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INTRODUCTION

Complexity is the price we pay for our cherished federal system of government with its parallel structures of state and federal laws and state and federal courts. Such complexity is nowhere more apparent than in litigation concerning the imposition of federal taxes. Stated broadly, two ever-present problems are: (1) What law controls, state[1] or federal? and (2) What court, state or federal, determines the application of such law? Sometimes these questions are susceptible of easy solution; but at other times, perhaps particularly in cases involving the imposition of federal taxes on estates and trusts, the decided cases offer no certain guide to the correct answers.

The ambitious objective of this discussion is to attempt to bring down to the irreducible minimum the tax uncertainties inherent in our state and federal parallelism. The path of judicial decisions in this area is strewn with red herrings, spurious principles tossed off

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1. If it is decided that state law controls, a further irksome question may be: The law of what state? We do not deal with this conflict of laws problem. For a discussion in this context, see 1 MERTENS, LAW OF FEDERAL GIFT AND ESTATE TAXATION § 10.07 (1959).

as determinative of controversies and sound principles questionably applied. Thus, particularly with regard to the second facet of the problem—what court, state or federal, determines the application of state law—an analysis and synthesis of the cases is not enough; a fresh identification of the principles that should control and a suggestion concerning the way they should be applied seem necessary.

I. THE FEDERAL TAX SIGNIFICANCE OF STATE LAW

The concurrent roles of state and federal law with respect to federal taxation have never been more succinctly expressed than in *Morgan v. Commissioner*,[2] where the court said: "State law creates legal interests and rights. The federal revenue acts designate what interests or rights, so created, shall be taxed."[3] The first part of this observation is accurate, because under our Constitution the great residual lawmaking authority is left with the states. The instances of federal establishment of rights and interests, while numerous and possibly growing,[4] are comparatively only a few threads in the entire fabric of juridical relationships. Quantitatively, the important authorities are the legislative, judicial, and administrative pronouncements at the state level. This is especially true since the repudiation in 1938 of a federal general common law.[5]

Unfortunately, the second part of the *Morgan* dictum—that the federal tax laws designate what locally created interests and rights shall be taxed—is an over-simplification and at best a key to doors that are already open. But, even here, the dictum is a forceful reminder that federal taxation is never practiced in a vacuum; it operates within the framework of established commercial and social structures of the community.

The controlling aspect of state law can best be examined by, first, dealing with some settled principles; second, considering in-

2. 309 U.S. 78 (1940).

3. *Id.* at 80.

4. Successful private litigation under the federal securities laws may be working toward a federalization of corporate law, at least with respect to corporations subject to such laws. See 2 LOSS, SECURITIES REGULATION 931–1036 (2d ed. 1961), discussing private litigation under § 14 of the Securities Act of 1934, 48 Stat. 881 (1934), 15 U.S.C. § 78n (1958), and Regulation X–14 thereunder, and 3 Loss, *op. cit. supra* at 1757–1805, discussing private litigation under § 10(b) of the Securities Act of 1934 and Rule 10b–5 thereunder.

5. Erie R.R. v. Tompkins, 304 U.S. 64, 78 (1938):

> There is no federal general common law. Congress has no power to declare substantive rules of common law applicable in a State whether they be local in their nature or "general," be they commercial law or a part of the law of torts. And no clause in the Constitution purports to confer such a power upon the federal courts.

stances of express reference to state law in the taxing statutes; third, appraising the possibility of implied reference to state law; and, finally, exploring a penumbra in which judicial action, seemingly sound, is difficult to square with established doctrine. This approach will lead us from the relatively simple to the more complex problems in this area and serve as a basis for discussion later of the effect of prior adjudication in the state courts.

A. SETTLED PRINCIPLES

It may be said at the outset that any reference to legal interests and rights created by state law, possibly affecting federal tax liability, is a reference to matters of substance and not to mere form, labels, or nomenclature. The Supreme Court emphasized this in the *Morgan* case,[6] saying: "If it is found in a given case that an interest or right created by local law was the object intended to be taxed, the federal law must prevail no matter what name is given to the interest or right by state law."[7] Thus, locally created relationships may be significant but not local characterization. It should quickly be added, however, that a disregard of the local label in favor of the substantive rights created may work to the taxpayer's benefit, as in *Lyeth v. Hoey*.[8] In that case, this settled proposition was invoked, two years before the *Morgan* decision, to exclude from gross income an amount received by an heir under a settlement of a will contest.

In the *Lyeth* case, the Court had to decide whether an amount received by the taxpayer upon settlement of a suit contesting the validity of his grandmother's will was taxable or was excluded from gross income as an amount received by "inheritance."[9] For state death tax purposes, Massachusetts did not consider amounts received upon such settlements to be acquired by inheritance. However, the Supreme Court rested its decision in favor of the exclusion on the substance of the taxpayer's interest created by state law, not the descriptive terms used in Massachusetts to identify such interest, saying:

6. Morgan v. Commissioner, 309 U.S. 78 (1940).

7. *Id.* at 81. See also Starr v. Commissioner, 274 F.2d 294 (9th Cir. 1959). A long-time problem has been the proper tax classification of business organizations. Whatever the difficulties involved in this, it is at least clear that local characterization of an organization as a trust, a partnership, a corporation, or a "hambangerino" is not determinative of its federal tax status. Morrissey v. Commissioner, 296 U.S. 344 (1935); Treas. Reg. § 301.7701–1(c) (1961).

8. 305 U.S. 188 (1938). See also United States v. Kintner, 216 F.2d 418 (9th Cir. 1954).

9. The federal taxing statute has long excluded from gross income amounts received by "inheritance." See INT. REV. CODE OF 1954, § 102.

> Petitioner's status as heir was . . . determined by the law of Massachusetts. . . . But when the contestant is an heir and a valid compromise agreement has been made and there is a distribution to the heir from the decedent's estate accordingly, the question whether what the heir has thus received has been "acquired by inheritance" within the meaning of the federal statute necessarily is a federal question. It is not determined by local characterization.[10]

The *meaning* of a term in a federal statute is always a federal question, even though the *application* of the term to a specific set of facts usually raises questions of relationships locally established. This is a settled principle which, when applicable, renders state law at least in part irrelevant in the decision of a tax controversy. A further clear example is the treatment of the term "gift" in the imposition of federal taxes on transfers of property by gift[11] as raising a question of meaning not governed by local concepts regarding gifts.[12] The principle does no violence to either the tenth amendment or the *Erie* doctrine.

Moreover, the supremacy clause of the United States Constitution[13] nullifies local laws that conflict with valid federal statutes. Thus, a state exemption statute cannot place property beyond the reach of the plenary taxing power of the federal government.[14] Nor can a state statute that frees property from the claims of creditors, generally, preclude the collection of federal taxes from such property, unless Congress chooses to give such effect to the state statute.[15]

B. Express Reference to State Law

It must be conceded that the classification adopted here, while convenient, is not flawless. We have suggested as relatively well settled three basic propositions: (1) that state law may be significant only as regards matters of substance, not form; (2) that interpretation of a federal statutory term raises a federal question; and (3) that the supremacy clause is as applicable here as in any area of the law. None of this, however, is inconsistent with the notion

10. 305 U.S. at 193. *Cf.* De Sylva v. Ballentine, 351 U.S. 570 (1956) concerning the meaning of "children" in the Copyright Act, 61 Stat. 652 (1947); 17 U.S.C. § 1 (1958).

11. Int. Rev. Code of 1954, § 2501(a).

12. Commissioner v. Wemyss, 324 U.S. 303 (1945); Stephens & Marr, The Federal Estate and Gift Taxes 329 (1959).

13. U.S. Const. art. VI.

14. Estate of Faber, 40 B.T.A. 1070 (1939); Treas. Reg. § 20.2033–1(b) (1961).

15. *Compare* Commissioner v. Stern, 357 U.S. 39 (1958), *with* United States v. Bess, 357 U.S. 51 (1958). *Cf.* United States v. Acri, 348 U.S. 211 (1955).

that Congress has wide discretion in adopting or rejecting local law as controlling in federal tax cases. When Congress exercises this discretion directly by express provision in a taxing statute, few problems arise.

In the trust provisions of the 1954 Code when "income" is used without other qualifying words,[16] the term is defined *in the Code* to mean "the amount of income of the estate or trust for the taxable year determined under the terms of the governing instrument and applicable local law."[17] In this and other such circumstances that need not be detailed,[18] there can be no reasonable argument that federal law controls regardless of local legal principles. If, as here, Congress chooses to defer to local law, the tax result, or a part of it as in this example, is determined by local law.

In contrast, Congress can and often does expressly reject local legal concepts for tax purposes. For example, most state corporation laws do not permit the payment of so-called "nimble dividends," dividends paid out of the earnings of an accounting period without regard to the question whether capital is impaired.[19] But Congress subjects to ordinary income rates *as dividends* any distributions out of accumulated *or current* earnings,[20] rendering irrelevant the question whether a distribution could qualify as a dividend under local law. In this instance and numerous others in which local law is rejected, which need not be detailed here,[21] resort to local principles is of course futile. Not only do local concepts, such as dividend restrictions, not control; they have no bearing whatever on the decision of the federal tax controversy.

