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William E. Martin

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## ***Bosch* and the Binding Effect of State Court Adjudications upon Subsequent Federal Tax Litigation**

### I. INTRODUCTION

One of the unique facets of American federalism involves the interaction of state court decrees which determine or characterize an individual's property rights with subsequent federal court litigation which imposes the federal tax burden upon those rights. While Congress determines what relationships are to be taxed, state law creates and state court adjudications measure these relationships.<sup>1</sup> In 1934 the Supreme Court formulated the standard that the state court decision was to be followed by a federal tax court in the absence of collusion, since the decree established the state "law" in regard to the relevant property.<sup>2</sup> However, the definitional and conceptual problems encountered by the various circuit courts led to a mélange of interpretations and an inconsistent application of the Supreme Court test. The ensuing diversity in the circuits was resolved in June of 1967 with the Supreme Court decision in *Commissioner v. Estate of Bosch*.<sup>3</sup> Holding that a state trial court adjudication of property rights is not binding upon subsequent tax litigation in a federal court and that the federal court is free to conduct an independent inquiry into the state "law" in the absence of a statement by the state's highest court, the Court discarded the old "binding unless collusive" test and established a more restrictive standard. The purpose of this note is to examine the decision and its context and to evaluate the analytical and practical consequences of the new rule.

### II. BACKGROUND

#### A. *Conceptual Context*

The touchstone for the primacy of state court judgments in federal tax litigation is the principle that federal tax consequences are dependent upon rights established under state law.<sup>4</sup> State law is determinative of the nature and scope of the individual's property rights, and Congress imposes the tax burden upon these established rights.<sup>5</sup> The relevant problem thus becomes: what is the applicable

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1. *Morgan v. Commissioner*, 309 U.S. 78 (1940); Cahn, *Local Law in Federal Taxation*, 52 *YALE L.J.* 799 (1943).

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

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

4. *Uterhart v. United States*, 240 U.S. 598 (1916).

5. "State law creates legal interests and rights. The federal revenue acts designate what interests or rights, so created, shall be taxed." *Morgan v. Commissioner*, 309 U.S. 78, 80-81 (1940).

state law pertaining to the issue in question? Basically, there are two distinct methods of proving state law.<sup>6</sup>

The first method involves a reliance on the "general" state law, that is, state statutes or precedential state court decisions to which the taxpayer was not a party. The methodology of this approach is to establish the general rule of law for a state and to reflect the probable action that the highest court of that state would take on the issue.<sup>7</sup> The "burden of legal persuasion" is upon the proponent to show effectively that the proposed rule comports with the general law of the state.<sup>8</sup> Applying the *Erie* principle of the diversity cases, it would appear that the "general law of the state" is the law enunciated by the legislature or by decision of the highest state court; that the rule of law announced by the intermediate state court is not to be disregarded by a federal court unless convinced that the highest court would hold otherwise; and that in the absence of an authoritative declaration of state law, the federal court should employ all available data to determine the probable disposition of the issue by the state's highest court.<sup>9</sup>

The second method of proving the applicable state law is to refer to the preceding state court disposition of the case in which the taxpayer's property rights were adjudicated or property interests characterized. Accordingly, this second method of proof is distinguishable from the first, since reference is made to a *specific* state court decree which established the property rights or interests of the taxpayer. "Where there is such a decision and it meets all the requirements for acceptance it ordinarily precludes reference to the general law of the state."<sup>10</sup> The policies which underlie the use of the particular state court decree in which the taxpayer's property rights were determined as proof of state law may be summarized as

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6. See generally 1 MERTENS, LAW OF FEDERAL GIFT & ESTATE TAXATION § 10.03, at 604 (1959).

7. *Id.*

8. See Marguerite T. Payne, 1 T.C. 360, 364 (1942), where the Tax Court said: "[T]he lack of any authority, statutory or judicial, justifying the conclusion that under state law the income in question belonged to the husband, utterly precludes the successful prosecution of petitioner's claim here. . . . Thus, the burden of legal persuasion to satisfy us that the state law would so operate as to confer upon the husband the necessary community rights has not been met. The absence of any such showing requires that the issue be determined in respondent's favor."

9. *West v. American Tel. & Tel. Co.*, 311 U.S. 223 (1940); *Erie R.R. v. Tompkins*, 304 U.S. 64 (1938).

10. 1 MERTENS, *supra* note 6, at 625. Mr. Mertens says that three basic requirements must be satisfied for the adjudication to be "acceptable": (1) the state court must have had jurisdiction of the parties and subject matter; (2) the decree must have been conclusive as to the parties; (3) the adjudications must have "passed upon" the merits of the precise issue before the tax court. If these three are not satisfied, then proof of the general state law is required. See *Id.* § 10.10, at 630.

follows: (1) Since federal tax consequences are imposed by Congress upon the property rights established and determined by state law, state, rather than federal, standards should be employed for the resolution of federal tax law issues in regard to these property rights. Thus, the acceptance of the state court decree is consistent with the Congressional purpose of deferring to the state's definition of the taxpayer's property rights. (2) In accordance with the *Erie* policy of uniformity in the administration of law within each state, the taxpayer's property rights should not be viewed dissimilarly by the state and federal governments. For example, it is inequitable to determine that an individual is to be regarded as the owner of certain property for federal tax purposes when, under a state court decree, he has no right to or interest in the property. This policy is reflected in the Supreme Court pronouncement that:

The right to succeed to the property of the decedent depends upon and is regulated by state law . . . and it is obvious that a judicial construction of the will by a state court with competent jurisdiction determines not only legally *but practically* the extent and character of the interests taken by the legatees.<sup>11</sup>

(3) Since the state courts are more familiar with the operation, direction, and eccentricities of their law, they are in a better position to apply it accurately.<sup>12</sup>

Weighed against these three policy considerations is the federal interest in protecting the treasury from the vicissitudes of collusive state suits and inaccurate state court decrees. The interest in defending against the "hazards to the federal fisc from dubious decisions of lower state courts"<sup>13</sup> necessitates a concern with the accuracy and trustworthiness of the state court decision and requires that the federal court set certain standards which will serve to evaluate the quality of the state court judgment.

