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3. "Allegedly restrictive policies governing admission to membership," specifically, the exclusion of mutual funds.⁴³

While this is by no means an exhaustive list of problem areas, it should serve to emphasize Mr. Cohen's point that congressional action is needed to achieve a balance between the antitrust policy of insuring free and unrestrained competition and the Exchange Act policy of self-regulation.

CHARLES E. ELROD, JR.

Taxation—Effect of State Court Adjudications in Federal Tax Litigation

From at least as early as the Supreme Court decision in *Freuler v. Helvering*¹ there has been great uncertainty and even conflict among the lower federal courts as to the extent to which those courts, when making determinations of federal tax liability, should be bound by lower state court adjudications of property rights. In *Freuler* the Commissioner of Internal Revenue argued that any state property decision reached in a collusive proceeding be denied conclusiveness in regard to federal tax liability. The Commissioner defined a collusive proceeding as one in which "all the parties joined in a submission of the issues and sought a decision which would adversely affect the Government's right to additional . . . tax."² The Court neither accepted nor rejected the Commissioner's proposed test for collusiveness and decided for the taxpayer by upholding the state decision because of the presence of certain circumstances which the Court apparently deemed to be controlling.³ By basing its decision on those circumstances, the Court gave little guidance to lower courts in the way of general principles to be followed, and its

⁴³ Wall Street Journal, March 26, 1965, p. 3, col. 1.

¹ 291 U.S. 35 (1934).

² *Id.* at 45.

³ The circumstances were that the case appears to have been initiated by the filing of a trustee's account, in the usual way. 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.

Id. at 45.

decision has been criticized for that reason and for being one on the facts only.⁴

An example of how this problem manifests itself can be seen in the recent case of *Commissioner v. Bosch*,⁵ where the United States Court of Appeals for the Second Circuit held a lower state court decree to be an authoritative determination of the property rights involved for federal estate tax purposes, even though the decree was rendered in a proceeding which was clearly nonadversary and which was brought at least partly for the purpose of affecting federal estate tax liability. In 1930 Mr. Bosch had created a trust that granted the income to his wife for life with the remainder to the settlor or his estate and reserved the right to revoke, alter or amend. The trust was never revoked and the only alteration occurred in 1931, when Mr. Bosch gave his wife a general power to appoint the remainder by will. However, in order to prevent inclusion of the trust corpus in her gross estate, Mrs. Bosch in 1951 executed an instrument in which she purported to convert her general power of appointment into a special one.⁶ Upon Mr. Bosch's death in 1957, his executor claimed the marital deduction in the amount of the value of the trust. The Commissioner asserted a deficiency in that amount, relying on Mrs. Bosch's release of her power of appointment. The executor, who was also trustee of the trust, then filed in the Tax Court for a redetermination of the deficiency. While action there was pending, the executor brought suit in the New York Supreme Court for a settlement of his account as trustee and for a determination of the validity of Mrs. Bosch's release of part of her power of appointment. It was conceded that the state proceeding was instituted "at least in part for the purpose of affecting the outcome" of the case pending in Tax Court.⁷ The issue in the lower state court was whether the release executed by Mrs. Bosch was effective. Three briefs were filed there, one for Mrs. Bosch, one for the trustee, and the third by a guardian *ad litem* for a minor who was a possible beneficiary if Mrs. Bosch died without exercising her power of appointment. All three briefs argued that the release was a nullity, and no argument to the con-

⁴ See Comment, 30 U. CHI. L. REV. 569, 570 (1963).

⁵ P-H EST. & GIFT TAXES (18 Am. Fed. Tax R.2d) ¶ 147,003 (2d Cir. July 6, 1966).

⁶ *Id.* at 147, 406 n.2.

⁷ *Id.* at 147, 407.

trary was presented. The New York court held that the purported release by Mrs. Bosch was a nullity.⁸

The Tax Court, while saying that it was unnecessary for it to rule that it was bound by the lower decision, nevertheless accepted the New York ruling "as an authoritative exposition of New York law and adjudication of the property rights involved," and in so doing prevented the Commissioner from relitigating the property issue.⁹ The Tax Court's reasoning was that the New York court had jurisdiction over the parties and subject matter of the state proceeding and its judgment was final and conclusive as to those parties; that although the Supreme Court of New York is a trial court, its decisions represent legal precedent for courts throughout the state; that the Commissioner was fully aware of the state proceeding and could have sought the opportunity to present his views there; that the New York court rendered a reasoned opinion and reached a deliberate conclusion;¹⁰ and that there appeared to be a good chance that Mrs. Bosch would exercise her power of appointment and work an inclusion of the trust corpus in her own estate.¹¹ In affirming, the Second Circuit generally accepted the reasoning of the Tax Court¹² and cited *Sharp v. Commissioner*,¹³ *Blair v. Com-*

⁸ The reasoning of the court here was that since the power of appointment was testamentary and revocable, it did not come into being until Mr. Bosch died. Since it was not created until his death, it could not possibly have been partially released prior to that time. *Id.* at 147, 407 n.3.