16. *E.g.*, INT. REV. CODE OF 1954, § 643(b).

17. *Ibid.* This does not mean that local law determines whether amounts received by a trust will be subjected to federal income taxation; the provision bears more on the question whether such amounts will be taxed initially to the trust or to the beneficiaries.

18. *E.g.*, INT. REV. CODE OF 1954, § 2041(a)(3) imposes estate tax liability with respect to certain exercises of powers of appointment, whether general or not, if such powers are exercised "by creating another power of appointment which under the applicable local law can be validly exercised" so as, among other things, to postpone vesting of interests in the trust property for periods not restricted by the date of the creation of the first power.

19. MODEL BUS. CORP. ACT ANN. § 40(a) Para. 2.02 (1960).

20. INT. REV. CODE OF 1954, §§ 301(c), 316(a)(2). The historical explanation for this unusual tax rule, not germane to the present discussion, is presented in BITTKER, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS § 5.03, at 139 n.6 (1959).

21. *E.g.*, INT. REV. CODE OF 1954, § 73(a); Treas. Reg. § 1.73–1(a) (1961): "Compensation for personal services of a child shall, regardless of the provisions of State law relating to who is entitled to the earnings of the child, . . . be deemed to be the gross income of the child and not the gross income of the parent of the child." See also INT. REV. CODE OF 1954, § 482, permitting artificial tax allocations of income and deductions.

Although Congress can go far in subordinating the role of local law in the imposition of federal taxes, there may be some constitutional limits to such congressional authority.[22] In any event, for most purposes congressional rejection of local concepts in favor of expressed federal standards and criteria eliminates the problem with which we are presently concerned.

C. Implicit Reference to State Law

The congressional definitions of the terms "income" and "dividend" described above are clearly express adoptions or rejections of local legal concepts. It must be admitted, however, that the comments made so far concerning what is an "inheritance" and what is a "gift," as those terms are used in the Code, may involve a severe oversimplification. Although no one will quarrel with the proposition that the meaning of a term in a federal statute is a federal question, still it is open to debate whether the terms mentioned connote common law (and therefore state law) notions of inheritances and gifts or whether Congress chose to give such terms a special federal meaning unaffected by local custom and usage. How should such debate be settled? The Supreme Court has supplied a guide: "State law may control only when the federal taxing act, by express language or *necessary implication,* makes its own operation dependent upon state law."[23]

It may well be asked: Why, if state law creates interests and rights and the federal taxing act taxes them, is there not a continuing presumption in favor of a reference to state law? Why limit such reference to instances in which a *necessary* implication is found? The uniformity doctrine is the answer.

Certainly it is reasonable to suppose that when Congress imposes taxes on various transactions and events it intends that persons similarly situated everywhere will be taxed alike. But to the extent that tax liability is made dependent upon the varying legal concepts applied in the several states, such like treatment will probably not follow.[24] If this is kept in mind when the question of "necessary implication" arises, correct answers are likely to be forthcoming, and some seemingly divergent judicial decisions may

22. Sutherland, J., dissenting in Burnet v. Wells, 289 U.S. 670, 684 (1933); *cf.* Hoeper v. Tax Comm'n, 284 U.S. 206 (1931).

23. Burnet v. Harmel, 287 U.S. 103, 110 (1932). (Emphasis added.)

24. *E.g.,* Poe v. Seaborn, 282 U.S. 101 (1930), dividing the income of husband and wife in a community property state for federal tax purposes; See Paul, Selected Studies in Federal Taxation 40 (2d Series 1938). The problem is by no means confined to federal tax controversies. See the divergent views of Harlan, J., writing for the Court, and Douglas, J., concurring, in De Sylva v. Ballentine, 351 U.S. 570 (1956), which arose under the Copyright Act.

be found to be harmonious after all.[25] Some illustrations will aid understanding.

The use of the term "inheritance" in a federal statute, when that term is not specifically defined, does make, by necessary implication, the operation of the statute in part dependent on state law. Only state law purports to establish one's status as heir and the rights one has as such in the estate of another. Since such status and rights *cannot* be established in any other way the *necessary* implication is that Congress referred to state law on these matters. But it is just as clearly *not necessary* to look to state law to see if what one receives as a result of such status and rights is an "inheritance" within the meaning of the Code. Here, the uniformity principle prevails so that persons whose heirship and rights and circumstances of receipt are similar are treated alike without regard to varying local attitudes and terminology.[26]

When Congress taxes "gifts," it would be possible to administer the statute on the basis of what is recognized as a gift locally, but it is not *necessary* to do so. Again, however, local law should be examined to see if there has been a transfer of an interest in property from one to another.[27] If a transfer is found to have occurred, Congress prescribes whether the transfer meets the federal gift concept without regard to varying local classifications.[28]

In *Burnet v. Harmel*,[29] the Supreme Court had to decide whether a bonus payment received by the lessor of oil and gas interests in Texas land, measured by the oil and gas produced, constituted a gain from the sale or exchange of a capital asset or rent. In such a case the shifting of property interests of the parties to the transaction is certainly governed by local law; but in deciding the

25. See KENNEDY, FEDERAL INCOME TAXATION OF TRUSTS AND ESTATES § 1.01 (1948).

26. Lyeth v. Hoey, 305 U.S. 188 (1938).

27. *E.g.*, in Ianthe & Gabrielle Hardenbergh, 17 T.C. 166 (1951), *aff'd*, 198 F.2d 63 (8th Cir. 1952), the Tax Court had to decide whether a renunciation of an intestate interest amounted to a transfer of property so as to constitute a gift for federal gift tax purposes. The Tax Court concluded that it did, because under local law the interest had vested in the one who purported to renounce it. *Accord*, William L. Maxwell, 17 T.C. 1589 (1952). *But cf.* Brown v. Routzahn, 63 F.2d 914 (6th Cir.), *cert. denied*, 290 U.S. 641 (1933), in which the court held there was no transfer in contemplation of death for estate tax purposes, because the interest under a will, which the decedent had renounced, had not vested.

28. But query, whether Congress should provide a special rule for renunciations such as those in the Hardenbergh, Maxwell and Brown cases, note 27 *supra*, regardless of locally identified transfers. See INT. REV. CODE OF 1954, §§ 2041(a)(2), 2514(b) expressly freeing the disclaimer or renunciation of a power of appointment from estate and gift tax consequences without regard to local rules on vesting.

29. 287 U.S. 103 (1932).

case the Fifth Circuit[30] went a step further and misapplied the *Morgan* doctrine to treat the transaction as a sale of property, supporting the taxpayer's contention that the bonus payment was capital gain. The court reached this result on the ground that under Texas law an oil and gas lease constitutes a sale of the oil and gas in place. But is there a *necessary* implication that Congress referred to this facet of Texas law? Hardly. It was in this case that the Supreme Court, reversing the Fifth Circuit, gave clear expression to the doctrine of necessary implication,[31] saying also:

> Here we are concerned only with the meaning and application of a statute enacted by Congress, in the exercise of its plenary power under the Constitution, to tax income. The exertion of that power is not subject to state control. It is the will of Congress which controls, and the expression of its will in legislation, in the absence of language evidencing a different purpose, is to be interpreted so as to give a uniform application to a nationwide scheme of taxation [citing cases].[32]

Is it not both possible (as regards any *necessary* implication) and desirable (as regards *uniformity*) to decide whether such a transaction should be accorded the special tax treatment afforded a sale or exchange of property without regard to the way that Texas views the transaction? The Court held the bonus payments were subject to tax at ordinary income rates.

On the question whether state law controls,[33] there is no inconsistency between the *Harmel* case and *Freuler v. Helvering*.[34] In the *Freuler* case, a trustee had distributed to income beneficiaries the entire income of a trust without reduction for depreciation on the trust res. The tax statute at the time taxed a beneficiary on "that part of the income of the estate or trust . . . which . . . is distributable to such beneficiary," pursuant to the instrument or order governing distribution.[35] A basic question in the tax controversy that ensued was whether the beneficiary was properly taxed on the entire amount distributed, as contended by the Commissioner. The Supreme Court held the taxpayer was liable for tax only on the amount *properly* distributed, which did not include amounts reflecting depreciation on trust property because the question of the amount distributable was a question of local law. This is clearly correct; that is, if tax liability hinges on what is dis-

30. Harmel v. Commissioner, 56 F.2d 153 (5th Cir. 1932).
31. Burnet v. Harmel, 287 U.S. 103, 110 (1932).
32. *Ibid.*
33. The question how state law is determined and applied is reserved for consideration later in this discussion.
34. 291 U.S. 35 (1934).
35. Rev. Act of 1921 § 219, 42 Stat. 246 (1921).

tributable to a beneficiary, there is no federal law that supplies an answer, and the *necessary* implication in the statute is a reference to state law to determine what is distributable. It should be emphasized that the comments here go only to the question whether state law is operative in such circumstances; there is more to say later as to how such law is determined in cases of this sort.[36] If Congress says: "We shall tax you on what you have a right to," the *Morgan* doctrine takes over, the necessary implication is clear, and notions of uniformity do not enter the picture at all.