### B. *Prior Supreme Court Cases*

In 1934 the Supreme Court first articulated the test for evaluating and ensuring the required quality of the state court determination before it was to become binding in subsequent federal tax litigation. The Court, in *Freuler v. Helvering*,<sup>14</sup> held that a California decree on a trustee's account, which determined that the life beneficiaries were

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11. *Uterhart v. United States*, 240 U.S. 598, 605 (1916) (emphasis added).

12. *See, e.g.*, Justice Harlan's dissent, joined by Justice Fortas, in *Commissioner v. Estate of Bosch*, 387 U.S. 456 (1967).

13. *Id.* at 479.

14. 291 U.S. 35 (1934).

to repay an excess distribution resulting from the trustee's failure to establish a depreciation reserve, was binding for federal income tax purposes. In so holding, the Court formulated the rule that a state court decision determining the property rights of the taxpayer is binding upon subsequent federal tax litigation, in the absence of collusion. The Commissioner had contended that the state proceeding was "collusive in that all parties had joined in a submission of the issues and sought a decision which would adversely affect the Government's right to additional income tax."<sup>15</sup> The Court rejected this contention, disagreeing because: the case was initiated in the state court in the usual manner; notice was given to the interested parties; objections were presented; all parties were represented by counsel; the decree purported to decide issues regularly submitted; the decree was not a consent decree; and the state court ruled for the proponents on one point and against them on another. Although noting that the California court judgment could not serve as a basis for res judicata (because the Commissioner was not a party) nor as a basis for full faith and credit, the Court stated that "the decision of [the state court], until reversed or overruled, established the law of California respecting distribution of the trust estate. It is none the less a declaration of the law of the State because not based on . . . earlier decisions."<sup>16</sup>

The fundamentals of the *Freuler* decision were reaffirmed three years later in *Blair v. Commissioner*,<sup>17</sup> where the relevant tax issue presented was whether a testamentary trust was a spendthrift trust barring the voluntary alienation of the beneficiary's interests. The Court held that a decision by an Illinois intermediate appellate court upholding the life beneficiary's right to assign portions of his interest was conclusive of the validity of the assignments in subsequent federal tax litigation. Noting that the state suit was not collusive, the Court placed crucial reliance on the fact that the Illinois court reviewed the decisions of the state's highest court and reached a "deliberate conclusion." "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."<sup>18</sup>

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15. *Id.* at 45.

16. *Id.* In the *Freuler* case, Justice Cardozo, joined by Justices Brandeis and Stone, dissented on the basis that the effect of the state court adjudication was *not* to diminish the taxable income of the life beneficiaries to the extent which the majority seemed to indicate.

17. 300 U.S. 5 (1937). The suit in the Illinois state courts was brought by the trustee for instructions. The adversarial interest was represented by the life beneficiary and his assignees.

18. *Id.* at 10.

### C. Responses by the Circuit Courts of Appeal

1. *The Split Over "Collusion."*—In response to the broad standard promulgated in *Freuler* and *Blair*, the courts of appeal of the various circuits split dramatically as to the interpretation and application of the rule. Central to the divisive interpretations was the problem of defining and delimiting the term "collusion."

At one end of the spectrum was the *Gallagher*<sup>19</sup> rule utilized by the Third Circuit. Reflecting a rather strict application of the Supreme Court standard, the court equated collusion with actual fraud and held that a nonadversary proceeding in the Pennsylvania Orphan's Court was conclusive in subsequent tax litigation as to the taxpayer's interest in a trust estate. Noting that the adversary positions in *Blair* were merely formal, the court rejected the argument that the state proceeding should be deemed collusive if it was not adversary in character<sup>20</sup> and stated:

[I]f the question at issue is fairly presented to the state court for its independent decision and is so decided by the court the resulting judgment if binding upon the parties under the state law is conclusive as to their property rights in the federal tax case, regardless of whether they occupied adversary positions in the state court or were all on the same side of the question.<sup>21</sup>

Under the *Gallagher* approach, the nonadversary character of the state proceeding "is relevant in so far as it is *evidence of collusion*."<sup>22</sup> The ramifications of the *Gallagher* rule can be seen more distinctly in the Third Circuit decision of *Estate of Darlington v. Commissioner*.<sup>23</sup> In that case the Tax Court made the factual determination

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

20. "If the question is fairly posed to the court and the tribunal is left free to decide it according to its own judgment it should not be necessary for the parties to take adversarial positions and engage in legal shadow boxing in order that the judgment of the court should have conclusive effect, tax-wise as well as property-wise." *Id.* at 225. The court noted that the lower court (7th Cir.) in *Blair* had stated that all the parties had the common goal of avoiding the burden of federal taxation and that they merely appealed until they received a favorable decision and then ceased appeals. *Id.* at 225. The majority opinion reasoned that their refusal to equate "collusion" with "nonadversary" was supported by the strong public policy favoring family harmony, because it is commonplace for members of a family group to take a common view as to the rights under a will. However, the dissent in *Gallagher* argued that the Orphan's Court did not purport to adjudicate property rights, but merely followed its practice of refusing to disturb distributions to which all parties in interest had assented.

21. *Id.* at 225. Thus, under the *Gallagher* decision, the test is: "whether the judgment is an adjudication upon which solely the federal tax is imposed, which adjudication was and is final and binding upon the parties under the state law, and which was not obtained by collusion for the purpose of defeating the tax." *Id.* at 226.