⁹ *Herman J. Bosch*, 43 T.C. 120, 124 (1964).

¹⁰ The court added that "although, in our judgment, a more persuasive case could possibly be made out for the opposite result, there do not appear to be any contrary decisions and we cannot with confidence say that the New York court was wrong or that its opinion will not be followed by other New York courts." *Id.* at 124.

¹¹ *Id.* at 123.

¹² The circuit court stated:

The issue is, then, strictly speaking, not whether the federal court is "bound by" the decision of the state tribunal, but whether or not a state tribunal has authoritatively determined the rights under state law of a party to the federal action. . . . An able Tax Court Judge quite explicitly undertook to balance several relevant factors . . . before deciding to accept the New York judgment as authoritative of the rights of the parties. We, too, have considered all of the circumstances and feel that the decision below was correct. We hold that the New York judgment, rendered by a court which had jurisdiction over parties and subject matter, authoritatively settled the rights of the parties, not only for New York, but also for purposes of the application to those rights of the relevant provisions of federal tax law.

P-H EST. & GIFT TAXES ¶ 147,003, at 147,409-10.

¹³ 303 U.S. 624 (1938).

missioner,¹⁴ *Freuler*, and *Gallagher v. Smith*¹⁵ as supporting authorities.

In order to view the problem here in a better perspective, it may be helpful to categorize the cases in this general area of the law. At least one commentator has suggested the use of three separate categories.¹⁶ Included in the first are those cases that do not involve property questions and hold the Treasury is not bound by local adjudications because the requirements of *res judicata* were not fulfilled. Cases in the second category reject local decrees where Congress has imposed its own criteria of taxability and where again there are no property questions. The third category includes cases that turn on the property rights of the litigants, which rights in turn depend on state law for their determination.¹⁷ The problem presented in *Freuler* and *Bosch* comes within this final category where there are no federal criteria and where, either expressly or by necessary implication, Congress has provided that state law shall determine the owner of the property right to be taxed.¹⁸

Freuler v. Helvering is the leading Supreme Court case that is concerned with the effect of state property decrees on federal tax liability, but, as has been pointed out, *Freuler* provides little guidance for the lower federal courts in the way of definite guidelines to be followed in deciding similar cases. The only addition to *Freuler* by the Supreme Court came in *Blair v. Commissioner*.¹⁹ There the Court held that the decision of the Illinois Appellate Court was final on the issue of whether a spendthrift trust had been created. The Court also said, "Nor is there any basis for a charge that the suit was collusive and the decree inoperative,"²⁰ thereby intimating it would not recognize a decree from a suit it found to be collusive. Here again, though, the Court offered no definite guidelines with

¹⁴ 300 U.S. 5 (1937).

¹⁵ 223 F.2d 218 (3d Cir. 1955).

¹⁶ 1 PAUL, FEDERAL ESTATE AND GIFT TAXATION 76 (1942); see also Braverman & Gerson, *The Conclusiveness of State Court Decrees in Federal Tax Litigation*, 17 TAX L. REV. 545, 547 (1962) [hereinafter cited as Braverman & Gerson].

¹⁷ "State law creates legal interests and rights. The federal revenue acts designate what interests or rights, so created, shall be taxed." *Morgan v. Commissioner*, 309 U.S. 78, 80 (1940).

¹⁸ "State law may control only when the federal taxing act, by express language or necessary implication, makes its own operation dependent upon state law." *Burnet v. Harmel*, 287 U.S. 103, 110 (1932).

¹⁹ 300 U.S. 5 (1937).

²⁰ *Id.* at 10.

which the lower courts can operate. As a result, there are vastly differing views among the lower federal courts as to what constitutes collusion and as to which circumstances will be determinative in a particular case.