In *Blair v. Commissioner*,[37] the taxpayer who was the life beneficiary of a testamentary trust assigned to his son and daughter portions of his interest in the trust. The tax controversy developed when the Commissioner asserted that the assignor continued to be liable for tax on all the trust income. A ground for such contention would be the invalidity of the assignments, and the Commissioner asserted that the assignments were invalid because the trust was a spendthrift trust. On this aspect of the case, local law clearly controls; no federal law purports to say what a trust beneficiary can do with his interest and, if tax liability is to depend on the validity of his attempted assignments, the *necessary* implication is a reference to local law. The Supreme Court so held, saying:

> The question of the validity of the assignments is a question of local law. The donor was a resident of Illinois and his disposition of the property in that State was subject to its law. By that law the character of the trust, the nature and extent of the interest of the beneficiary, and the power of the beneficiary to assign that interest in whole or in part, are to be determined.[38]

This is not completely determinative of tax liability in such a setting, however. Two further questions remain: (1) How should it be determined whether local law barred the assignments, or more broadly, what court determines the local law that may control? and (2) Even if the assignments were valid, are there nevertheless federal tax principles under which the assignor can continue to be taxed on all the income, or more broadly, do federal tax principles sometimes simply override seemingly controlling local law? We approach the second question here and the first question in the next part of this article.

36. See "The Determination of Local Law," pp. 234–51 *infra*.
37. 300 U.S. 5 (1937).
38. *Id.* at 9.

D. THE PENUMBRA

When Congress imposes a tax on income without express identification of the taxpayer, it seems almost axiomatic to say that in each instance the one taxed is the one to whom the income belongs. Recalling the *Morgan* doctrine—that state law creates legal interests and rights—we may be tempted too quickly to find, by necessary implication, a reference to state law to determine ownership of the income and so to determine the proper taxpayer. Thus, it comes as something of a shock to find that for tax purposes the question: Whose income is it? is not invariably answered by reference to locally determined right to the income in question, even when Congress has not laid down express rules.

Problems concerning the proper taxpayer[39] are directly traceable to our progressive tax rates.[40] A flat tax rate, at least one not rendered partially progressive by exemptions, would make it largely immaterial who was taxed on an item of income. But progression invites fragmentation of income within family groups which, in turn, poses a threat to the over-all plan and purpose of the taxing statute. The question then comes down to this: In the absence of express congressional direction, how far can and should the federal courts go, in the name of the plan and purpose of the taxing statute, to say to a taxpayer that he is to be taxed on income which under local principles of law is not *his?* The conflicting philosophies are easily identified: Does apparent necessary implication give way to somewhat less apparent over-all congressional purpose?[41] This is not the place for extended treatment of this question, although its close relationship to comments made above compels some brief discussion.

In the celebrated case of *Lucas v. Earl*[42] the Supreme Court side-stepped the question whether the taxpayer had the right to income under local law by boldly interpreting the taxing statute as taxing income to the one who *earned* it. So much for income derived "from labor"; if the earning of, as opposed to the right to, the

39. The "whose income?" question is not the only penumbra problem, *e.g.*, White v. Fitzpatrick, 193 F.2d 398 (2d Cir. 1951), *cert. denied,* 343 U.S. 928 (1952), but it is used for illustrative purposes.

40. See Blum & Kalven, *The Uneasy Case For Progressive Taxation,* 19 U. CHI. L. REV. 417, 431 (1952): "It is . . . progression which is the true father of such distinguished precedents in taxation as *Lucas v. Earl, Corliss v. Bowers, Burnet v. Wells, Poe v. Seaborn, Helvering v. Clifford, Helvering v. Horst,* and *Comm'r v. Culbertson.*" (Citations omitted.)

41. In Doll v. Commissioner, 149 F.2d 239, 242 (8th Cir. 1945), the court raises the question, among others: "whether the purposes of the taxing act would be avoided or defeated by applying the State law."

42. 281 U.S. 111 (1930).

income is the touchstone, who has the right to the income under local law becomes immaterial. This has become a settled principle.[43]

There has been a somewhat parallel development with regard to income "from capital." In general, the one who owns income-producing property is taxed on the income produced, even though he has effectively assigned to another his right to the income.[44] "The fruits are [not to be] attributed to a different tree from that on which they grew."[45] The *statute* does not raise the simple question: Whose income is it? As interpreted, it asks who owns the property that gave rise to the income. This is an unsettled and unsettling principle. For here we are concerned, apparently, with legal interests and rights created by state law—if not rights in the income, at least rights in the property that produced it. And yet the courts have been willing to join the Commissioner in the creation of a *federal tax* concept of property ownership, which sometimes operates in disregard of state law.

Time and experience have conditioned us to many aspects of this matter. It no longer seems strained to say that the owner of property who has effectively assigned the *income* from it to another remains taxable on such income,—that is, to disregard the legal right to the *income* as the basis for imposing the tax.[46] But problems continue to arise in attempting to say whether the assignee is a bare *income* assignee or whether he has become an owner of an interest in the *property* so as to be taxed on the income as his.[47] These are matters of detail; but in some circumstances in which it cannot be denied that the assignee has become an owner of a property interest under local law *and* has an attending right to the *income* from his interest, the courts have still been willing to say that he is not the proper one to pay the tax on such income. *This* is the penumbra.

43. Commissioner v. Culbertson, 337 U.S. 733 (1949); Helvering v. Eubank, 311 U.S. 122 (1940); Doll v. Commissioner, 149 F.2d 239 (8th Cir. 1945); Parkford v. Commissioner, 133 F.2d 249 (9th Cir.), *cert. denied*, 319 U.S. 741 (1943); Rev. Rul. 55-2, 1955-1 CUM. BULL. 211.

44. Helvering v. Horst, 311 U.S. 112 (1940); Galt v. Commissioner, 216 F.2d 41 (7th Cir. 1954); Floyd v. Scofield, 193 F.2d 594 (5th Cir. 1952); United States v. Lynch, 192 F.2d 718 (9th Cir. 1951), *cert. denied*, 343 U.S. 934 (1952); Lum v. Commissioner, 147 F.2d 356 (3d Cir. 1945); Napoleon Palmieri, Jr., 27 T.C. 720 (1957); *cf.* White v. Fitzpatrick, 193 F.2d 398 (2d Cir. 1951).

45. Lucas v. Earl, 281 U.S. 111, 115 (1930).

46. Helvering v. Horst, 311 U.S. 112 (1940).

47. Harrison v. Schaffner, 312 U.S. 579 (1941); United States v. Shafto, 246 F.2d 338 (4th Cir. 1957).

The *Clifford* case[48] is the classic example. If one is the sole beneficiary of an irrevocable short-term trust, all of the income from which is distributable currently or ultimately to him, he certainly has an ownership interest in the property and is the owner of the income under local law. But such arrangements, usually intrafamily, pose a threat to the effective working of a progressive rate structure. From a policy point of view, one cannot seriously quarrel with a desire to defeat such attempts to frustrate the federal tax collector. But even before express statutory language was added to the Code, the courts dealt with this problem by effectively disregarding state law in circumstances in which it might well be argued that the *necessary* implication of the federal act was that state law should control.[49]

As a final word it should be stated that we are dealing with a matter of interpretation of a federal statute, not a question of congressional power. "It is the will of Congress which controls,"[50] subject only to mild constitutional restraint. In the trust area, Congress has now expressly repudiated reference to state law to determine who is the tax owner of trust property. But it remains true, in other areas in which the taxing statute does not purport to be precise, that strong administrative and judicial notions of the plan and purpose of the statute may result in incursions into the necessary implication doctrine[51] expressed in the *Harmel* case.[52]

II. THE DETERMINATION OF LOCAL LAW

The phenomenon discussed in the preceding section—two sets of laws concurrently applicable everywhere in the nation—is a natural consequence of a federal government possessing limited law-making power composed of states with residual powers. As we have seen, both sets of laws *may* bear on the same controversy; if state law controls or affects a federal tax case, it must be determined and

48. Helvering v. Clifford, 309 U.S. 331 (1940).

49. This is why Mr. Justice Roberts, dissenting, castigated the *Clifford* decision as judicial legislation. *Id.* at 338.

50. Burnet v. Harmel, 287 U.S. 103, 110 (1932).

51. See, *e.g.*, the divergent views of the Tax Court and the Court of Appeals. In Estate of Frank K. Sullivan, 10 T.C. 961 (1948), the Tax Court said: "The application of Federal taxing statutes to property interests is not always determined by local law, and the statutory provisions governing the question here are not dependent upon local law." *Id.* at 972. But in Sullivan's Estate v. Commissioner, 175 F.2d 657 (9th Cir. 1949), the court of appeals said: "It has long been established that what constitutes an interest in property held by a person within a state is a matter of state law." *Id.* at 658.

52. 287 U.S. 103 (1932).

applied before the federal question can be decided.[53] But by whom? That is our present question.

Just as state law creates legal interests and rights, so in our system state courts have the final say as to what the state law is.[54] Of the federal courts, only the Supreme Court has jurisdiction to review a state court decision and, then, its appellate power extends only to a review of federal questions.[55] Of course, local issues do arise in cases properly brought in the federal courts. Then, such issues must be decided on the basis of the applicable state statutes and, at least since *Erie*,[56] the state common law.[57] Thus, in a federal tax case, if a local issue is presented the *controversy* must be decided by a federal court, but the *local issue* must be decided in conformance with state law with respect to which the state courts predominate.