22. *Id.* at 225 (emphasis added).

23. 302 F.2d 693 (3d Cir. 1962).

that the state court action was nonadversary in character and that the state court proceeding was instituted for the sole purpose of establishing a basis for an estate tax deduction. On appeal to the Third Circuit, the Commissioner asserted, as he did in *Blair*, that collusion should be found when all parties join in the submission of the issues and jointly seek a decision which would adversely affect the Government's right to additional tax. However, the court disregarded this contention and held that the state court proceeding was determinative of the relevant property rights and binding upon the subsequent federal tax action.

At the opposite end of the spectrum was the Fifth Circuit position, as espoused in *Saulsbury v. United States*.<sup>24</sup> There the court held that the decision of an Indiana probate court was obtained by collusion, because all parties were in accord as to the proposed decision in the state court, and the probate court did not reach the merits of the true issue as to the beneficiary's property rights.<sup>25</sup> In defining the term "collusion" the court adopted a liberal interpretation of the Supreme Court standard and stated:

By the word *collusion*, we do not mean to imply fraudulent or improper conduct, but simply that all interested parties agreed to the order and that it was apparently to their advantage from a tax standpoint to do so. We mean that there was no genuine issue of law or fact as to the right of the beneficiary to receive this income, and no *bona fide* controversy between the trustee and the beneficiary as to property rights under the trust instrument.<sup>26</sup>

Between the two extremes of *Gallagher* and *Saulsbury* were variants of both these rules, including interpretations which provided a more moderate approach to the problem. The Eighth Circuit's position was expressed in *Peyton's Estate v. Commissioner*<sup>27</sup> where the court held that since the state proceeding was collusive, a Minnesota probate court decree was not binding on the federal tax question of whether the widow had a terminable interest. A sufficient basis for the holding of collusion was found in the following factors: the estate's counsel represented the widow; the counsel received the probate court's prior

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24. 199 F.2d 578 (5th Cir. 1952), *cert. denied*, 345 U.S. 906 (1953).

25. The court held that where the terms of the trust instrument provided that the life beneficiary was to receive trust income for life and the estate taxes on the settlor's estate were to be paid from corpus, even though the trustee had obtained an order from the Indiana probate court directing him to apply all the income to repayment of money borrowed to pay estate taxes, the trust income was taxable to the life beneficiary for income tax purposes, because the beneficiary did not contest the state court action and the issue of whether the beneficiary was *entitled* to the income was not raised in the state court.

26. *Saulsbury v. United States*, 199 F.2d 578, at 580 (5th Cir. 1952). The burden of proof as to collusion was apparently placed on the taxpayer.

27. 323 F.2d 438 (8th Cir. 1963).

assurance as to the interpretation of the will; notice was given to relatives, but they made no appearance; no notice was given to the Commissioner; and there was no opposition to the advocated decree. However, the court was careful to note that the mere fact that the state suit was nonadversary does not, per se, render the proceeding collusive. Citing *Gallagher*, the court determined that the nonadversary character was *evidence* of collusion. As to the elements of collusion, the court stated that while actual fraud is the most obvious example, the definition relevant to tax cases is not so narrow; collusion is to be defined in terms of all parties joining to affect adversely the government's right to taxes.<sup>28</sup>

The Seventh Circuit position, which gravitated more toward *Saulsbury*, can be seen in a series of cases beginning with *Brainard v. Commissioner*<sup>29</sup> and culminating in *Faulkerson's Estate v. United States*.<sup>30</sup> In *Brainard* the court refused to give binding effect to a decision of the Cook County (Illinois) Circuit Court, ostensibly on the basis of the limited geographical jurisdiction of that tribunal. The court noted that there were some 100 circuit courts in Illinois and that their decisions provided diverse interpretations of the state law; the correct statement of state law was to be found in the Illinois appellate or Supreme Court decisions.<sup>31</sup> In *Merchants National Bank & Trust Co. v. United States*<sup>32</sup> the Seventh Circuit refused to be bound by a consent decree issued by a state probate court. And finally, in *Faulkerson's Estate* the Seventh Circuit held that an Indiana circuit court decree was not binding on the federal tax determination of whether a widow was entitled to take the marital deduction, since the state decree was entered in an *ex parte* proceeding without notice to interested persons, without appearances, and without a hearing on the merits. Here, as in *Brainard*, the court referred to the limited jurisdiction of the state court<sup>33</sup> and the fact that the Commissioner, not a party to the state proceeding, had no right to appeal. The court formulated its definition of collusion in terms of the Commissioner's long-established position: "[C]ollusive in the sense that a decision was sought which would adversely affect the Government's right to additional estate tax."<sup>34</sup> In a significant dictum, the court delineated

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28. The *Peyton* court quoted this definition from *Saulsbury*.

29. 91 F.2d 880 (7th Cir. 1937).

30. 301 F.2d 231 (7th Cir. 1962).

31. Note that all the parties to the state proceeding were satisfied with the state decree and did not appeal, and furthermore, the Commissioner was not made a party, thus having no right to appeal.

32. 246 F.2d 410 (7th Cir. 1957).

