the federal tax law.

Yet it appears that both parties to the Tax Court proceeding assumed that the adjudication in probate court could be conclusively dispositive of the tax issue.⁴¹ And the Tax Court, while it reappraised the evidence relating to the withdrawals "in the light of a standard peculiar to federal tax law,"⁴² appears to have proceeded upon the assumption that the allowance of the claim would have been conclusive upon it if it had been the result of a bona fide adversary proceeding.⁴³

35. *Id.*

36. *Id.* at 32.

37. *Chism's Estate v. C.I.R.*, 322 F.2d 956 (9th Cir. 1963).

38. *Id.* at 959.

39. *Id.*

40. *Clark v. C.I.R.*, 266 F.2d 698, 710-11 (9th Cir. 1959); *Wiese v. C.I.R.*, 93 F.2d 921, 923 (8th Cir. 1938), *cert. denied*, 304 U.S. 562 (1938).

41. 322 F.2d at 959.

42. *Id.* at 960.

43. *See Chism's Estate v. C.I.R.*, 322 F.2d 956, 959 (9th Cir. 1962); *Chism's Estate*, TAX CT. MEM. 1962-6, C.C.H. TAX CT. MEM. 25, 32 (1962).

In the absence of a state court judgment, it is likely that neither the Tax Court nor the Commissioner would have considered the fact of legal obligation to repay as dispositive of the case. But when cloaked with a state court adjudication, the obligation assumed a new importance. It would, if the result of a bona fide adversary proceeding, have been conclusively dispositive of the case.

The Collusion Issue

Code,⁴⁴ regulations,⁴⁵ and cases⁴⁶ alike, indicate that a term's meaning as used for federal tax purposes will not necessarily coincide with that of its counterpart in the local law. At least one court⁴⁷ and one textwriter⁴⁸ have indicated the futility of litigating the issue of whether a state adjudication has been obtained collusively in cases in which tax liability has not been made to depend wholly on state law.⁴⁹ Federal courts have declined to accord conclusiveness to state adjudications in cases in which the state courts rendering them have not considered an issue peculiar to the tax controversy.⁵⁰

But so long as the exact role of state court adjudications goes undefined, and so long as they are regarded as something more than conclusive evidence of rights and duties, the precise limits of the underlying tax problem are likely to be obscured. Taxpayers are likely to continue their efforts to strengthen weak tax cases by dignifying them with state court adjudications.⁵¹ Litigants are also likely to continue to address their arguments to the nature of state adjudications which are not relevant or are not dispositive, as was done in *Chism*. Thus, the potential for erroneous results is likely to continue.

44. *E.g.*, the very detailed definition of "general power of appointment" contained in INT. REV. CODE OF 1954, § 2041(b), indicates that that term's definition is not to be derived wholly from state law concepts.

45. *E.g.*, Treas. Reg. § 301.7701-1(c), "Effect of local law," which states that "the clause into which organizations are to be placed for purposes of taxation are determined under the Internal Revenue Code."

46. *E.g.*, *Morgan v. Commissioner*, 309 U.S. 78 (1940); and see the cases listed in 10 MERTENS, FEDERAL INCOME TAXATION, § 61.02 n.7 (Zimet Rev. 1964).

47. *Gallagher v. Smith*, 233 F.2d 218, 222 (3d Cir. 1955).

48. I PAUL, FED. ESTATE & GIFT TAXATION, § 1.11 at 75-77 (1942).

49. *Chism's Estate v. C.I.R.*, 322 F.2d 956, 959 (9th Cir. 1963).

50. *E.g.*, *Earle v. C.I.R.*, 157 F.2d 501 (6th Cir. 1946); *Estate of Hagenlocher*, 42 T.C. No. 80 (1964).

51. *See, e.g.*, *Darlington's Estate*, 36 T.C. 599 (1961), *rev'd*, 302 F.2d 693 (3d Cir. 1962); *Sweet's Estate*, 24 T.C. 488 (1955), *aff'd*, 234 F.2d 401 (10th Cir. 1956) *cert. denied*, 352 U.S. 878 (1956); *Leslie H. Green*, 7 T.C. 263 (1946), *aff'd per curiam*, 168 F.2d 994 (6th Cir. 1948) [in which the taxpayers began state court proceedings only after tax deficiency proceedings had been initiated]. *See also Berger, Tax Consequences of Non-Tax Proceedings*, 17 INST. ON FED. TAX. 87, 102-14 (N.Y.U. 1959), which outlines points of strategy to be employed in obtaining the state judgment so that it will best serve the tax needs.

Heretofore, it has been suggested that state judgments be regarded as conclusive evidence of rights and duties only as they existed at the time of entry.⁵² It has also been suggested that events may occur subsequent to entry which will change the nature of the relationship of which the judgment is evidence.⁵³

Similarly, the judgment may not accurately reflect the legal relationships of the parties to it as they existed prior to the time of its entry. The judgment, entered either through collusion or without active opposition, may establish relationships entirely out of keeping with the actual state of affairs as they existed prior to entry.