The dual system of courts, as opposed to a dual set of laws, is *not* a natural consequence of a federal form of government. Indeed, it would be perfectly possible to have a single court structure, fed-

53. The reverse situation sometimes arises in a non-tax setting. *E.g.*, in Dann v. Studebaker-Packard Corp., 288 F.2d 201 (6th Cir. 1961), a shareholder sued his corporation for a fraud upon the stockholders, resting his claim on proxy irregularities that allegedly violated § 14 of the Federal Securities Exchange Act, 48 Stat. 881 (1934), 15 U.S.C. § 781 (1958). The court held that he had stated a cause of action under the Federal Declaratory Judgments Act, 28 U.S.C. § 2201 (1958), and that the federal court could determine the validity of the proxies, which would "greatly affect the relief which will be available . . . under the local law of Michigan." *Id.* at 214.

54. See West v. American Tel. & Tel. Co., 311 U.S. 223 (1940); Blair v. Commissioner, 300 U.S. 5 (1937); Freuler v. Helvering, 291 U.S. 35 (1934); see also, 1 BARRON & HOLTZOFF, FEDERAL PRACTICE AND PROCEDURE § 8 (Wright Rev. 1960); 1 MOORE, FEDERAL PRACTICE ¶0.307 [1] & [2] (2d ed. 1960).

55. 28 U.S.C. § 1257 (1958); STERN & GRESSMAN, SUPREME COURT PRACTICE ch. III (1950).

56. Erie R.R. v. Tompkins, 304 U.S. 64 (1938).

57. It is sometimes suggested that the *Erie* doctrine applies only in diversity cases. See 1 BARRON & HOLTZOFF, FEDERAL PRACTICE AND PROCEDURE § 8, at 36 (Wright Rev. 1960). But the better view seems not to so limit the doctrine. *Ibid.*, and see BUNN, JURISDICTION AND PRACTICE OF THE COURTS OF THE UNITED STATES 272 (5th ed. 1949); 1 MOORE, FEDERAL PRACTICE ¶0.305, at 3052 (2d ed. 1959); Railroad Comm'n v. Pullman Co., 312 U.S. 496 (1941). However this may be, the need to ascertain the local law, whether based on statutes or decisions, in deciding a federal tax case was recognized before *Erie*, Blair v. Commissioner, 300 U.S. 5 (1937); Freuler v. Helvering, 291 U.S. 35 (1934), and the approach to local law in such cases continues to be the same as in diversity cases. Estate of Spiegel v. Commissioner, 335 U.S. 701 (1949); Morgan v. Commissioner, 309 U.S. 78 (1940).

eral[58] or state (subject to national review),[59] which administered all law, national and local.[60] But, since we do not have such a monolithic judicial system, we are faced with the problems dealt with in this section.

The local issues on which federal tax liability depends may arise for the first time in tax litigation in the federal courts. On the other hand, the issues may have been adjudicated in the state courts in litigation involving the persons whose tax liability is later brought into question. How should the decision-maker in the tax case proceed in each of these situations? To attempt, as we do here, to answer this question may be more a matter of bravado than of bravery. Nevertheless, our attempt proceeds on two fronts. First, we try, without complete success, to mark off a discernible path through the present morass. Second, we offer, timorously, some suggested minor changes that might circumvent the morass.

A. THE MORASS

1. No Local Adjudication

If there has been no decision in the state courts on the rights and interests of the parties in the tax case, unquestionably the federal court *can* decide the local issues in disposing of the tax controversy. When the jurisdiction of either a state court or of a federal court is properly invoked, either court can generally decide matters of state law or of federal law involved in the case, or of both. Still there is an anomaly here. When a state court decides a federal question, a method of review of that question in the federal system is provided.[61] When a federal court decides a state law question, no review in the state courts is available even though the state courts generally have the final say as to such law.

On the other hand, while it is very rarely done, a federal court faced with a state law issue in litigation properly before it *can*, at least if the state concerned provides the necessary judicial machinery, suspend its proceeding pending a determination of the

58. *E.g.*, India. See 1960–1961 THE STATEMAN'S YEARBOOK 150.

59. *E.g.*, Canada & Australia. See 1960–1961 THE STATEMAN'S YEARBOOK 366, 464.

60. In the United States,

> The federal judicial system is based upon the premise that the federal judicial power cannot be entrusted to the state courts but requires a separate organization of federal courts. Doubtless no other arrangement was possible at the time when the federal judicial system was inaugurated, since the states and the federal government were too jealous of each other to tolerate a unitary system.

Radin, *Courts*, IV ENCYC. SOC. SCI. 515, 527 (1931).

61. See note 55 *supra*.

local issue in the state courts.[62] Perhaps it is not clear that this option exists. In the *Spiegel* case,[63] Mr. Justice Black speaking for the majority said: "The record reveals that the state law problem here is not an easy one, but under this Court's decision in *Meredith v. Winter Haven,* 320 U.S. 228, the difficulty involved did not relieve the Court of Appeals of its duty to make a decision."[64]

Conflicting expressions in the opinions concerning the option of the federal court to refer a state issue to the state courts leave open the question whether a federal court *should* interrupt a tax case to await settlement of a local issue locally. We think it usually should not.

Notwithstanding state-federal jealousies, federal judges are competent to decide state law issues. Under our advocacy system, a judge's personal knowledge of the law may be less important than his judicial temperament and whether those who appear as counsel before him have done a competent job. Even so, many federal district court judges have been appointed to the bench from the bar of the state in which they sit. Moreover, their physical presence in the state gives them the kind of local orientation that state judges have. We suggest later a different view concerning Court of Claims and Tax Court judges who have less connection with local matters, but there may be other reasons in favor of disposition of the local issues in the tax proceeding that often override such judges' lack of local orientation.

Perhaps a stronger reason for rejecting the appealing notion of a reference to the state courts is the need to simplify litigation. Such a reference would make two law suits out of one, and the sensible trend in many areas of the law looks toward the elimination of such multiplicity.[65] Furthermore, if the trial court judge in the tax

62. Spector Motor Co. v. McLaughlin, 323 U.S. 101 (1944); see Frankfurter, J., dissenting, in Estate of Spiegel v. Commissioner, 335 U.S. 701 (1949), *sub nom.* Commissioner v. Estate of Church, 335 U.S. 632, 673 (1949).

63. Estate of Spiegel v. Commissioner, 335 U.S. 701 (1949).

64. 335 U.S. at 707. *But see* City of Meridian v. Southern Bell Tel. & Tel. Co., 358 U.S. 639 (1959), involving the validity of a state statute under both state and federal constitutions.

65. *E.g.,* the development of the doctrine of pendent jurisdiction of the federal courts. Hurn v. Oursler, 289 U.S. 238 (1933); see Loss, *The SEC Proxy Rules and State Law,* 73 HARV. L. REV. 1249, 1284 (1960). The development of the equity courts, and the widespread merger of law and equity have been prompted by similar considerations. See Lord Mfg. Co. v. Stimson, 73 F. Supp. 984, 989 (D.D.C. 1947):

> If there was any advantage or disadvantage in the old separation between the equity court and the court of law, it has been wiped out by the elimination of the difference in the federal system. . . . Every practical consideration supports the disposition of the controversy in a single proceeding rather than in a multiplicity of suits.

case does decide the local issues, it would seem very questionable for an appellate court to remand for reference to the state court. If such reference is not required by law, or even if it were, a litigant might well feel aggrieved and generally hostile to our judicial system to be told at an advanced appellate stage that he must go back and start over.[66]

Still, especially when the local issue may be one of first impression in the state, or when local decisions in other cases leave the law quite unsettled, the temptation is strong to defer to the acknowledged expert; and the lack of opportunity for state court review of the federal court's decision of the local issue gives further pause. In a tax case hinging on whether a decedent had at death a reversionary interest in property, Mr. Justice Frankfurter, even at the Supreme Court stage, urged a reference to the Illinois courts in the name of "common sense"; saying: "If tax liability is to hang by a gossamer thread, the Court ought to be sure that the thread is there."[67]

Support for Mr. Justice Frankfurter's view can be found in cases in which subsequent state litigation has shown that the decision-maker in the tax case has made a wrong guess on the state law issue. The case of *May Chandler Goodan*[68] is illustrative. It presented a question whether stock dividends received by a trust were taxable to the trust or to its income beneficiaries. Among other things, the Commissioner rested his assertion of tax liability to the beneficiaries on the proposition that under California law the trust was revocable. The Tax Court decided this local law issue against the Commissioner on the basis of *Bixby v. California Trust Company*,[69] an analogous case involving different parties which had just been decided by the California District Court of Appeals. But before the tax case appeal was perfected in the Ninth Circuit, the California Supreme Court reversed *Bixby*,[70] and the Tax Court vacated its judgment. To be sure, the Tax Court found other grounds to support the decision it had originally reached, and its

66. In Spector Motor Service v. O'Connor, 340 U.S. 602 (1951), the litigation had worked up through the district court and the court of appeals only to be remanded to the district court pending proceedings to be brought in a Connecticut court. When the case again came to the Supreme Court, Mr. Justice Clark, dissenting, pointed out: "It has taken eight years and eight courts to bring this battered litigation to an end." *Id.* at 614.

