RECENT DEVELOPMENTS

FEDERAL TAXATION: SUPREME COURT ANNOUNCES "PROPER REGARD" TEST TO DETERMINE CONCLUSIVENESS OF STATE COURT ADJUDICATIONS OF PROPERTY RIGHTS

MORE than thirty years has elapsed since the Supreme Court's enigmatic pronouncement in *Freuler v. Helvering*[1] that, in the absence of collusion, federal courts are bound by state trial court characterizations of property interests when state law is determinative of federal tax liability. In an effort to resolve the ensuing conflict and confusion both among and within the circuits,[2] the problem was revisited in *Commissioner v. Estate of Bosch*.[3] The decedent Bosch created a trust for his wife and gave her a general power of appointment which she subsequently attempted to release. Upon decedent's death, the estate, asserting that the release was invalid, claimed a marital deduction for the widow's trust under section 2056 (b) (5) of the Internal Revenue Code.[4] After receiving a deficiency notice from the Commissioner, respondent-estate concurrently petitioned for redetermination in the Tax Court[5] and successfully sought to have a state trial court declare the release null and void.[6] The Tax Court accepted the state trial court's decision as conclusive since it was "an authoritative exposition of New York law and adjudication of the property rights involved."[7] The Supreme Court, reversing the court of appeal's affirmance of the Tax Court decision,[8] held that where federal estate tax liability is at stake, federal courts are

[1] 291 U.S. 35, 45 (1934); *accord,* Sharp v. Commissioner, 303 U.S. 624 (1938) (mem.); Blair v. Commissioner, 300 U.S. 5, 9-10 (1937).

[2] *See* Commissioner v. Bosch, 363 F.2d 1009, 1015-16 (2d Cir. 1966) (Friendly, J., dissenting).

[3] 387 U.S. 456 (1967).

[4] INT. REV. CODE OF 1954, § 2056 (b) (5).

[5] Estate of Herman J. Bosch, 43 T.C. 120 (1964).

[6] *See* Commissioner v. Bosch, 363 F.2d 1009, 1011 n.3 (2d Cir. 1966) (reproducing fully the decision of the New York Supreme Court).

[7] 43 T.C. at 124.

[8] Commissioner v. Bosch, 363 F.2d 1009 (2d Cir. 1966).

not bound by state trial court characterizations of the property interests involved.[9]

While some courts have felt that the *Erie* doctrine[10] compelled deference to state substantive determinations,[11] others[12] have relied upon the Rules of Decision Act[13] which provides that, in the absence of contrary authorization, the "laws of the several states . . . shall be regarded as rules of decision in civil actions in the courts of the United States, in cases where they apply." However, neither *Erie* nor the Rules of Decision Act encompasses guidelines for determining the effect to be given decrees of *subordinate* state courts where the question is not whether the federal court is bound by the law as stated therein, but rather, whether it is bound by that particular adjudication of the parties' rights.[14]

Prior to *Bosch* virtually every circuit had attempted to formulate a test for assessing the weight to be accorded such state trial court decisions. Some interpreted *Freuler* as indicating that state court decrees, if binding on the parties, were conclusive, even where the proceeding was non-adversary.[15] Others held that a decision resulting from a non-adversary proceeding was not binding.[16] Several circuits[17] attempted to ascribe to "adversity" the attributes of "collusion" set forth in *Freuler,* "collusive in the sense that all parties . . . sought a decision which would adversely affect the Government's right to additional . . . tax."[18] Another line of cases turned on the effect of the state trial court decision upon other state courts at the same level.[19] Still other circuits based their decisions on variations

[9] 387 U.S. at 465.

[10] *See* Erie R.R. v. Tompkins, 304 U.S. 64 (1938).

[11] *See* Kilian v. Louisville & N.R.R., 374 F.2d 61 (7th Cir. 1967); Peyton v. Commissioner, 323 F.2d 438 (8th Cir. 1963).

[12] *See* Salt Lake County v. Kennecott Copper Corp., 163 F.2d 484 (10th Cir. 1947), *cert. denied,* 333 U.S. 832 (1948); United States v. Thurston County, 54 F. Supp. 201 (D. Neb. 1944), *aff'd,* 149 F.2d 485 (8th Cir.), *cert. denied,* 326 U.S. 744 (1945).

[13] 28 U.S.C. § 1652 (1964).

[14] *See* Cardozo, *Federal Taxes and the Radiating Potencies of State Decisions,* 51 YALE L.J. 783, 792-93 (1942).

[15] *See* Commissioner v. Bosch, 363 F.2d 1009 (2d Cir. 1966); Darlington v. Commissioner, 302 F.2d 693 (3d Cir. 1962); Gallagher v. Smith, 223 F.2d 218 (3d Cir. 1955).

[16] *See* Stallworth v. Commissioner, 260 F.2d 760 (5th Cir. 1958); Wolfsen v. Smyth, 223 F.2d 111 (9th Cir. 1955).

[17] *See* Peyton v. Commissioner, 323 F.2d 438 (8th Cir. 1963); Sweet v. Commissioner, 234 F.2d 401 (10th Cir. 1956); Newman v. Commissioner, 222 F.2d 131 (9th Cir. 1955).