33. There are eighty-four circuit courts in Indiana.

34. *Faulkerson's Estate v. United States*, 301 F.2d 231, at 232 (7th Cir. 1962).

the "proper case" in which it would accept the state decree as determinative:

[W]here the state court proceeding was adversary and not *ex parte*; where a hearing was had on the merits; where the question of law has been settled by the appellate courts of the state or where the judgment of an intermediate may be fairly accepted as evidencing the law of the state; and where the judgment is not collusive.<sup>35</sup>

These requirements, taken conjunctively, would appear to necessitate that there be an adversary contest and that the proceeding not be collusive in the sense that the proceeding was instituted in order to obtain favorable tax treatment. This intimates that even where the state court suit is opposed by an interested party, the decree may be inconclusive in subsequent federal tax litigation if the purpose of the state proceeding was to defeat the federal tax.<sup>36</sup>

An approach which is consistent with the *Brainard* and *Faulkerson* cases, but which was based upon the conceptual principles of the *Erie* doctrine,<sup>37</sup> was taken by the Fourth and Sixth Circuits. In *Pierpont v. Commissioner*<sup>38</sup> the Fourth Circuit held that a state court decree that a widow possessed the requisite power of appointment to qualify the testator's estate for the marital deduction was not binding upon the federal court, because the state decision was rendered by a *nisi prius* court in a nonadversary proceeding in which the state court did not make an independent inquiry into the state law. The court declared that under *Erie*, "state law" is determined by the appellate courts, and the decisions of *nisi prius* courts are not required to be followed as binding precedents; thus the state court decree was not an authoritative statement of "state law."<sup>39</sup> Similarly, in *Old Kent Bank & Trust Co. v. United States*<sup>40</sup> the Sixth Circuit held that the Rules of Decision Act does not require that a federal tax court be bound by the construction of a will by a Michigan probate court. The court noted the limited jurisdiction of the Michigan probate court to construe and interpret wills<sup>41</sup> and stated that the opinions of the

35. *Id.* at 233.

36. See Sacks, *The Binding Effect of Nontax Litigation in State Courts*, N.Y.U. 21ST INST. ON FED. TAX 295 (1963).

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

38. 336 F.2d 277 (4th Cir. 1964).

39. *Blair* was distinguished on two grounds: the appellate court in *Blair* reviewed the state supreme court decisions and reached a deliberate conclusion; the appellate court decision in *Blair* had the effect of *stare decisis*.

40. 362 F.2d 444 (6th Cir. 1966) (order of Michigan probate court, construing will, not binding and conclusive on federal tax court in determining the amount of the marital deduction under the federal estate tax) (the court expressly declined to follow *Gallagher*).

41. This jurisdiction is generally vested in the Michigan circuit courts.

probate court are not published, digested, or made available to the profession, and they do not constitute binding precedents in other Michigan courts.

2. *Elements of an "Adversary Contest."*—Although the circuit courts of appeal were dramatically split as to whether nonadverseness was determinative or merely evidence of collusion, the presence or absence of this factor had an apparent effect upon the cases. Yet, the precise definition and scope of "adversary" was never reduced to a single, functional formula. Rather, it must be comprehended from an examination of the courts' considerations of the various indicia of adverseness. Obviously, a primary element is that in the state proceeding there must be some party, given notice or appearing, who represents a countervailing interest. It has been stated that "[l]egal adverseness . . . can be proven by a showing of economic adverseness."<sup>42</sup> The courts have generally applied this definition literally, and an economic adverseness is not vitiated merely because the opposing economic interests are represented within the same family unit.<sup>43</sup>

It has been clearly determined that the Commissioner does not have to be one of the adverse parties, nor does his position have to be asserted in the state court.<sup>44</sup> As a matter of strategic preference, the Commissioner has abstained from litigating federal tax liability in state courts,<sup>45</sup> and when he is made a party defendant, the established practice of the government is to appear specially and to move the dismissal of the action as it relates to the Commissioner. Nevertheless, the taxpayer has received significant benefits by giving notice to the Commissioner and apprising him of the state proceeding.<sup>46</sup> In one instance, the taxpayer prevailed in the federal tax litigation primarily because the New York state tax commissioner entered the

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42. Sacks, *supra* note 36.

43. See, e.g., *Blair v. Commissioner*, 300 U.S. 5 (1937) and *Freuler v. Helvering*, 291 U.S. 35 (1934), where close relationship of the adversaries did not deter the binding effect of the state decree. But see *Charles S. McVeigh*, 4 T.C. 1291 (1944).

44. *Blair v. Commissioner*, 300 U.S. 5 (1937); *Freuler v. Helvering*, 291 U.S. 35 (1934); *Gallagher v. Smith*, 223 F.2d 218 (3d Cir. 1955). Granting conclusive effect to a state decree in which the Commissioner's argument was not presented has been challenged in: Note, *Effect of State Court Decrees in Federal Tax Litigation: A Proposal for Judicial Reform*, 30 U. CHI. L. REV. 569, 581 (1963): "If a taxpayer, intending to avoid tax liability, institutes a state suit, and if no interested party presents the argument urged by the Commissioner, then the state court judgment should be considered to have been collusively obtained." (Emphasis added.)

45. See Mem. 6134, April 3, 1947, CCH 1947 FED. TAX REP. ¶ 6137: "It is neither the policy nor practice of the Bureau of Internal Revenue to participate in litigation in state courts between private litigants even though the purpose of the parties is to obtain a decree or judgment affecting Federal tax liability of one . . . of the parties to the litigation."

46. Sacks, *supra* note 36.

state litigation and argued that the trust did not qualify for the New York marital deduction (similar to IRC section 2056).<sup>47</sup> Of course, if the Commissioner were to appear generally and litigate his position in the state suit, the state decree would be binding in subsequent federal tax litigation as *res judicata*.