67. Frankfurter, J., dissenting in Estate of Spiegel v. Commissioner, 335 U.S. 701 (1949), *sub nom.* Commissioner v. Estate of Church, 335 U.S. 632, 673 (1949).

68. 12 T.C. 817 (1949), *aff'd per curiam*, 195 F.2d 498 (9th Cir. 1952).

69. 190 P.2d 321 (Cal. Dist. Ct. App. 1948).

70. Bixby v. California Trust Co., 33 Cal. 2d 495, 202 P.2d 1018 (1949).

final decision was sustained by the court of appeals,[71] but Judge Fee wrote a blistering dissent contending that the whole matter was proof that "local law should be left to the local courts . . . ."[72]

In some circumstances, however, the state courts may not provide the machinery for decision of the local issues that arise in the tax case.[73] Moreover, if we assume general competence on the part of federal judges (not as superior to state judges but as experienced decision-makers), the simplification of litigation accomplished by having *all* the issues decided in the tax tribunal seems an adequate answer to some admitted difficulties that arise. In any event, the "common sense" reference suggestion of Mr. Justice Frankfurter has not gained acceptance and, subject to some qualifications suggested below, the present status of the law in this respect should not be disturbed.

The preceding discussion indicates an inescapable conflict between two strong policies: (1) simplification in the administration of justice and (2) local determination of local controversies. While we take the position that the simplification policy should generally prevail, the problem is certainly not one susceptible of categorical answer. We suggest that the practice of deciding local issues in the tax tribunal should be the invariable rule only in tax cases arising in the district courts. Since such courts have both general jurisdiction and local orientation and, indeed, may often be required to decide local issues under their "diversity" jurisdiction, we see no reason why they should not always proceed to decide *all* the issues in a tax case. However, neither the Tax Court nor the Court of Claims, the other courts of original jurisdiction in tax cases, has either general jurisdiction or local orientation. In tax cases arising in these courts, there are stronger reasons for a reference of state issues to the state courts.[74] We feel that the Tax Court and Court of Claims should be recognized as having *final* discretion to decide whether to refer the local issues, when possible, but that their dis-

71. May Chandler Goodan, 8 CCH TAX CT. MEM. 1119 (1949), *aff'd per curiam*, 195 F.2d 498 (9th Cir. 1952).

72. *Id.* at 500. For a discussion of recent Supreme Court decisions involving the application of the federal court abstention doctrine in non-tax cases, see Kurland, *Toward a Cooperative Judicial Federalism*, 24 F.R.D. 481 (1960).

73. In a recent estate tax case the court refers to the refusal of a state court to construe a will on the ground that such construction should be undertaken by the court deciding the tax controversy. United States v. Merchants Nat'l Bank, 261 F.2d 570, 576 (5th Cir. 1958), citing State v. Merchants Nat'l Bank, 265 Ala. 375, 91 So. 2d 480 (1956).

74. See Fee, J., dissenting in Commissioner v. Goodan, 195 F.2d 498, 500 (9th Cir. 1952).

cretion to do so should be exercised with *restraint* in the light of the policy in favor of simplification.

The *finality* suggestion is made in the light of the thought expressed above that a person may legitimately feel aggrieved to be told at an advanced appellate stage in litigation that he must go back and start over, when this is not absolutely necessary. A related thought is that a taxpayer who has *lost* his tax case in the trial court, and who therefore might *wish* to start again, should not be accorded an opportunity to engage in forum shopping by way of urging the appellate court to remand for reference of the local issues to the state courts.[75]

As regards the *restraint* to be exercised by the Tax Court and the Court of Claims, neither court shows any particular reluctance to decide local issues,[76] and the restraint urged may accord with present practice. If a suggestion is to be made as to when such courts should seriously consider local reference, it might be done on the basis of the question whether the local issue presents a difficult question of law or only a question, difficult or otherwise, of fact. The approach might be: law sometimes, fact never. We fully recognize that issues often cannot be so conveniently classified and that the court may be faced at best with a mixed question of law *and* fact.[77] Nevertheless, if the relevant local doctrine is not well established,[78] should the Tax Court or the Court of Claims pretend to "find" the law or undertake otherwise to participate in the shaping of the law of a state? As a minimum, identification of local doctrinal confusion should be a factor weighing heavily in favor of local reference by the Tax Court and the Court of Claims, when that is possible.

75. *E.g.*, Estate of Spiegel v. Commissioner, 335 U.S. 701 (1949). Curiously, a recent piece of state legislation that permits certification of local law questions to a state supreme court authorizes such reference only by the federal *appellate* courts. FLA. STAT. ch. 25, § 25.031 (1959); FLA. APP. RULES 4.61 (Supp. Mar. 1961). Such certification at an advanced stage in the tax litigation seems undesirable.

76. Martin v. United States, 121 Ct. Cl. 829 (1952); May Chandler Goodan, 12 T.C. 817 (1949), *reinstated*, 8 CCH TAX CT. MEM. 1119 (1949), *aff'd per curiam*, 195 F.2d 498 (9th Cir. 1952).

77. Dobson v. Commissioner, 320 U.S. 489 (1943); see Paul, *Dobson v. Commissioner: The Strange Ways of Law and Fact*, 57 HARV. L. REV. 753 (1944). There may be uncertainty whether local law itself may be viewed as raising a question of fact, Cahn, *Local Law in Federal Taxation*, 52 YALE L.J. 799, 815 (1943), and if so we may wonder whether to differentiate "fact-fact" from "law-fact," Oliver, *Federal Tax Significance of State Law*, 1953 So. CAL. TAX INST. 483, 486 n.11. Neither thought lends much assurance to a state court reference policy based on the law and fact dichotomy.

78. *E.g.*, Goodan v. Commissioner, 195 F.2d 498 (9th Cir. 1952).

If in a tax case the trial court (1) holds that local law affects or controls the tax controversy and (2) undertakes to decide the local issues, both matters are subject to review by the federal appellate courts. The first point is a pure federal question with respect to which the scope of review is and should be unlimited.[79] As regards the second point, the courts of appeals and the Supreme Court should often rely on the lower federal courts' decisions. This is the current attitude of the appellate courts. The Supreme Court has said: "If reasonably avoidable we should certainly avoid becoming a Court of first instance for the determination of the varied rules of local law prevailing in the forty-eight states."[80] And the courts of appeals are inclined to defer to the district courts on such issues.[81] This is supportable on the basis of usual lack of local orientation in the case of the courts of appeals[82] and the Supreme Court as compared to the district courts. But the reason does not extend to the Tax Court[83] or the Court of Claims.

Thus, with respect to review of the decision of state law issues in federal tax cases, the following conclusions are indicated: (1) The decision of a district court should rarely be disturbed by the appellate courts; (2) The decision of the Tax Court should be fully reviewed by the courts of appeals[84] but, in such cases, the

79. Blair v. Commissioner, 300 U.S. 5 (1937); Lyeth v. Hoey, 305 U.S. 188 (1938).

80. Helvering v. Stuart, 317 U.S. 154, 164 (1942). See also Huddleston v. Dwyer, 322 U.S. 232, 237 (1944): "The decision of the highest court of a state on matters of state law are [sic] in general conclusive upon us, and ordinarily we accept and therefore do not review, save in exceptional cases, the considered determination of questions of state law by the intermediate federal appellate courts. . . ." See also MacGregor v. State Mut. Assur. Co., 315 U.S. 280, 281 (1942), in which the Court deferred to a Michigan law decision by "a Michigan federal judge of long experience and by three circuit judges whose circuit includes Michigan."

81. *E.g.*, Kasper v. Kellar, 217 F.2d 744 (8th Cir. 1954), *on remand*, 138 F. Supp. 738 (W.D. S. Dak. 1956) (estate tax); *In re* Glassman, 262 F.2d 857 (6th Cir. 1958) (bankruptcy); Woodhull v. Minot Clinic, 259 F.2d 676 (8th Cir. 1958) (rescission for stock fraud); 1 BARRON & HOLTZOFF, FEDERAL PRACTICE AND PROCEDURE § 8, at 42 (Wright Rev. 1960).

82. *But see* Estate of Spiegel v. Commissioner, 335 U.S. 701, 707–08 (1949): "The . . . ruling was made by three judges who are constantly required to pass upon Illinois law questions. One of the three judges has long been a resident and lawyer of Illinois."

83. Helvering v. Stuart, 317 U.S. 154, 164 (1942): "Nor do we see any reason why we should prefer the view of the Board of Tax Appeals concerning Illinois law to that of the Circuit Court of Appeals within which Illinois is embraced."

84. The courts of appeals have more local orientation *and* a broader jurisdictional base than the Tax Court. See Estate of Spiegel v. Commissioner, 335 U.S. 701, 707–08 (1949).