In both *Freuler v. Helvering*,⁵⁴ and *Blair v. Commissioner*,⁵⁵ the Supreme Court has indicated that state court judgments that have been collusively or fraudulently obtained are not entitled to be regarded as conclusive.⁵⁶ The Court did not consider the state judgments in either case to have been collusively obtained, and its statements in those cases concerning collusion are brief and obscure. The fact of their ambiguity has been stated and their possible meaning explored elsewhere⁵⁷ and will not be treated here.

Essentially, the lower courts have divided on what constitutes fraud or collusion of a nature that will undermine the conclusiveness of a state court adjudication. Some circuit courts and the Tax Court have adopted the rule that an adjudication is collusive and the resulting judgment is not conclusive if there is no adversity of parties in the state court proceeding.⁵⁸ The Third Circuit has taken the position that a state judgment is conclusive unless obtained for the purpose of defeating the tax.⁵⁹ Between these poles the circuit courts have assumed positions which one writer has cataloged into a spectrum ranging from "strict" to "easy."⁶⁰

The proper classification of state judgments as collusive or not

52. See notes 41-47 *supra* and accompanying text.

53. *Id.*

54. 291 U.S. 35 (1934).

55. 300 U.S. 5 (1937).

56. The Court was not confronted with a judgment that it considered to have been collusively or fraudulently obtained in either case. Consequently, the Court has not definitively held that collusively or fraudulently procured judgments are not to be accorded conclusive effect.

57. Sachs, *The Binding Effect of Nontax Litigation in State Courts*, 21 INST. ON FED. TAX. 277, 279-81 (N.Y.U. 1963); Berger, *supra* note 51, at 103-05; Colowick, *The Binding Effect of a State Court's Decision in a Subsequent Federal Income Tax Case*, 12 TAX. L. REV. 213, 214-18 (1957).

58. *E.g.*, *Third National Bank & Trust Co. v. United States*, 228 F.2d 772 (1st Cir. 1956); *Stevens' Estate*, 36 T.C. 184 (1961).

59. *Darlington's Estate v. C.I.R.*, 302 F.2d 693 (3d Cir. 1962); *Babcock's Estate v. C.I.R.*, 234 F.2d 837 (3d Cir. 1956); *Gallagher v. Smith*, 223 F.2d 218 (3d Cir. 1955).

60. Berger, *supra* note 51, at 106.

collusive has assumed a large measure of importance. A perusal of the lower court tax cases involving state judgments will reveal that in many cases the bulk of the effort of both litigants and courts has been directed to the resolution of this issue.⁶¹

The importance which is currently attached to this classification is attributable to the magnitude of the consequences which follow. It is an "all or nothing" proposition. If the judgment is determined to have been collusively obtained, its subject will be relitigated in the federal forum, normally to the chagrin of the taxpayer and the gratification of the Commissioner.⁶² If the judgment is deemed to have been obtained bona fide, or with the requisite degree of adversity, or both, it will be conclusive of the entire matter, with appropriate differences in the attitudes of the parties litigant.

A Critical Appraisal of the Rationale of Current Rules

As indicated above, if the state judgment passes the litmus test, conclusiveness attaches. It attaches not only to the rights and duties which the judgment reflects, but also, apparently, to all of the legal and factual bases upon which it is purported to be predicated.

The reasons behind this phenomenon are not easy to isolate. For federal tax purposes a non-appellate state court's interpretation of state law is not binding *per se* upon the federal forum;⁶³ it is binding only if merged into a conclusive judgment.⁶⁴ Also, absent the applicability of *res adjudicata* or collateral estoppel, a state court's adjudication of an issue of fact only collaterally germane to the tax issue would surely not be binding upon the federal forum. Yet, when made in support of a judgment determined to be conclusive, determinations of fact and pronouncements of law become conclusive.

The reason most often given is that the state judgment conclusively fixes the rights and liabilities of the parties.⁶⁵ As indicated in *Darlington's Estate v. C.I.R.*,⁶⁶ if anybody changes his mind he will have a hard time trying to avoid the state court decree.

61. See cases cited in Berger, *supra* note 51, n.77.

62. "[S]ometimes the shoe is on the other foot, and the taxpayer considers that he will benefit by the application of a federal, as distinguished from a local, rule of property." 10 MERTENS, FEDERAL INCOME TAXATION, § 61.01 (Zimet Rev. 1964). See also Harry F. Shannon, 29 T.C. 702 (1958) (taxpayer would undoubtedly have been willing to relitigate the partnership issue).