Another factor giving rise to an inference of adverseness is appeal of the state court decision. "The mere fact that the state court determination was affirmed on appeal seems determinative of the issue."<sup>48</sup> The touchstone of this doctrine is found in *Kelly's Trust v. Commissioner*,<sup>49</sup> where the Second Circuit upheld the binding effect of the state court decree on the basis of the appeal: "Whatever may have been the nature of the state-court suit in its inception, the appeal made it adversary."<sup>50</sup> The affirmative significance of this factor is seen in the Tax Court's consistent adherence to the *Kelly* rule.<sup>51</sup>

The courts have also regarded more subtle factors than the presence of an adverse party or an appeal as indicative of the adversary character of the state suit. For example, negative implications have been drawn where the state proceeding appears perfunctory, that is, where there is an absence of counsel, pleadings, argument, or briefs.<sup>52</sup> In addition, the taxpayer's case has been considered as weakened where there has been a relatively short period of time between the filing in the state court and the issuance of the state decree.<sup>53</sup> Declaratory judgments have occasionally been denied binding effect,<sup>54</sup> but this has been criticized as specious reasoning where the state suit meets all other requirements of adverseness.<sup>55</sup>

### III. BOSCH AND THE NEW STANDARD

In an attempt to resolve the disparities in the application of the *Freuler* rule by the various circuits, the Supreme Court granted certiorari in two cases from separate panels of the Second Circuit,

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47. *Estate of Dake v. United States*, CCH 1961 STAND. FED. TAX REP. (61-2 U.S. Tax Cas.) ¶ 12,033 (W.D.N.Y. July 31, 1961).

48. Sacks, *supra* note 36.

49. 168 F.2d 198 (2d Cir. 1948).

50. *Id.* at 198-99.

51. *See, e.g.*, *Estate of Beechy*, 15 T.C. 136 (1950); *Commissioner v. Thomas Flexible Coupling Co.*, 14 T.C. 802 (1950), *aff'd* 198 F.2d 350 (3d Cir. 1952).

52. Sacks, *supra* note 36.

53. *Estate of Sweet v. Commissioner*, 234 F.2d 401 (10th Cir. 1956); *Estate of Elson*, 28 T.C. 442 (1957).

54. *See, e.g.*, *Loggie v. Thomas*, 152 F.2d 636 (5th Cir. 1945).

55. *See*, Sacks, *supra* note 36, and his reference to *Commissioner v. Thomas Flexible Coupling Co.*, 14 T.C. 802 (1950); *Consumer-Farmer Milk Co-operative, Inc. v. Commissioner*, 186 F.2d 68 (2d Cir. 1950).

*Commissioner v. Estate of Bosch*<sup>56</sup> and *Second National Bank v. United States*.<sup>57</sup>

#### A. *Bosch*

In 1930 Herman Bosch established a revocable inter vivos trust providing that his wife receive the trust income for life and giving her, in the event she survived him, a general testamentary power of appointment over the corpus.<sup>58</sup> In 1951, Mrs. Bosch executed an instrument purporting to convert the general power into a special power of appointment. Herman Bosch died in 1957, and his executor claimed the value of the widow's trust as a marital deduction under section 2056(b)(5) of the Internal Revenue Code.<sup>59</sup> The Commissioner denied the deduction and assessed a deficiency on the basis that the conversion of the general power into a special power disqualified the trust corpus from the marital deduction.

While the executor's petition for redetermination was pending in the Tax Court, an action was brought in a New York Supreme Court for a determination under state law of the validity of the 1951 release. The state court issued an order to show cause upon Mrs. Bosch and twenty-three potential beneficiaries,<sup>60</sup> and three briefs were filed,<sup>61</sup> all contending that the release was a nullity. The New York court held that Mrs. Bosch could not release the power until she survived her husband, and that since her husband was still alive at the time the purported release was executed, the release instrument was ineffective.<sup>62</sup>

In the subsequent proceedings, the Tax Court accepted the New York decision as "an authoritative exposition of New York law and

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56. 363 F.2d 1009 (2d Cir. 1966).

57. 351 F.2d 489 (2d Cir. 1965).

58. This provision was inserted by an amendment to the trust instrument in 1931.

59. Under INT. REV. CODE of 1954, §§ 2056(a) and 2056(b)(5), the decedent's estate is allowed to deduct from the gross estate the value of interests in property passing to the surviving spouse. If the interest is in trust, then the spouse must be entitled to the income for life and must have a general power of appointment, *i.e.*, the power to appoint to herself, her estate, or both.

60. These potential beneficiaries would take under the trust instrument if Mrs. Bosch failed to effect an appointment. Under the trust instrument, in event of default of appointment, the trust corpus was to be split evenly between the next of kin of Mr. and Mrs. Bosch.

61. The briefs were filed by counsel for the trustee, Mrs. Bosch, and the guardian *ad litem* of a minor who would be a potential beneficiary in event of default of appointment. The other twenty-two potential beneficiaries failed to appear.

62. "It seems clear that the donee of a power of appointment cannot exercise it prior to its creation. . . . A power of appointment created under a revocable deed of trust, which power shall be exercised by will, may not be exercised while the settlor of the trust is still alive." *In re Bosch*, N.Y.L.J., (Sup. Ct., Nov. 15, 1963) as cited in *Estate of Bosch*, 43 T.C. 120, 122 (1964).

adjudication of the property rights involved,"<sup>63</sup> and consequently overturned the Commissioner's assessment of the deficiency. The Tax Court relied on five basic factors in reaching its conclusion: (1) The state court had personal and subject matter jurisdiction, and its judgment was final and conclusive as to the parties. (2) Although the New York Supreme Court is a trial court, its decisions have precedential value throughout the state.<sup>64</sup> (3) The Commissioner was notified of the state proceeding, and he could have entered the contest. (4) The state court rendered a reasoned opinion and reached a deliberate conclusion. (5) The state decree provided more than a label for past events; it determined the nature of the power of appointment with potentially adverse tax consequences at a future date (when Mrs. Bosch exercises the power).<sup>65</sup>

On appeal, the Second Circuit affirmed the decision of the Tax Court.<sup>66</sup> The court characterized the issue as whether the federal court should "accept" the state court decision, rather than whether the federal court was "bound" by the state decision, and relied upon basically the same factors cited by the Tax Court in holding that the state court decision settled the rights of the parties for purposes of the application of the federal tax law. In a dissenting opinion, Judge Friendly rejected the "mechanical" approach of the majority and proposed the following test: when the state court action is brought primarily to affect federal taxes, the judgment of an inferior state court should be accorded little weight; when the state court has not received a fair presentation of both sides of the controversy, the decree is entitled to no weight. Since he was convinced that the New York proceeding was obviously instituted for tax purposes<sup>67</sup> and the state court was so busy that it "erroneously ratified the parties' unanimous contention,"<sup>68</sup> he argued that the Tax Court's decision should have been reversed.