Supreme Court should rarely disturb the court of appeals decision; (3) Since Court of Claims decisions are not subject to review by an intermediate appellate court, its decisions should be fully reviewed by the Supreme Court.[85]

2. Prior Local Adjudication

The immediately preceding discussion concerns the determination and application of local law in a federal tax case when the taxpayers involved in such case have not previously engaged in state court litigation with respect to the local issues that control or affect the tax controversy. We now assume that such local issues have been the subject of state court proceedings. Thus, we finally reach a point where one might reasonably expect fairly easy going. The expectation stems from the following syllogism:

Major Premise:	State law creates legal interests and rights.[86]
Minor Premise:	State courts determine and apply state law.[87]
Conclusion:	Legal interests and rights are established by the determination and application of state law by state courts.[88]

The corollary is that, if interests and rights have been so established, it remains for the federal court deciding the tax controversy only to say how *such* interests and rights are taxed.[89] The cases

85. Although the Supreme Court may be no more locally oriented than the Court of Claims, its obviously broader jurisdictional base seems to support unrestricted review of local issues, notwithstanding its disinclination to be drawn into local law-making. See Helvering v. Stuart, 317 U.S. 154, 164 (1942). See also text accompanying note 80 *supra.*

86. Morgan v. Commissioner, 309 U.S. 78 (1940).

87. Blair v. Commissioner, 300 U.S. 5, 10 (1937): "The decision of the state court upon these [local law] questions is final." Sharp v. Commissioner, 91 F.2d 802 (3d Cir. 1937), *rev'd per curiam* 303 U.S. 624 (1938); Uterhart v. United States, 240 U.S. 598 (1916); Rhodes v. Commissioner, 41 B.T.A. 62 (1940), *aff'd sub nom.* Helvering v. Rhodes' Estate, 117 F.2d 509 (8th Cir. 1941). Throughout this discussion reference to prior adjudication under state law assumes litigation in the state courts. It is possible of course that such prior adjudication has occurred in the federal courts which can determine and apply state law under their diversity jurisdiction. If so the prior decision in the federal court with respect to legal interests and rights under state law should not be differentiated from a prior state court decision.

88. Blair v. Commissioner, 300 U.S. 5 (1937); Uterhart v. United States, 240 U.S. 598 (1916). See 1 PAUL, FEDERAL ESTATE AND GIFT TAXATION § 1.11 (1942).

89. The conclusive effect accorded a state court decision in a federal tax case, when the state court decision is recognized as such, does not flow from the doctrine of *res judicata* or its companion doctrine, collateral estoppel, because the parties in the tax and local proceedings are not the same. Freuler v. Helvering, 291 U.S. 35, 43 (1934). A thorough discussion of the application of these doctrines in tax cases is presented in Commissioner v. Sunnen, 333 U.S. 591, 597 (1948). Nor does the full

reflect confusion as regards the major premise, the minor premise, the conclusion and its corollary. Such confusion at the first two stages can be eliminated by awareness of the problem and careful analysis. Present doctrine does not afford a basis for eliminating confusion as to the conclusion, but steps *can* be taken to reduce such confusion. We adopt this syllogism as an outline for the ensuing discussion.

(a) The Major Premise

This discussion began with a recognition that it is accurate to say "State law creates legal interests and rights." But, as was also observed, federal tax liability may not hinge on such interests and rights. Thus, it is not sensible to discuss the controlling effect of a state court *decision* if in the particular case state *law* does not control. A hypothetical and a concrete example will show the kind of confusion that can arise here.

First, suppose in the celebrated *Clifford* case[90] there had been a local determination that Mrs. Clifford had a *property* interest in the five year trust Mr. Clifford created for her and that the *income* from the trust was hers. Whatever one may think of the *Clifford* doctrine,[91] if it is accepted as established tax law, Mrs. Clifford's interests and rights under local law become irrelevant and the suggested local determination simply would have no bearing on the tax controversy. Obviously, confusion creeps in if the tax tribunal concerns itself with the validity of a state court decision in such circumstances when the local decision will not control or affect the tax result, be it valid or not.

Second, an actual case illustrates such possible confusion, although criticism should be modified by a recognition that the tax controversy involved a family partnership and was decided before

faith and credit clause compel this result. Freuler v. Helvering, *supra.* The doctrine of *stare decisis,* while applicable, obviously does not require adherence to the prior local decision. However, the syllogism presented in the text does compel adherence to the prior state court decision as a general rule; troublesome exceptions are discussed further in the text.

90. Helvering v. Clifford, 309 U.S. 331 (1940).

91. In Helvering v. Clifford, 309 U.S. 331 (1940), the court, recognizing the close family relationship between the grantor of the trust and its beneficiary, the short duration of the trust, and administrative powers retained by the grantor, viewed the arrangement as a mere temporary reallocation of income within the family and refused to accord the trust *tax* recognition, regardless of its status under local law. Compare Commissioner v. Clark, 202 F.2d 94 (7th Cir. 1953), rejecting part of the so-called "Clifford Regulations," Treas. Reg. 111 § 29.22(c)–21 (1945). This area of the tax law is now controlled by express statutory provisions, INT. REV. CODE OF 1954, §§ 671–78.

the Supreme Court's *Culbertson* decision[92] and the addition to the Code of a family partnership provision.[93] In *Doll v. Commissioner*,[94] a deficiency notice raised the question whether the taxpayer's business of selling shoes on a commission basis was a sole proprietorship, so that all the income could be taxed to him, or whether an asserted partnership between the taxpayer and his wife should be recognized, so that part of the income could be taxed to her. In support of his partnership argument, the taxpayer relied in part on a decree by a Missouri court that Mr. and Mrs. Doll had created a valid partnership in which they were equal partners.[95] The Commissioner's cautious answer seems to have been two-pronged:[96] (1) The local decree was not material; and (2) The local decree was not binding, even if material, because it was a mere consent decree in a nonadversary proceeding. The Tax Court rejected the decree on the basis of the Commissioner's second ground.[97] But, in affirming the Tax Court, the Court of Appeals rejected the local decree on the Commissioner's first ground:

> We do not examine the issues as to the force of a judgment of an inferior court or as to whether this was a consent judgment or collusive or if either, its effect under the declaratory judgment law of Missouri or under the national revenue statutes. We omit this because we think this judgment is not decisive of this case.[98]

Hindsight, aided by the Supreme Court's *Culbertson* decision,[99] indicates that in the *Doll* case the court of appeals took the correct stand. But, lest our immediate point be obscured by detail, the significant thought is that the validity or acceptability of the state court decree need never become an issue at all unless the major premise in the suggested syllogism is relevant, that is, unless it is correctly determined that within the suggested major premise the rights or interests established by state law control or at least affect the federal tax result.

92. In Commissioner v. Culbertson, 337 U.S. 733 (1949), the Supreme Court undertook to lay down federal tax criteria for determining the existence of a partnership and to reduce confusion generated by its earlier decisions in Commissioner v. Tower, 327 U.S. 280 (1946), and Lusthaus v. Commissioner, 327 U.S. 293 (1946).

93. Int. Rev. Code of 1939, §§ 191 and 3797(a)(2), added by the Revenue Act of 1951, ch. 521, § 340, 65 Stat. 511; INT. REV. CODE OF 1954, § 704(e).

95. See Francis Doll, 2 T.C. 276, 282 (1943).

96. Doll v. Commissioner, 149 F.2d 239, 241 (8th Cir. 1945).

97. Francis Doll, 2 T.C. 276, 284 (1943).

98. Doll v. Commissioner, 149 F.2d at 241.

99. Commissioner v. Culbertson, 337 U.S. 733 (1949).

(b) The Minor Premise

So much for confusion regarding the major premise. Difficulty may arise under the minor premise—that state courts have the final say as to the determination and application of state law—because of a failure to identify just what was decided by the state court. Paradoxically, the best illustration of this can be found in an opinion of the Third Circuit which, otherwise, is one of the most enlightened and enlightening judicial treatments of the state law—state decision problem in recent years. In *Gallagher v. Smith*,[100] the question was whether the surviving wife of a decedent was taxable on all the income from a testamentary trust created by his will or whether she should be taxed only on a part, along with other alleged beneficiaries of the trust. The question *was* one of interests and rights under state law,[101] and there *was* a Pennsylvania Orphans' Court decree concerning the administration of the trust. The Third Circuit held that the decree established the rights of others as beneficiaries and that the wife was taxable on only a part of the income. But did it establish such rights?

The local adjudication in *Gallagher* arose out of an audit of the trustees' accounts, so that "its confirmation might provide a basis for the discharge of Louis Marion as a co-trustee under the will."[102] An argument on behalf of the taxpayer was that she had disclaimed all but a one-thirteenth interest in the trust which left her with that interest and no more. The Government argued, on the other hand, that the disclaimer should be viewed as only a revocable assignment, because the trust was a spendthrift trust. Under Pennsylvania law an interest in a spendthrift trust cannot be irrevocably assigned. There was no doubt that the taxpayer remained taxable on all the trust income if her disclaimer amounted only to a revocable assignment. More precisely, then, the question was whether the decision of the Pennsylvania Orphans' Court determined the irrevocable nature of the assignment. The majority of the Third Circuit, and the Commissioner as well, viewed the local decree as a determination that there had been an irrevocable assignment, the Commissioner contending, however, that the decree was not binding. With due deference, the view of Judge Kalodner, dissenting, seems sounder than the majority view. He said: "The [Orphans'] Court merely held that the plaintiff could assign her income to her children and that this assignment would continue to

100. 223 F.2d 218 (3d Cir. 1955).