[18] 291 U.S. at 45.

[19] *See* Second Nat'l Bank v. United States, 351 F.2d 489 (2d Cir. 1965), *aff'd,* 387 U.S. 456 (1967); Pierpont v. Commissioner, 336 F.2d 277 (4th Cir. 1964).

of these approaches.[20] By the time *Bosch* was considered by the Court, however, it had become clear that regardless of the test employed, some circuits rarely followed state trial court decisions,[21] while others consistently gave them conclusive effect.[22]

The uncertainty evidenced in the lower federal courts finds little resolution in *Bosch,* a five-to-four decision with three separate dissents. Concluding that the Commissioner was not bound by the state court decision under either the principle of res judicata or collateral estoppel, and that the proceeding was "brought for the purpose of directly affecting federal estate tax liability,"[23] the Court sought exposition of the problem in the legislative history of the tax provision in question. Focusing on a Senate Finance Committee's conclusion that "proper regard" should be accorded state court determinations,[24] the Court reasoned that the phrase implied that state court decisions were not necessarily conclusive.[25] Further, the Court analogized to the effect given state court decrees in diversity cases under the Rules of Decision Act and *Erie* doctrine, and concluded that, as in diversity cases, in the absence of a determination by the highest state court, the decision of a state trial court, though a datum for ascertaining state law, is not controlling.[26] The Court also indicated that the same reasoning applies in a lesser degree to decisions of intermediate state appellate courts.[27]

The "proper regard" test enunicated by the majority in *Bosch* casts no additional light on the problem since no attempt was made to give content to the phrase. Hence the federal courts, again, are left to resolve the question for themselves. The *Bosch* case, however, represents a marked change in the Court's attitude toward the conclusiveness of state court decrees. While *Freuler* responded to the

[20] *See, e.g.,* Faulkerson v. United States, 301 F.2d 231 (7th Cir. 1962) (non-adversary, collusive, and ex parte); Saulsbury v. United States, 199 F.2d 578 (5th Cir. 1952) (non-adversary and collusive); First Nat'l Bank v. United States, 176 F. Supp. 768 (M.D. Ala. 1959), *aff'd,* 285 F.2d 123 (5th Cir. 1961) (non-adversary and collusive).

[21] *See* Stallworth v. Commissioner, 260 F.2d 760 (5th Cir. 1958); Wolfsen v. Smyth, 223 F.2d 111 (9th Cir. 1955); Newman v. Commissioner, 222 F.2d 131 (9th Cir. 1955); Saulsbury v. United States, 199 F.2d 578 (5th Cir. 1952).

[22] *See* Darlington v. Commissioner, 302 F.2d 693 (3d Cir. 1962); Gallagher v. Smith, 223 F.2d 218 (3d Cir. 1955).

[23] 387 U.S. at 463.

[24] S. REP. No. 1013, pt. 2, 80th Cong., 2d Sess. 4 (1948).

[25] 387 U.S. at 464.

[26] *Id.* at 465.

[27] *Id.*

problem with a qualified "conclusive," the tenor of *Bosch* favors a more ready reexamination of the parties' legal status in the federal courts. This difference in approach will undoubtedly encourage those circuits which denied effect to state court decrees to continue doing so, and may induce the others to follow suit.

While the narrow holding in *Bosch* is no more than a rejection of the conclusive effect which the Second and Third Circuits, among others, have given state adjudications not obviously collusive,[28] the impact of *Bosch* may transcend these bounds. The decision could be extended to allow a federal rehearing on the merits in any case where interests under a federal statute are determined by state law. The extent of federal legislation incorporating state law[29] draws sharply into focus the potential impact of *Bosch* on the "delicate and important"[30] relationship between state and federal judicial systems. Should the *Bosch* principle be extended to other federal statutes incorporating state law, the federal courts would not merely be rejecting an offered interpolation of state law deduced from lower state court cases, as may occur in diversity cases; rather, an adjudication of property and other rights traditionally within the state court's jurisdiction would be rejected. In an action involving a title controversy, for example, a party's property rights and tax liabilities lose their essential nexus if *Bosch* is extended indiscriminately.[31] Taken in this light the Court's failure to provide a standard for assessing the conclusiveness of state court decisions may well have outweighed the advantage gained in protecting federal revenue from the minor threat of ex post facto estate planning.

[28] *See* Commissioner v. Bosch, 363 F.2d 1009 (2d Cir. 1966); Darlington v. Commissioner, 302 F.2d 693 (3d Cir. 1962); Gallagher v. Smith, 223 F.2d 218 (3d Cir. 1955).

[29] *See, e.g.*, Cruz v. Gardner, 375 F.2d 453 (7th Cir. 1967); Hill, *The Erie Doctrine in Bankruptcy*, 66 HARV. L. REV. 1013 (1953); Seidelson & Bowler, *Determination of Family Status in the Administration of Federal Acts: A Choice of Law Problem for Federal Agencies and Courts*, 33 GEO. WASH. L. REV. 863 (1965); Note, 77 HARV. L. REV. 1084 (1964).

[30] 387 U.S. at 477 (Harlan, J., dissenting).

[31] 387 U.S. at 470 (Douglas, J., dissenting).