#### B. *Second National Bank v. United States*

In 1958 the testator died, leaving a will and codicil which provided that the residue of the estate was to be left in trust: one-third for

63. *Estate of Bosch*, 43 T.C. 120, 124 (1964).

64. The Tax Court distinguished *Brainard* and *Faulkerson* on the grounds that they involved courts of limited geographical jurisdiction whose decisions are not binding as precedents on other state courts.

65. If Mrs. Bosch exercises the power, then the trust corpus will be subject to taxation in her estate. However, as the dissent in the court of appeals decision noted, if she does not exercise the power, then Mr. Bosch's estate is allowed the marital deduction, but it is not taxed in her estate.

66. *Commissioner v. Estate of Bosch*, 363 F.2d 1009 (2d Cir. 1966).

67. Judge Friendly declared that this was obviously a case in which all parties joined in seeking to affect adversely the government's right to taxes.

68. 363 F.2d at 1018.

the benefit of his widow and two-thirds for the benefit of certain grandchildren. In addition, the testator directed that any statute which required proration of death taxes among his beneficiaries should have no effect. The executor applied the Connecticut proration statute,<sup>69</sup> which provides that a bequest to a widow which qualifies for the marital deduction is not to be reduced by federal estate taxes, and computed the marital deduction on the basis of the widow's share of the residue before estate taxes were taken into consideration. The Commissioner assessed a deficiency on the ground that the widow's share should be reduced by the proportionate amount of the estate tax attributable to that share. Subsequent to the Commissioner's assessment, the executor petitioned a Connecticut probate court for a determination of the proration of the federal estate tax. The guardian *ad litem* of the grandchildren entered an appearance in support of the executor's petition, and the probate court applied the proration statute on the basis that the testator's directive was ambiguous.

Within a year of the decision of the probate court, the executor brought an action in the federal district court for a refund of the deficiency assessment. The district court noted that the Connecticut probate court was not a court of record and that most of the judges were laymen, and accordingly held that "under no circumstances can [their decrees] be construed as binding and conclusive upon a federal court in construing and applying the federal revenue laws."<sup>70</sup> However, upon an independent examination of the facts of the case and state law, the district court concluded that the proration statute applied.

On appeal, the Second Circuit reversed the district court decision on the basis that "the testator specifically wished to have death taxes paid . . . without proration."<sup>71</sup> As to the weight to be accorded to the Connecticut probate court decree, the court agreed with the district court that such decisions are never binding upon subsequent federal tax litigation, noting that the probate court decisions are not binding on the state's higher courts and are even subject to collateral attack in another probate district. Consequently, the court concluded that it was unnecessary to determine whether the state court proceedings were collusive or nonadversary.

### C. *The Supreme Court Disposition*

After tracing the diverse approaches taken by the circuit courts in applying the *Freuler* standard, the Supreme Court concluded: "We

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69. CONN. GEN. STAT. REV. § 12-401(a) (1964).

70. *Second Nat'l Bank v. United States*, 222 F. Supp. 446, 457 (D. Conn. 1963).

71. *Second Nat'l Bank v. United States*, 351 F.2d 489, 493 (2d Cir. 1965).

look at the problem differently."<sup>72</sup> First, since the Commissioner was not made a party in either of the state proceedings, the principles of *res judicata* and collateral estoppel were not considered relevant. In determining the weight to be accorded the decree of a state trial court, the Court looked to the legislative history of the marital deduction statute and concluded that the state court interpretations of the will are only entitled to "proper regard" rather than "finality" and then only when resulting from "a bona fide adversary proceeding."<sup>73</sup> Moreover, the Court viewed the strict limitations which Congress placed on the marital deduction as indicating a meticulous concern with eliminating loopholes. From this legislative context the Court inferred that Congress did not intend to make the decrees of state trial courts binding or conclusive upon a federal court in estate tax cases. This was deemed to be consistent with the principles of *Erie* and the congressional policy behind the Rules of Decision Act.<sup>74</sup> In diversity cases a lower state court adjudication is attributed some weight, but it is not controlling; an intermediate appellate state court decision is a datum for determining state law, which a federal court should not disregard unless convinced that the highest state court would hold otherwise.<sup>75</sup> Though recognizing that a federal tax case differs from a diversity case, the Court determined that the *Erie* principle applies for the same reasons, that is, the "substantive rule involved is based on state law and the State's highest court is the best authority for its own law."<sup>76</sup> In the absence of a decision by the state's highest court, the federal tax court must make an independent examination of state law, giving "proper regard" to lower state court rulings. Accordingly, the Court affirmed the decision below in *Second National* and remanded *Bosch* for a determination of the applicable "state law."

In the first of three dissenting opinions, Justice Douglas criticized as a misinterpretation<sup>77</sup> the majority's reliance on the *Erie* principle.

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72. *Commissioner v. Estate of Bosch*, 387 U.S. 456, 463 (1967).