101. There were no factors present that would bring the case into the penumbra, discussed in text accompanying notes 39–52 *supra*.

102. Gallagher v. Smith, 223 F.2d 218, 221 (3d Cir. 1955).

be effective until withdrawn."[103] Seemingly, this was all the Orphans' Court had to say to sustain the account[104] and, if so, its decree was not a local decision that the taxpayer had irrevocably assigned an interest in the trust.

For present purposes we need not reach a final position on whether Judge Kalodner or the majority took the proper view of the local decree. The point is that even if state *law* controls, and even if there is a local *decision,* still the case is one in which there is no binding local adjudication, *unless* within the suggested minor premise the local decision settles the very rights and interests on which federal tax liability depends. This is what we mean by possible confusion at the "minor premise" stage.[105] If the wrong step is taken here it leads to the "conclusion" stage where confusion under present doctrine is inherent. That is, the court in *Gallagher* would not have *reached* (and perhaps should not have reached) the question whether they were bound by the local decree if they had decided, as Judge Kalodner did, that "the Orphans' Court did not purport . . . to adjudicate property rights . . . ."[106]

(3) The Syllogistic Conclusion

Forgive us Artistotle if we wonder whether in this tax area of the law, this area of "quasi-knowledge,"[107] a sound major premise and a sound minor premise may not lead invariably to a sound conclusion. Or should we wonder instead whether Aristotelian logic, something like the electronic brain, is only as good as the premises that are fed into it?

The broad proposition seems to be that: (1) when state law creates the legal interests and rights upon which tax liability admittedly depends, and (2) when a state court has made final determination of those interests and rights as regards the very parties in the tax case, still (3) the federal court can *sometimes* disregard that determination and decide the tax controversy on the basis of *its own* determination of such interests and rights. This seems illogical; our suggested syllogism indicates that the federal

103. *Id.* at 228.

104. See *id.* at 226 n.11, where the court quotes the questions presented to the Orphans' Court.

105. The problem may be pointed up by reference to Cook, *Scientific Method and the Law,* 13 A.B.A.J. 303, 305 (1927), as quoted in MCDOUGAL, STUDIES IN WORLD PUBLIC ORDER 82 n.67 (1960): "We may say that 'all gostaks are doshes' and that 'all doshes are galloons' and conclude with strictest logic that 'all gostaks are galloons' and still not know what we are talking about."

106. Gallagher v. Smith, 223 F.2d 218, 228 (3d Cir. 1955).

107. KENNEDY, FEDERAL INCOME TAXATION OF TRUSTS AND ESTATES § 1.01, at 3 (1948).

court can decide only how such interests and rights established by the state court are taxed. But it is not illogical if in the federal tax case there is a sound basis for the federal court to say that the state court has not really made a final determination of such interests and rights, that is, if the federal court can properly say that the state decision is something other than what it appears to be. The attack, then, is not on Aristotle; the question instead is: When is a state court decision not a decision? The imprimatur of a state judge may not be the true hallmark of a state decision. When is this so?

We think a proper distillation of the variant expressions in the cases is that a state court decision of local issues germane to a federal tax controversy must be accorded full recognition by the tax tribunal if it is an adjudication of the local issues on the merits.[108] By this we mean that a federal judge requested to accord full recognition to a state court decision should consciously ask himself this question: Did the parties in the state proceeding invoke the function of the state judiciary in such a way that the state judge has actually gone about his usual business of interpreting state law in the light of facts fairly presented to reach and express a conclusion as to the interests and rights of the parties? If so, as the Supreme Court has said: "To derogate from the authority of that conclusion 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."[109] The question whether the state court decision is such as to compel full recognition is a federal question.[110]

The origin of the suggested test for recognition of a local decision in a subsequent tax case is very general language in two Supreme Court opinions, both according full recognition to a local decree. In *Freuler v. Helvering*,[111] the Court expressly rejected the contention that the state suit was "collusive" or the decree a mere "consent decree." Similarly, in *Blair v. Commissioner*,[112] the Court found no basis for saying "that the suit was collusive and the de-

108. See 1 MERTENS, LAW OF FEDERAL GIFT AND ESTATE TAXATION § 10.10, at 631 (1959). After suggesting that the court must have had jurisdiction and that the decree must be binding on the parties, Mertens indicates that "the adjudication must have 'passed upon' the merits . . . " for the state decision to qualify as binding.

109. Blair v. Commissioner, 300 U.S. 5, 10 (1937).

110. In Blair v. Commissioner, 300 U.S. 5 (1937), and Freuler v. Helvering, 291 U.S. 35 (1934), the Supreme Court considered whether the state court decisions involved were required to be accorded full recognition and decided that they were.

111. 291 U.S. 35 (1934).

112. 300 U.S. 5 (1937).

cree inoperative."[113] It is a reasonable inference that the Court would not have accorded recognition to a decree obtained in a collusive suit or *possibly* to a consent decree.[114] But there are no later Supreme Court tax opinions that eliminate lurking uncertainty, and in this context the term "collusive" may have quite a special meaning.

Discussion of the problem in opinions of the lower federal courts is as profuse as such discussion is scarce in the Supreme Court opinions. It is difficult to escape the feeling that subordinate tests for recognition, suggested by the lower courts within the loose framework of the Supreme Court pronouncements, rarely rise above the verbalistic level. But it would be tautological to undertake here a thorough cruise of this judicial timber. A very recent edition of an outstanding tax treatise[115] presents a comprehensive collection of many relevant decisions and commentaries, together with analysis and comment on the development of this area of the law. The difficulty is that such analysis leads only to the view we have suggested as the proper test for conclusiveness of a state court decision,[116] and this test cannot be expressed in any way that makes its application anything better than uncertain in most cases.

A clear illustration of a state decision that does not meet the test for recognition is found in *Martin v. United States*.[117] There the decedent was the life beneficiary of a testamentary trust under which, upon her death, the remainder was to pass to her heirs. A New York Surrogate had held that the decedent life beneficiary had, at death, no interest in crops that had been harvested from trust farming properties. The Court of Claims rejected the estate's contention that this local determination barred inclusion of the value of the crops in the decedent's gross estate and held such value includible under its own interpretation of New York law. Regardless of possible collusion, disregard of the local decision is fully supportable on the ground that it was without local significance: "the same persons got the property, whether they took as heirs of Elizabeth Smith [the life beneficiary] or as remaindermen under the will of Hiram Sibley [the settlor of the trust]."[118] In such a setting the asserted state decision can be viewed as little

113. *Id.* at 10.
114. *But see* Commissioner v. Blair, 83 F.2d 655, 657 (7th Cir. 1936), *rev'd*, Blair v. Commissioner, 300 U.S. 5 (1937).
115. 1 MERTENS, LAW OF FEDERAL GIFT AND ESTATE TAXATION §§ 10.15–10.17 (1959).
116. *Id.* § 10.10, at 631; see note 108 *supra*.
117. 121 Ct. Cl. 829 (1952.)
118. *Id.* at 845.

more than an advisory opinion on the federal tax question, which the federal court should feel free to take or leave alone.[119]

The *Martin* case reflects a sound decision based on a sound expressed reason, but the court there also said: "There was, therefore, no *adversary* litigation . . . ."[120] While true, adversariness or the lack of it is one among many spurious tests suggested for enforced recognition of the state decision. The court of appeals dealt deftly with this proposition in the famous *Blair* litigation:[121]

> We would be better satisfied if the suit in the state court had been more adversary in its nature . . . . But consent decrees are binding if entered by a court of competent jurisdiction with the parties properly before it, in the absence of a showing of collusion between the parties or fraud upon the court.[122]

While rejecting adversariness as a test, it is interesting to note that the court of appeals expressly acknowledged collusion and fraud upon the court as grounds for rejection of a state decision. Collusion, as used here and by the Supreme Court in the same case,[123] is an uncertain concept,[124] adding nothing to the test we have suggested. Fraud, too, is an elusive concept, but there may be a reasonably well defined area in which a judgment is vulnerable to attack by one who was not a party to the proceeding.[125] At least in such cases, fraud should be a clear basis for rejecting the state court decision as not a controlling adjudication of interests and rights.

The fact that a few problems in this area can be whittled down to rule-of-thumb proportions is no indication that we can escape complexity. Even with the benefit of hindsight, the proper view

119. Even if a state court decision need not be treated as binding, the federal court may be inclined to view it as persuasive or else find in it confirmation of its own determination, if that happens to accord with the result reached locally. Channing v. Hassett, 200 F.2d 514 (1st Cir. 1952). Moreover, the effect of a state court decision may depend very much on whether the issue in the tax case involves the interests and rights of the parties at a point of time before the state decision was rendered, or only prospectively. Rejected for the first purpose, it may still be accepted for the second. M. T. Straight Trust, 24 T.C. 69 (1955), *aff'd sub nom.* Straight's Trust v. Commissioner, 245 F.2d 327 (8th Cir. 1957).