In deciding *Bosch*, the Second Circuit has apparently adopted the view taken by the Third Circuit in its leading case of *Gallagher v. Smith*,²¹ which has been consistently followed in that circuit.²² In *Gallagher* the court held that the federal courts were bound by a decree of a county court as to what the taxpayer's interest was under a will. This result was reached despite the fact that the proceedings were of a nonadversary nature.²³ The court gave substantial weight to the fact that the local decree was conclusive as to the litigant's property rights, apparently feeling that there should be no tax on something not owned under local property law.²⁴ The Third Circuit rule, then, is that determinations of property issues by lower state courts will be given conclusive effect in determining federal tax liability unless the state proceeding is shown to have been collusive. Although this circuit has not ruled on what, if anything short of fraud, actually constitutes collusion, it has clearly stated that mere nonadverseness of the parties in the state proceeding will not alone be sufficient to warrant a finding of collusion.²⁵ Therefore, it seems apparent that, in order for the Commissioner to re-litigate a property issue for tax purposes in the Third Circuit, he will have to show some form of conduct by the litigants in the state proceeding that is actually improper. It appears that both the Sixth and Ninth Circuits are now leaning toward, if not following, the position taken by the Third Circuit in *Gallagher*.²⁶

²¹ 223 F.2d 218 (3d Cir. 1955).

²² See, e.g., *Darlington v. Commissioner*, 302 F.2d 693 (3d Cir. 1962); *Beecher v. United States*, 280 F.2d 202 (3d Cir. 1960); *Babcock v. Commissioner*, 234 F.2d 837 (3d Cir. 1956).

²³ 223 F.2d at 220-21.

²⁴ *Id.* at 223, 225.

²⁵ *Id.* at 225.

²⁶ In *Nashville Trust Co. v. Commissioner*, 136 F.2d 148 (6th Cir. 1943), the question was whether certain claims against the estate were deductible for federal estate tax purposes. The local chancery court's decree was that certain legacies were based on valuable consideration and were not gifts, and therefore qualified for the deduction. This decree was based on "depositions which were in no way controverted," yet it was nevertheless held to be binding on the Tax Court. A more recent case is *Old Kent Bank & Trust Co. v. United States*, 232 F. Supp. 970 (W.D. Mich. 1964), in which a local probate court's construction of a will was held to be conclusive in determining federal estate tax liability. Here there was "no active contest

While the rule adopted by the Third Circuit may well be the easiest to apply to any given case, it does not appear to be the best. Much of the rationale behind it seems to be found in the hesitancy of some federal courts to impose tax liability on property rights not actually owned by the taxpayer under state law. Another reason frequently mentioned is the failure of the Commissioner to intervene in the state proceeding and present his point of view there. Still another is that the state court has peculiar knowledge of the local law and its judgment on local matters must be respected.²⁷ After all, it is argued that all state judges cannot be assumed to be "mere puppets in the hands of litigants."²⁸ Judge Friendly rebuts this line of reasoning in his dissent²⁹ in *Bosch* on the grounds that the view taken by the majority needlessly handicaps the Commissioner in the fair and equal enforcement of the federal revenue laws, that the state court might have reached the opposite result had the opposing view been fairly presented,³⁰ that the state proceeding had

regarding the construction of the decedent's will, but the consents were given by persons whose financial interests were adverse to those of the widow." *Id.* at 978. In the Ninth Circuit two earlier cases had held that "an order of a state court that adversely affects the tax right of the United States and which is based upon a nonadversary proceeding does not foreclose the federal courts from determining the tax liability." *Wolfsen v. Smyth*, 223 F.2d 111, 113-14 (9th Cir. 1955), *Newman v. Commissioner*, 222 F.2d 131, 136 (9th Cir. 1955). However, this position was modified in *Flitcroft v. Commissioner*, 328 F.2d 449 (9th Cir. 1964), in which the court said that where the only apparent reason for a state decision was its effect on federal taxation, then this alone would not be enough to prove collusion. The court distinguished its two earlier holdings by maintaining that in both cases the state decision "was in fact collusive, was erroneous, and was obtained without notice to the federal tax authorities." *Id.* at 458.

²⁷ Colowick, *The Binding Effect of a State Court's Decision in a Subsequent Federal Income Tax Case*, 12 TAX L. REV. 213, 217 (1957).

²⁸ 10 MERTENS, LAW OF FEDERAL INCOME TAXATION § 61.03, at 8 (1964).

²⁹ P-H EST. & GIFT TAXES ¶ 147,003, at 147,410.