63. *C.I.R. v. Estate of Bosch*, 387 U.S. 456 (1967); *Estate of Pierpont v. C.I.R.*, 336 F.2d 277, 281 (4th Cir. 1964). But see *Freuler v. Helvering*, 291 U.S. 35, 45 (1934) in which the Court indicated that a statement of law by a state court of original jurisdiction may be binding *per se* on the federal court.

64. Cf. *Estate of Pierpont v. C.I.R.*, 336 F.2d at 281.

65. *Gallagher v. Smith*, 223 F.2d 218, 223 (3d Cir. 1955).

66. 302 F.2d 693, 695 (3d Cir. 1962).

But the difficulty in avoiding the effect of a state court decree is indicative of only one thing—that upon its entry the decree has conclusively fixed or established the rights and duties of the parties. Likewise, the same can be said for a judgment collusively obtained. If the rendering court has jurisdiction of the subject matter and of the parties, the rights and duties which obtain are fixed no less conclusively because the judgment has been collusively or fraudulently obtained. Evidence of fraud or of collusion may serve to indicate that the rights and duties are not fixed for the reasons of fact or of law, or of both, for which they are purported to have been fixed, but it will not alter the fact that the rights and duties are conclusively established by the judgment or decree.

The state court decree considered in *Darlington's Estate*⁶⁷ directed that any federal estate tax savings resulting from the estate's deduction of state taxes on charitable gifts, if permitted, should inure solely to the charities.⁶⁸ The decree did conclusively entitle the charities to the tax savings if any were effected, and the other beneficiaries of the estate would have a hard time avoiding the effect of the decree.⁶⁹ Why this fact should conclusively establish that the savings would inure as a gift of the testator rather than by consent of the other beneficiaries, if the source of the inurement was important,⁷⁰ is not indicated in the opinion.

It would seem that if the source of the inurement was not significant, then neither was the issue of collusiveness or adversity. If the crux of the controversy was whether the tax saving would, without regard to the reasons, in fact inure to the charitable recipients, the issue of collusiveness or adversity was totally irrelevant. The charities were conclusively entitled to the tax savings, if any, without regard to the nature of the proceedings that culminated in the decree.

Time of Entry as the Basis for a New Approach

It may be asked, if state judgments are treated only as conclusive evidence of rights and duties as of the time of their entry, what of significance will be left of them? Why should federal courts not proceed entirely oblivious to them and relitigate their subjects? Certainly the

67. *Id.*

68. Pursuant to INT. REV. CODE of 1954, § 2053(d)(2).

69. Though it is difficult to imagine why they should want to avoid it, the only persons monetarily interested were the Government and the charities. *Darlington's Estate*, 36 T.C. 599, 604 (1961).

70. The presence of a state decree seems to have obscured this federal question of vital significance. The Tax Court and the Commissioner appear to have assumed that § 2053(d)(2) may be availed of only if its resulting savings will inure to the charitable recipient by virtue of the will as affected by state law. The Third Circuit may have assumed that the all important question was whether the charities would get the benefit of any tax saving.

moment, or for that matter the day, of their entry will be but a minute portion of the tax period or periods under review.

The time of entry may serve as a convenient *starting* point, both chronologically and analytically. If the period under review precedes or follows entry of the judgment, and if the only issue is whether the taxpayer's rights and duties, as evidenced by the judgment, obtained during that period, the party introducing the judgment might be made to enjoy a presumption that the judgment rights did obtain, in the absence of evidence to the contrary. Similarly, if the inquiry is whether the taxpayer's rights and duties obtain for the reasons for which they are purported to obtain, the introducing party might enjoy a like presumption.

The facts of *Leslie H. Green*⁷¹ can be made to serve as an illustration. The taxpayer in that case had established a trust, naming himself as trustee. The Commissioner sought to tax trust income to the settlor-grantor on the theory that he had retained unlimited power over the trust corpus, thereby making the trust revocable. After deficiency proceedings had been initiated, the taxpayer went into a Michigan court⁷² to have the trust instrument interpreted. The Michigan court decreed that the trust was not revocable, that trust income and corpus belonged solely to the beneficiaries, that the settlor could not borrow money from the trust except upon adequate security and for the going interest rates, and that he could not purchase property from or sell property to the trust except for fair value.⁷³

Upon entry of the Michigan court's decree, the trust became irrevocable.⁷⁴ It was no longer subject to the objections that the Commissioner had raised. In a federal tax case relating to a period after its entry, the taxpayer might be accorded a presumption that the trust continued to be irrevocable in the absence of evidence to the contrary. In a case relating to a period prior to entry of the decree, the taxpayer might be accorded a presumption that the trust was irrevocable prior to entry of the decree, but the presumption might be rebutted by evidence that a construction of the trust instrument was not sought until after deficiency proceedings were begun.

The time of entry may also serve as a *turning* point. Under the facts of *Leslie H. Green*,⁷⁵ if the tax period under inquiry included the date of entry of the decree, the taxpayer might be determined to be taxable

71. 7 T.C. 263 (1946).