120. 121 Ct. Cl. 829, 845 (1952). (Emphasis added).

121. Commissioner v. Blair, 83 F.2d 655 (7th Cir. 1936), *rev'd on other grounds,* Blair v. Commissioner, 300 U.S. 5 (1937); see also Gallagher v. Smith, 223 F.2d 218, 226 (3d Cir. 1955): "whether the proceeding was adversary or nonadversary is not the test of conclusiveness . . . ."

122. Commissioner v. Blair, 83 F.2d at 657.

123. Blair v. Commissioner, 300 U.S. 5 (1937).

124. See Saulsbury v. United States, 199 F.2d 578, 580 (5th Cir. 1952).

125. See 30A AM. JUR. *Judgments* § 18 (1958).

of the local litigation in the celebrated *Blair* case itself is at best controversial. How should the following factors be appraised?

> There is that which suggests a friendly suit to avoid taxes, to which there was no opposition or adverse party. All who joined in the litigation were desirous of obtaining the same end—the avoidance of a large part of the Federal income tax through division of the income by the beneficiary among his children. The Government was not a party to that suit. The suit was prosecuted only until a favorable decision was reached and then no appeal was taken. The first court ruled adversely to the complainants. On appeal a favorable decree was entered. There was no one interested in taking the case to the Illinois Supreme Court and the litigation ceased. In other words it was not unlike a consent decree.[126]

Would the Tax Court (then B.T.A.), the Seventh Circuit, and the Supreme Court now all agree, as they did then, that the state court decree was binding on the local issues? One wonders.

We identified earlier the characteristics of a morass when a tax case arises in which local interests and rights have not been the subject of prior local adjudication. Disappointingly, we now conclude that these characteristics persist even when there has been prior local litigation *seemingly* settling the local issues.

B. Escape from the Morass?

We do not believe that any imaginable refinement or elaboration of or change in existing doctrine can chart a clear path through the state decree morass that we have been discussing. It is relevant therefore to ask whether there may be a way around it. Are there procedural, as opposed to doctrinal, changes that might reduce controversy and uncertainty? Others have been here before us.[127]

One procedural thought that we think is properly rejected seems to assume that, if the Commissioner is an uninvited guest at a family gathering, he can be made to wash the dishes. By statute, at least, the Commissioner could be required, upon notification of pending state litigation that would affect tax liability, either: (1) to intervene in such litigation to protect the revenue or (2) if he did not intervene, to accept the results without regard to the usual tests for recognition. Whenever such notification was given, the doctrinal difficulties suggested above would be eliminated. Unfortunately, however, the notion is not practicable. Others seem to

126. Commissioner v. Blair, 83 F.2d 655, 657 (7th Cir. 1936).

127. See Colowick, *The Binding Effect of a State Court's Decision in a Subsequent Federal Income Tax Case*, 12 Tax L. Rev. 213, 229 (1957); Cardozo, *Federal Taxes and The Radiating Potencies of State Court Decisions*, 51 Yale L.J. 783, 796 (1942).

agree.[128] Not only would it require impossible forecasting by both private parties and the Commissioner but, if the revenue were in fact to be protected under such a plan, a very heavy burden would be placed upon Treasury or other Government attorneys. The Treasury Department, probably in part for the reasons indicated, has rejected this procedure.[129]

CONCLUSION

We believe there are workable procedural alternatives that could be adopted by statute without change in present doctrine, which would lead toward smoother adjudication of tax controversies presenting difficult local issues. We present these suggestions, acknowledging their skeletal nature, with respect to each of the three tax tribunals of original jurisdiction.

A. The Tax Court

When in a Tax Court proceeding there is drawn in question the validity or acceptability of a state court decision, the Tax Court judge should be required to invite to sit with him on the case a district judge for the district in which the hearing is being or is to be held.[130] The district judge should sit only as an advisor to the Tax Court, but he should have the privilege of writing a dissenting opinion in any case in which the Tax Court decision on the binding effect of the local decision, or the resolution of the local law issue, if the local decision is held not binding, is at variance with his advice.

In this fashion, both the technical tax expertise of the Tax Court judge and the general local expertise of the district judge would be brought to bear on the decision of the tax controversy. While the district judge selected from the district where the case is being heard may not invariably be geographically associated with the local law involved in the case, administrative convenience seems to dictate such choice.

We believe that much the same procedure should be followed when in a Tax Court proceeding an issue of local law arises with respect to which there has been no prior local adjudication, except that the invitation to the district judge to participate should be discretionary with the Tax Court judge. We take account here of

128. *Ibid.*
129. Mim. 6134, 4 CCH ¶6137 (1947).
130. The procedure suggested might be facilitated by altering the status of the Tax Court from an administrative agency to a tax division of the district court.

the fact that local issues vary greatly as to complexity,[131] and suggest that the Tax Court judge would not extend this invitation when such issues were routine.

B. COURT OF CLAIMS

When in a Court of Claims refund suit there is drawn in question the validity or acceptability of a state court decision, the court should be required to dismiss the proceeding and the taxpayer should be permitted promptly, but without regard to usual limitation periods, to resume his suit in the appropriate district court.[132] We think such outright reference is preferable to the advisory arrangement suggested for the Tax Court because, in contrast to the Tax Court, the Court of Claims has no particular tax expertise that would justify its retention of the suit and because the refund nature of a suit in the Court of Claims makes it the kind of suit also brought in the district courts.

We believe that much the same procedure should be followed in a Court of Claims refund suit when an issue of local law arises with respect to which there has been no prior local adjudication,[133] except that the dismissal of the suit should then be discretionary with the Court of Claims. Again we take account of the variation in the complexity of local issues.[134]

C. DISTRICT COURT

We suggest no change here with respect to the treatment of local issues and local decisions in tax cases because, as we have indicated, we feel the district courts are in the best position to cope with such issues. However, we venture one related suggestion.

131. *Compare* May Chandler Goodan, 12 T.C. 817 (1949), *aff'd sub nom.* Commissioner v. Goodan, 195 F.2d 498 (9th Cir. 1952) (complex state law issue) *with* Erik Krag, 8 T.C. 1091 (1947) (routine application of state statute).

132. There may be numerous reasons why a litigant would prefer to prosecute a refund suit in the Court of Claims instead of bringing such a suit in the district court. See 3 CASEY, FEDERAL TAX PRACTICE § 11.54 (1955); BICKFORD, SUCCESSFUL TAX PRACTICE 293 (3d ed. 1956). Nevertheless, we need not question whether the Court of Claims should have *any* tax jurisdiction to reject such preference as a reason against adoption of the procedure suggested.

133. Admittedly, in either of the circumstances suggested, the reference could be to the appropriate state court rather than to the federal district court. We reject the state court alternative because of uncertainty regarding the availability of state court procedures, confidence in the ability of federal district judges, a desire to avoid multiplicity of suits, and related considerations more fully expressed elsewhere in this discussion.

134. See note 131 *supra*.

We believe that, when in a refund suit in the district court there arises a federal tax issue of unusual complexity, the district judge in his discretion should be permitted to invite a Tax Court judge to sit with him on the case. The Tax Court judge should sit only as an advisor to the district judge, but he should have the privilege of writing a dissenting opinion in any case in which the district court decides the tax issues at variance with his advice.

While these suggestions would probably make necessary the appointment of some additional Tax Court and district court judges, we believe it is sensible to propose a two-judge court for two-problem cases. Moreover, we believe the suggestions have some advantages with respect to review of federal tax cases. For in cases that have been heard by both a Tax Court and a district court judge, and in which the judge sitting as advisor did not dissent, the appellate court should show more than usual reluctance to disturb the initial decision. On the other hand, a Tax Court judge's advisory dissent on a tax issue or a district judge's advisory dissent on a local issue might be given considerable weight in an appellate proceeding.

The suggestions made here are not necessarily incompatible with giving the state courts the final say on issues of local law in a way they sometimes do and sometimes do not have under present procedures. If it is thought their participation should be assured, perhaps the best way to implement this desire is to split the appellate procedure in tax cases hinging in part at least on local law. Provision might be made for the review of the local issues in the highest courts of the states[135] and for suspension of the review of the federal issues in the federal appellate courts until completion of such state proceedings. As previously indicated, we question the need for such a procedure but, if review by the state courts were discretionary with them, as we feel it certainly should be, it seems doubtful the review procedure in the state courts would often become a reality.

135. Perhaps this is a matter for consideration by the Commissioners on Uniform State Laws. A recent Florida statute, FLA. STAT. ch. 25, § 25.031 (1959), while not aimed at the suggested review procedure, indicates the manner in which this could be accomplished. See Clay v. Sun Ins. Offices, Ltd., 363 U.S. 207 (1960), in which questions certified to the Supreme Court of Florida by the Court of Appeals for the Fifth Circuit, were decided by the Florida Supreme Court on October 18, 1961. Tampa Tribune, Oct. 19, 1961, p. 18, col. D. Although that statute looks toward certification only from federal *appellate* courts, the local high courts would not have to fear being overburdened if their review of local issues arising in tax cases were discretionary with them. It may be that federal legislation would also be required to give finality to the judgment of the state court in an unusual review procedure such as this.