³⁰ The controlling statute was N.Y. REAL PROPERTY LAW § 183 which provided:

"Any power which is exercisable by deed, by will, by deed or will, or otherwise, whether general or special, other than a power in trust which is imperative, is releasable . . . with respect to the whole or any part of the property subject to such power and may also be released in such manner as to reduce or limit the persons or objects, or classes of persons or objects, in whose favor such power would otherwise be exercisable."

Judge Friendly pointed out that what appears to be the only New York case raising the problem in a truly adversary context held that the contingent nature of a power of appointment . . . did not prevent release under § 183, *In re Woodcock's Will*, 19 Misc. 2d 268, 186 N.Y.2d 447, 450 (Surr. Ct. Westchester Co. 1959) The sole relevant authority, *In re Woodcock's*

no significant purpose other than the reduction of tax liability, and that it is standard policy of the Internal Revenue Service not to intervene in such suits because of insufficient staff, unfamiliarity with state procedures, and lack of standing to intervene and appeal without conceding the conclusiveness of the state proceeding which the Commissioner disputes.³¹ In addition to Judge Friendly's reasons, it is difficult to understand why these federal courts wish to protect the taxpayer who goes to state court with the principal purpose of reducing his federal tax liability. If the state decree is a fair and correct application of state law, the taxpayer should have nothing to fear from defending his position against that taken by the Commissioner. Since tax liability in this category depends on local property rights, it is only equitable that the Government's point of view be presented when those property rights are adjudicated.³² In view of the present impracticability of the Commissioner's intervening in state court, the only feasible result is that he be given his day in federal court. Besides, it is too much to assume that the local judge will consider the Commissioner's arguments when no one has presented them to the court.³³

Although the decisions of the remaining circuit courts lack needed certainty and tend to be confined to their facts, most of them have been kinder to the Commissioner's viewpoint. As a general proposition, the Fourth, Fifth, Seventh, Eighth, and Tenth Circuits will deny conclusive effect to a state decree that was rendered in a proceeding that was nonadversary or collusive.³⁴ The problem here is in ascribing definitive meaning to "nonadversary"

Will, . . . was not cited, and the legislative purpose behind § 183 was not explored.

P-H EST. & GIFT TAXES ¶ 147,003, at 147,412-13.

³¹ P-H EST. & GIFT TAXES ¶ 147,003, at 147, 413 n.6.

³² Comment, 30 U. CHI. L. REV. 569, 575-76.

³³ *Id.* at 578-79.

³⁴ *Pierpont v. Commissioner*, 336 F.2d 227 (4th Cir. 1964); *Peyton v. Commissioner*, 323 F.2d 438 (8th Cir. 1963); *Faulkerson v. United States*, 301 F.2d 231 (7th Cir. 1962); *Stallworth v. Commissioner*, 260 F.2d 760 (5th Cir. 1958); *In re Sweet v. Commissioner*, 234 F.2d 401 (10th Cir. 1956); *Pitts v. Hamrick*, 228 F.2d 486 (4th Cir. 1955); *Saulsbury v. United States*, 199 F.2d 578 (5th Cir. 1952); *Brainard v. Commissioner*, 91 F.2d 880 (7th Cir. 1937); *Farish v. United States*, 233 F. Supp. 220 (S.D. Tex. 1964). The question appears to be an open one in the First Circuit. *Third Nat'l Bank & Trust Co. v. United States*, 228 F.2d 772 (1st Cir. 1956); *Channing v. Hassett*, 200 F.2d 514 (1st Cir. 1952); *Plunkett v. Commissioner*, 118 F.2d 644 (1st Cir. 1941); *Old Colony Trust Co. v. United States*, 165 F. Supp. 669 (D. Mass. 1958).

and "collusive." These circuit courts have attempted to do so by denoting certain circumstances that prompt the courts to hold a state proceeding to be nonadversary or collusive when they are present in a given case. For example, in *Pierpont v. Commissioner*,³⁵ the Fourth Circuit found that the petition upon which the decree in the lower court³⁶ was based was uncontested and its only apparent purpose was to obtain a tax advantage, that the examiner-master failed to make an independent inquiry of the state law involved, and that the lower court failed to do any more than to rubber stamp the examiner-master's report. On these circumstances the court found that the state decree was obtained in a proceeding that was both nonadversary and collusive.³⁷ Circumstances prompting the Seven Circuit Court of Appeals to find a state proceeding nonadversary and non-controlling have been an *ex parte* proceeding or a proceeding without notice to anyone, without appearances and without a hearing on the merits.³⁸ Conversely, that circuit has described a "proper" case as one which is "adversary and not *ex parte* . . . where a hearing was had on the merits . . . where the question of law has been settled by the appellate courts of the state or where the judgment of an intermediate court may be fairly accepted as evidencing the law of the state . . . and where the judgment is not collusive. . . ."³⁹ In *Peyton v. Commissioner*,⁴⁰ the Eighth Circuit found the local decree to have been collusively obtained on these circumstances: the state court proceeding was conducted in a nonadversary atmosphere, there was no notice to federal tax authorities, there was no real opposition to the advocated fee simple, and the circuit court was persuaded that the state court was wrong in its determination of state law.