73. *Id.* at 464. The Court found this illumination in S. REP. NO. 1013, Pt. 2, 80th Cong., 2d Sess. 4 (1948).

74. 28 U.S.C. § 1652 (in the absence of federal requirements, such as the Constitution or federal statutes, state law, when applicable, is to be regarded as a rule of decision in federal court civil actions).

75. As authority for this proposition the Court cited, among others, the following cases: *King v. Order of Travelers*, 333 U.S. 153 (1948); *West v. American Tel. & Tel. Co.*, 311 U.S. 223 (1940); *Erie R.R. v. Tompkins*, 304 U.S. 64 (1933).

76. 387 U.S. at 465.

77. *See* 387 U.S. at 466: "[W]e have never suggested that the federal court may ignore a relevant state court decision because it was not entered by the highest state court. Indeed, we have held that the federal court is obligated to follow the decisions of a lower state court in the absence of decisions of the State Supreme Court showing that the state law is other than announced by the lower court."

Moreover, he noted that refusal of the federal court to give effect to the state court decree may result in unfairness to taxpayers; they may be taxed for benefits which they do not have under state law, a position contrary to the congressional policy of making federal tax consequences dependent upon rights established under state law. Basing his position on *Freuler* and *Blair*, Justice Douglas contended that, absent fraud or collusion, a federal court should not ignore the state court judgment.<sup>78</sup>

Justice Harlan's dissent, with Justice Fortas joining, rejected the Douglas approach as too risky and the majority approach as requiring far more federal intervention than necessary to protect the federal interest. Although admitting that *Erie* and the Rules of Decision Act were applicable, he asserted that these authorities do not compel any single conclusion. Furthermore, he found no rational basis for the automatic application of the diversity formula in all cases where the federal courts were to ascertain the state law. "The relationship between the state and federal judicial systems is simply too delicate and important to be reduced to any single standard."<sup>79</sup> As an alternative solution, Justice Harlan proposed that the problem be approached by balancing the state and federal interests. He viewed the state interests here to be: uniformity of the administration of law within each state; proper regard by federal courts for these areas of law left to the states by the Constitution; and, the "better position" of the state courts to assess their own laws. The federal interest involved was expressed as the danger to the federal treasury and to the administration of the federal tax law presented by inaccurate state court decisions which favor the taxpayer. This federal interest, said Justice Harlan, is satisfied if the state court renders a considered judgment. Therefore, he would have held that a federal court must accept any state court decision that bears the indicia of a genuinely adversary contest.<sup>80</sup>

In his own separate dissent, Justice Fortas agreed with the approach taken by Justice Harlan but argued that the "adversity" test was not entirely sufficient. Rather, he would have relied upon a broader scope of factors, and he listed those indices cited by Judge Raum in the Tax Court decision of *Bosch*.<sup>81</sup>

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78. Justice Douglas posed two examples where the state court decree should not be given effect: where the judgment is by consent decree and where fraud or collusion are present. 387 U.S. at 471.

79. 387 U.S. at 477.

80. In determining adverseness between the parties, Justice Harlan would look to the "actual adversity of their financial and other interests."

81. See text accompanying notes 64-65 *supra*.

## IV. CRITICISMS AND PROPOSALS

In response to the diversity in the circuit courts' interpretations of the *Freuler* rule, the Supreme Court has discarded effectively the old "binding unless collusive" standard and has substituted a more mechanical test based upon the *Erie* principle. The new rule is: state trial court decisions are to be accorded only a "proper regard"; an intermediate court decision is controlling unless the federal court is convinced that the state's highest court would hold otherwise; and the decision by the state's highest court is binding upon subsequent tax litigation. Under this new approach the Court has effectively eliminated the method of proof of the state law which was based upon the decision of a state court proceeding in which the specific taxpayer's property rights were adjudicated. Now, the only method of proof is by reference to the general law of the state, that is, the probable action the state's highest court would take in a similar situation.<sup>82</sup>

Since the diverse interpretations had demonstrated that the "collusion" test had lost its efficacy, the Court was wise in abandoning it. However, the analytical precision of the new rule may be seriously questioned. Indeed, the intrusion of the *Erie* principle into the state court-federal tax court context appears totally inapposite and artificial. The *Erie* doctrine was fashioned as a means of ascertaining the general law of the state in order to apply that law to a case which originated in the federal court system. The situation in the *Bosch* context is significantly different: the federal tax court considers the same facts and issues presented in the state court proceeding involving the taxpayer, *and* the federal court also confronts a state decree which has determined the property rights of the taxpayer and has practical consequences aside from the tax question. Thus, the federal court is presented not just with the law of the state as an abstraction; the state law has been legally and practically translated into an application to this particular taxpayer. To refuse to accept this translation and application of state law by the state court is to violate the basic premise that the federal tax consequences are to be imposed upon property rights created and determined by state law. Yet, under the new approach it is quite possible for there to be a variance between the rights and interests held by the taxpayer under a state court decree (which is the effective state law relevant to his interests) and the tax imposed upon those interests as determined by a federal court. It is conceivable that an individual could be taxed on certain property rights which, according to a reasoned opinion rendered by a

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82. See text accompanying notes 5-8 *supra*.

state court in a truly adversary proceeding, he does not possess. Since all the federal interest requires is an accurate and trustworthy state court decision, to allow a federal court to make an independent inquiry into state law may result in a gross unfairness to taxpayers without any concomitant promotion of the federal interest.