72. Circuit Court, County of Oakland, State of Michigan.

73. 7 T.C. at 269.

74. *Id.* at 270.

75. 7 T.C. 263 (1946).

on trust income earned before but not after the date of entry.

The same principles might be applied in cases in which the reasons behind the right-duty relationship are important. In the area of the marital deduction, for example, the interest in property must pass from the decedent to the surviving spouse in order to qualify for the deduction.⁷⁶ A decree reciting that the surviving spouse is entitled to given property tells only one-half of the story. If the decree purports to make the award on the basis of the will or laws of intestate succession, the estate might be accorded a rebuttable presumption that the property has passed from the decedent and is not a gift from the other beneficiaries.

The kinds of evidence sufficient to rebut the presumption and subject the judgment to relitigation might be of the kinds now deemed sufficient to undermine the conclusiveness of the judgment.⁷⁷ It is suggested that the present "strict"⁷⁸ standard be followed, *i.e.*, that the factual and legal determinations, upon which judgments obtained in non-adversary proceedings are purported to be predicated, be subject to relitigation.

A Rationale of the New Approach

Treating state judgments in this manner would likely lead to tax results that are much the same as are now achieved. However, it would permit a uniform standard of review to replace the state of confusion that now exists concerning the determination of which judgments shall be accorded conclusiveness.⁷⁹ It would provide a basis for reconciling the views of the Third Circuit and the other circuit courts.⁸⁰ Taxpayers, certain in the knowledge that a judgment obtained in non-adversary proceedings would be subject to review, would be spared unnecessary trips to the local courthouse, and the dangers presented by the aura of judgment would be minimized.

One reason sometimes given for according conclusiveness to state court judgments is that failure to do so would be a reflection upon the state courts' integrity.⁸¹ One writer has stated in this regard that, "The

76. INT. REV. CODE OF 1954, § 2056(a).

77. See Sachs, *supra* note 57; Berger, *supra* note 51; Colowick, *supra* note 57. These articles contain discussions of the kinds of evidence that have invalidated the conclusiveness of state court judgments.

78. See Berger, *supra* note 51, at 106.

79. See Berger, *supra* note 51, at 107-08 for a discussion of the lack of uniformity in Tax Court decisions.

80. This can be accomplished by acknowledging the conclusiveness of rights and duties as adjudicated but recognizing that they may not have obtained prior to judgment and that they may not obtain for the factual or legal reasons upon which they are purported to be predicated.

81. Frank C. Rand, TAX CT. MEM. 1960-216, 29 P-H TAX CT. MEM. 60, 215 at 60-1349.

realities of the federal-state court institutional relationships are such that an inhibiting delicacy must be overcome by a federal court before impugning the integrity of the state court proceeding."⁸²

It is questionable whether according state judgments conclusiveness only as evidence of rights and duties as of the time of entry of the judgment would impugn the integrity of the courts rendering them. If by "proceedings" the pleadings, determinations of fact and announcements of law behind a judgment are meant, then to accord the proceedings something less than conclusiveness would be to impugn *their* integrity for federal tax purposes. But the integrity of the rendering court could be considered impugned only if it is assumed that state courts are charged with guarding the federal revenue. The courts' integrity can be impugned only if it is assumed that they have breached or neglected some duty.

Whether the federal treasury is a legitimate concern of the state courts is subject to question. Surely no court should actively and consciously lend its counsel and aid to a scheme to deny the Government its just amount of tax. But, is a state court, in the face of crowded calendars and the many other concerns with which it has been specifically charged, bound to thwart or question, in the interest of a party not represented, what may be legitimate, non-tax-motivated objectives of its litigants?⁸³ If it is not, then to accord its "proceedings" something less than conclusiveness is not to impugn its integrity.

CONCLUSION

The role of state judgments in federal tax cases should be more precisely defined. Their role should be limited to that of conclusive evidence of rights and duties as of the time of their entry and presumptive evidence of the factual and legal determinations upon which they are based.

If state judgments are viewed only as evidence, of the qualities indicated above, the tax issue will be more carefully sought out and analyzed before the search for evidence begins. When treated as evidence, their relevance to the issue can better be tested. And surely, the application of relevant evidence to the real tax issue can only lead to better and more efficient tax administration.

82. Oliver, *The Compulsive Effect of State Law in Federal Tax Proceedings*, 41 CALIF. L. REV. 638, 665 (1953).

83. Query, whether the Secretary of State of a state is bound to inquire, before issuing a certificate of incorporation, if a primary purpose of the applicants in securing it is to evade or avoid a part of the federal tax. Query, also, whether his integrity is impugned if the corporation is subsequently denied a surtax exemption pursuant to INT. REV. CODE of 1954, § 1551.