³⁵ 336 F.2d 277 (4th Cir. 1964).

³⁶ Circuit Court of Baltimore City.

³⁷ The court adopted the definition of collusion that was submitted by the Government in *Freuler*, that "all the parties joined in a submission of the issues and sought a decision which would adversely affect the Government's right to additional . . . tax." In *Pitts v. Hamrick*, 228 F.2d 486 (4th Cir. 1955) the court accepted the decree of a South Carolina probate court as "evidencing the law of the state," especially since there was "no showing that it was entered as result of collusion or fraud or in a nonadversary proceeding." *Id.* at 490.

³⁸ *Faulkerson v. United States*, 301 F.2d 231, 232 (7th Cir. 1962).

³⁹ *Id.* at 233. The court defined "collusive" as "in the sense that a decision was sought which would adversely affect the Government's right to additional estate tax." *Id.* at 232.

⁴⁰ 323 F.2d 438 (8th Cir. 1963).

Various suggestions have been made on how to reconcile the differing views among the circuit courts.⁴¹ An obvious answer would be for the Supreme Court to grant certiorari in order to clarify what was said in *Freuler* and *Blair* and to pronounce definite guidelines to be used by the lower federal courts in dealing with present and future situations such as are found in *Bosch*. However, in view of the Court's refusal to grant certiorari in the past and in consideration of the fact that no legislative solution appears imminent, it is suggested that the circuit courts attempt to clarify their own rules and guidelines. Because the Fourth, Fifth, Seventh, Eighth, and Tenth Circuits tend to decide each case on its circumstances without giving weight to any particular circumstances, it is difficult to predict how these circuit courts would rule in any particular case. Still, their view, taken generally, is better than that of the Third Circuit because of reasons already mentioned and because of the need to strive for greater uniformity in federal taxation.⁴² What they need is greater certainty in their general rules regarding non-adversary and collusive proceedings. This can be done by ascribing controlling weight to the presence or absence of one or more particular circumstances. For example, one solution would be to give the state court adjudication little or no weight when the Commissioner's argument has not been fairly presented,⁴³ thus allowing him to relitigate the property issue in federal court. Out of respect for the state court, its proceeding would be presumed to have been regular, and the Commissioner would have the burden of proving that its decision on the property issue was incorrect for purposes of federal taxation.⁴⁴

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⁴¹ See Cahn, *Local Law in Federal Taxation*, 52 YALE L.J. 799, 819 (1943); Stephens & Freeland, *The Role of Local Law and Local Adjudications in Federal Tax Controversies*, 46 MINN. L. REV. 223, 251 (1961).

⁴² As early as 1796 the Supreme Court announced that "the articles taxed in one state should be taxed in another . . ." *Hylton v. United States*, 3 U.S. (3 Dall.) 171, 180 (1796). A transfer or property right federally taxed in state X should not be tax free in state Y just because of the label pinned on it by the latter state. Consider the following hypothetical example from Oliver, *The Nature of the Compulsive Effect of State Law in Federal Tax Proceedings*, 41 CALIF. L. REV. 638, 658 n.93 (1953): "What if a state legislature provides that any power of appointment may be renounced or disclaimed by the donee any time prior to exercise in his favor and that a non-exercised power shall be deemed to have been disclaimed or to have been renounced, rather than lapsed or released?"

⁴³ P-H EST. & GIFT TAXES ¶ 147,003, at 147,411.

⁴⁴ Other suggestions include the following: "Whenever all parties to the

state court proceeding approve and have never opposed the proffered result, and the decree embodying it appears to serve no purpose other than to avoid federal taxation, the decree should not be regarded as determinative of the state law property rights purportedly adjudicated." *Braverman & Gerson* 576. "If a taxpayer, intending to avoid tax liability, institutes a state suit, and if no interested party presents the argument urged by the Commissioner, then the state court judgment should be considered to have been collusively obtained." Comment, 30 *U. CHI. L. REV.* 569, 581 (1963).