Hopefully, these potential adverse consequences of the new standard can be avoided by utilization of the Court's directive to give "proper regard" to state trial court determinations. The meaning of "proper regard" was not thoroughly delineated by the Court, and unfortunately its interpretation will be a problem for the circuit courts. But, there is a strong probability that the state trial court's judgment will be given varying weight, ranging from the full weight of precedent to no weight at all, depending upon the quality and characteristics of the state court proceeding. Yet, evaluating the quality of the state court action will undoubtedly lead the circuits back to the collusive-adversary syndrome experienced in the wake of *Freuler* and *Blair*. To achieve a more precise and a more uniform treatment of the problem, it would be well for the courts to refrain from the use of the vague term "collusive." This term is at best ambiguous, and its various nuances and connotations have led to a welter of diverse interpretations. Thus, a new approach is needed for evaluating the proper regard to be accorded state trial court decisions.

A more proper approach would lie in identifying the various interests of the federal government, the states, and the taxpayers and then fashioning a set of standards to reconcile effectively any competition among these interests. Assuming the basic premise that the federal taxing statutes apply to property rights created and determined by state law, the fundamental inquiry must be directed toward ascertaining the state law in regard to the taxpayer's property rights. Since the state trial court has determined, both legally and practically, the taxpayer's rights under state law, this determination would stand as long as it met certain criteria designed to assess the quality of the judgment. These criteria should be fashioned so as to promote state and taxpayer interests in having property rights treated consistently by the state and federal governments and to promote the federal interest in safeguarding the treasury from inaccurate and untrustworthy state court decisions favorable to the taxpayer. Both these interests are served if the federal court accepts a state court decision which has been reached after a full hearing on the merits and adequate deliberation by the court. Accordingly, the standard should be whether the state trial court rendered a reasoned decision after an adequate opportunity to consider all aspects

of the issue.

To insure that this standard is met, the courts should employ certain guidelines which serve to indicate the degree of accuracy of the state court decree. Chief among the guidelines would be the presence or absence of an actual adverseness of economic interests.<sup>83</sup> Perhaps under the new Supreme Court standard there must be a demonstration of adverseness; however, this has not been clearly established.<sup>84</sup> Certainly, affirmative implications may be drawn from the fact that adverse parties were given notice, appeared, and made objections to the proposed rulings, for this would indicate that the court was presented with the different views of the issue and that it had a sufficient basis for rendering a reasoned decision. Although negative implications should be drawn from the absence of adverse parties, this should not preclude the federal court's acceptance of the state court decree. There are situations in which the court could reach a decision after a full analysis of the issue, even though all parties support the proposed ruling. "Where there is a full hearing on the merits, even though all the parties are on the same side of the question, it is difficult to bar acceptance on some generalized definition of collusion which automatically excludes nonadversary adjudications."<sup>85</sup> And, where the parties adopt a unanimous position, the *Bosch* requirement that the decision be appealed until the state's highest court has ruled on the case would indeed be most difficult to meet. However, it is human nature and the tendency of many probate courts to readily accede to a proposed holding where all the interested parties are in agreement. Therefore, where there is no actual adversity, the burden of proof should shift to the taxpayer, and he should be compelled to persuade the court that the state court made a discerning analysis of the issue after a consideration of the opposite view.

In addition, the state court decree should have substantial practical consequences to the interested parties apart from the consequences of federal tax liability.<sup>86</sup> If the adjudication amounts to no more than a labelling of the parties' existing interests in the property and serves to affect adversely the government's right to taxes, then the decision

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83. Economic adverseness is shown when the decision favorable to one party would adversely affect another party's financial interests in the property in question.

84. It is not clear whether the Supreme Court intended the directive gleaned from the legislative history of the marital deduction ("proper regard" shall be given state trial court determinations, and then only when rendered in an adversary proceeding) to be the standard, or whether the rule presented by the *Erie* principle ("some weight" shall be attributed to the state trial court decisions) should prevail.

85. 1 MERTENS, LAW OF FEDERAL ESTATE AND GIFT TAXATION § 10.15 at 648-49 (1959).

86. Cf. *Estate of Bosch*, 43 T.C. 120, 123 (1964).

should not be accepted.<sup>87</sup> Similarly, if there is no bona fide controversy as to the property rights of the parties involved, the state decree should not be accepted. If the single purpose of the state suit is to defeat the federal tax, and the state decision *only* affects the federal tax liability, then it should not be regarded as conclusive.

No state court decision should be accepted in which the Commissioner was not notified of the proceeding; or if the state proceeding was initiated before the tax question could have been reasonably foreseen, the decree should not be accepted unless the Commissioner's position was asserted by a party to the state suit. Although this requirement does not directly relate to the basic standard, it is necessary to insure that a decision will not be asserted against the Commissioner when he has had no opportunity to present his position.

If all these requirements are fulfilled, the federal court could then entertain a contention by the Commissioner that the state court decision is in clear conflict with the established law of the state. This of course would be another factor indicating the inaccuracy and untrustworthiness of the state decree. However, the burden of proof would be upon the Commissioner to show conclusively that the established state law was clearly contra. Absent a showing of an obvious conflict, there should be no independent inquiry into the general state law, and the state judgment should be accepted if all the other factors are satisfied. To hold otherwise would violate the basic premise that the state decree has determined the "state law" with respect to these particular property rights.

#### V. CONCLUSION

Although the Supreme Court has established a new standard for determining the effect of a state court adjudication of property rights upon subsequent federal tax litigation, the scope and content of that standard is unclear. Moreover, the approach employed by the Court in formulating the new rule is subject to criticism. The interpretation and application of the *Bosch* rule, which will be the function of the circuit courts of appeal, hopefully will give content to the test and will eliminate its analytical shortcomings. These ends will be attained if the courts apply the standard in a manner designed to give effect to the various interests of the taxpayer, the states, and the federal treasury.

WILLIAM E. MARTIN

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87. See Justice Fortas' dissent in *Commissioner v. Estate of Bosch*, 387 U.S. 456 (1967).